MOODY'S
PUBLIC SECTOR EUROPE

CREDIT OPINION
15 September 2020

Rate this Research

RATINGS

Berlin, Land of

Domicile	Germany
Long Term Rating	Aa1
Type	LT Issuer Rating
Outlook	Stable

Please see the ratings section at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

Contacts

Harald Sperlein +49.69.70730.906
VP-Senior Analyst
harald.sperlein@moodys.com

Max Dietz +49.69.70730.890
Associate Analyst
max.dietz@moodys.com

Massimo Visconti +39.02.9148.1124
VP-Sr Credit Officer/Manager
massimo.visconti@moodys.com

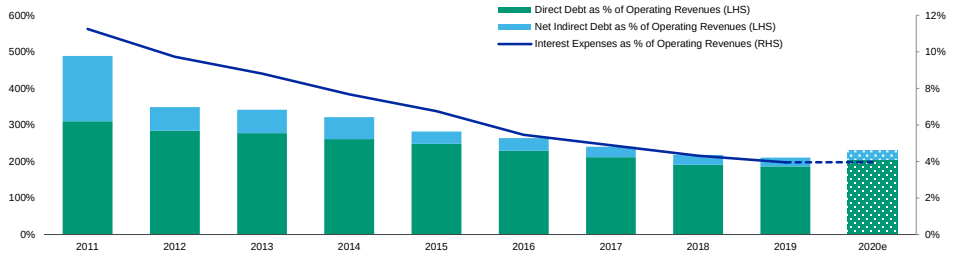
Land of Berlin (Germany)

Update to credit analysis

Summary

The credit profile of the Land of Berlin (Berlin, Aa1 stable) reflects the Land's solid economic and financial performance, as well as its conservative financial management. These positives are counterbalanced by Berlin's high debt and limited financial flexibility. Despite long track record of steady decline in net direct and indirect debt (NDID), it remains very high and is set to increase in 2020 to almost 230% of operating revenue (Exhibit 1), a result from financial deficits in 2020. The credit profile also reflects our assessment of a very high likelihood that the Government of Germany (Aaa stable) would provide support in case of acute liquidity stress. The coronavirus outbreak, the associated deterioration in the global economic outlook combined with significant tax revenue declines are creating a considerable deterioration of credit indicators across many regions, including Berlin.

Exhibit 1
Coronavirus to reverse continuous debt level decreases



2020e: Moody's estimated data
Source: Issuer, German Statistics Office, Moody's Investors Service

Credit strengths

» Solid financial performance with long record of financial surpluses will allow for managing expected budgetary pressure

» Supportive framework, including strong financial equalisation

» Solid economic fundamentals and favourable demographics despite the impact of the pandemic

Credit challenges

» Very high and moderately increasing debt levels with some refinancing needs

» Limited financial flexibility, although mitigated by the city-state status

Rating outlook

The outlook is stable. This reflects our expectation that the regional government, in particular with an expected recovery of its economy and growing tax revenues from 2021 and in light of lower-for-longer interest rates, is able to manage the immediate challenges posed by the pandemic and to return to balanced financial accounts over the medium-term.

Factors that could lead to an upgrade

Upward rating pressure on Berlin could be exerted by any significant improvement in its financial performance, including a substantial reduction in its debt burden, combined with a sustained track record of balanced financial budgets.

Factors that could lead to a downgrade

A significant and prolonged deterioration in the Land's fiscal metrics leading to a material increase in debt levels, any alterations in the fundamental supportive structure of the Länder (regional governments) sector — although not expected — or an — also unlikely — downgrade of Germany's sovereign rating would lead to a downgrade.

Key indicators

Exhibit 2
Land of Berlin

	2015	2016	2017	2018	2019	2020e
GDP per capita (EUR)	35,765	37,553	38,748	40,105	41,967	39,000
Intergovernmental revenues /operating revenues (%)	35.8	34.0	36.0	34.4	33.4	25.0
Interest expenses/operating revenues (%)	6.8	5.5	4.9	4.3	4.0	4.0
Gross operating balance/operating revenues (%)	7.4	8.5	10.8	11.9	10.3	-8.0
Financing (deficit/surplus)/total revenues (%)	0.9	0.6	3.7	5.3	2.7	-11.6
Net direct and indirect debt/operating revenues (%)	282.1	264.0	240.4	218.1	210.7	228.6
Capital expenses/total expenses (%)	9.9	11.1	10.6	9.7	10.6	7.0

2020e: Moody's estimated data
Source: Issuer, German Statistics Office, Moody's Investors Service

Detailed credit considerations

The credit profile of Berlin, as expressed in its Aa1 (stable) rating, combines its (1) Baseline Credit Assessment (BCA) of aa3, and (2) the very high likelihood of extraordinary support coming from the German federal government in the event that Berlin faces acute liquidity stress.

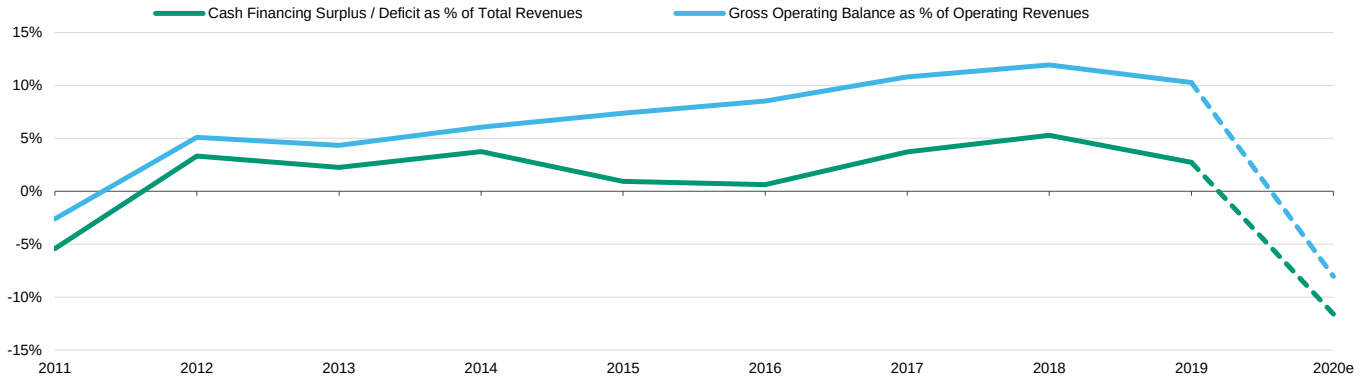
Baseline Credit Assessment

Solid financial performance with long record of financial surpluses will allow for managing expected budgetary pressure

The coronavirus outbreak and the associated deterioration in the economic outlook is resulting in material tax revenue declines, turning upside down the city's previously strong operating and financial performance. After eight consecutive years of operating and financial surpluses, we expect the gross operating balance to drop to -8% of operating revenues and the city-state to record a financial deficit of around 12% of total expenses this year. In the first year of the debt-brake, the constitutional requirement has been suspended both on the federal and regional level due to the extraordinary emergency situation, thus enabling the funding of measures to alleviate the economic and social impact of the pandemic.

Exhibit 3

Pandemic to turn upside down previously strong operating and financial performance



2020e: Moody's estimated data

Source: Issuer, German Statistics Office, Moody's Investors Service

The strong drop in the financial metrics is mainly driven by tax revenue shortfalls: we reckon around €2 to €3 billion versus budgeted tax revenue in 2020. However, the revenue loss is somewhat cushioned by transfers from the central government, for instance a compensation of around €280 million for the local business tax revenue shortfall. Moreover, the city-state is calculating with additional expenditure needs of €500 million (or 1.7% of operating revenues) mainly to accommodate the coronavirus' effects in the health sector and to offset the revenue shortfall of city-owned companies and cultural institutions.

While we expect the Land to continue to record deficits over the next years due to prolonged tax shortfalls (around €2 billion versus initially forecast tax revenue yearly over 2021-2023), we nonetheless view Berlin's credit profile as robust. Considering the city-state's solid track record in containing expenditures over the past several years and in light of lower-for-longer interest rates, we believe the region will manage the immediate challenges posed by the pandemic and return to balanced financial accounts over the medium-term. In addition, while recording financial surpluses the city established reserves, amounting to around €3 billion, that it can now draw on, providing it with some flexibility to address the investment needs of a constantly growing city.

Supportive framework, including strong financial equalisation

The institutional framework, which encompasses legislative background and financial flexibility, is reflected in the arrangements determining intergovernmental relations at all levels, and jurisdictional powers and responsibilities. The framework is mature and highly developed, with minor changes occurring at a measured pace and in a transparent manner.

Germany has one of the strongest equalisation systems in the world, which combines revenue sharing and financial transfers. This scheme protects all Länder against above-average revenue shortfalls, yet limits their revenue flexibility. The German federal constitution guarantees that the Länder receive appropriate levels of funding and prescribes a very high fiscal homogeneity among the Länder.

From 2020, the Länder sector benefits financially from the amended financial equalisation scheme because of a higher share in value-added tax revenue, higher general federal transfers and higher supplementary transfers. This confirms the Länder's strong position within the federation. The new equalisation scheme will continue to support Berlin's financial position.

Moreover, we note substantial central government financial transfers in the wake of the coronavirus pandemic such as grants for small and medium-sized enterprises provided via Länder budgets, partly compensation for local business tax shortfalls, the provision of up to 75% of housing subsidies paid to social security recipients (usually covered by municipalities), and compensation for revenue shortfalls from a temporary reduction in value added tax. These transfers reflect our assumption of very high extraordinary support consideration and will result in lower revenue shortfalls for Berlin in 2020 and mitigate expenditure needs.

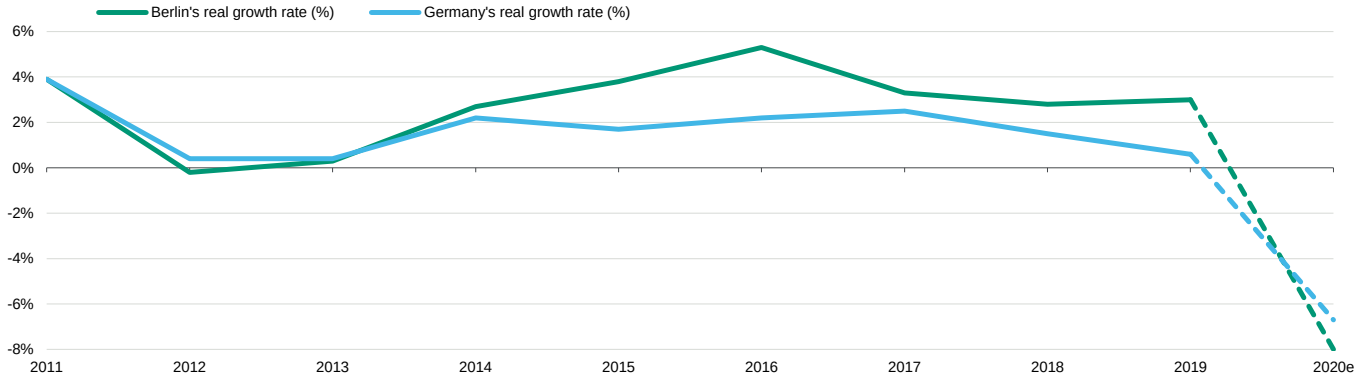
Another factor is the "debt-brake mechanism", which was introduced in 2009 to limit structural financial deficits of the federal government and the Länder in the future. Starting from 2020, Germany's regional governments are - in general - no longer allowed to run structural fiscal deficits. In addition to the limit, a stronger joint supervision of the Bund and Länder budgets has been implemented. Due to the extraordinary emergency situation because of the coronavirus however, the constitutional requirement has been suspended this year and we deem it likely that the exemption will be prolonged in 2021. Nonetheless, we expect the mechanism to result in a decline in the Länder sector's debt burden, once the economic shock will fade away and economic activity will resume.

Solid economic fundamentals and favourable demographics despite the impact of the pandemic

Berlin has posted positive real GDP growth over seven consecutive years and started exceeding the German average in 2014 (see Exhibit 4). However, this trend is likely to be reversed by the coronavirus - at least - in 2020. In 2019, Berlin's strong GDP growth was at 3% (following 2.8% in 2018), compared with the German average of 0.6% in 2019 and 1.5% in 2018. We expect Berlin's growth rate in 2020 to be weaker than the German average, mainly driven by the capital city's larger service sector as a percentage of the economy, suffering relatively more from the pandemic. Hence, while Berlin's GDP per capita rose above the national average for the first time in 2019, this is set to reverse again this year.

Exhibit 4

Berlin's above German average growth of last years to be reversed by pandemic



2020e: Moody's estimated data

Source: German Statistics Office, Investitionsbank Berlin, Moody's Investors Service

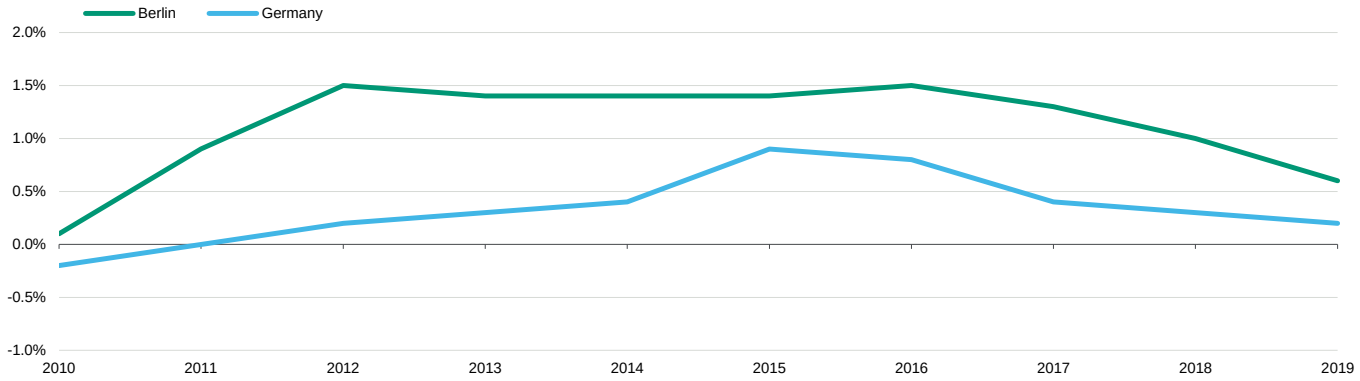
The temporary shock of the coronavirus aside, the changes in the city's economic structure have become very evident in the past five years and have made Berlin's economy increasingly dynamic. The public and manufacturing sectors have become less significant, while the financial, trade, transport and value-added service sectors such as software development have become more prominent. The city continues to attract foreign direct investment, with services being the largest beneficiary, as many multinational corporations have sought to locate their representative offices or relocate their European headquarters to the capital. Berlin has also become a leading cultural and touristic location in Europe. Hence, we expect Berlin's economy to fully recover from the crisis by 2022 at the latest.

The Land of Berlin, with its 3.7 million inhabitants, is the capital of Germany and its population continues to grow faster than that of Germany (see Exhibit 5). We expect this trend to continue as the sound economic trajectory (except for the temporary coronavirus shock) and Berlin's strong cultural offering are likely to lead to continued domestic and international migration into the city.

Exhibit 5

Berlin's population is growing faster than that of Germany

Inhabitants (annual growth rate in %)



Source: German Statistics Office

Very high and moderately increasing debt levels with some refinancing needs

Berlin's direct debt, excluding guarantees and company debt, further declined to 186% of operating revenue as of year-end 2019 from 191% the year earlier. This level is still high compared with that of Berlin's international peers and other German Länder. However, as Berlin is a city-state, the debt also includes municipal debt, unlike that of its German peers that we rate. If we include other indirect debt (for example, guarantees), the net direct and indirect debt (NDID) ratio stands at a high level of 211% of operating revenue as of year-end 2019, compared with 218% in 2018 (see Exhibit 1). We believe that the steady reduction in NDID over the last decade reflects the city's prudent management. In the past years, budget plans were exceeded, with the city posting very sizeable financial surpluses.

The deteriorating financial performance due to the impact of the coronavirus will however reverse the continuous debt level decreases: we forecast a moderate increase to 229% of operating revenue. The region's rise in debt metrics is mainly driven by the direct debt component, from 186% of operating revenues in 2019 to 204% in 2020, a rise that is the direct result of the fiscal deficit this year due to the crisis.

Any risk of rising interest rates is fairly moderate, because almost all euro-denominated debt is at fixed rates (around 90%). Debt service was below 20% of operating revenue in 2019, down significantly from more than 50% before 2012, however we expect this ratio to increase again in 2020. Berlin's interest payments are at 4% of operating revenue in 2019, also down significantly from more than 10% before 2012. Thanks to the lower-for-longer interest rate environment, higher debt is affordable and interest costs may continue to decline further.

The city has excellent access to the capital markets, thanks to a sophisticated state treasury and excellent liquidity management. In the money markets, Berlin has access to the German state financing agency (BRD Finanzagentur GmbH), as well as the inter-Länder liquidity pool, whereby individual Länder offer their surplus cash to other Länder, and to a (uncommitted) credit facility with a commercial bank to bridge intra-day needs. Despite considerable refinancing needs, Berlin benefits from low borrowing costs. This reflects investors' willingness to fund the German Länder, given their perceived status as a safe haven comparable to the German sovereign. Berlin, as a long-established issuer, has the particular advantage of a broad investor base.

Berlin directly owns and controls around 40 companies, most of which are public-limited companies, including a few that receive subsidies. Contingent liabilities in the form of these companies' financial debt are moderate. The key companies include six housing companies (including GEWOBAG Wohnungsbau-AG Berlin; A2 stable), the local public transport company Berliner Verkehrsbetriebe, and the water utility company Berliner Wasserbetriebe. Overall, most of these entities are considered self-supporting.

Another possible source of contingent liability is its 37% share in a new airport, Flughafen Berlin Brandenburg GmbH (A1 stable), which it is building together with the Land of Brandenburg (Aaa stable) and the federal government. Delays and additional costs have had a negative impact on Berlin's financial performance in the past and the coronavirus will have an impact on operations and profitability after the airport's opening. On a positive note, the airport is scheduled to open this year after significant construction delays in the past.

Berlin's pension obligations are largely unfunded, as is the case for most German Länder, which could negatively affect its creditworthiness in the future. We estimate the level of unfunded pension obligations will exceed Berlin's annual revenue. However, Berlin's obligations appear somewhat lower than those of most West German Länder.

Limited financial flexibility, although mitigated by its city-state status

Berlin, like other German Länder, has little flexibility to adjust revenue or expenditures in its budget. Despite its status as a city-state and having the right to adjust local business tax, the effect appears limited. Nevertheless, the city has used its city-state status to introduce some municipal fees to foster budget consolidation. On the expenditure side, in the past, the city has used a range of adjustments and, therefore, further flexibility in savings appears limited. Many standards are set at the national level and cannot be adjusted at the city's discretion.

Extraordinary support considerations

We consider Berlin to have a very high likelihood of extraordinary support from the federal government, which reflects our assessment of (1) the high reputational risk for Germany as a whole in case of default by a Land, and (2) the Bundestreuekonzept, according to which all German Länder must provide mutual support in the event that one of them or the federal republic faces a severe budgetary crisis. Also, the debt volumes and structure of the German Länder are extremely complex, and an event of non-payment would be considered to have a corresponding impact on Germany as a whole.

ESG considerations

How environmental, social and governance risks inform our credit analysis of Berlin

We take account of the impact of environmental (E), social (S) and governance (G) factors when assessing sub-sovereign issuers' economic and financial strength. In the case of Berlin, the significance of ESG factors to the credit profile is as follows:

Environmental considerations are not material to Berlin's rating. The Land has very limited exposure to flood risk, for example. We expect the central government would provide support in such a scenario.

Social considerations are not material to the city's credit profile. We note, however, that the city's growing population has an impact not only on its operating expenses but also on its investment needs. As such, rising housing cost is an important issue in Berlin at present and putting social pressure on the city's policy-makers. Berlin, like other German Länder, has an ageing population, which results in declining labour supply and higher pension and social costs. However, we assess these effects as manageable for the city. We view the coronavirus outbreak as a social risk under our ESG framework, given the substantial implications for public health and safety in Berlin and the risk of a continued spread of the outbreak within the city.

Governance considerations are material to Berlin's rating. Budgetary discipline in Germany is a constitutional requirement (debt-brake mechanism), which requires each of the regions to maintain structurally balanced budgets. Budget planning is prudent, transparent and predictable.

Further details are provided in the "Detailed credit considerations" section above. Our approach to ESG is explained in our cross-sector methodology General Principles for Assessing ESG Risks.

Rating methodology and scorecard factors

The assigned BCA of aa3 is in line with the scorecard-indicated BCA. The matrix-generated BCA of aa3 reflects an Idiosyncratic Risk score of 4 (presented below) on a 1-9 scale, where 1 represents the strongest relative credit quality and 9 the weakest; and (2) a Systemic Risk score of Aaa, as reflected in the sovereign bond rating for Germany (Aaa stable).

For details about our rating approach, please refer to Rating Methodology: Regional and Local Governments, 16 January 2018.

Exhibit 6

Land of Berlin

Baseline Credit Assessment	Score	Value	Sub-factor Weighting	Sub-factor Total	Factor Weighting	Total
Scorecard						
Factor 1: Economic Fundamentals						
Economic strength	5	100.49	70%	3.8	20%	0.76
Economic volatility	1		30%			
Factor 2: Institutional Framework						
Legislative background	1		50%	3	20%	0.60
Financial flexibility	5		50%			
Factor 3: Financial Performance and Debt Profile						
Gross operating balance / operating revenues (%)	1	10.82	12.5%	3.5	30%	1.05
Interest payments / operating revenues (%)	5	4.19	12.5%			
Liquidity	1		25%			
Net direct and indirect debt / operating revenues (%)	9	210.66	25%			
Short-term direct debt / total direct debt (%)	1	9.83	25%			
Factor 4: Governance and Management - MAX						
Risk controls and financial management	5			5	30%	1.50
Investment and debt management	1					
Transparency and disclosure	1					
Idiosyncratic Risk Assessment						**3.91(4)**
Systemic Risk Assessment						**Aaa**
Suggested BCA						**aa3**

2019 data
Source: Moody's Investors Service

Ratings

Exhibit 7

Category	Moody's Rating
BERLIN, LAND OF	
Outlook	Stable
Issuer Rating	Aa1
Senior Unsecured	Aa1

Source: Moody's Investors Service

REPORT NUMBER 1239713

CLIENT SERVICES

Americas	1-212-553-1653
Asia Pacific	852-3551-3077
Japan	81-3-5408-4100
EMEA	44-20-7772-5454

MOODY'S
PUBLIC SECTOR EUROPE