

RATING ACTION COMMENTARY

# Fitch Affirms Municipality of San Pedro's LC IDR at 'BBB-' and National LT Rating at 'AAA(mex)'

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Fitch Ratings - Monterrey - 08 Sep 2021: Fitch Ratings has affirmed Municipality of San Pedro Garza Garcia, Nuevo Leon'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. The municipality's Stand-alone Credit Profile (SCP), that connects risk profile with debt sustainability assessment (relevant for cross country comparison), is assessed at 'aa-'. San Pedro's IDR is capped by Mexico's sovereign rating of 'BBB-/Outlook Stable', reflecting Fitch's view that a subnational in Mexico cannot be rated above the sovereign.

The action reflects Fitch's unchanged expectations that the Municipality will maintain a strong payback ratio expected to remain negative (higher unrestricted cash relative to financial obligations) and debt service coverage ratios assessed well above 4.0x. The rating reflects the combination of a 'Midrange' risk profile and an 'aaa' debt sustainability under Fitch's rating case scenario.

Fitch classifies San Pedro (as with all Mexican LRGs) as type B as it covers debt service from its cash flow on an annual basis. San Pedro is part of the metropolitan area of Monterrey in the state of Nuevo Leon, one of the three most important and diverse economic centers in Mexico, contributing to approximately 7.5% of national GDP.

## KEY RATING DRIVERS

### Risk Profile: 'Midrange'

San Pedro Garza Garcia 's risk profile 'Midrange' is based on all six key risk factors assessed as midrange. The assessment reflects Fitch's view of a moderately low risk relative to international peers that the issuer's ability to cover debt service with the operating balance may weaken unexpectedly over the forecast horizon (2021-2025) due to lower revenue, higher expenditure, or an unexpected rise in liabilities or debt or debt-service requirement. It is worth noticing that, in the national context, San Pedro is the only entity with a 'Midrange' risk profile as it presents financial and socioeconomic strengths relative to national peers.

### Revenue Robustness: 'Midrange'

San Pedro has an operational revenue growth above national GDP growth. The deflated five-year CAGR (2016-2020) of its operating revenue was 2.4% compared to -1.1% of national GDP growth. Rates presents lower levels, impacted by the coronavirus pandemic that's still present in the national and international context. The municipality has a stable revenue source as tax collection represented 44.3% of operating revenues in 2020. High valued properties in San Pedro and collection efficiency explain the strong property tax collection.

Although operational transfer dependence is much lower than other sub nationals in Mexico; the municipality receives slightly less than half of their operating revenue from federal transfers which come from a counterparty rated by Fitch at 'BBB-'. Fitch classifies these resources as strong, as they present a stable trend and come from a trustworthy source with a supportive framework. Due to this combination of factors, Fitch assesses the attribute as Midrange. Revenue growth is expected to be marginally positive due to a recovery in economic growth prospects.

### Revenue Adjustability: 'Midrange'

This attribute evaluated as 'Midrange' is an outlier from the rest of the Mexican entities. The most important reason is the very high affordability of the Municipality's population. In addition, it has a high proportion of taxes over operating revenue supported with high value properties. The latter implies that the municipality would have an adequate independent ability to increase taxes or fees in the event of an economic downturn that may pose a revenue decline for subnationals. The fact that there is no constitutional ceiling to increase taxes, together with the high affordability of San Pedro's population is mitigated into a

midrange attribute because any additional tax or increase in tax has to be approved by the State's Congress.

#### Expenditure Sustainability: 'Midrange'

This attribute is considered as midrange given that the entity has responsibilities over moderately countercyclical expenditure (maintenance and public services). Moreover, operating expenditure has more often shown a lesser pace growth rate than operating revenues. It is worth noticing that 2020 was different in terms of opex, as the Municipality implemented several support programs for those affected by the COVID-19 and small businesses, impacting year-end figures.

San Pedro manages social security, public lighting, waste collection and road maintenance. At YE 2020, operating expenditure increased 16.8%, resulting in a deflated five-year CAGR (2016-2020) of 5.7%. When compared to operating revenue figures, which were impacted in 2020 by the pandemic, opex resulted higher. However, operating balances remain high and stable with an average of 32.8% during 2016-2020. Fitch considers the entity has a strong revenue budget, cash position, adequate financial management and no long-term debt that could pressure its finances as a result of a sudden increase in expenditure.

#### Expenditure Adjustability: 'Midrange'

San Pedro has above average expenditure adjustability as the current level of capex totaled 27.2% of total expenditure on average in the last three years (2018-2020), and could be discretionarily adjusted or subject to reductions in case of financial stress. It is worth noticing that despite the coronavirus contingency and its impact on tax collection, the Municipality was able to continue with its capex program, mainly focused on mobility, public parks, pluvial systems and infrastructure improvement. Staff expenditure represented a moderate 39% of total expenditure in 2020, and its growth has been controlled. Fitch considers San Pedro has an effective budget balance rules to control its expenditure in addition to a strong financial profile.

#### Liabilities and Liquidity Robustness: 'Midrange'

Fitch evaluates as moderate the national framework for debt and liquidity management since there are prudential borrowing limits and restrictions on loan types. By law, an issuer's specific framework for debt, liquidity and off-balance sheet management must be aligned with the national framework; however, the federal financial discipline law in force started in 2016, so it has a very recent track record. Also, San Pedro's appetite for risk is

evaluated as low and does not hold off balance sheet risks nor pension liabilities that pose a risk to its budget.

At YE 2020 San Pedro does not hold long-term debt as it prepaid in full in 2018. The only outstanding financial debt is a PPP that totaled MXN47 million in 2020 which is considered as other Fitch classified debt. With an unrestricted cash of MXN1,261 million, the calculated net overall debt is a negative figure of MXN1,214 million. Fitch evaluates San Pedro's appetite for risk as low.

#### Liabilities and Liquidity Flexibility: 'Midrange'

Mexican framework provides no emergency liquidity support from upper tiers. Therefore, this key risk factor (KRF) is assessed only considering the entity's available liquidity or unrestricted cash. In addition, the assessment as Midrange on this KRF is driven by a metric of liquidity (cash to current liabilities). Entities are assessed as midrange when this indicator is above 1x as an average for the last three years, which has been the case of San Pedro during 2018-2020. Currently, they do not have external liquidity sources due to its high unrestricted cash; however, it has a wide external market which will be willing to provide external liquidity resources in case they need it.

#### Debt sustainability: 'aaa' category

San Pedro's debt sustainability score of 'aaa' is the result of an expected negative payback ratio (net adjusted debt/operating balance under Fitch's rating case) in 2025; this is higher unrestricted cash relative to financial obligations. The secondary metrics are the debt service coverage ratio (DSCR), which is favorable and assessed above 4.0x, and the fiscal debt burden, also evaluated to remain negative due its high levels of cash and low expected debt.

In its rating case scenario, Fitch also expects operating balance to represent 23% of operating revenue on average in the forecasted period (2021-2025) which is still below the average observed in the last five years (2016-2020) of 32.8%. Although revenues are expected to improve as a result of an economic recovery in the national and municipal context, opex will continue with its growing trend. Additional long-term debt is considered as per Fiscal Discipline Law limits; however, net adjusted debt is still expected in to be negative as a result of an adequate cash position and still low debt levels.

#### **DERIVATION SUMMARY**

San Pedro's SCP is assessed at 'aa-', reflecting a combination of a 'Midrange' risk profile and debt sustainability metrics assessed in the 'aaa' category under Fitch's rating case scenario. The SCP, positioned in 'aa-', also reflects the peer comparison. Fitch does not consider any extraordinary support and does not apply any asymmetric risk given neutral assessments of management, governance and pension liabilities. Finally, Fitch applied a rating cap at Mexico's sovereign rating of 'BBB-' based on high revenue dependence and a centralized institutional framework for subnationals. Hence, the municipality's IDR is 'BBB-'. Finally, the National Long-Term Rating of 'AAA(mex)' is derived from the 'BBB-' IDR.

## **KEY ASSUMPTIONS**

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 2016-2020 figures and 2021-2025 projected ratios. The key assumptions for the scenario include:

- Operating Revenue: CAGR 7.4% from 2021 to 2025;
- Operating Expenditure: CAGR 9.8% from 2021 to 2025;
- Additional debt of MXN400 million in line with Fiscal Discipline Law;
- TIIE 28 of 3.8% in 2021 and 4.5% in 2025.

## **RATING SENSITIVITIES**

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

- San Pedro's IDR is currently capped by the sovereign rating at 'BBB-'. Given the centralized framework in Mexico, an upgrade would be possible only if the sovereign is upgraded.

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

- A payback higher than 13x could lead to a negative action in the IDR; however, this is not expected by Fitch. Also, a downgrade in the sovereign will impact San Pedro's IDR.

## **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 OF RATING**

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

**PUBLIC RATINGS WITH CREDIT LINKAGE TO OTHER RATINGS**

Ratings capped by the sovereign ratings.

**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](http://www.fitchratings.com/esg)

**RATING ACTIONS**

ENTITY/DEBT	RATING			PRIOR
San Pedro Garza Garcia NL, Municipio de	LC LT IDR	BBB- Rating Outlook Stable	Affirmed	BBB- Rating Outlook Stable
●	Natl LT	AAA(mex) Rating Outlook Stable	Affirmed	AAA(mex) Rating Outlook Stable

VIEW ADDITIONAL RATING DETAILS

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**APPLICABLE CRITERIA**

Metodología de Calificación de Gobiernos Locales y Regionales Internacionales (pub. 11 Nov 2020)

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)

## **ADDITIONAL DISCLOSURES**

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

## **ENDORSEMENT STATUS**

San Pedro Garza Garcia NL, Municipio de

EU Endorsed, UK Endorsed

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International Public Finance	Supranationals, Subnationals, and Agencies	Latin America
Mexico		

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