Research Update:

Swiss City of Lausanne Upgraded To 'AA-' On Improved Liquidity Position And Robust Budgetary Performance; Outlook Stable

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Overview

- We expect the City of Lausanne's prudent financial management and tight grip on operating spending will preserve its strong budgetary performance despite inflationary pressures and elevated capital spending needs.
- Lausanne will benefit from a higher debt service coverage ratio due to a decline in long-term debt repayments in the coming years and persistent access to ample liquidity lines with two Swiss cantonal banks.
- We therefore raised our long-term issuer credit rating on Lausanne to 'AA-' from 'A+'.
- The outlook is stable.

Rating Action

On June 2, 2023, S&P Global Ratings raised its foreign and local currency long-term issuer credit ratings on the Swiss City of Lausanne to 'AA-' from 'A+'. The outlook is stable.

We also raised our issue rating on Lausanne's senior unsecured debt to 'AA-' from 'A+'.

Outlook

The stable outlook reflects our view that solid economic performance and prudent financial management will continue to support Lausanne's budgetary performance, with the city posting only limited deficits after capital accounts. Lower debt service levels will also support the city's liquidity position.

Downside scenario

We could lower the ratings on Lausanne in case of a significant deterioration in budgetary performance, with after-capital deficits persistently exceeding 5% of total revenue. This could, for example, occur due to looser controls on operating expenditure (opex) or much higher than expected capital expenditure (capex). We could also lower the ratings in case of a substantial increase in the risk of contingent liabilities materializing, or in the city's debt service coverage ratio.

Upside scenario

We could raise the ratings on Lausanne if fiscal risks stemming from unfunded pension liabilities continue to moderate or if the city's tax-supported debt burden declines to below 120% of consolidated operating revenue. That could come about, for example, if higher-than-expected tax revenue growth and more prudent financial policies bolster the city's budgetary performance.

Rationale

The upgrade reflects our expectation of Lausanne's continuously strong budgetary performance and improvements in its liquidity position.

We expect that Lausanne's budgetary performance will stay strong over our rating horizon to 2025. The city's tight grip on spending will allow it to mitigate pressures from high inflation and energy prices. The municipal government's sizeable investment plan, which includes acquisitions of residential properties as part of an affordable housing policy, should also give rise to only limited net borrowing needs, in our view.

Moreover, the city's liquidity position should continue to improve over our rating horizon, since its long-term debt service schedule for 2024 and 2025 only includes one Swiss franc (CHF) 100 million bond amortization, whereas it repaid CHF400 million of bank loans and bonds in 2022 and 2023. We also expect Lausanne will reduce its reliance on short-term debt in the next two years, while keeping large undrawn amounts on its three credit lines with the Banque Cantonale Vaudoise (BCV; AA/Stable/A-1+) and the Basellandschaftliche Kantonalbank (BLKB; AA+/Stable/A-1+).

Lausanne's dynamic economy and the supportive institutional framework for municipalities in the Canton of Vaud (AAA/Stable/--) remain key credit strengths. The recent agreement between the canton and the municipal sector on equalization reforms should have a net positive, if modest, effect on Lausanne's finances. Nevertheless, Lausanne's debt burden, at over 140% of operating revenue, remains elevated in a national and international context.

A resilient economy and supportive institutions underpin the ratings

We expect that global economic headwinds and monetary tightening will slow Swiss GDP growth to about 0.6% in 2023 from 2.1% in 2022, while also muting economic dynamism at the local level. The city's still-elevated inflation by Swiss standards (2.5% in 2023) should dent domestic consumption, with increasing interest rates also slowing real estate activity. Nevertheless, labor market trends remain robust in Lausanne, where the unemployment rate (4.4% at year-end 2022) is below pre-pandemic levels. We expect that economic growth will accelerate in 2024-2025 to average 1.5%. Overall, we view the city's economy as well diversified, with strong health and education sectors, representing nearly 25% of jobs.

In our view, Lausanne's management will maintain a tight grip on spending despite inflationary pressures, thanks to conservative budget planning and close monitoring. The socialist/green municipal majority, which won reelection in 2021, introduced CHF20 million of new spending in its 2021-2026 term program, but also pledged to offset this through a package of savings and new revenue sources. The authorities successfully implemented similar programs during the two previous municipal terms. We also consider Lausanne's debt and liquidity management prudent.

We continue to assess the institutional framework for municipalities in the Canton of Vaud as predictable and well-balanced. Thanks to shared taxes with the canton, the city has a good ability to match expenditure with revenue, although tax cuts decided at the cantonal level can have a knock-on effect on municipal tax outturns. In March 2023, the canton and the organizations representing communes agreed to launch a reform of the municipal equalization system, making it more transparent while maintaining its redistributive characteristics. The canton also agreed to assume a larger share of the increase in social spending from 2026, superseding a previous agreement. In the medium term, this should largely shelter municipal finances from additional expenditure linked to demographic ageing.

Budgetary discipline and robust tax outturns will help Lausanne mitigate pressures on operating performance

In our view, the city's strong economic and labor market performance should support tax receipts in 2023-2025 (up 1.9% per year on average), albeit at a slower rate than in 2020-2022 (3.6%). In previous years, Lausanne's corporate income tax collection was enhanced by one-off payments, while volatile tax items such as succession duties came in higher than the historical average. We do not incorporate any such windfall in our scenario over the forecast period to 2025.

We expect that high inflation by Swiss standards and elevated, albeit declining, energy prices will have an important effect on Lausanne's spending in 2023, before abating in 2024-2025. The city's wage bill will be fully indexed to inflation in 2023, adding about CHF20 million to personnel costs. The same drivers also affect the operating costs of entities that Lausanne subsidizes, chiefly public transportation company Transports Lausannois (TL). The city's 2023 budget includes nearly CHF20 million in additional transfers to TL, although this sum also reflects efforts to increase frequency on some routes. Part of this spending should be compensated by the canton and surrounding municipalities also covered by TL services. We also believe the city will successfully implement the cost-cutting and revenue-raising measures envisaged for the rest of the municipal term, considering its track record. The equalization reform should allow Lausanne to pay less toward cantonal police expenditure starting next year.

In sum, we forecast that Lausanne's operating balance will normalize over our rating horizon compared to the 2021-2022 period. We expect operating surpluses will average 8.6% of operating revenue in 2023-2025, down from close to 10% in 2021-2022. These still robust levels will help Lausanne fund part of its sizeable investment plan, in our view. We expect the city will spend nearly CHF200 million a year in 2023-2025--CHF145 million, net of federal and cantonal capital grants--on a variety of projects, including a new tramway line, water and electricity networks, as well as major urban planning operations in the north and west of the city center. Lausanne also uses its preemption right to acquire residential properties, with a view to maintaining the supply of affordable housing in strained areas. The city then carries out operations to improve energy efficiency and roll out district heating, and gradually sells the buildings to social housing operators. We forecast that such acquisitions and related investments will average about CHF60 million a year in 2023-2025. We also expect that sales will be exceptionally high next year, since the city plans to sell 11 properties that it purchased in 2022. This should considerably boost capital revenue in 2024.

Our assessment of Lausanne's fiscal risks also reflects the unfunded liabilities of the city's pension plan CPCL. At about 73% in 2022--up from 40% in 2008, before the two rounds of recapitalization in 2009 and 2012--CPCL's funding ratio remains consistent with the path set by federal legislation. However, the ratio could erode in the next few years in case of poor portfolio performance, which could prompt Lausanne to recapitalize the plan again.

Overall, Lausanne's operating and investment activities should only generate modest net borrowing needs, averaging 0.75% of total revenue in 2023-2025. As a result, we project that the city's tax-supported debt will increase moderately in nominal terms, but decline somewhat as a share of operating revenue, reaching about 143% in 2025 from 149% at year-end 2022. The city's continued ability to access long-term debt financing at comparatively favorable rates will also help curtail increases in average financing costs. It already issued a CHF100 million bond in 2023, at a 2.1% interest rate and with a 25-year maturity.

We believe that Lausanne's contingent liabilities, which represent about 40% of the city's operating revenue and are mostly composed of loan guarantees, only pose limited realization risks. Indeed, about one-third of the loans that Lausanne guarantees are also mortgage-backed. Other entities that benefit from sizeable city guarantees--such as EPURA SA, the company operating Lausanne's water-treatment plant--are also self-supporting.

Lausanne's debt service coverage ratio will continue to improve. The city only faces a CHF100 million long-term debt amortization in 2024, compared with CHF200 million per year in 2022 and 2023. We still expect it to retain CHF275 million available under three undrawn liquidity facilities with the BLKB and the BCV, which represent more than 40% of debt service (including short-term debt repayments) in the next 12 months. The city also plans to replace part of its short-term debt stock with long-term borrowing later this year, which would curb rollover risks and further strengthen the debt service coverage ratio. Regardless, Lausanne's internal liquidity coverage will continue to be supplemented by its strong access to external liquidity, which we expect it will maintain even in times of financial stress.

Key Statistics

Table 1

Lausanne (City of) Selected Indicators

	2020	2021	2022	2023bc	2024bc	2025bc
Operating revenues	1,644	1,689	1,793	1,864	1,883	1,903
Operating expenditures	1,481	1,523	1,612	1,706	1,720	1,737
Operating balance	162	166	181	158	163	166
Operating balance (% of operating revenues)	9.9	9.9	10.1	8.5	8.7	8.7
Capital revenues	31	26	32	58	139	50
Capital expenditures	194	212	278	246	270	260
Balance after capital accounts	(0)	(20)	(65)	(31)	32	(44)
Balance after capital accounts (% of total revenues)	(0.0)	(1.2)	(3.6)	(1.6)	1.6	(2.2)
Debt repaid	210	100	200	369	170	0
Gross borrowings	172	102	300	400	138	44
Balance after borrowings	(39)	(17)	34	0	(0)	0

Table 1

Lausanne (City of) Selected Indicators (cont.)

	2020	2021	2022	2023bc	2024bc	2025bc
Direct debt (outstanding at year-end)	2,540	2,543	2,642	2,673	2,641	2,684
Direct debt (% of operating revenues)	154.6	150.5	147.3	143.4	140.2	141.1
Tax-supported debt (outstanding at year-end)	2,572	2,572	2,673	2,703	2,671	2,714
Tax-supported debt (% of consolidated operating revenues)	156.5	152.3	149.0	145.1	141.8	142.7
Interest (% of operating revenues)	2.8	2.4	2.1	2.2	2.3	2.3
Local GDP per capita (single units)	71,967	74,283	75,784	76,908	77,895	78,881
National GDP per capita (single units)	80,120	83,726	87,552	89,215	90,554	91,911

The data and ratios above result in part from S&P Global Ratings' own calculations, drawing on national as well as international sources, reflecting S&P Global Ratings' independent view on the timeliness, coverage, accuracy, credibility, and usability of available information. The main sources are the financial statements and budgets, as provided by the issuer. bc--Base case reflects S&P Global Ratings' expectations of the most likely scenario. N/A--Not applicable. N.A.--Not available. N.M.--Not meaningful.

Ratings Score snapshot

Table 2

Lausanne (City of) Ratings Score Snapshot

Key rating factors	Scores
Institutional framework	2
Economy	1
Financial management	2
Budgetary performance	3
Liquidity	2
Debt burden	4
Stand-alone credit profile	aa-
Issuer credit rating	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.

Key Sovereign Statistics

- Sovereign Risk Indicators, April 10, 2023. An interactive version is available at https://disclosure.spglobal.com/sri/

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: Principles Of Credit Ratings , Feb. 16, 2011

Related Research

- Economic Outlook Eurozone Q2 2023: Rate Rises Weigh On Return To Growth, March 27, 2023
- Switzerland, Feb. 13, 2023
- Swiss Canton of Vaud ‘AAA’ Rating Affirmed; Outlook Stable, Nov. 25, 2022

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

Upgraded

	To	From
Lausanne (City of)		
Issuer Credit Rating	AA-/Stable/--	A+/Positive/--
Senior Unsecured	AA-	A+

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.standardandpoors.com for further information. A description of each of

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