

RATING ACTION COMMENTARY

Fitch Affirms Municipality of Chihuahua's LC IDR at 'BBB-' and National L-T Rating at 'AAA(mex)'

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Fitch Ratings - Monterrey - 17 May 2023: Fitch Ratings has affirmed the Municipality of Chihuahua, Chihuahua's Long-Term Local Currency Issuer Default Rating (IDR) at 'BBB-' and the National Long-Term Rating at 'AAA(mex)'. The Rating Outlook is Stable.

Fitch lowered the municipality's Standalone Credit Profile (SCP) to 'a-' from 'a', due to the adjustment of one of the key risk factors. Chihuahua's IDR is capped by Mexico's sovereign 'BBB-' ratings and Stable Outlook, reflecting Fitch's view that a subnational in Mexico cannot be rated above the sovereign.

Fitch expects Chihuahua will maintain strong operating performance and low debt metrics with a payback ratio lower than 5x and debt-service coverage ratios (synthetic) above 4x in the projection period. This reflects the municipality's strong financial and liquidity position. In addition, the municipality's rating reflects the combination of a 'Low Midrange' risk profile and 'aaa' debt sustainability under Fitch's rating case scenario.

Chihuahua compares favorably on primary and secondary metrics against peers. Fitch does not apply any asymmetric risk given the neutral assessment of accounting policies, reporting, level of transparency, management and governance, and pension liabilities.

KEY RATING DRIVERS

Risk Profile: 'Low Midrange'

The 'Low Midrange' risk profile assessment reflects a moderately high risk relative to international peers that Chihuahua's ability to cover debt service with the operating balance may weaken unexpectedly over the forecast horizon (2023-2027). This is either because of

lower-than-expected revenue or expenditure above expectations, or because of an unanticipated rise in liabilities or debt-service requirements.

Revenue Robustness: 'Midrange'

Chihuahua's operating revenue (OR) is closely linked to the national transfer's performance, coming from the sovereign counterparty 'BBB-' rating. Fitch believes the transfer's framework and its evolution are stable and predictable. In 2022, federal transfers were 49% of Chihuahua's total revenue (TR). The OR was positive with 15% nominal growth in 2022, totaling MXN4,231 million, due to the recovery on taxes and fees, fines, and other operating revenue with 13% and 14%, respectively, driven by economic recovery and the local tax collection effort implemented by the entity.

Revenue Adjustability: 'Weaker'

Chihuahua has a high dependence on national transfers, which is a structural characteristic of Mexican subnational entities due to fiscal decentralization. Compared to international peers, Mexican subnational governments have low local revenue-raising capacity and limited fiscal autonomy. This makes it difficult to compensate for a drop in federal revenues with a greater tax collection effort.

Expenditure Sustainability: 'Weaker'

Fitch has lowered its assessment of the municipality's expenditure sustainability to 'Weaker' from 'Midrange', due to the limited operating margin (less than 12% of peers in Mexico) observed during the last two fiscal years. The agency expects this to remain limited due to investments and opex projected under the rating case scenario. 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 expenditures do not heavily outpace operating revenue growth.

In 2022, opex grew in line with the OR due to the government's policy of focusing on improving public services and the security of the entity. Fitch expects that this expenditure policy continues with the current municipal administration, supported by the local tax collection effort. This also reflected in lower operating margins under Fitch's rating scenario, although still favorable given the municipality's very low level of debt.

Expenditure Adjustability: 'Midrange'

The municipality has midrange expenditure adjustability as the current level of capex is moderate at around 15% of total expenditure (2020-2022) and could be discretionarily adjusted or subject to reductions. Operating expenditure represents on average of 85% for the same period of total expenditure. Fitch sees this growth as 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. Fitch expects the capex level to be higher during the following years, given the investment projected by the entity and the investment needs for the following years.

Liabilities & 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 paid off all of its debt in 2021: MXN15.1 million of long-term debt and MXN113.7 million of short-term debt.

In March 2022, the administration contracted a bank loan with Banobras for MXN318 million, which will be paid off in August 2024, affecting 50% of the Fondo General de Participaciones (FGP). The loan will be used for public productive investment in security, roads, street lighting and a sport center. The administration contracted an additional bank loan for MXN132 million which will be used for the construction of a new sanitary landfill in the municipality (first stage), which will be paid off in August 2027.

Liabilities & Liquidity Flexibility: 'Midrange'

Chihuahua has adequate unrestricted cash (year-end average of up to MXN207 million). Liquidity lines are used up to MXN150 million (in 2020). Chihuahua presents an adequate indicator of assets to short term liabilities, greater than 1x, calculated by Fitch with the Ministry of Finance public financial figures to estimate its cash position. The Mexican framework provides no emergency liquidity support from upper tiers. The entity does not have short-term credits, financial factoring and financial leasing.

Asymmetric Risks: 'Neutral': Fitch does not apply asymmetric risks given the neutral assessment on accounting policies, reporting the entity's level of transparency, management and governance, and pension liabilities. Management has extensive experience in the sector

and has been stable. The municipality presents resource management plans, which include forecasts of revenue estimates and management policies that generally reflect current economic, systemic and political conditions.

Debt Sustainability: 'aaa category'

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 scenario) that is expected to remain well below 5x during 2023-2027. Debt sustainability also considers the entity's actual debt service coverage ratio (ADSCR) of around 1.2x for 2023 and 2024 and higher synthetic DSCR of 'aaa' for the entire projection period.

The fiscal debt burden is also 'aaa'. Even though that actual DSCR is below 2x during several years of the rating case, this is mitigated by high levels of unrestricted cash. The ADSCR metrics are explained by the medium-term amortization profile of the municipality's debt, where the maturity of one of the bank loans is in 2024 and the other during 2027.

DERIVATION SUMMARY

Chihuahua's SCP of 'a-' is derived from a combination of a 'Low Midrange' risk profile assessment and debt sustainability metrics assessed at the 'aaa' category under Fitch's rating case scenario (synthetic coverage). 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 sub-nationals. 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

Qualitative assumptions

Risk Profile: 'Low Midrange'

Revenue Robustness: 'Midrange'

Revenue Adjustability: 'Weaker'

Expenditure Sustainability: 'Weaker'

Expenditure Adjustability: 'Midrange'

Liabilities and Liquidity Robustness: 'Midrange'

Liabilities and Liquidity Flexibility: 'Midrange'

Debt sustainability: 'aaa'

Support (Budget Loans): 'N/A'

Support (Ad Hoc): 'N/A'

Asymmetric Risk: 'N/A'

Sovereign Cap (LT IDR): '-'

Sovereign Cap (LT LC IDR) 'BBB-'

Sovereign Floor: 'N/A'

Quantitative assumptions - Issuer Specific

Fitch's rating case scenario is a "through-the-cycle" scenario, which incorporates a combination of revenue, cost and financial risk stresses. It is based on the 2018-2022 figures and 2023-2027 projected ratios.

The key assumptions for the scenario include:

--Operating revenue: 6.8% CAGR, 2023-2027;

--Operating expenditure: 7.5% CAGR, 2023-2027;

--Operating margin: decreasing from 5.4% in 2023 to 3.7% in 2027;

--Capital expenditure: an average negative net expenditure of MXN282 million from 2023 to 2027;

--Short-term debt of MXN42.5 million as the average balance observed during the period;

--Long-term direct debt: MXN450 million, based on entity projections and 15% additional debt (MXN535 million) in 2025 of disposable revenues, according to the Alert System;

--Floating interest rate (known as TIIE 28): 12.3% in 2023, 11% in 2024 and up to 12% in 2027.

Liquidity and Debt Structure

Fitch's net adjusted debt corresponds to the difference between Fitch-adjusted debt and the LRGs' unrestricted cash. The latter corresponds to the level of cash at the end of the year, excluding the cash that Fitch views as earmarked for payables or restricted.

Issuer Profile

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 971,693. Socioeconomically, Chihuahua has the fifth lowest social development gap in Mexico and only 0.9% of the population lives in extreme poverty. The state and the municipality have strong economic links with the U.S. The presence of manufactories run by U.S. companies that export products to the U.S., highlights strong U.S.-Mexican economic ties. The majority of the working population is employed in the manufacture and commerce sectors.

Fitch classifies Chihuahua as a type B government because it covers its debt service with its annual cash flow.

RATING SENSITIVITIES

Factors that Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade

--A negative rating action on the sovereign rating would lead to a downgrade of Chihuahua's IDR. In addition, the IDR will be downgraded if the SCP is downgraded due to the debt sustainability score deteriorating to 'a', which would result from a debt payback ratio exceeding 5x coupled with a debt service coverage ratio below 2x (actual and synthetic);

--Likewise, a deterioration in the risk profile could affect the SCP and the municipality's IDR.

Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade

--Chihuahua'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;

--The National Scale Rating is in the lower range of default risk compared to the rest of the subnational governments in Mexico, therefore positive actions on this scale are not possible.

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.

Sources of Information

The principal sources of information used in the analysis are described in the Applicable Criteria.

PUBLIC RATINGS WITH CREDIT LINKAGE TO OTHER RATINGS

Chihuahua's IDR is linked to the sovereign rating (Mexico/BBB-).

Best/Worst Case Rating Scenario

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit <https://www.fitchratings.com/site/re/10111579>.

References for Substantially Material Source Cited as Key Driver Rating

The principal sources of information used in the analysis are described in the Applicable Criteria.

RATING ACTIONS

ENTITY / DEBT ⇅	RATING ⇅		PRIOR ⇅
Chihuahua CHIH, Municipio de	LC LT IDR	BBB- Rating Outlook Stable	BBB- Rating Outlook Stable
	Affirmed		
	Natl LT	AAA(mex) Rating Outlook Stable	AAA(mex) Rating Outlook Stable
	Affirmed		

[VIEW ADDITIONAL RATING DETAILS](#)

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APPLICABLE CRITERIA

[Metodología de Calificaciones en Escala Nacional \(pub. 22 Dec 2020\)](#)

[International Local and Regional Governments Rating Criteria \(pub. 03 Sep 2021\) \(including rating assumption sensitivity\)](#)

[Metodología de Calificación de Gobiernos Locales y Regionales Internacionales \(pub. 30 Sep 2021\)](#)

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Chihuahua CHIH, Municipio de

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