

## CREDIT OPINION

26 July 2018

✓ Rate this Research

### RATINGS

#### Lugano, City of

Domicile	Switzerland
Long Term Rating	Aa3
Type	LT Issuer Rating - Dom Curr
Outlook	Stable

Please see the [ratings section](#) at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

### Contacts

**Gianluca Beltracchi** +44.20.7772.1054  
Associate Analyst  
gianluca.beltracchi@moodys.com

**Elise Savoye, CFA** +33.1.5330.1079  
AVP-Analyst  
elise.savoye@moodys.com

**Massimo Visconti** +39.02.9148.1124  
VP-Sr Credit Officer/Manager  
massimo.visconti@moodys.com

### CLIENT SERVICES

Americas 1-212-553-1653  
Asia Pacific 852-3551-3077  
Japan 81-3-5408-4100  
EMEA 44-20-7772-5454

## City of Lugano

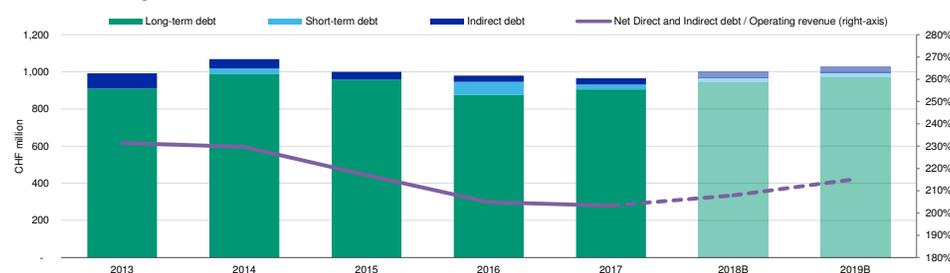
### Update to credit analysis

#### Summary

The credit profile of the [City of Lugano \(Lugano, Aa3 stable\)](#) reflects (1) the city's sound financial performance, supported by a strong and diversified economy; (2) the city's untapped and improving fiscal flexibility; and (3) a strong cantonal institutional framework, which enhances the city's financial sustainability. In addition, the credit profile reflects Lugano's structurally very high debt exposure, although it is expected to remain stable in the medium term. The city also has a high debt service volatility, which challenges its operating margin. Tight expenditure controls and a cautious budgetary strategy should enable Lugano to maintain balanced budgets in the medium term. The credit profile also reflects a moderate likelihood of the [Republic and Canton of Ticino \(Ticino, Aa2 stable\)](#) providing support if the city were to face acute liquidity stress.

Exhibit 1

**Very high debt, although it is expected to remain stable at 205%-215% of operating revenue in the next two years**



B = Budget, Indirect debt = Cassa Pensioni di Lugano.

Sources: Issuer, Moody's Public Sector Europe

#### Credit strengths

- » Sound financial performance, supported by a strong and diversified economy
- » Untapped and improving fiscal flexibility
- » Strong cantonal institutional framework, which ensures financial equilibrium

#### Credit challenges

- » Very high debt level, although it is expected to remain stable over the next two years
- » High debt service volatility, which challenges the operating margin

## Rating outlook

The stable rating outlook reflects our expectation that Lugano will maintain financial equilibrium and keep its debt level stable in the medium term.

## Factors that could lead to an upgrade

- » Debt level declining to below 150% of operating revenue
- » A structural increase in the city's gross operating balance above 20%

## Factors that could lead to a downgrade

- » Net direct and indirect debt ratios increasing significantly
- » A deterioration in the canton's economic performance, which could cause the city's operating margin to decline

## Key indicators

Exhibit 2

### City of Lugano

Year ending 31 December

	2013	2014	2015	2016	2017	2018B	2019B
Net direct and indirect debt as % of operating revenue	231.4	229.7	217.0	204.9	203.3	207.9	215.2
Accrual financing surplus (requirement) as % of total revenue	-27.6	-17.2	4.2	1.5	6.9	-2.5	-4.3
Gross operating balance as % of operating revenue	-1.4	9.0	8.0	10.1	8.6	9.2	7.4
Interest payments as % of operating revenue	4.9	4.6	4.7	3.9	3.2	3.0	2.8
Intergovernmental transfers as a % of operating revenue	11.5	10.4	8.8	8.1	6.6	6.1	6.2
Capital spending as a % of total expenditure	26.5	24.0	11.5	12.2	10.0	14.4	13.5
GDP per capita as a % of national average	102.4	104.9	104.9	104.9	104.9	-	-

B = Budget.

Sources: Issuer, Moody's Public Sector Europe

## Detailed credit considerations

The credit profile of the City of Lugano combines (1) a Baseline Credit Assessment (BCA) of aa3, and (2) a moderate likelihood of extraordinary support from the Republic and Canton of Ticino in the event that the city faces acute liquidity stress.

### Baseline credit assessment

#### Sound financial performance, supported by a strong and diversified economy

##### Sound financial performance

Lugano benefits from a strong gross operating balance, which averaged 8.9% of operating revenue between 2015 and 2017. The city is committed to a financial recovery plan to structurally improve its operating balance by 2018, in line with the cantonal law requirement for all cantonal municipalities to reach financial operating equilibrium. The gross operating balance is underpinned by (1) a solid and growing personal income tax base, and (2) measures to streamline the city's structural operating expenditure, which began in 2013. Lugano reached operating breakeven in 2015, reflecting its ability to streamline operating expenditure and a conservative planning approach.

Lugano's sound financials also reflect the prudent budgeting process, which leads to actual performance consistently higher than budgeted. In 2017, the accrued financial surplus was 6.9% of total revenue, materially higher than a deficit of 7.2% budgeted in the same year.

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on [www.moody's.com](http://www.moody's.com) for the most updated credit rating action information and rating history.

**Strong and diversified economy**

Lugano is located in the southern, Italian-speaking canton of Ticino and is an international hub for import and export businesses, a strong source of potential growth. Lugano is Switzerland's ninth-largest city, with a population of 68,387 as of 2016 and a relatively diversified services-based economy. Over the last few decades, the city has been affected by a number of groupings that have reduced the number of municipalities to 115 from 250 at a cantonal level. This has generated not only important benefits in respect of personal income tax collection but also significant rigidity because of municipal debt consolidation.

Lugano shares its border with the [Region of Lombardy](#) (Baa1 RUR-), Italy's wealthiest region. Lugano's labour force benefits from cross-border workers, whose number has increased in recent years. Lugano has seen steady economic development in several sectors, including the banking and fiduciary sectors, which provide 25% of cantonal GDP. The city's central position on the north-south route, acting as a bridge between Milan and Zurich, has resulted in a dynamic commercial sector.

**Untapped and improving fiscal flexibility**

Lugano has a solid operating revenue base, consisting 76% of tax revenue, 7% of transfers and 17% of other revenue. Swiss municipalities are able to increase their tax rates up to the level set by their respective cantons. Unlike many other Ticino municipalities that have reached their maximum of 100% set by the canton, Lugano only taxes at 80% of Ticino's fiscal base.

Lugano has not increased its tax rate multiplier since 2014 and it plans to decrease it to 78% in 2018 to compensate the introduction of a waste tax in 2019. This would add a marginal fiscal flexibility of around CHF6 million, or 1.3% of operating revenue. On average, 68% of cities in Ticino have increased their tax multiplier above 80%. Lugano's current low rate compared with that of its peers provides it with important fiscal flexibility, which could increase its operating revenue by 13%-14%. The lower tax rate multiplier than that of its peers in Ticino also reflects the fiscal competition with other cities.

**Strong cantonal institutional framework ensures financial equilibrium**

The city's finances benefit from oversight by the canton. The city's financial sustainability is enhanced by the cantonal requirement to reach operating financial equilibrium for all Ticino's municipalities. The law reflects a federal norm that reinforces annual and cumulative financial deficit limits. The canton receives the annual reports and has the right to request any financial information from the city for the current fiscal year. It can also intervene in the event of delays in agreeing the budget.

The institutional framework is mature and highly developed. Similar to other Swiss cantons, Swiss municipalities have fiscal autonomy within limits fixed by the canton (Article 50 of the Swiss constitution). This is embedded in a law for municipalities that exists in each canton. External auditors audit the city's financial statements.

Respective constitutions outline the precise distribution of rights and responsibilities, with cantonal constitutions being key for municipalities. Ticino's constitution allows local governments to exercise discretion over rates and objects of own-source revenue. Local governments receive most of their tax revenue from personal income, wealth and corporates, with the details based on the canton's general tax framework. In addition, an equalisation system at the municipal level provides weaker local governments with limited transfers from stronger municipalities and minimal financial strength, limiting the impact of structural economic divergence.

**Very high debt exposure, although it is expected to remain stable over the next two years**

As of year-end 2017, Lugano's net direct and indirect debt amounted to CHF965 million, or 203.3% of operating revenue, very high compared with that of national and international peers. This primarily reflects a prolonged municipal merger process over the past decade and the higher infrastructure needs stemming from the enlarged urban area. We expect net direct and indirect debt as a percentage of operating revenue to remain stable at 205%-215% of operating revenue until 2019, when deleveraging is expected to start.

According to cantonal law, the city can plan new debt but within its capital spending limits. In addition, the debt is 100% fixed rate and Swiss franc denominated, reflecting a prudent debt management approach.

Lugano's debt mainly consists of direct debt. Bonds account for 68% and bank debt for 28% and 4% indirect debt. Unfunded pension liabilities arising from Cassa Pensioni di Lugano (indirect debt), which stood at a low CHF34 million in 2017, are overall modest and represent a limited contingent liability. The city is aiming to reach a funding level of 97% by 2018 from the current 96% through

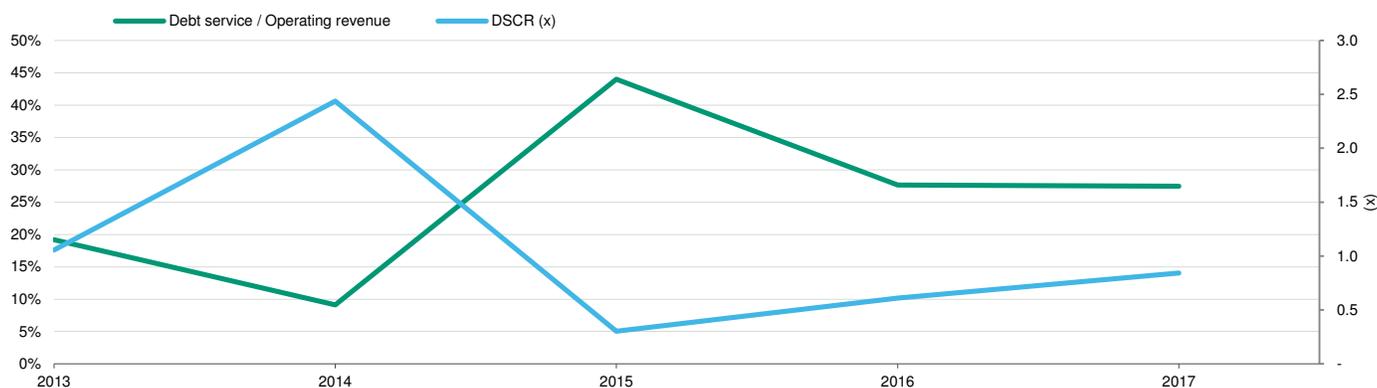
Cassa Pensioni di Lugano's accrued earnings retention. Debt arising from company affiliates is negligible and does not materially affect Lugano's debt position.

### High debt service volatility challenges the operating margin

Lugano's very high debt stock, characterised by a relatively short-maturity debt profile (8.7 years), mainly comprises bullet bonds. This results in volatile debt service levels, challenging the city's operating margin. Between 2014 and 2017, debt service as a percentage of operating revenue ranged between 9% and 44%, primarily because of the composition of the city's debt portfolio, which is mainly repaid at maturity.

Exhibit 3

### Comfortable cash position mitigates volatile debt service



Sources: Issuer, Moody's Public Sector

Interest payments as a percentage of operating revenue averaged 4.1% between 2014 and 2017. However, this percentage is expected to fall to around 3% in 2018 as a result of favourable interest rate conditions. The weight of interest expense on operating expenditure is 3.5% for Lugano, higher than the peer average of around 2.8%. However, the city's debt service coverage ratio has averaged a satisfactory 1x over the past four years because of a strong liquidity position. Lugano's cash position is CHF110 million as of YE2017, representing a high 23% of operating revenue. The city also benefits from sufficient short-term credit lines of CHF165 million, which significantly mitigate short-term financial risks.

### Extraordinary support considerations

The moderate likelihood of extraordinary support from Ticino reflects our assessment of the canton's stringent supervision. However, there are no implicit or explicit bail-out mechanisms between the city and the canton.

### Output of the Baseline Credit Assessment Scorecard

The assigned BCA of aa3 is close to the scorecard-indicated BCA of aa2. The one-notch differential reflects a very high debt level compared with that of its peers.

The matrix-generated BCA reflects (1) an Idiosyncratic Risk score of 3 (presented below) on a 1 to 9 scale, where 1 represents the strongest relative credit quality and 9 the weakest; and (2) a Systemic Risk score of Aaa, as reflected in the [Swiss](#) bond rating (Aaa stable).

For details about our rating approach, please refer to [Rating Methodology: Regional and Local Governments](#), published on 16 January 2018.

## Rating methodology and scorecard factors

Exhibit 4

### City of Lugano

#### Regional and Local Governments

Baseline Credit Assessment	Score	Value	Sub-factor Weighting	Sub- factor Total	Factor Weighting	Total
<b>Scorecard</b>						
<b>Factor 1: Economic Fundamentals</b>						
Economic strength	5	104.86	70%	3.80	20%	0.76
Economic volatility	1		30%			
<b>Factor 2: Institutional Framework</b>						
Legislative background	1		50%	3.00	20%	0.60
Financial flexibility	5		50%			
<b>Factor 3: Financial Performance and Debt Profile</b>						
Gross operating balance / operating revenue (%)	3	8.92	12.5%	3.75	30%	1.13
Interest payments / operating revenue (%)	5	3.60	12.5%			
Liquidity	1		25%			
Net direct and indirect debt / operating revenue (%)	9	203.29	25%			
Short-term direct debt / total direct debt (%)	1	2.69	25%			
<b>Factor 4: Governance and Management - MAX</b>						
Risk controls and financial management	1			1.00	30%	0.30
Investment and debt management	1					
Transparency and disclosure	1					
<b>Idiosyncratic Risk Assessment</b>						2.79(3)
<b>Systemic Risk Assessment</b>						Aaa
<b>Suggested BCA</b>						aa2

Sources: Issuer, Moody's Public Sector Europe

## Ratings

Exhibit 5

Category	Moody's Rating
<b>LUGANO, CITY OF</b>	
Outlook	Stable
Issuer Rating -Dom Curr	Aa3
Senior Unsecured -Dom Curr	Aa3

Source: Moody's Investors Service

Moody's Public Sector Europe is the trading name of Moody's Investors Service EMEA Limited, a company incorporated in England with registered number 8922701 that operates as part of the Moody's Investors Service division of the Moody's group of companies.

© 2018 Moody's Corporation, Moody's Investors Service, Inc., Moody's Analytics, Inc. and/or their licensors and affiliates (collectively, "MOODY'S"). All rights reserved.

CREDIT RATINGS ISSUED BY MOODY'S INVESTORS SERVICE, INC. AND ITS RATINGS AFFILIATES ("MIS") ARE MOODY'S CURRENT OPINIONS OF THE RELATIVE FUTURE CREDIT RISK OF ENTITIES, CREDIT COMMITMENTS, OR DEBT OR DEBT-LIKE SECURITIES, AND MOODY'S PUBLICATIONS MAY INCLUDE MOODY'S CURRENT OPINIONS OF THE RELATIVE FUTURE CREDIT RISK OF ENTITIES, CREDIT COMMITMENTS, OR DEBT OR DEBT-LIKE SECURITIES. MOODY'S DEFINES CREDIT RISK AS THE RISK THAT AN ENTITY MAY NOT MEET ITS CONTRACTUAL, FINANCIAL OBLIGATIONS AS THEY COME DUE AND ANY ESTIMATED FINANCIAL LOSS IN THE EVENT OF DEFAULT. CREDIT RATINGS DO NOT ADDRESS ANY OTHER RISK, INCLUDING BUT NOT LIMITED TO: LIQUIDITY RISK, MARKET VALUE RISK, OR PRICE VOLATILITY. CREDIT RATINGS AND MOODY'S OPINIONS INCLUDED IN MOODY'S PUBLICATIONS ARE NOT STATEMENTS OF CURRENT OR HISTORICAL FACT. MOODY'S PUBLICATIONS MAY ALSO INCLUDE QUANTITATIVE MODEL-BASED ESTIMATES OF CREDIT RISK AND RELATED OPINIONS OR COMMENTARY PUBLISHED BY MOODY'S ANALYTICS, INC. CREDIT RATINGS AND MOODY'S PUBLICATIONS DO NOT CONSTITUTE OR PROVIDE INVESTMENT OR FINANCIAL ADVICE, AND CREDIT RATINGS AND MOODY'S PUBLICATIONS ARE NOT AND DO NOT PROVIDE RECOMMENDATIONS TO PURCHASE, SELL, OR HOLD PARTICULAR SECURITIES. NEITHER CREDIT RATINGS NOR MOODY'S PUBLICATIONS COMMENT ON THE SUITABILITY OF AN INVESTMENT FOR ANY PARTICULAR INVESTOR. MOODY'S ISSUES ITS CREDIT RATINGS AND PUBLISHES MOODY'S PUBLICATIONS WITH THE EXPECTATION AND UNDERSTANDING THAT EACH INVESTOR WILL, WITH DUE CARE, MAKE ITS OWN STUDY AND EVALUATION OF EACH SECURITY THAT IS UNDER CONSIDERATION FOR PURCHASE, HOLDING, OR SALE.

MOODY'S CREDIT RATINGS AND MOODY'S PUBLICATIONS ARE NOT INTENDED FOR USE BY RETAIL INVESTORS AND IT WOULD BE RECKLESS AND INAPPROPRIATE FOR RETAIL INVESTORS TO USE MOODY'S CREDIT RATINGS OR MOODY'S PUBLICATIONS WHEN MAKING AN INVESTMENT DECISION. IF IN DOUBT YOU SHOULD CONTACT YOUR FINANCIAL OR OTHER PROFESSIONAL ADVISER. ALL INFORMATION CONTAINED HEREIN IS PROTECTED BY LAW, INCLUDING BUT NOT LIMITED TO, COPYRIGHT LAW, AND NONE OF SUCH INFORMATION MAY BE COPIED OR OTHERWISE REPRODUCED, REPACKAGED, FURTHER TRANSMITTED, TRANSFERRED, DISSEMINATED, REDISTRIBUTED OR RESOLD, OR STORED FOR SUBSEQUENT USE FOR ANY SUCH PURPOSE, IN WHOLE OR IN PART, IN ANY FORM OR MANNER OR BY ANY MEANS WHATSOEVER, BY ANY PERSON WITHOUT MOODY'S PRIOR WRITTEN CONSENT.

CREDIT RATINGS AND MOODY'S PUBLICATIONS ARE NOT INTENDED FOR USE BY ANY PERSON AS A BENCHMARK AS THAT TERM IS DEFINED FOR REGULATORY PURPOSES AND MUST NOT BE USED IN ANY WAY THAT COULD RESULT IN THEM BEING CONSIDERED A BENCHMARK.

All information contained herein is obtained by MOODY'S from sources believed by it to be accurate and reliable. Because of the possibility of human or mechanical error as well as other factors, however, all information contained herein is provided "AS IS" without warranty of any kind. MOODY'S adopts all necessary measures so that the information it uses in assigning a credit rating is of sufficient quality and from sources MOODY'S considers to be reliable including, when appropriate, independent third-party sources. However, MOODY'S is not an auditor and cannot in every instance independently verify or validate information received in the rating process or in preparing the Moody's publications.

To the extent permitted by law, MOODY'S and its directors, officers, employees, agents, representatives, licensors and suppliers disclaim liability to any person or entity for any indirect, special, consequential, or incidental losses or damages whatsoever arising from or in connection with the information contained herein or the use of or inability to use any such information, even if MOODY'S or any of its directors, officers, employees, agents, representatives, licensors or suppliers is advised in advance of the possibility of such losses or damages, including but not limited to: (a) any loss of present or prospective profits or (b) any loss or damage arising where the relevant financial instrument is not the subject of a particular credit rating assigned by MOODY'S.

To the extent permitted by law, MOODY'S and its directors, officers, employees, agents, representatives, licensors and suppliers disclaim liability for any direct or compensatory losses or damages caused to any person or entity, including but not limited to by any negligence (but excluding fraud, willful misconduct or any other type of liability that, for the avoidance of doubt, by law cannot be excluded) on the part of, or any contingency within or beyond the control of, MOODY'S or any of its directors, officers, employees, agents, representatives, licensors or suppliers, arising from or in connection with the information contained herein or the use of or inability to use any such information.

NO WARRANTY, EXPRESS OR IMPLIED, AS TO THE ACCURACY, TIMELINESS, COMPLETENESS, MERCHANTABILITY OR FITNESS FOR ANY PARTICULAR PURPOSE OF ANY SUCH RATING OR OTHER OPINION OR INFORMATION IS GIVEN OR MADE BY MOODY'S IN ANY FORM OR MANNER WHATSOEVER.

Moody's Investors Service, Inc., a wholly-owned credit rating agency subsidiary of Moody's Corporation ("MCO"), hereby discloses that most issuers of debt securities (including corporate and municipal bonds, debentures, notes and commercial paper) and preferred stock rated by Moody's Investors Service, Inc. have, prior to assignment of any rating, agreed to pay to Moody's Investors Service, Inc. for appraisal and rating services rendered by it fees ranging from \$1,500 to approximately \$2,500,000. MCO and MIS also maintain policies and procedures to address the independence of MIS's ratings and rating processes. Information regarding certain affiliations that may exist between directors of MCO and rated entities, and between entities who hold ratings from MIS and have also publicly reported to the SEC an ownership interest in MCO of more than 5%, is posted annually at [www.moody's.com](http://www.moody's.com) under the heading "Investor Relations — Corporate Governance — Director and Shareholder Affiliation Policy."

Additional terms for Australia only: Any publication into Australia of this document is pursuant to the Australian Financial Services License of MOODY'S affiliate, Moody's Investors Service Pty Limited ABN 61 003 399 657AFSL 336969 and/or Moody's Analytics Australia Pty Ltd ABN 94 105 136 972 AFSL 383569 (as applicable). This document is intended to be provided only to "wholesale clients" within the meaning of section 761G of the Corporations Act 2001. By continuing to access this document from within Australia, you represent to MOODY'S that you are, or are accessing the document as a representative of, a "wholesale client" and that neither you nor the entity you represent will directly or indirectly disseminate this document or its contents to "retail clients" within the meaning of section 761G of the Corporations Act 2001. MOODY'S credit rating is an opinion as to the creditworthiness of a debt obligation of the issuer, not on the equity securities of the issuer or any form of security that is available to retail investors. It would be reckless and inappropriate for retail investors to use MOODY'S credit ratings or publications when making an investment decision. If in doubt you should contact your financial or other professional adviser.

Additional terms for Japan only: Moody's Japan K.K. ("MJKK") is a wholly-owned credit rating agency subsidiary of Moody's Group Japan G.K., which is wholly-owned by Moody's Overseas Holdings Inc., a wholly-owned subsidiary of MCO. Moody's SF Japan K.K. ("MSFJ") is a wholly-owned credit rating agency subsidiary of MJKK. MSFJ is not a Nationally Recognized Statistical Rating Organization ("NRSRO"). Therefore, credit ratings assigned by MSFJ are Non-NRSRO Credit Ratings. Non-NRSRO Credit Ratings are assigned by an entity that is not a NRSRO and, consequently, the rated obligation will not qualify for certain types of treatment under U.S. laws. MJKK and MSFJ are credit rating agencies registered with the Japan Financial Services Agency and their registration numbers are FSA Commissioner (Ratings) No. 2 and 3 respectively.

MJKK or MSFJ (as applicable) hereby disclose that most issuers of debt securities (including corporate and municipal bonds, debentures, notes and commercial paper) and preferred stock rated by MJKK or MSFJ (as applicable) have, prior to assignment of any rating, agreed to pay to MJKK or MSFJ (as applicable) for appraisal and rating services rendered by it fees ranging from JPY200,000 to approximately JPY350,000,000.

MJKK and MSFJ also maintain policies and procedures to address Japanese regulatory requirements.

## CLIENT SERVICES

Americas	1-212-553-1653
Asia Pacific	852-3551-3077
Japan	81-3-5408-4100
EMEA	44-20-7772-5454