
**Fitch Affirms Municipality of Chihuahuas' LC IDR at 'BBB';
Outlook Stable**

Fitch Ratings has affirmed the Municipalities of Chihuahua's Long-Term Local-Currency Issuer Default Rating (LC IDR) at 'BBB' with a Stable Rating Outlook.

Fitch assesses Chihuahuas' standalone credit profile (SCP) at 'a' considering the municipality's 'aaa' debt sustainability score and its 'Low Midrange' risk profile. Chihuahuas' strong fiscal performance and low debt result in strong payback and debt service coverage ratios.

The rating is capped by Mexico's sovereign rating of 'BBB'/Stable, reflecting Fitch's view that a subnational in Mexico cannot be rated above the sovereign.

KEY RATING DRIVERS

Revenue (Robustness) Assessed as Midrange

There is a close performance of Chihuahua's operating revenue (2.5% CAGR 5Y) to the national real GDP growth (2.0%). Also, it presents dynamic tax revenue driven by the local economic growth, the real GDP growth is 4.0% on average the last three years. Local GDP Growth is explained by the manufacture base that has attracted foreign investment. Half of revenues stem from federal transfers comes from the sovereign counterparty rated at 'BBB'. Fitch considers that transfers framework and its evolution are stable and predictable.

Revenue (Adjustability) Assessed as Weaker

The entity presents a much lower dependence of federal transfers than other municipalities within Mexico given that government's legal control revenues represent 50% of the total. However, during an economic downturn that may pose a revenue decline for sub nationals, the Municipality has limited independent ability to increase taxes or fees given political approval through state congress and the local council.

The municipality's own revenues rely more on the tax base than the tax rate. For instance, collection of the property tax has increased by the municipal administration's strategies, such as the past-due portfolio recovery of local liens and the update of the cadastral values.

Expenditure (Sustainability) Assessed as Midrange

The entity has a responsibility over moderately countercyclical expenditure (maintenance and public services) matched by

adequate own taxes and central government transfers to finance these expenses. This is captured by the fact that total expenditure does not heavily outpace operating revenue growth (4.1% vs 3.4% CAGR 5y) and it generally grows close to national inflation (4.7% in 2018).

The municipality has prudent expenditure control policies and we expect operating expenditures to remain under control in 2019 and the near future, despite the pressure for more expenditure in the public security service.

Expenditure (Adjustability) Assessed as Midrange

The municipality has midrange expenditure adjustability as the current level of capex is moderate at around 14% of total expenditure (2016-2018) and could be discretionarily adjusted or subject to reductions. Staff expenditure represents a moderate 48% of total expenditure and its growth is also deemed to be still controlled. Committed expenditure is less than 90%, considered a moderate share of inflexible costs.

Chihuahua's infrastructure needs are typically funded by national capital transfers and the entity's own resources rather than relying on debt. Moreover, the municipality complies with federal financial discipline law for subnationals (legal leeway), which mandates posing budget balance and that staff costs cannot increase more than local GDP growth.

Liabilities and Liquidity (Robustness) Assessed as Midrange

Fitch views the national framework for debt and liquidity management as moderate. The federal financial discipline law in force (since 2016), has a very recent track record and allows subnationals to acquire short term bank lines for a limit of up to 6% of their annual revenues.

The municipalities' direct debt is low and it has some appetite to risk. Short term debt is preferred over long term debt. Under our projections, we are considering as Other Fitch classified debt, the investment component of a street lighting concession that will be engaged in the forthcoming months.

Fitch considers contingent liabilities to be manageable. Based on the last actuarial valuation results carried out by an external specialist in 2018, the pension system, a defined contribution scheme, has financial sufficiency for the next 28 years.

Liabilities and Liquidity (Flexibility) Assessed as Midrange

Mexican framework provides no emergency liquidity support from upper tiers. Chihuahua has moderate unrestricted cash; up to MXN120 millions year-end average. Liquidity lines are used up to MXN150 million (5% of operating revenues), less than the legal ceiling of around MXN200 million. Counterparty risk on committed liquidity lines (banks' ratings) are rated between BBB and A category, considered a midrange attribute by Fitch.

Debt Sustainability Assessment: 'aaa'

Chihuahuas' debt sustainability score of 'aaa' is the result of a low payback ratio (net adjusted debt including the capitalized PPP project / operating balance under Fitch's rating case) that is expected to remain below 5x in 2021. The secondary metrics are the debt service coverage ratio (ADSCR), which is low and assessed at less than 4x, and the fiscal debt burden, also assessed at a very low level of 17%.

Rating Derivation

Chihuahuas' 'a' SCP is derived from a combination of a 'Low Midrange' risk profile assessment and debt metrics, which resulted in 'aaa' debt sustainability assessment. The SCP also factors in appropriate rated peers positioning. Fitch does not apply any asymmetric risk, given neutral assessment of management, governance and pension's liabilities. Fitch either applies extraordinary support from upper-tier government, non-existent in the Mexican subnational framework.

KEY ASSUMPTIONS

Rating case:

- Operating Revenue increases 4.5% on average for 2019-2023.
- Operating Expenditure increases 7% on average for 2019-2021.
- Variable Interest rate of 11% on average 2019-2023 (TIIE₂₈).
- Renewal of the short term debt at MXN150 million in 2021.
- MXN1,000 million as a capital expenditure component under a new street lighting concession agreement.

RATING SENSITIVITIES

Chihuahuas's IDR is constrained by the sovereign rating. A rating action on Mexico's IDR (BBB/Stable) would lead to a corresponding rating action on the issuer.

Fitch could downgrade the entity's SCP if material borrowing leads to a debt payback ratio above five years under Fitch's rating case or if the ADSCR gets below 2x.

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