

CREDIT OPINION

15 February 2019

Update

✓ 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.

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Land of Berlin (Germany)

Update to credit analysis

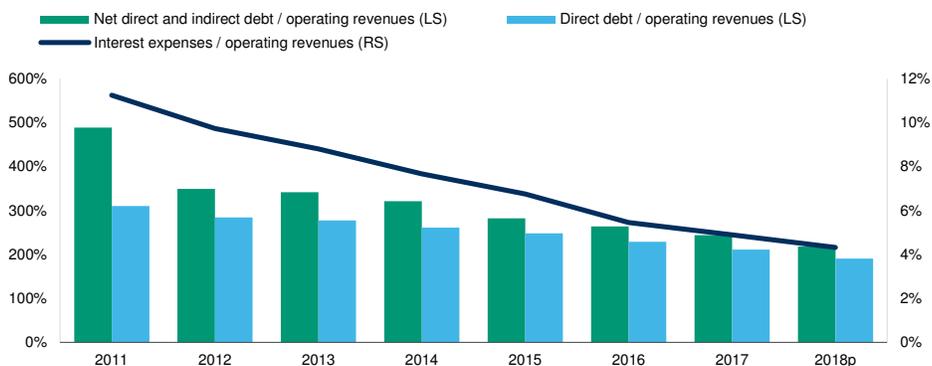
Summary

The credit profile of [Berlin \(Aa1, stable\)](#) reflects its solid financial performance, the good regional economic development, sharply declining debt ratios over the past years and a very high likelihood that the [Government of Germany \(Aaa, stable\)](#) would provide support if the Land were to face acute liquidity stress. Further, the robust legal framework including the high level of financial support from equalisation mechanisms supports the city's rating. These positives are balanced by Berlin's high debt levels and its limited financial flexibility.

Maturing guarantees, tight expenditure control and tax revenue growth, more than halved Berlin's net direct and indirect debt to operating revenues ratio from its peak of almost 500% in 2010 to 218% by year end 2018.

Exhibit 1

Berlin's debt indicators are steadily improving and interest expenses declining



2018 data is provisional (2018p)

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

Credit strengths

- » Solid financial performance with financial surpluses
- » Supportive framework, including strong financial equalisation
- » Strong economic development and favourable demographics

Credit challenges

- » Very high, albeit declining debt levels and high refinancing needs
- » Limited financial flexibility, although mitigated by city state status

Rating outlook

The outlook is stable. This reflects Berlin's continuously growing tax revenues and the stable outlook on Germany's Aaa government bond ratings, given the extremely strong macroeconomic, fiscal and institutional linkages between the sovereign's and the regional governments' credit risk.

Factors that could lead to an upgrade

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

Factors that could lead to a downgrade

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 leading to an increase in its debt levels could trigger a downgrade. Although not expected, any alterations in the fundamental supportive structure of the sector could lead to a negative rating action.

Key indicators

Exhibit 2

Land of Berlin

Berlin, Land	2013	2014	2015	2016	2017	2018p
GDP per capita (EUR)	33,133	34,191	35,594	36,798	38,032	39,421
Intergovernmental revenues /operating revenues (%)	38.4	35.8	35.8	34.0	36.0	32.2
Interest expenses/operating revenues (%)	8.8	7.7	6.8	5.5	4.9	4.3
Gross operating balance/operating revenues (%)	4.3	6.1	7.4	8.5	10.8	12.3
Financing (deficit/surplus)/operating revenues (%)	2.3	3.7	0.9	0.6	3.9	8.5
Net direct and indirect debt/operating revenues (%)	341.5	321.4	282.1	264.0	240.4	218.0
Capital expenses/total expenses (%)	6.1	6.1	9.9	11.1	10.6	7.1

2018 data is provisional (2018p)

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

Detailed credit considerations

The credit profile of Berlin, as expressed in an Aa1 stable rating, combines the baseline credit assessment (BCA) of aa3 for the Land and the very high 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

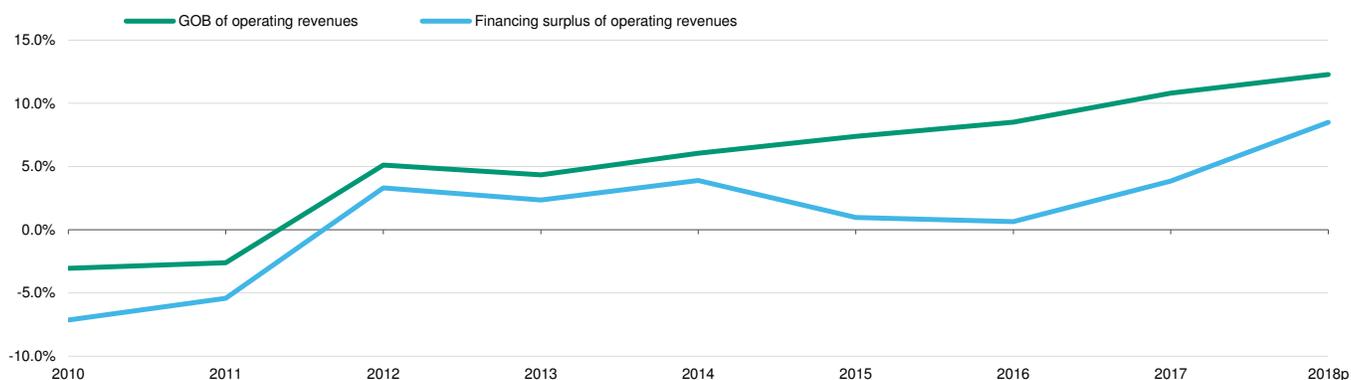
In 2018, Berlin continued to demonstrate its ability to exceed fiscal targets significantly. The Land continued to benefit from higher-than-expected tax revenues and has surpassed its own initial targets for spending control. Consequently, Berlin is well ahead of the requirement for reaching the so-called debt brake mechanism. The city's operating balance has been positive since 2012 and GOB is projected to have reached a very good 12.3% of operating revenues in 2018 and is expected to remain at around double digits over the medium term. This appears realistic, given the latest tax estimate, which project a good albeit slowing tax revenue growth in combination with the city's positive demographic and economic trend.

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Berlin's financial performance remaining in strong surplus for seven years, is a significant improvement compared to decades with a deficit prior to 2012. This development reflects the city's ongoing savings efforts, besides strong tax revenue dynamics and low interest cost. In 2018, the city achieved a financial surplus of 8.5% of total revenues, significantly above recent years' results (see Exhibit 3). For the medium term, the city forecasted financial surpluses in low single digits. We regard this as a realistic, given the currently good, albeit slowing revenue environment. In addition to reported surpluses, the city established reserves, which will provide some flexibility to address investment needs of a growing city.

Over the next three years, key expenditure elements that are likely to exert pressure include higher personnel costs as well as other costs related to cope with city's growing population. Berlin's administration is committed to limiting expenditure growth to around 3% per year over the planning period (2018-2022). 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.

Exhibit 3

Berlin reports surpluses since 2012

2018 data is provisional (2018p)

Source: Issuer, German Ministry of Finance, Moody's Investors Service

SUPPORTIVE FRAMEWORK, INCLUDING STRONG FINANCIAL EQUALISATION

Germany has one of the strongest equalisation systems worldwide, which combines revenue equalisation and investment support from the federal government. This scheme protects all Laender against above-average revenue shortfalls, yet limits their revenue flexibility. The German federal constitution guarantees that Laender receive appropriate levels of funding and prescribes a very high fiscal homogeneity among Laender.

Under the current system, Berlin's annual receipts under the national financial equalisation system amount to around about 20% of its revenue. Due to its special characteristics as a (1) financially weak (2) city state (3) located in former East Germany, Berlin is one of the biggest winners of the current German equalisation system under which city states benefit from special receipts.

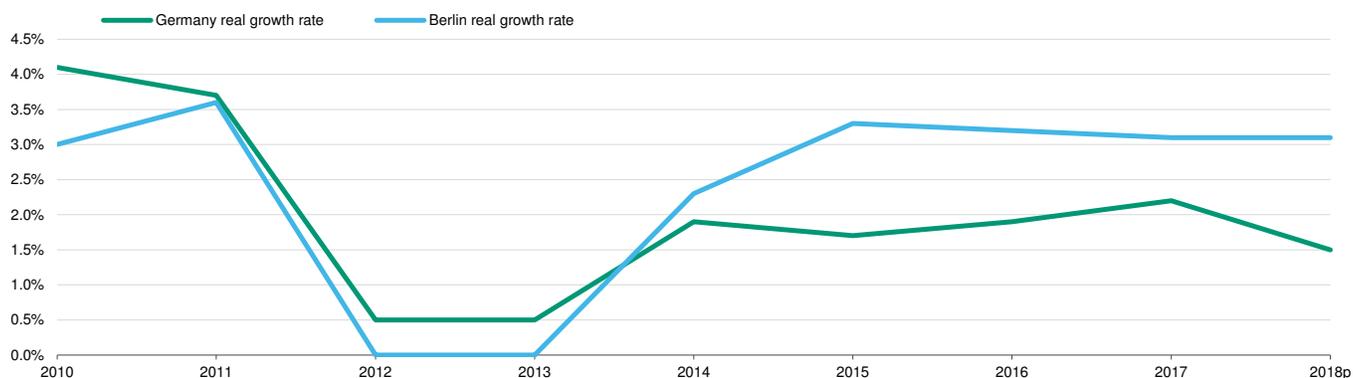
In October 2016, after years of negotiation, the German central government and the sixteen Laender agreed to changes in the German financial equalisation system. As a result, from 2020 onward, the Laender sector will benefit financially from a larger share of total tax revenues (at the expense of the central government). This confirms the Laender's strong position within the federation. The new set of rules will govern the German financial equalisation mechanisms after 2019, when the current system phases out. As a result of these changes, we do not see any significant rating implication for Berlin's credit rating.

Another factor is the so-called "debt-brake mechanism", which was introduced in 2009 to limit future structural financial deficits of the federal government and the Laender. Starting from 2020 onwards Germany's regional governments are not longer allowed to run structural fiscal deficits. In addition to the limit, a stronger joint supervision of Bund and Laender budgets has been implemented. We expect the mechanism to result in a decline of the Laender sectors debt burden (see also: [Fiscal Framework Prompts Sharp Decline in Debt Burden, reduces Political Interference](#), May 2017).

STRONG ECONOMIC DEVELOPMENT AND FAVOURABLE DEMOGRAPHICS

Berlin has posted positive real GDP growth over the last five years and has started to exceed the German average in 2014. In 2017, GDP growth was at 3.1% (following 3.2% in 2016) compared to the German average of 2.2% in 2017 and 1.9% in 2016 (see Exhibit 4). Germany's GDP has grown at 1.5% in 2018, but is expected to grow at a slower rate in 2019. We expect Berlin's economy to continue to outperform the national average growth rates.

Exhibit 4

Berlin's growth rate is above national average

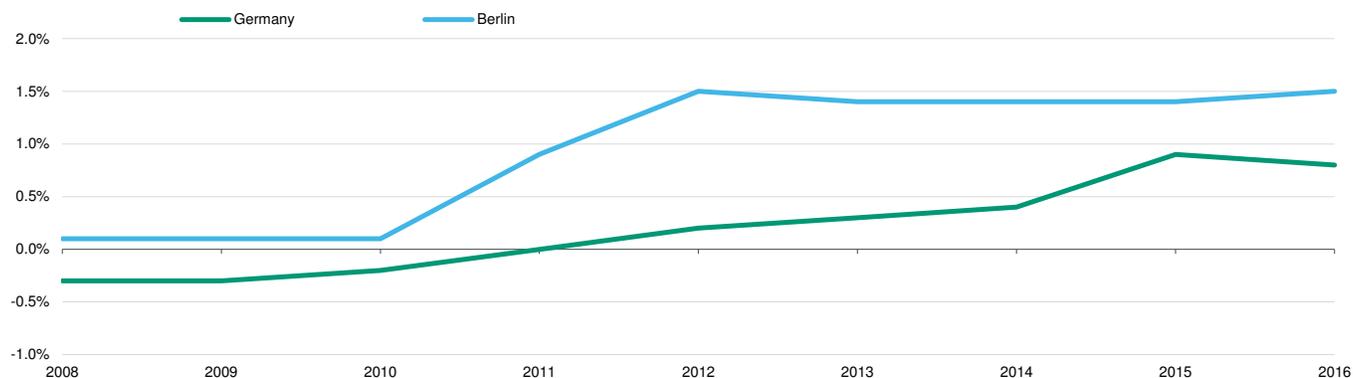
2018 data is provisional (2018p)

Source: German Statistics Office, Moody's Investors Service

The changes in the city's economic structure has become very evident in the past five years and resulted in Berlin's economy being increasingly dynamic. 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 become a leading cultural and touristic location in Europe.

The Land of Berlin, with its 3.7 million inhabitants, is the capital of Germany and its population continues to grow at a faster pace than Germany overall (see Exhibit 5). We expect this trend to continue as the sound economic trajectory and Berlin's strong cultural offering is likely to lead to continuation of domestic and international migration towards the city.

Exhibit 5

Berlin's population is growing at a faster pace than Germany overall
Inhabitants (annual growth rate in %)

Source: German Statistics Office

VERY HIGH, ALBEIT DECLINING DEBT LEVELS AND HIGH REFINANCING NEEDS

Berlin's direct debt, excluding guarantees and company debt, was further reduced to about 190% of operating revenues by the end of 2018 from 211% the year before. This is still 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 high 218% of operating revenues as of 2018, compared to 240% in 2017 (see Exhibit 1).

Until 2021 Berlin's budget plan foresees slight financial surpluses each year, which are intended to be used for debt reduction and building up financial reserves. We believe that a further steady reduction of net direct and indirect debt is achievable and reflects the city's prudent management. In the past two years this target was overachieved by far with the city posting very sizeable financial results of 8.3% of operating revenues in 2018 and 3.7% in 2017.

Any risk from rising interest rates is fairly moderate, as almost all euro-denominated debt is at fixed rates (90%). Debt service was at somewhat below 30% of operating revenues in 2018, significantly lower than more than 50% of operating revenues before 2012. We expect the ratio to decline towards 20% of operating revenues by 2020, following interest savings, slight debt reduction and a trend towards longer-term borrowing that the administration is targeting. We estimate Berlin's interest payments to stand at 4.3% of operating revenues in 2019, a significant decline from more than 10% before 2012.

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 inter-Laender liquidity pool, whereby individual Laender offer their surplus cash to other Laender, and to a (uncommitted) credit facility with a commercial bank to bridge intra-day needs. Despite high refinancing needs Berlin benefits from cheap borrowing costs. 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.

Berlin directly owns and controls around 40 companies, the majority of which are public limited companies, some of them receiving subsidies. Contingent liabilities in the form of financial debt of these companies are moderate. Key companies include six housing companies (including [GEWOBAG Wohnungsbau AG, A1 stable](#)), the public transport company, Berliner Verkehrsbetriebe and the water utility company, Berliner Wasserbetriebe. Overall, most entities are considered self-supporting.

Another possible source of liability is its 37% share of 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 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 unfunded, as is the case for most German Laender, which could negatively affect creditworthiness in the future. We estimate the level of unfunded pension obligations to exceed Berlin's annual revenues. However, Berlin's obligations appear somewhat lower than those of most West German Laender.

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 savings flexibility appears limited. A lot of standards are set at national level and cannot be adjusted at the city's discretion.

Extraordinary Support Considerations

We consider a very high likelihood of extraordinary support for Berlin from the Federal Government of Germany (Aaa, stable) reflecting our 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.

Rating methodology and scorecard factors

The assigned baseline credit assessment (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 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 for Germany (Aaa, stable).

For details about our rating approach, please refer to [Rating Methodology: Regional and Local Governments, 16 Jan 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		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	11.33	12.5%	3.5	30%	1.05
Interest payments / operating revenues (%)	5	4.64	12.5%			
Liquidity	1		25%			
Net direct and indirect debt / operating revenues (%)	9	218.02	25%			
Short-term direct debt / total direct debt (%)	1		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

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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

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