

Fitch Affirms Municipality of Chihuahua's Ratings

Fitch Ratings has affirmed Municipality of Chihuahua's Long-Term Local Currency Issuer Default Rating (LC IDR) at 'BBB-' and the National Long-Term Rating (NLTR) at 'AAA(mex)', both with a Stable Rating Outlook. The municipality's Standalone Credit Profile (SCP) is 'a'; however, the LC IDR 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.

The affirmation of both ratings reflects Fitch Ratings' expectation that the Municipality of Chihuahua will preserve stable budgetary performance with payback ratios consistently below 5.0x and debt service coverage ratio that is expected to remain above 2.0x (actual and synthetic), reflecting the municipality's good financial and liquidity position. Chihuahua's ratings reflect the combination of the 'Low Midrange' risk profile and 'aaa' debt sustainability under Fitch's rating case scenario. The Stable Rating Outlook reflects our expectation that the entity's debt metrics will remain in line with the revised rating case.

The capital city of Chihuahua is one of 67 municipalities in the State of Chihuahua. It occupies 3.73% of the state's geographic area and, according to the National Population Council, had a total population of 946,900. Socioeconomically, Chihuahua has the fifth lowest social development gap in Mexico and only 0.6% of the population lives in extreme poverty.

KEY RATING DRIVERS

Risk Profile: 'Low Midrange'

Fitch has assessed Chihuahua's risk profile at 'Low Midrange', reflecting a favorable mix of Midrange and one Weaker attribute on the six key risk factors. The 'Low Midrange' assessment reflects the moderately high risk relative to international peers that the municipality's debt service coverage by operating balance will weaken unexpectedly over the forecast horizon (2021-2025), either because of revenue falling short of expectations or spending above expectations, or an unanticipated rise in liabilities/debt.

Revenue Robustness: 'Midrange'

Chihuahua's operating revenue is closely linked to the national transfer's performance, coming from the sovereign counterparty rated at 'BBB-'. Fitch considers that the transfer's framework and its evolution are stable and predictable. The municipality's revenues somehow mimic the national GDP, in the last five years the average real growth of total revenue was 2.7% while the national 5-year average was -0.3%. The latter is explained by the relevance and proportion of federal transfers in the municipality's budget.

As a result of the coronavirus pandemic, the local and national economy experienced a negative GDP and as a result some LRGs presented decline in revenue collection. In the case of the Municipality of Chihuahua, taxes collected presented a decline but national transfers presented stability. The municipality's revenue budget for 2021 is conservative in terms of operating revenue, with a slight decline in tax and fees collection and in federal transfers. However, as of March 2021 the entity outperformed its forecast in tax collection.

Revenue Adjustability: 'Weaker'

The entity presents a much lower dependence of federal transfers than other municipalities within Mexico given that the government's legal control revenues represent 42.3% of the total. However, during an economic downturn that may result in a revenue decline for subnationals, the municipality has limited independent ability to increase taxes or fees, given political approval through the state congress and the local council.

The municipality's own revenues rely on the tax base rather than the tax rate. For instance, the collection of property taxes, the main tax revenue for Chihuahua, has presented an adequate performance due to the municipal administration's strategies, such as the past-due portfolio recovery of local liens and the update of the cadastral values. However, in 2020 tax collection declined 1.3% when compared to those collected in 2019; the local economy was hit by the lockdown measures even with the financial support offered by the municipality. Despite of being the capital of the State of Chihuahua and having a good manufacture sector, most of the employed population works in small businesses, which were mostly hit by the pandemic.

As of March 2021, tax collection presents an important recovery representing 70% of the tax collection at YE2020. Not the case of national transfers, which presents a lower recovery rate when compared to those registered at YE2020. Administrative efforts to recover revenue and strengthen fees collection have been applied by the current administration in order to maintain a stable financial performance.

Expenditure Sustainability: 'Midrange'

Chihuahua has responsibilities over moderately counter-cyclical expenditure (maintenance and public services) and has shown adequate control over expenditure growth. This is captured by the fact that operating expenditure does not heavily outpace operating revenue growth. In 2020 however, a decline in operating revenue is observed which impacts the CAGR of operating revenue (1.8%) versus operating expenditure (5.6%). Despite the challenges in operating revenue, Chihuahua generated a positive operating balance with an average of 10.1% in the last three years (2020-2018). Fitch will monitor the entity's operating balances, considering 2020 was a challenging year and a recovery in 2021.

Expenditure Adjustability: 'Midrange'

The municipality has midrange expenditure adjustability as the current level of capex is moderate at around 15.2% of total expenditure (2018-2020) and could be discretionarily adjusted or subject to reductions. Operating expenditure represents on average of 84.6% for the same period of total expenditure and its growth is deemed to be controlled. Committed expenditure is less than 90%, considered a moderate share of inflexible costs. Capex is supported by own-revenue generation and national transfers and its level is flexible as per administrative management.

Chihuahua is the capital city of the state of Chihuahua, it has a Very Low marginal level and it represents one of the main economic motors for the State. As per internal figures, it represents 29.8% of the state's GDP just behind Juarez Municipality. Its population reaches 960,989 or 25% of the State's population.

Liabilities and Liquidity Robustness: 'Midrange'

Fitch views the national framework for debt and liquidity management as moderate for most Mexican entities. Chihuahua presents sound cash management and high liquidity. Accounts payables are manageable and show a stable evolution. The entity does not present off-balance sheet debt and indirect debt (state decentralized agencies do not incur debt).

The municipality's direct debt is low, totaling MXN15 million as of December 2020, composed of one long-term secured loan, with some appetite for risk. Short-term debt is preferred over long-term debt as a result of its adequate cash position and financial performance. At year-end 2020, MXN113.7 million of short-term debt was registered and is considered as net direct debt of the entity. However, as of March 2021, long term debt has been completely served and short-term debt amounts MXN56.8 million, the complete payment of the latter was in April 2021.

Fitch considers contingent liabilities to be manageable. Based on the last actuarial valuation review 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: 'Midrange'

The Mexican framework provides no emergency liquidity support from upper tiers. Chihuahua has adequate unrestricted cash (year-end average slightly above MXN200 million). Liquidity lines are used up to MXN150 million, below the legal ceiling of around MXN233 million. The entity does not hold significant long-term debt nor its in yellow/red as per regulatory framework. Counterparty risk on committed liquidity lines (banks ratings) are in line with the Municipality's ratings. Chihuahua presents an adequate indicator of assets to short term liabilities, mostly greater than 1.0x, calculated by Fitch with the Ministry of Finance public financial figures to estimate its cash position.

Debt Sustainability Assessment: 'aaa'

Chihuahua's debt sustainability score of 'aaa' is the result of a low payback ratio (net adjusted debt/operating balance under Fitch's rating case) that is expected to remain below 5.0x. The secondary metrics are the actual debt service

coverage ratio (ADSCR), which reaches 2.6x in 2021 and is expected to remain above 2.0x until 2025, was scored at 'aa'. The synthetic DSCR is expected to be above 4x in 2025 and was scored at 'aaa'. The entity holds a strong liquidity position and a fiscal debt burden, assessed at a very low level, 2.7% --scored in the 'aaa' category.

Chihuahua's net adjusted debt has been consistently low, resulting in a very low payback ratio below 5x. Long-term debt has remained stable in the analyzed period from 2016-2020, with no disposals of long-term debt as short-term debt is preferred with outstanding management and a prudential limit. Budgetary performance has been stable, presenting margins of 12.4% on average in the last five years, and the cash position has been adequate. The entity has managed adequately the adverse economic and financial situation.

DERIVATION SUMMARY

Chihuahua's SCP of 'a' is derived from a combination of a 'Low Midrange' risk profile assessment and debt sustainability metrics assessed in the 'aaa' category under Fitch's rating case scenario. The SCP also factors in appropriate rated peers' positioning. Fitch does not apply any asymmetric risk, given neutral assessment of management, governance and pension liabilities. Moreover, no extraordinary support from the upper-tier government is applied as it is non-existent in the Mexican subnational framework.

Fitch applied a rating cap at Mexico's sovereign rating at 'BBB-' due to the high revenue dependence and centralized institutional framework for subnationals. Hence, Chihuahua's IDR is at 'BBB-'. Finally, the National Long-Term rating of 'AAA(mex)' is derived from the 'BBB-' rating and also takes into account the municipality's relative position among peers.

KEY ASSUMPTIONS

Fitch's rating case is a "through-the-cycle" scenario, which incorporates a combination of revenue, cost and financial risk stresses. It is based on 2016-2020 figures and 2021-2025 projected ratios. The key assumptions for the scenario include:

- Operating revenue CAGR of 6.4% 2021-2025.
- Operating expenditure CAGR of 7.2% for 2021-2025.
- Variable interest rate (TIIE 28) average of 6.3% for 2021-2025.
- Additional long-term debt in 2022 as per Fiscal Discipline Law of 15% of available operating revenues.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

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

Factors that could, individually or collectively, lead to negative rating action/downgrade:

--Fitch could downgrade the municipality's SCP if material short or long-term borrowing leads to a payback ratio above five years under Fitch's rating case or if the ADSCR is consistently close or below 2.0x. A deterioration of the entity's operating balance could also lead to a deterioration of the primary and secondary metrics.

ESG CONSIDERATIONS

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg