

Research Update:

Municipality of Östersund Outlook Revised To Negative On Risks From Soaring Capital Expenditure; Ratings Affirmed

October 11, 2024

Overview

- The Municipality of Östersund's capital expenditure will surge more than previously expected for a new water treatment plant, local infrastructure, and maintenance needs of school properties.
- Deficits after capital accounts will widen to almost 10% of operating revenue through 2026, rapidly adding the city's already high indebtedness in the context of Swedish local and regional governments.
- We therefore revised our outlook to negative from stable and affirmed our 'AA+/A-1+' and 'K-1' ratings.

Rating Action

On Oct. 11, 2024, S&P Global Ratings revised its outlook on the municipality of the Swedish Municipality of Östersund to negative from stable.

At the same time, we affirmed our 'AA+/A-1+' long- and short-term global scale issuer credit ratings and 'K-1' short-term Nordic regional scale rating on Östersund.

Outlook

The negative outlook reflects the risk that Östersund's management will be unable to contain spending such that the city's indebtedness widens further.

Downside scenario

We could lower the rating if Östersund's investments remain high for an extended period or exceed our current base-case assumptions. This is because it could lead to higher debt levels than

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forecast and indicate deficiencies in planning processes and cost management.

Upside scenario

We could revise the outlook to stable if Östersund's management were able to mitigate the impact the current investment phase would have on the municipality's debt burden. This could be the case if Östersund were able to finance a higher share of its investments by its operating balance or if the investment levels turn out to be lower than we currently assume in our base case.

Rationale

We expect Östersund's capital expenditure will soar and generate large deficits through 2026. Östersund is investing heavily in a water treatment plan, local infrastructure, and maintenance needs of school properties. These will lead to significantly higher capital expenditure than previously anticipated. We expect that Östersund will be able to maintain high operating balances, which will contain deficits within 10% of operating revenue, supported by lower cost inflation and stronger tax revenue growth. Although we believe management will remain committed to its financial policies and try to mitigate deficits with stronger operating performance, deficits could widen beyond what we anticipate.

An extremely supportive and institutional framework and strong local economy continue to support our rating on Östersund

We consider the institutional framework for local and regional governments (LRGs) in Sweden extremely predictable and supportive. In our view, the framework displays a high degree of stability, and the sector's revenue and expenditure management are based on a far-reaching equalization system and tax autonomy. Historically, the central government has provided extensive support to the LRG sector, for example through additional grants distributed in response to the pandemic or more recently to cover rising pension costs (for more information, see "Swedish Municipalities And Regions Have Flexibility To Balance Costs," published Nov. 29, 2023, on RatingsDirect).

Östersund is a well-managed and stable municipality with relatively stable population and low unemployment. There is a positive trend of employers relocating operations to the city, although population growth has slowed due to lower immigration and birth rates. Östersund is governed by a majority collaboration between the Social Democrats and the Center Party, which will have to adapt to changing population growth and the consequential shift in demand of welfare services. Management will also be challenged by the sharp increase in capital expenditure and debt accumulation, which will require proactive containment of the growth in indebtedness. The accumulation of debt and concentration of capital expenditure needs that will pressure finances in the coming years could indicate weakness in the long-term planning process. We think that management will aim to contain pressure and remain committed to fiscal discipline. We also expect that Östersund's management will continue to use prudent debt and liquidity practices as the municipal group's debt stock is growing.

Östersund's economy is supported by Sweden's comparably high wealth levels, as seen in our estimated 2024 GDP per capita of \$60,000. We expect population growth for the municipality, roughly in line with the national average, from about \$65,000 in 2023. The local economy is diversified with a wide range of small and midsize enterprises in various industries. Unemployment, at 4.6% as of August 2024, is better than the national average, supported by

centralization of jobs in Östersund because it is the region's largest city.

Deficits will widen considerably as more expensive infrastructure projects and maintenance in school properties is carried out

We expect operating performance to normalize in 2024, coming from an exceptionally strong 2023 owing to a one-off dividend from the government-related entities (GREs) of Swedish krona (SEK) 576 million (€50 million). While operating performance is normalizing at a strong level, very high capital expenditure due to investments in local infrastructure, such as a new water treatment plant, new schools, and maintenance of existing schools, will lead to deficits widening considerably through 2026. Although we expect some delays in capital expenditure being carried out and that the municipality will be able to uphold stronger operating balances, Östersund's deficit is still expected to move toward 10% of operating revenue in 2026. The widening deficit trend is a shift from historic performance of very low deficits.

Debt accumulation in Östersund has historically been mainly a reflection of capital expenditure carried out by its GREs, with about 70% of debt being lent on to Jämtkraft as of year-end 2023. From 2024 and thereafter the municipality will, however, be the main driver of debt accumulation. Capital expenditure related to educational facilities and local infrastructure--for instance in water and waste infrastructure--will increase to levels of about SEK1.1 billion annually through 2026. This is about 50% higher than we previously anticipated, coming mainly from the revised budget for the water treatment plant, but also owing to more expensive construction and maintenance of educational facilities. The new water treatment plant is seeing a steep increase in costs, due to higher safety requirements, local sediment conditions, and higher inflation since the project's approval. Among Östersund's group of companies, we expect energy company Jämtkraft will have significant borrowing needs through 2026, due to relatively ambitious investment plans requiring debt funding. Consequently, we expect Östersund's debt will notably increase in the coming years and reach 165% of operating revenue by 2026.

Like most other Swedish LRGs, the profile of Östersund's debt is short dated from an international perspective, which has pushed up average interest rates for the debt stock. The steep increase in debt stock will push interest expenditure to continue growing as a share of revenue and peak at 4.8% in 2026, despite interest rates falling quickly through 2025. The debt is mainly serviced by Östersund's group companies, as about 85% or SEK6.85 billion of debt was lent on to these companies as of the beginning of 2024. Östersund charges a margin fee on this debt and, as a result, the impact on Östersund's operating balance from rising interest expenses is limited. We continue to consider the municipality's contingent liabilities as limited because they constitute only a small amount of extended guarantees.

We regard Östersund's liquidity position as exceptionally strong, stemming from an ample amount of liquidity sources, covering 154% of average annual debt service, and our view of its strong access to external capital. We note that Östersund has structurally increased its liquidity sources over the past year, and we expect the coverage ratio will remain solid. In our liquidity calculation, we include SEK4.2 billion in cash, financial assets, and back-up facilities. We also include an average of SEK2.3 billion of maturing debt and interest.

Key Statistics

- Sovereign Risk Indicators, July 8, 2024. An interactive version is available at <http://www.spratratings.com/sri>

Ratings Score Snapshot

Table 1

Municipality of Ostersund--Selected indicators

| Mil. SEK | --Fiscal year ending Dec. 31-- | | | | | |
|---|--------------------------------|-----------|-----------|-----------|-----------|-----------|
| | 2021 | 2022 | 2023 | 2024bc | 2025bc | 2026bc |
| Operating revenues | 5,523.4 | 5,832.9 | 6,926.0 | 6,589.4 | 6,748.6 | 6,952.9 |
| Operating expenditures | 5,097.9 | 5,329.7 | 5,952.9 | 6,080.5 | 6,312.0 | 6,493.3 |
| Operating balance | 425.5 | 503.2 | 973.1 | 508.9 | 436.6 | 459.7 |
| Operating balance (% of operating revenues) | 7.7 | 8.6 | 14.0 | 7.7 | 6.5 | 6.6 |
| Capital revenues | 21.5 | 19.0 | 24.1 | 45.0 | 64.0 | 50.0 |
| Capital expenditures | 705.0 | 1,161.0 | 871.5 | 880.0 | 1,056.0 | 1,132.5 |
| Balance after capital accounts | (258.0) | (638.8) | 125.7 | (326.1) | (555.4) | (622.8) |
| Balance after capital accounts (% of total revenues) | (4.7) | (10.9) | 1.8 | (4.9) | (8.2) | (8.9) |
| Debt repaid | 1,750.0 | 1,900.0 | 1,700.0 | 2,375.0 | 2,250.0 | 2,300.0 |
| Gross borrowings | 2,150.0 | 3,120.0 | 3,350.0 | 3,650.0 | 3,550.0 | 3,100.0 |
| Balance after borrowings | (71.0) | (25.8) | (165.1) | (76.1) | (10.4) | 2.2 |
| Direct debt (outstanding at year-end) | 5,225.0 | 6,445.0 | 8,095.0 | 9,370.0 | 10,670.0 | 11,470.0 |
| Direct debt (% of operating revenues) | 94.6 | 110.5 | 116.9 | 142.2 | 158.1 | 165.0 |
| Tax-supported debt (outstanding at year-end) | 5,419.8 | 6,634.8 | 8,282.1 | 9,560.8 | 10,860.4 | 11,660.0 |
| Tax-supported debt (% of consolidated operating revenues) | 45.3 | 40.6 | 51.6 | 60.1 | 67.6 | 71.6 |
| Interest (% of operating revenues) | 1.0 | 1.3 | 4.1 | 4.4 | 4.6 | 4.8 |
| Local GDP per capita (single units) | N/A | N/A | N/A | N/A | N/A | N/A |
| National GDP per capita (single units) | 526,517.1 | 561,139.3 | 589,839.9 | 605,835.6 | 626,891.5 | 647,406.0 |

SEK--Swedish krona. N/A--Not applicable

Key Sovereign Statistics

Table 2

Municipality of Ostersund--Ratings score snapshot

| Key rating factors | Scores |
|-------------------------|--------|
| Institutional framework | 1 |
| Economy | 1 |
| Financial management | 2 |
| Budgetary performance | 3 |
| Liquidity | 1 |

Table 2

Municipality of Ostersund--Ratings score snapshot (cont.)

| Key rating factors | Scores |
|----------------------------|--------|
| Debt burden | 4 |
| Stand-alone credit profile | aa+ |

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.

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., Sept. 18, 2024
- Nordic Public Finance Credit Outlook 2024: A Mixed Picture, May 16, 2024
- Subnational Debt 2024: Focus on Debt Sustainability, Feb. 29, 2024
- Subnational Debt 2024: Infrastructure Spending Succumbs To Economic Slowdown, Feb. 29, 2024
- Subnational Debt 2024: Global LRGs Can Handle Rising Interest Expenses, Feb. 29, 2024
- Institutional Framework Assessment: Swedish Municipalities And Regions Have Flexibility To Balance Costs, Nov. 29, 2023
- Sweden's Local And Regional Governments Have Less Room To Maneuver Over The Next Year As Pension Costs Rise, Sept. 14, 2023

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; Outlook Action

| | To | From |
|------------------------------------|-------------------|-----------------|
| Ostersund (Municipality of) | | |
| Issuer Credit Rating | AA+/Negative/A-1+ | AA+/Stable/A-1+ |
| Nordic Regional Scale | --/--/K-1 | --/--/K-1 |

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.spglobal.com/ratings for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at <https://disclosure.spglobal.com/ratings/en/regulatory/article/-/view/sourceid/504352>. Complete ratings information is available to RatingsDirect subscribers at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.spglobal.com/ratings. Alternatively, call S&P Global Ratings' Global Client Support line (44) 20-7176-7176.

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