

CREDIT OPINION

19 March 2020

Update

✓ Rate this Research

RATINGS

Yokohama, City of

Domicile	Japan
Long Term Rating	A1
Type	LT Issuer Rating - Fgn Curr
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

Hiroe Yamamoto +81.3.5408.4175
 Analyst
 Moody's Japan K.K.
 hiroe.yamamoto@moodys.com

Mihoko Manabe, CFA +81.3.5408.4033
 Associate Managing Director
 Moody's Japan K.K.
 mihoko.manabe@moodys.com

» *Contacts continued on last page*

CLIENT SERVICES

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

City of Yokohama (Japan)

Update following rating affirmation

Summary

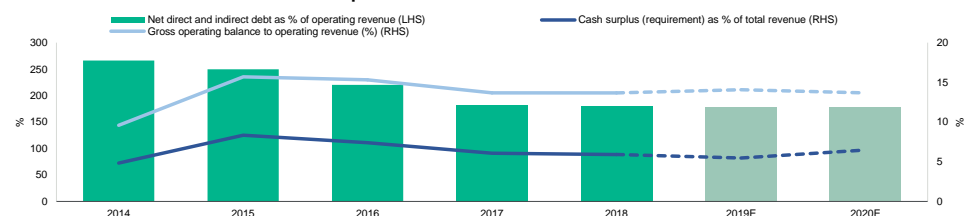
The [City of Yokohama's](#) A1 rating is at the same level as that of the [Government of Japan](#) (A1 stable), reflecting our view that the central government's rating and those of the regional and local governments (RLGs) in Japan should be the same, given their close links.

The considerable level of oversight and supervision exercised by the central government, as well as the well-developed equalization system of transfers through the local allocation tax (LAT) system, ensures that credit issues at the RLG level are identified and addressed early. We also assess that there is a very high likelihood that the Japanese government would step in to provide immediate assistance.

Yokohama's rating also reflects the city's favorable fiscal performance and prudent management practices, as well as its economy, which is weaker than the national average, and higher leverage because of its infrastructure development responsibility.

Exhibit 1

Yokohama maintains a solid fiscal performance



Fiscal year starting from April and ending in March of the following year. Our estimate for fiscal 2019-20.

Source: Moody's Investors Service

Credit strengths

- » Strong institutional framework is supported by its close relationship with the central government
- » Stable revenue supports favorable fiscal performance
- » Prudent management practices control expenditure

Credit challenges

- » Local economy is weaker than the national average
- » The responsibility for infrastructure development has elevated Yokohama's debt burden

Rating outlook

The rating outlook is stable, reflecting the outlook on Japan's sovereign rating.

Factors that could lead to an upgrade

An upgrade of the sovereign rating would lead to an upgrade of Yokohama's rating.

Factors that could lead to a downgrade

A downgrade of the sovereign rating would lead to a downgrade of Yokohama's rating. Furthermore, any policy changes that would materially weaken the highly centralized system or the level of oversight provided by the central government could trigger downward pressure on the rating.

Key indicators

Exhibit 2

Yokohama City	FY2014	FY2015	FY2016	FY2017	FY2018[1]
Net Direct and Indirect Debt / Operating Revenues (%)	266.3	249.8	220.1	182.0	180.6
Interest Payments / Operating Revenues (%)	3.3	2.9	2.7	2.2	2.1
Gross Operating Balance / Operating Revenues (%)	9.6	15.7	15.3	13.7	13.7
Cash Financing Surplus (Requirement) / Total Revenues (%)	4.8	8.3	7.4	6.1	5.9
Capital Spending / Total Expenditures (%)	11.9	14.0	14.7	14.1	14.9
Unemployment Rate (%) [2]	3.4	3.3	3.1	2.7	2.3
Population ('000s)	3,727	3,734	3,737	3,740	3,749

[1] Fiscal 2018 begins on 1 April 2018 and ends on 31 March 2019. [2] Kanagawa Prefecture.

Source: Moody's Investors Service

Detailed credit considerations

Yokohama's A1 rating combines (1) its Baseline Credit Assessment (BCA) of a3, and (2) the very high likelihood of extraordinary support from the central government in the event that the entity faces acute liquidity stress.

Baseline Credit Assessment

Strong institutional framework is supported by the close relationship with the central government

RLGs in Japan benefit from a highly developed, predictable and stable institutional framework. This protective arrangement contributes notably to their credit strength through the central government's oversight of RLG performance and provision of fiscal transfers that reduce fiscal disparities.

Under the New Revival Law, passed in 2007, RLGs' fiscal operations are overseen by the central government, which uses various fiscal indicators to monitor their performance. If an entity's indicators exceed defined thresholds, it is identified as either an early correcting entity or a revival entity and must then carry out plans to improve its fiscal situation.

We believe that this law, which covers a wide range of RLGs activities, reflects the central government's strong resolve to reduce the risk of a financial crisis at the local level and bolster the local sector's credit risk profile.

Japanese RLGs have limited flexibility in terms of own-source revenue. The country's Local Tax Law determines the tax base available to RLGs and limits the range of permitted tax rates. For each major local tax, RLGs may apply the standard rate or a higher rate, up to a prescribed maximum. Depending on the tax, the maximum rate is typically 10%, or 50% higher than the standard rate, although in some cases (for example, the inhabitants tax on individuals and property tax) there is no legal maximum. While an RLG may impose a tax not specified in the Local Tax Law, the Minister of Internal Affairs and Communications (MIC) must first approve it.

Because of insufficiency in the central government's tax revenue, which is used to fund LAT, the central government has allocated specific amounts of rinzai-sai debt (an operating debt approved by MIC) that are to be issued by the RLGs in place of LAT cash transfers

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from the central government. The larger RLGs, in particular, have been apportioned larger rinzai-sai amounts because the market access of the smaller RLGs is more limited.

The cost of rinzai-sai debt servicing is included in each RLG's future LAT transfers. However, because the central government has seen shortfalls in those sources that fund LAT, we are monitoring the sustainability of the LAT transfer model, including the debt-servicing costs for rinzai-sai.

Yokohama's stable revenue supports favorable fiscal performance

Yokohama's financial performance is favorable, as illustrated by its consistent operating margin (gross operating balance as a percentage of operating revenue) of 13%-15% over the past several years, with the exception of a slightly lower operating margin (of 9.6%) in the fiscal year ended 31 March 2015 (fiscal 2014) because of a one-time accounting change that hurt revenue. We expect the city to maintain its high operating margin, supported by the city's fiscal discipline as well as its stable tax revenue.

Yokohama benefits from stable trends in revenue, supported by its tax revenue. Yokohama's tax revenue is less volatile than that of the country's prefectures and other large cities, given the city's higher share of residential tax and property tax revenue, and lower reliance on more volatile sources of tax revenue related to corporate businesses.

The largest component of its operating expenditure in core government activities (general account) is the social welfare cost which continues to increase moderately, similar to other RLGs because of the increase in child care costs. Personnel expenditures have been around ¥350 billion since fiscal 2017 compared with ¥190 billion-¥200 billion until fiscal 2016. This is because designated cities have their responsibilities of paying the salaries of public school teachers transferred from the prefectures, along with the transfer of the appropriate amount of revenue.

Some new infrastructure projects have been carried forward by the city, such as the ringed networks (Yokohama Ringed Northwest Line) in view of the Tokyo 2020 Summer Olympic Games, which are close to completion. The city's capital spending will reach its peak in fiscal 2019, a 2.2% increase from the previous year. The city's disciplined financial policies allowed it to post consecutive cash surplus despite such pressures. We expect the cash surplus to improve moderately to 6% level in fiscal 2020 of its total revenue from 5% levels in fiscals 2018-19, after reaching the peak in capital spending.

Disciplined financial policies contain spending

Yokohama has an excellent track record of fiscal discipline, controlling both operating and capital spending through strong internal controls and planning, which helps it better contain its spending through the cycles. The city has focused its fiscal strategy on containing spending because of its relatively lower level of tax revenue from the business sector than other RLGs. In some other jurisdictions, faster tax revenue growth tended to accelerate expenditure growth, which could not be easily curbed when tax revenue growth declined.

Yokohama has clear and prudent debt management and investment policies, as well as guidelines to ensure that the city minimizes its exposure to investments and debt structures, which pose financial risks. The city also provides high-quality information, thereby ensuring transparency, timely delivery and accuracy of disclosures. In addition, the city's audit process is in line with the national legal framework.

The local economy is weaker than the national average

Yokohama is a residential suburb for the Tokyo Metropolitan Area, with many of its 3.75 million residents (as of March 2019) commuting to jobs in central business districts. The relatively lower level of commercial and manufacturing activities located in Yokohama, along with its large population, results in the city's relatively low GDP per capita of 85% of the national average.

However, this measure of economic performance understates the city's economic importance because the city benefits from a stable, well-diversified service base and higher-income households. We expect the city to continue to have a broader and more stable tax base (the high market value of taxable properties to support its property taxes) than other municipalities in Japan.

The responsibility for infrastructure development elevates the debt burden

Yokohama's debt burden ratio (measured by net direct and indirect debt/operating revenue) is relatively high, amounting to 180.6% in fiscal 2018, although improved from 266.3% in fiscal 2014, largely because of a decline in its indirect debt. We expect the ratio will remain around upper 170% levels in the coming 1-2 years. Like other designated cities in Japan, Yokohama's debt profile reflects the

cost of infrastructure operations, such as water, sewage, mass transport, roads, ports and land redevelopment projects. The city relies on significant levels of debt financing to provide the required facilities to a rapidly increasing number of households.

Yokohama's debt levels have been falling since the peak at ¥5,028.2 billion in fiscal 2003 to ¥4,128 billion in fiscal 2018. Given the current recovery in capital spending, the city's debt will increase slightly to ¥4,185 billion by fiscal 2019. However, we do not expect the city to reverse its debt reduction because it continues to control capital spending. Also, the city plans to control the new debt issuance to around ¥590 billion for the four years of its medium-term plan (fiscal 2018-21).

We expect Yokohama's debt to decrease faster if its infrastructure projects operate more efficiently and are able to generate higher revenue. Yokohama will also have to prepare for additional maintenance expenses, which may need to be funded by debt, resulting in the city's debt burden taking longer to improve.

In 2019, Yokohama officially announced its candidacy to host the casino-featuring integrated resort (IR), a central government initiative. If selected expected during fiscal 2021, hosting IR will generate new employment opportunities and boost tourism activities, which will support Yokohama's economy. Meanwhile, although it is premature to estimate the impact, the city may need to develop infrastructure such as transport infrastructure in view of the IR developments, which could increase its capital spending.

Yokohama has strong liquidity, with sufficient financial assets to cover debt service for fiscal 2020. In addition, the city has short-term bank facilities that can cover its annual debt service. The city's debt repayment fund (totaling an expected ¥134.1 billion for March 2020) will be sufficient to cover debt servicing in its general account, including principal payments of ¥88.2 billion (excluding fund contributions) and interest of ¥25.9 billion, as planned for fiscal 2020. The city continues to have strong access to the domestic capital markets, which we view as deep and mature. The city does not issue foreign-currency debt.

ESG considerations

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

We take into account the impact of ESG factors when assessing sub-sovereign issuers' economic and financial strength. In the case of Yokohama, we assess the materiality of ESG to the credit profile as follows:

Environmental risks are not material to Yokohama's rating, given its strong links with the central government. Although the country's exposure to natural disasters have required large reconstruction and disaster prevention expenditures, the financial burden is mitigated by the central government's strong support.

Social risks are not material to Yokohama's rating, given its strong links with the central government. Although it is exposed to demographic risks, a nationwide phenomena of ageing and low birthrate, which is straining social welfare expenditure, the risks are mitigated by the equalization system.

Governance risks are material to Yokohama's rating, but are mitigated by its strong links with the central government. Its governance is sound, with prudent management policies.

Further details are provided in the "Baseline Credit Assessment" section. Our approach to ESG factors is explained in our cross-sector rating methodology [General Principles for Assessing Environmental, Social and Governance Risks](#).

Extraordinary support considerations

We assume a very high likelihood of extraordinary support for the city from the national government, reflecting our assessment of Japan's highly centralized system of local government, as well as the country's unique history of risk socialization.

Rating methodology and scorecard factors

The assigned BCA of a3 is the same as the scorecard-indicated BCA of a3.

The scorecard-indicated BCA of a3 reflects (1) an Idiosyncratic Risk score of 3 on a scale of 1-9, where 1 represents the strongest relative credit quality and 9 represents the weakest; and (2) a Systemic Risk score of A1, as reflected by the sovereign bond rating for Japan.

Exhibit 3

City of Yokohama, fiscal 2018
 Regional and Local Governments

Baseline Credit Assessment	Score	Value	Sub-factor Weighting	Sub-factor Total	Factor Weighting	Total
Scorecard						
Factor 1: Economic Fundamentals						
Economic strength	7	85.00	70%	5.2	20%	1.04
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 revenue (%)	1	13.93	12.5%	2.75	30%	0.83
Interest payments / operating revenue (%)	3	2.21	12.5%			
Liquidity	1		25%			
Net direct and indirect debt / operating revenue (%)	7	180.60	25%			
Short-term direct debt / total direct debt (%)	1	9.20	25%			
Factor 4: Governance and Management - MAX						
Risk controls and financial management	1			1	30%	0.30
Investment and debt management	1					
Transparency and disclosure	1					
Idiosyncratic Risk Assessment						2.77(3)
Systemic Risk Assessment						A1
Suggested BCA						a3

Source: Moody's Investors Service

Ratings

Exhibit 4

Category	Moody's Rating
YOKOHAMA, CITY OF	
Outlook	Stable
Issuer Rating	A1
Senior Unsecured -Dom Curr	A1

Source: Moody's Investors Service

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Analyst Contacts

Ryota Nagasawa +81.3.5408.4184
Associate Analyst Moody's Japan K.K.
ryota.nagasawa@moody's.com

CLIENT SERVICES

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