

Research Update:

# Swedish Municipality of Nacka Affirmed At 'AAA/A-1+'; Outlook Stable

August 18, 2023

## Overview

- Despite cost pressure from inflation and a lower-than-expected population growth rate, we forecast broadly stable operating margins for Nacka thanks to cost-containment measures.
- We anticipate that Nacka's tax-supported debt will increase to 33% by 2025 from 19% in 2022, largely because of Nacka's self-sustaining water utility company's financing needs and its own investment plan.
- We expect Nacka to be able to absorb the effects of rising interest rates because the major part is on-lent to its municipal company sector.
- We are therefore affirming our 'AAA/A-1+' long- and short-term ratings on Nacka. The outlook is stable.

## Rating Action

On Aug. 18, 2023, S&P Global Ratings affirmed its 'AAA' long-term and 'A-1+' short-term issuer credit ratings on the Swedish municipality of Nacka. The outlook is stable.

## Outlook

The stable outlook reflects our expectation that Nacka has budgetary headroom to manage cost pressures stemming from macroeconomic factors, including high inflation and rising pension-related expenditure for all Swedish local and regional governments (LRGs).

## Downside scenario

We could consider a downgrade if budgetary performance falls far below our expectation and the municipality's debt metrics deteriorate materially. This could, for instance, happen if Nacka fails to impose sufficient cost-containment measures, and interest expenditure as a share of revenue continues to rise markedly.

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## Rationale

Our affirmation of the 'AAA' rating on Nacka is supported by the expectation that cash-flow-based operating performance will remain robust through 2025, and that Nacka will sustain operating balances above 5%. We think the municipality's investments, together with the municipal company sector's increased financing needs, will drive a gradually expanding debt burden through 2025. That said, we consider Nacka's on-lending to its water company a mitigating factor. We also expect Nacka to maintain its favorable liquidity position, supported by ample reserves of contracted facilities and strong access to external financing.

### **Sweden's supportive institutional framework reduces LRG sector risks, while the local and regional economy benefits from a strong demographic profile.**

Nacka's local economy remains strong, owing to its close integration with the Stockholm region and its favorable socioeconomic profile, illustrated, for instance, by residents' high incomes and a strong employment structure compared with domestic peers'. Nacka benefits from Sweden's comparably high wealth levels and resilient economy, reflected in our estimate of 2023 national GDP per capita at about \$58,300. We expect Nacka's population growth to remain above the national average, supporting strong tax-revenue growth.

We regard the institutional framework in Sweden as extremely predictable and supportive. In our view, the framework displays a high degree of stability, and the sector's revenue and expenditure management benefits from a far-reaching equalization system and local tax autonomy. Furthermore, the central government's swift response to the COVID-19 pandemic, partly through the distribution of general grants to the sector, supports our view.

The political situation in Nacka is stable. Since elections in September 2022, the municipality is governed by a center-right minority government, with support from the Green Party. With the group of opposition parties being somewhat fragmented, we do not expect the new cross-block collaboration to disrupt Nacka's operations or strategies. Overall, Nacka has a track record of prudently managing its expenditure and implementing necessary policy reforms, and we believe its risk management is conservative. This is illustrated by risk-minimizing debt and liquidity policies, although we regard the municipality's approach to not hedge its energy exposures as somewhat less prudent than that of many rated Swedish peers.

### **A growing debt burden is mitigated by largely being on-lent to the company sector, which also absorbs a large part of the interest-rate exposure.**

Amid rising interest costs, inflationary pressure, and a new pension agreement, we expect Nacka's operating balance will fall to 5.4% in 2023 from 6.6% in 2022, with some further weakening in 2024. That said, we now think Nacka will achieve operating balances that remain above 5% through 2025. Regarding exposure to higher interest rates, Nacka will be largely reimbursed for rising interest costs by its municipal-owned government-related entities (GREs), to which it has on-lent most of its debt.

In 2023-2024, Swedish LRGs' performance will be burdened by significantly larger pension costs. This is because of a new pension agreement from January 2023, which includes a larger contribution to employees (6.0% instead of 4.5%) and a negative cash flow effect compared with the old agreement. A further effect stems from the existing pension liability being consumer price index (CPI)-linked, which forces Swedish LRGs to increase pension provisions. However, this is a

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noncash expense that does not affect S&P Global Ratings' calculation of the operating balance. Overall, on an accrual basis, the increase in pension costs will have a notable effect on Swedish LRGs' income statements. Moreover, since a share of the pension-related expenditure increase does not affect cash outflows, while LRGs adjust their budgets to accommodate the full accrual-based impact, it does not have a significant net effect on our calculated budgetary performance ratios.

We expect deficits after capital accounts to widen somewhat in 2023-2024 as capital expenditure (capex) increases and internal cash generation weakens, and over 2023-2025, we forecast deficits will average 1.2% of revenue. The municipality is expected to undertake sizable infrastructure investments to facilitate subsequent large-scale new construction of housing in close proximity to the subway network's extension. We also expect capital revenue will remain at fairly high levels throughout the forecast period, primarily from selling land and real estate, thereby partially mitigating high investments. Historically, Nacka has managed to contain its debt burden, thanks to asset sales being higher than expected. We have cautiously forecast asset sales but acknowledge that borrowing needs could further reduce should they materialize at higher amounts.

Because of the municipality's and its company sector's growing financing, we expect tax-supported debt to surpass 30% of consolidated revenue by 2025. This, however, is still among the lowest in a national comparison with rated peers. For example, we expect water and waste company Nacka vatten och avfall AB to take on an annual average of Swedish krona (SEK) 210 million in new debt between 2023 and 2025, and we estimate that almost 60% of the total debt will be on-lent to the company by 2025. The company has the legal power to adjust user fees to offset cost increases and capital cost for investments, however, so we consider this on-lending to be a mitigating factor, which improves our assessment of Nacka's debt.

The municipality's liquidity position remains exceptional, and we estimate that available liquidity will cover 250% of upcoming average annual debt service. Sources total about SEK2 billion of cash and committed backup facilities, while uses include maturing debt and interest payments. We expect commercial paper will finance an increasing share of debt maturities in coming years, although we do not think this will materially weigh on the liquidity coverage ratio. Like other rated LRGs in Sweden, we consider Nacka to have strong access to external liquidity, thanks to its established relationships with capital markets and financial institutions.

## Key Statistics

Table 1

### Municipality of Nacka--Selected Indicators

Mil. SEK	--Fiscal year end Dec. 31--					
	2020	2021	2022	2023bc	2024bc	2025bc
Operating revenue	7,250	7,488	7,867	8,096	8,465	8,794
Operating expenditure	6,816	6,890	7,347	7,656	8,037	8,185
Operating balance	434	598	520	440	429	608
Operating balance (% of operating revenue)	6.0	8.0	6.6	5.4	5.1	6.9
Capital revenue	852	245	319	487	638	712
Capital expenditure	991	878	863	1,009	1,254	1,404
Balance after capital accounts	295	(35)	(25)	(82)	(187)	(84)

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Table 1

### Municipality of Nacka--Selected Indicators (cont.)

Mil. SEK	--Fiscal year end Dec. 31--					
	2020	2021	2022	2023bc	2024bc	2025bc
Balance after capital accounts (% of total revenues)	3.6	(0.5)	(0.3)	(1.0)	(2.1)	(0.9)
Debt repaid	650	0	0	400	977	729
Gross borrowings	600	0	200	940	1,596	1,108
Balance after borrowings	275	(165)	(277)	5	39	(4)
Direct debt (outstanding at year-end)	1,350	1,350	1,550	2,090	2,709	3,087
Direct debt (% of operating revenue)	18.6	18.0	19.7	25.8	32.0	35.1
Tax-supported debt (outstanding at year-end)	1,387	1,389	1,583	2,135	2,754	3,132
Tax-supported debt (% of consolidated operating revenue)	18.4	17.8	19.3	24.7	30.5	33.4
Interest (% of operating revenue)	0.1	0.1	0.2	0.6	1.1	1.7
Local GDP per capita (single units)	N/A	N/A	N/A	N/A	N/A	N/A
National GDP per capita (single units)	487,872	526,244	566,987	598,376	622,440	643,101

The data and ratios above result in part from S&P Global Ratings' own calculations, drawing on national as well as international sources, reflecting S&P Global Ratings' independent view on the timeliness, coverage, accuracy, credibility, and usability of available information. The main sources are the financial statements and budgets, as provided by the issuer. bc--Base case reflects S&P Global Ratings' expectations of the most likely scenario. SEK--Swedish krona. N/A--Not applicable.

## Ratings Score Snapshot

Table 2

### Municipality of Nacka--Ratings Score Snapshot

Key rating factors	Scores
Institutional framework	1
Economy	1
Financial management	2
Budgetary performance	2
Liquidity	1
Debt burden	1
Stand-alone credit profile	aaa
Issuer credit rating	AAA

S&P Global Ratings bases its ratings on non-U.S. local and regional governments (LRGs) on the six main rating factors in this table. In the "Methodology For Rating Local And Regional Governments Outside Of The U.S.," published on July 15, 2019, we explain the steps we follow to derive the global scale foreign currency rating on each LRG. The institutional framework is assessed on a six-point scale: 1 is the strongest and 6 the weakest score. Our assessments of economy, financial management, budgetary performance, liquidity, and debt burden are on a five-point scale, with 1 being the strongest score and 5 the weakest.

## **Key Sovereign Statistics**

- Sovereign Risk Indicators, July 10, 2023. An interactive version is available at <http://www.spratings.com/sri>

## **Related Criteria**

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- Criteria | Governments | International Public Finance: Methodology For Rating Local And Regional Governments Outside Of The U.S., July 15, 2019
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

## **Related Research**

- Institutional Framework Assessments For Local And Regional Governments Outside Of The U.S., March 22, 2023
- Most Rated Swedish LRGs Can Absorb Higher Interest Costs, Sept. 12, 2022
- Southern Swedish LRGs Bear The Brunt Of Surging Electricity Prices, July 20, 2022
- Swedish Local Governments Are Holding Up Against Cyber Attacks, Jan. 26, 2022
- Institutional Framework Assessment: Swedish Municipalities And Counties, Dec. 13, 2021

In accordance with our relevant policies and procedures, the Rating Committee was composed of analysts that are qualified to vote in the committee, with sufficient experience to convey the appropriate level of knowledge and understanding of the methodology applicable (see 'Related Criteria And Research'). At the onset of the committee, the chair confirmed that the information provided to the Rating Committee by the primary analyst had been distributed in a timely manner and was sufficient for Committee members to make an informed decision.

After the primary analyst gave opening remarks and explained the recommendation, the Committee discussed key rating factors and critical issues in accordance with the relevant criteria. Qualitative and quantitative risk factors were considered and discussed, looking at track-record and forecasts.

The committee's assessment of the key rating factors is reflected in the Ratings Score Snapshot above.

The chair ensured every voting member was given the opportunity to articulate his/her opinion. The chair or designee reviewed the draft report to ensure consistency with the Committee decision. The views and the decision of the rating committee are summarized in the above rationale and outlook. The weighting of all rating factors is described in the methodology used in this rating action (see 'Related Criteria And Research').

## Ratings List

### Ratings Affirmed

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#### Municipality of Nacka

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Issuer Credit Rating AAA/Stable/A-1+

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Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at [www.standardandpoors.com](http://www.standardandpoors.com) for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at [https://www.standardandpoors.com/en\\_US/web/guest/article/-/view/sourceId/504352](https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352) Complete ratings information is available to subscribers of RatingsDirect at [www.capitaliq.com](http://www.capitaliq.com). All ratings affected by this rating action can be found on S&P Global Ratings' public website at [www.standardandpoors.com](http://www.standardandpoors.com). Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; or Stockholm (46) 8-440-5914

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