MOODY'S
PUBLIC SECTOR EUROPE

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

City of Lugano

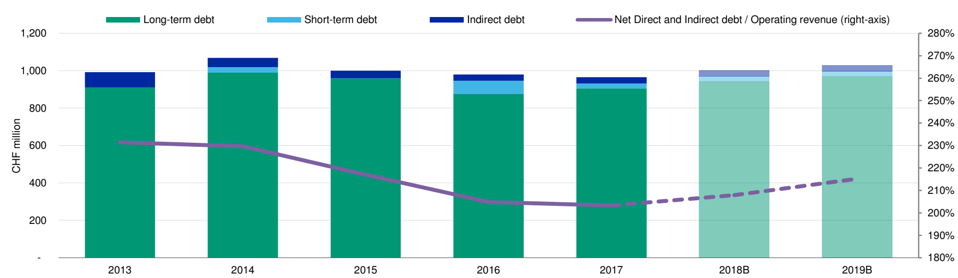
Update to credit analysis

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.

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

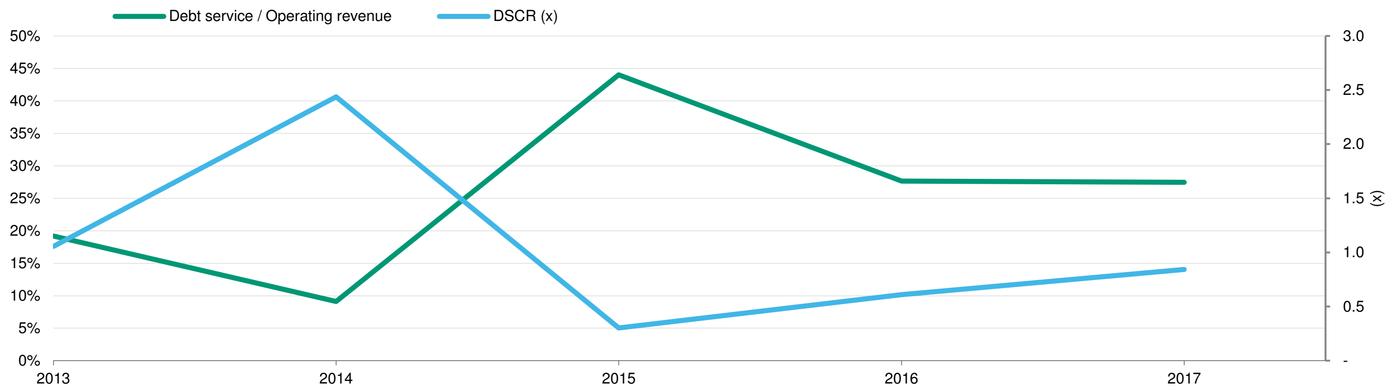
Cassa Pensioni di Lugano's accrued earnings retention. Debt arising from company affiliates is negligible and does not materially affect Lugano's debt position.

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
Scorecard						
Factor 1: Economic Fundamentals						
Economic strength	5	104.86	70%	3.80	20%	0.76
Economic volatility	1		30%			
Factor 2: Institutional Framework						
Legislative background	1		50%	3.00	20%	0.60
Financial flexibility	5		50%			
Factor 3: Financial Performance and Debt Profile						
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%			
Factor 4: Governance and Management - MAX						
Risk controls and financial management	1			1.00	30%	0.30
Investment and debt management	1					
Transparency and disclosure	1					
Idiosyncratic Risk Assessment						2.79(3)
Systemic Risk Assessment						Aaa
Suggested BCA						aa2

Sources: Issuer, Moody's Public Sector Europe

Ratings

Exhibit 5

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

Source: Moody's Investors Service

REPORT NUMBER 1132995

CLIENT SERVICES

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

Moody's
PUBLIC SECTOR EUROPE