MOODY'S
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Credit Opinion: Berlin, Land of

Global Credit Research - 12 Dec 2014

Germany

Ratings

Category	Moody's Rating
Outlook	Stable
Issuer Rating	Aa1
Bonds	Aa1

Contacts

Analyst	Phone
Sperlein, Harald/Frankfurt am Main	49.69.707.30.700
David Rubinoff/London	44.20.7772.5454

Key Indicators

Berlin, Land of
600049394

	2009	2010	2011	2012	2013
GDP per capita	27,764	28,658	29,620	29,865	30,642
Intergovernmental revenues as a % of Operating Revenues	40.45	38.23	37.23	39.08	38.39
Interest payments as a % of Operating Revenues	11.91	11.48	11.25	9.73	8.80
Gross Operating Balance as a % of Operating Revenues	-3.51	-3.05	-2.61	5.11	4.34
Financing surplus(deficit) as a % of Total Revenues	-7.27	-6.77	-5.17	3.17	2.26
Net Direct and Indirect Debt as a % of Operating Revenues	496.44	498.11	488.91	348.99	341.48
Capital expenses as a % of Total expenses	7.53	8.38	7.17	6.40	6.12

Opinion

SUMMARY RATING RATIONALE

The Land of Berlin's Aa1 issuer and long-term bond ratings reflect (1) the Land's strong financial performance as a result of successful financial consolidation efforts; (2) the robust legal framework including the high level of financial support from equalisation mechanisms which we expect to remain (3) excellent capital market access and (4) favourable economic and demographic trends. We also factor in its very high debt levels and limited financial flexibility.

The Aa1 rating also reflects our assessment of a very high likelihood that the Federal Republic of Germany (Aaa, stable) would support the Land financially by taking measures to prevent a default.

National Peer Comparison

Berlin is rated in line with the average of German Laender (regional governments), whose ratings span from Aaa to Aa1. Berlin's position relative to its peers reflects its extremely high indebtedness. These high debt levels are offset by the strong equalisation system in Germany, the Land's robust access to liquidity and the very high likelihood of support from the German government.

Credit Strengths

Credit strengths for Berlin include:

- Strong financial performance with financial surpluses since 2012, projected to continue

- Supportive framework, expected to remain

- Excellent capital markets access coupled with low funding costs

- Strong economic development and favourable demographics

Credit Challenges

Credit challenges for Berlin include:

- Very high debt levels and high refinancing needs, albeit projected to decline

- Some contingent liabilities

- Limited financial flexibility, although mitigated by city state status

Rating Outlook

The outlook is stable.

What Could Change the Rating - Up

Upward rating pressure on Berlin's rating would require evidence of Berlin's capacity to display comparatively stronger credit fundamentals than its peers, including a substantial reduction of the land's debt burden.

What Could Change the Rating - Down

Although unlikely, a downgrade of Germany's sovereign rating would lead to a downgrade of Berlin's rating. A significant deterioration in Berlin's fiscal metrics that led to an increase in its debt levels would lead to a downgrade. Although not expected, any alterations in the fundamental supportive structure of the sector could lead to a negative rating action.

DETAILED RATING CONSIDERATIONS

The rating assigned to Land of Berlin combines the baseline credit assessment (BCA) for the Land and the likelihood of extraordinary support coming from the German federal government in the event that Berlin faced acute liquidity stress.

Baseline Credit Assessment

STRONG FINANCIAL PERFORMANCE WITH FINANCIAL SURPLUSES SINCE 2012, PROJECTED TO CONTINUE

In FY 2013 Berlin has continued to demonstrate its ability to meet or even exceed fiscal targets. For example, the Land has surpassed its own initial targets for spending control, as well as those set out under the so-called debt brake mechanism.

Berlin's operating balance turned positive in 2012, with a surplus of more than 5%, it has remained nearly at that level in 2013 and will continue so over the medium-term. Over the last few years, revenues exceeded pre-crisis levels due to good tax revenue development. Tax revenue for the Land is expected to increase by 3% to 4% per year over the medium term. This appears achievable, given the latest tax estimate and the city's positive demographic and economic trend.

Berlin's financial performance is in surplus since 2012, which is a significant improvement compared to several years of deficit prior to 2012. This development reflects the city's ongoing savings efforts. Over the medium-term, the city has forecast slightly lower, albeit still positive, financial results, which we regard as a realistic forecast. In addition, the city is considering establishing monetary reserves, which will provide some flexibiltity.

Over the next three years, key expenditure elements that are likely to exert pressure include higher personnel costs. Berlin's administration is committed to limiting expenditure growth to around 2% per year over the planning period. This is slightly higher than in the past, but reflects the requirements of a growing city. We believe that the medium term plans are manageable in light of Berlin's solid track record in containing expenditures over the past

several years.

Berlin's capital expenditure is low and relatively stable, averaging 7% of total expenditures over the past five years. However, in the medium term it will likely fall to around 6% of operating revenues, reflecting declining subsidies and the ongoing budgetary consolidation. The Land estimates that it has some marginal flexibility in its investment plan, given its already solid infrastructure endowment.

SUPPORTIVE FRAMEWORK, EXPECTED TO REMAIN

Germany has one of the strongest equalisation systems worldwide, which combines revenue equalisation - both horizontal and vertical - and investment support from the federal government. This scheme protects all Laender against above-average revenue shortfalls, yet limits their revenue flexibility.

Under the current system, Berlin has a helping hand from annual subsidies amounting to around 35 percent of revenues that it receives under the national "equalisation" system. Due to its special characteristics as a (1) financially weak (2) city state (3) located in former Eastern Germany, the capital is one of the biggest winners of the German equalisation system under which city-states benefit from special subsidies. Policymakers are currently discussing adjustments to the system beyond 2019, but we expect no fundamental changes to the system, nor any significant rating implications.

The German federal constitution guarantees that Laender receive appropriate levels of funding and prescribes a very high fiscal homogeneity among Laender.

Another factor is the so-called "debt-brake mechanism", which was introduced to limit the structural deficit of the federal government to 0.35 per cent of gross domestic product from 2016 onwards, while after 2019 Germany's 16 regional governments are no longer allowed to run fiscal deficits. In addition to the limit, a stronger joint supervision of Bund and Laender budgets has been implemented.

The debt brake appears more binding than the former arrangement and respective Laender constitutional rules, which stipulate that revenue from borrowing may not exceed the total expenditure for investment provided for in the budget estimates. In our view, a rule driven fiscal policy approach seems less exposed to political interference.

EXCELLENT CAPITAL MARKETS ACCESS COUPLED WITH LOW FUNDING COSTS

Berlin has excellent access to the capital markets, thanks to a sophisticated state treasury and excellent liquidity management, which remained good even during the last financial crisis. Berlin has financial relationships with several financial institutions, which are willing to grant it continued access to liquidity based on their confidence in the German Laender solidarity system. In the money markets, Berlin has access to the inter-Laender credit pool, whereby individual Laender offer their surplus cash to other Laender, and to a credit facility with a commercial bank to bridge intra-day needs.

Despite high refinancing needs Berlin benefits from cheap borrowing costs notwithstanding a funding requirement that is among the highest of German Laender. This reflects investors' willingness to fund the German Laender, with a 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. Bonds with medium maturities currently trade at a spread of around 20 to 30 basis points over German sovereign bonds, a relatively low level compared to recent years. In combination with overall low interest level, Berlin can lock in lower rates now and cut its interest cost as a percentage of operating revenues.

In the absence of economic shocks that could trigger a sharp rise in interest rates, these favorable conditions look set to persist. We estimate that Berlin's interest payments as a percentage of operating revenues will further decline to below 8% of operating revenues from a level of around 12% five years earlier.

STRONG ECONOMIC DEVELOPMENT AND FAVOURABLE DEMOGRAPHICS

The Land of Berlin, with its 3.4 million inhabitants, is the capital of the Federal Republic of Germany. Berlin has posted positive real GDP growth over the last five years. In 2013, GDP growth was 1.2% compared to German average of 0.4%. Germany's GDP is expected to grow at around 1.5% this year and 1.0% in 2015, which is also our baseline expectation for Berlin.

Berlin's unemployment rate (according to national calculation) was 11.7% in 2013, down from 12.3% in 2012. This improvement compares with the German 2013 and 2012 rates of 6.9% and 6.8% respectively, but remains somewhat higher than the East German average of 10.3% in 2013.

The changes in the city's economic structure reflect the trends of many new Laender: i.e. the public and manufacturing sectors have become less significant, while the financial, trade, transport and value-added service sectors 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.

VERY HIGH DEBT LEVELS AND HIGH REFINANCING NEEDS, ALBEIT PROJECTED TO DECLINE

Berlin's direct debt, excluding guarantees and company debt, was further reduced in 2013 and 2014. It totalled EUR59.6 billion as of September 2014. This is a reduction from the EUR61.2 as of end 2011. In relative terms, direct debt was equivalent to 278% of its operating revenues in 2013 versus 284% in 2012 and 310% in 2011. This is still very high compared to Berlin's international peers and other German Laender. However, as Berlin is a city-state, the debt also includes municipal debt, unlike its Moody's-rated German peers.

If we include other indirect debt i.e., debt of non-self-supporting, majority-owned companies and guarantee obligations, the net direct and indirect debt (NDID) ratio rises to a considerable 341% of operating revenues as of 2013, compared to 349% in 2012.

Berlin's budget plan till 2018 foresees slight financial surpluses each year, which are intended to be used mainly for debt reduction. Over the medium to longer term, the city's debt reduction plan still depends on economic development and the control of expenditure, including capital expenditures. We believe that a further reduction of net direct and indirect debt to lower levels is achievable and reflects the city's prudent management.

In 2013, interest on debt represented 8.8% of operating revenues - from around 12% five years earlier - a level we expect to continue to decline to below 8% over the next few years, as a result of low interest rates and reducing outstanding debt.

Debt is almost all euro-denominated, with an average maturity of 6.6 years, of which 87% is at fixed rates and the rest at variable or semi-variable rates. While this leaves some interest rate risk, we believe that in the current environment such risk is moderate, particularly as the administration uses derivatives - swaps and options - to hedge potential interest or currency risks.

Debt service was a remarkably high 45% of operating revenues in 2013, slightly lower than previous years. We expect it to stabilise at around 40% of operating revenues, following some interest savings, slight debt reduction and a trend towards longer-term lending that the administration is targeting.

SOME CONTINGENT LIABILITIES

Berlin owns or has shares in several companies, the majority of which are public limited companies, some of them receiving subsidies. Contingent liabilities in the form of indirect financial debt at these companies are moderately high, though decreasing. Key companies include six housing companies in which Berlin has majority ownership, the public transport company, Berliner Verkehrsbetriebe and the water utility, Berliner Wasserbetriebe. Overall, most entities are considered self-supporting. Berlin sold its 80.95% stake in Landesbank Berlin Holding AG in 2007, which was the most substantial company in its portfolio, however some guarantees provided earlier remained but are declining and appear as very low risk to the city's budget.

Another possible source of liability is its 37% share of a new airport, which it is building together with the Land of Brandenburg (Aa1, stable) and the federal government. Delays and additional costs have caused Berlin to budget for cost overrun estimates, which may prompt further financing needs. We will continue to monitor the situation and its risk for Berlin's budget very closely.

Berlin's pension obligations are largely underfunded, as is the case for most German Laender, which could negatively affect creditworthiness in the future. However, Berlin's obligations appear somewhat lower than western German Laender's.

LIMITED FINANCIAL FLEXIBILITY, ALTHOUGH MITIGATED BY CITY STATE STATUS

Berlin, like other German Laender, has little flexibility to adjust revenues or expenditures in its budget. Despite its status as a city-state and as such having the right to adjust municipal corporate 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 so further cuts appear limited. A lot of standards are set at national level and cannot be adjusted at the city's discretion.

Extraordinary Support Considerations

The very high likelihood of extraordinary support from the Federal Government of Germany (Aaa, stable) reflects Moody's assessment of (1) the elevated reputational risk for Germany as a whole in case of default by a Land, and (2) the Bundestreuekonzept, according to which all German Laender 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 German Laender are extremely complex and an event of non-payment would be considered to have a corresponding impact on Germany as a whole.

Output of the Baseline Credit Assessment Scorecard

In the case of Land of Berlin, the BCA matrix generates an estimated BCA of a1, in line with the a1 assigned by the rating committee.

The matrix-generated BCA of a1 reflects (1) an idiosyncratic risk score of 5 (presented below) on a 1 to 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 (Aaa, stable).

The idiosyncratic risk scorecard and BCA matrix, which generate estimated baseline creditassessments from a set of qualitative and quantitative credit metrics, are tools used by the rating committee in assessing regional and local government credit quality. The credit metrics captured by these tools provide a good statistical gauge of stand-alone credit strength and, in general, higher ratings can be expected among issuers with the highest scorecard-estimated BCAs. Nevertheless, the scorecard-estimated BCAs do not substitute for rating committee judgments regarding individual baseline credit assessments, nor is the scorecard a matrix for automatically assigning or changing these assessments. Scorecard results have limitations in that they are backward-looking, using historical data, while the assessments are forward-looking opinions of credit strength. Concomitantly, the limited number of variables included in these tools cannot fully capture the breadth and depth of our credit analysis.

ABOUT MOODY'S SUB-SOVEREIGN RATINGS

National and Global Scale Ratings

Moody's National Scale Credit Ratings (NSRs) are intended as relative measures of creditworthiness among debt issues and issuers within a country, enabling market participants to better differentiate relative risks. NSRs differ from Moody's global scale credit ratings in that they are not globally comparable with the full universe of Moody's rated entities, but only with NSRs for other rated debt issues and issuers within the same country. NSRs are designated by a ".nn" country modifier signifying the relevant country, as in ".za" for South Africa. For further information on Moody's approach to national scale credit ratings, please refer to Moody's Credit rating Methodology published in June 2014 entitled "Mapping Moody's National Scale Ratings to Global Scale Ratings".

The Moody's Global Scale rating for issuers and issues allows investors to compare the issuer's/issue's creditworthiness to all others in the world, rather than merely in one country. It incorporates all risks relating to that country, including the potential volatility of the national economy.

Baseline Credit Assessment

Baseline credit assessments (BCAs) are opinions of entity's standalone intrinsic strength, absent any extraordinary support from a government. Contractual relationships and any expected ongoing annual subsidies from the government are incorporated in BCAs and, therefore, are considered intrinsic to an issuer's standalone financial strength.

BCAs are expressed on a lower-case alpha-numeric scale that corresponds to the alpha-numeric ratings of the global long-term rating scale.

Extraordinary Support

Extraordinary support is defined as action taken by a supporting government to prevent a default by a regional or local government (RLG) and could take different forms, ranging from a formal guarantee to direct cash infusions to facilitating negotiations with lenders to enhance access to needed financing. Extraordinary support is described as either low (0% - 30%), moderate (31% - 50%), strong (51% - 70%), high (71% - 90%) or very high (91% - 100%).

Rating Factors

Berlin, Land of

Baseline Credit Assessment Scorecard	Score	Value	Sub-factor Weighting	Sub-factor Total	Factor Weighting	Total
Factor 1: Economic Fundamentals						
Economic strength	7	92.20	70%	5.2	20%	1.04
Economic volatility	1		30%			
Factor 2: Institutional Framework						
Legislative background	1		50%	4	20%	0.80
Financial flexibility	7		50%			
Factor 3: Financial Performance and Debt Profile						
Gross operating balance / operating revenues (%)	5	3.54	12.5%	5	30%	1.50
Interest payments / operating revenues (%)	9	9.40	12.5%			
Liquidity	1		25%			
Net direct and indirect debt / operating revenues (%)	9	341.48	25%			
Short-term direct debt / total direct debt (%)	3	13.25	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						4.84(5)
Systemic Risk Assessment						Aaa
Suggested BCA						a1

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on http://www.moodys.com for the most updated credit rating action information and rating history.

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