



RATING ACTION COMMENTARY

**Fitch Affirms
Municipality of
San Pedro's LC IDR
at 'BBB-' and Nat'l
L-T Rating at
'AAA(mex)'**

Mon 28 Sep, 2020 - 17:01 ET

Fitch Ratings - Monterrey - 28 Sep 2020: Fitch Ratings has affirmed the Long-Term Local Currency Issuer Default Rating (IDR) at 'BBB-' and the National Long-Term Rating at 'AAA(mex)' of the Municipality of San Pedro Garza Garcia, Nuevo Leon. The Rating Outlook is Stable. The municipality's Stand-alone Credit Profile (SCP) 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 affirmation reflects Fitch's unchanged expectations that the Municipality of San Pedro, Garza Garcia will maintain a strong operating performance and low debt metrics with a payback ratio expected to remain negative (higher unrestricted cash than financial obligations) and debt service coverage ratios higher than 14x, as expected in the previous review. The municipality's rating reflects the combination of a 'Midrange' risk profile and an 'aaa' debt sustainability under Fitch's rating case scenario.

While San Pedro's most recently available data may not have indicated performance impairment, material changes in the government's debt, revenue and expenditures are occurring across the sector and are

likely to worsen in the near future as economic activity suffers and government restrictions are maintained or broadened. Fitch's ratings are forward-looking in nature, and the agency will monitor the pandemic's severity and duration on the sector, and incorporate revised base- and rating-case qualitative and quantitative inputs based on performance expectations and assessment of key risks.

KEY RATING DRIVERS

Risk Profile: Midrange

'Midrange' risk profile reflects the six risk factors assessed as midrange: revenue robustness and adjustability, expenditure sustainability and adjustability, liabilities and liquidity robustness and flexibility. The municipality's 'Midrange' risk profile reflects less dependence on transfers from the sovereign compared to the rest of the municipalities in Mexico, adequate capacity to adjust revenues in the case of an economic downturn due to the very high affordability of its population, favorable control over operational expenditure, which grows at a slower pace than

operating revenue, and very low debt levels and high liquidity available under various forms, notably unrestricted cash.

Revenue Robustness: Midrange

The municipality of San Pedro has an operational revenue growth highly above national GDP growth. The deflated five-year CAGR15-19 of San Pedro's operating revenue was 9.2% compared to 1.7% of national GDP growth. It also has a stable revenue source mostly based on proprietary revenues since tax collection represented 42.3% of operating revenues in 2019. High valued properties in San Pedro and collection efficiency explain the property tax collection. Even though operational transfer dependence is much lower than other subnationals in Mexico; the municipality receives slightly less than half of its operating revenue from federal transfers which come from a counterparty rated 'BBB-' by Fitch. 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.

Given the current sanitary contingency, Fitch estimates that San Pedro's local revenues might fall in 2020, mainly the acquisition of property tax. However, Fitch expects a faster recovery in subsequent years compared to other municipalities in Mexico due to the municipality's economic strength. Federal transfers (Fondo General de Participaciones, FGP) are also expected to decline in 2020, but it is expected to be compensated by the FEIEF (Fondo de Estabilización de los Ingresos de las Entidades Federativas), which is a stabilization fund created for offsetting shortfalls in the FGP's budget. For 2021, the FGP is estimated to keep this negative trend and there is still uncertainty if the federal government would be able to support the subnationals to compensate this shortfall.

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 its 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, operational expenditure has been increasing in a much lesser pace than operating revenues.

San Pedro carries out social security, public lighting, waste collection and road maintenance. Operational expenditure has increased at a much lower pace than revenues, explained by strict expenditure policies and also modest growing population. The deflated five-year CAGR15-19 of operating expenditure was 2.3% compared to 9.2% of operating revenue. The latter has led to very high and stable operating margins, averaging 32.4% in the last five years.

Expenditure Adjustability: Midrange

San Pedro has above average expenditure adjustability as the current level of capex totaled 22% of total expenditure on average in the last three years, and could be discretionarily adjusted or subject to reductions in case of financial stress. It is important to mention that this key rating factor (KRF) could be assessed as 'Weaker' if capex to total expenditure diminishes below 17.5% on average over the last three years of the reviewed period of analysis. Also, staff expenditure represented a moderate 43% of total expenditure in 2019, and its growth has been controlled.

Given the expected decline on revenue derived from the coronavirus contingency, the municipality is applying strict expenditure policies; additionally, there are some savings given that all the events have been canceled. The entity expects to be able to decrease operating expenditure in the same amount as operating revenue to keep adequate balances in 2020, without affecting their capex program. However, a decrease in capex could occur in 2021 as a measure of financial stress.

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.

Given its sound tax revenue more than budgeted, the entity prepaid its debt in full in 2018. The only outstanding financial debt is a PPP that totaled MXN53 million in 2019 which is considered as other fitch classified debt, with an unrestricted cash of MXN1,693 million, derives to a net overall negative debt of -MXN1,640 million.

Liabilities and Liquidity Flexibility: Midrange

Mexican framework provides no emergency liquidity support from upper tiers. Therefore, this 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. This ratio averaged 8.1x in 2017-2019 in San Pedro. 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'

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 2024; this is higher unrestricted cash than financial obligations. The secondary metrics are the debt service coverage ratio (ADSCR), which is favorable and assessed higher than 14x, and the fiscal debt burden, also evaluated to remain negative due its high levels of cash and low expected debt.

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. Nuevo Leon is highly industrialized and has a total population of 5.31 million inhabitants, of which 94.7%

are urban inhabitants. Within the highly industrialized context of Nuevo Leon, San Pedro's economic structure is based on services and real estate sectors. Several national corporate headquarters are based in this municipality. Relative to national peers and in the Latin American context, San Pedro has the highest income per capita; a low level of poverty; ample access to basic needs; an adequate level of formal employment; and a moderate population growth, which translates into lower urban services pressures. San Pedro's main economic and insecurity ratios compare favorably relative to national peers. Fitch classifies San Pedro (and all Mexican LRGs) as type B since it covers debt service from its cash flow on an annual basis.

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 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 2015-2019 figures and 2020-2024 projected ratios.

The key assumptions for the scenario include:

--Operating revenue: CAGR of 6.9% from 2020 to 2024;

--Operating expenditure: CAGR of 15.1% from 2020 to 2024;

--Additional short-term debt is not considered;

--The possibility of additional long-term debt is considered including up to MXN400 million, according to the 15% of its non-earmarked revenue allowed under Mexican Law; ;

--Floating Interest rate (known as TIIE 28) of 5.0% in 2020 and 7.1% in 2024.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to a 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 a 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;

--A prolonged pandemic impact and a much slower economic recovery lasting until 2025 would pressure municipality tax receipts. If San Pedro is unable to proactively reduce expenditure or complement weaker receipts from increased central government transfers, could lead to a downgrade.

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>].

SUMMARY OF FINANCIAL ADJUSTMENTS

The only outstanding financial debt is a PPP that totaled MXN53 million in 2019 which is considered as Other Fitch Classified Debt, with an unrestricted cash of MXN1,693 million, and derives to a net overall negative debt of -MXN1,640 million.

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.

ESG CONSIDERATIONS

The highest level of ESG credit relevance, if present, is a score of 3. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity(ies), either due to their nature or to the way in which they are being managed by the entity(ies). For more information on Fitch's ESG Relevance Scores, visit

www.fitchratings.com/esg.

RATING ACTIONS

ENTITY/DEBT RATING

San Pedro LC BBB- Rating Outlook Stable

Garza Garcia LT

NL, Municipio
de IDR

● Natl AAA(mex) Rating Outlook Stal
LT

[VIEW ADDITIONAL RATING DETAILS](#)

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APPLICABLE CRITERIA

[Metodología de Calificación de Gobiernos Locales y Regionales Internacionales \(pub. 27 Sep 2019\)](#)

[Metodología de Calificaciones en Escala Nacional \(pub. 08 Jun 2020\)](#)

[International Local and Regional Governments Rating Criteria - Effective from 11 September 2020 to 27 October 2020 \(pub. 11 Sep 2020\) \(including rating assumption sensitivity\)](#)

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San Pedro Garza Garcia NL, Municipio de

EU Endorsed

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International Public Finance

Supranationals, Subnationals, and Agencies

Latin America Mexico
