



Credit Rating Announcement

GCR upgrades Lagos State Government's national scale long term and short term Issuer ratings to AA_{-(NG)} / A1_{+(NG)}, Stable Outlook.

Rating Action

Lagos, Nigeria, 31 August 2022 – GCR Ratings ("GCR") has upgraded the national scale long term and short term Issuer ratings of Lagos State Government to AA_{-(NG)} and A1_{+(NG)} respectively. Concurrently, GCR has upgraded the national scale long term Issue ratings of Lagos State Government's Programme 3 Series 2 (Tranches II & IV), Series 3 and Series IV Senior Unsecured Bond Issuances to AA_{-(NG)} each. The Outlook on the ratings is Stable.

Rated Entity / Issue	Rating class	Rating scale	Rating	Outlook
Lagos State Government of Nigeria	Long Term Issuer Short Term Issuer	National National	AA _{-(NG)} A1 _{+(NG)}	Stable
Senior Unsecured P3S2 T II N38.8bn Bonds	Long Term Issue	National	AA _{-(NG)}	Stable
Senior Unsecured P3S2 T IV N5.3bn Bonds	Long Term Issue	National	AA _{-(NG)}	Stable
Senior Unsecured P3S3 N100bn Bonds	Long Term Issue	National	AA _{-(NG)}	Stable
Senior Unsecured P3SIV N137.3bn Bonds	Long Term Issue	National	AA _{-(NG)}	Stable

Rating Rationale

The ratings upgrade is underpinned by Lagos State Government of Nigeria's ("the State" or "Lagos State") strong revenue generation, with a diversified internal economy which has supported robust growth in internally generated revenue ("IGR"). However, this strength is tempered by its weak leverage metrics due to the persistent rise in debt.

Lagos State's strong business profile is a key rating strength. The State is the economic and commercial centre of Nigeria, contributing over 25% to national gross domestic product and housing some of the country's critical infrastructures. This, combined with its well-diversified economy continues to attract more migrants, as evidenced by the growth in population to over 28 million people in 2021 (2020: 26 million+). Notwithstanding these strengths, the State's socio-economic profile is relatively modest, characterised by high poverty and unemployment levels and large informal settlements. The infrastructure deficit remains a bottleneck to economic performance, particularly as the ever-increasing population exceeds the State's ability to undertake capex. Nevertheless, Lagos State has a robust project pipeline aimed at expanding the economy and improving the business environment.

The State's operating performance is also a positive rating factor underpinned by consistent growth in IGR over the review period. Accordingly, IGR rose by 22.7% in FY21 and further by 32.4% during 1H FY22 on the back of continued improvement in tax collection. This was also supported by higher tax assessment arising from the recent amendment to Personal Income Tax Act covered under the Finance Act 2020. While the State's IGR has maintained a strong upward momentum over the last two years, federal transfers excluding value-added tax are yet to recover from the negative impact of COVID-19 pandemic. Thus, the overall increase in total recurrent income only stood at 17.4% and 26.7% at FY21 and 1H FY22 respectively, well below the growth in IGR.

Operating costs increased significantly in the period under review mainly due to the additional costs incurred towards increased tax collection drive. Nevertheless, a higher operating surplus of N293.8bn was reported in FY21 (FY20: N280.5bn). Looking ahead, GCR expects IGR and total recurrent income to grow by 32.4% and 25.7% respectively for

full year 2022. In addition, improved operating efficiencies should contain expenditure progression, which should translate into continued operating surpluses.

Leverage and capital structure is a negative rating factor due to high debt. Gross debt amounted to N1.3tr at end-June 2022 (FY21: N1.2tr; FY20: N1tr), following additional N137.3bn raised from the debt capital market. The impact of the higher debt was however tempered by the robust revenue, with debt service ratios remaining stable. Net debt to income improved marginally to 1.48x (FY20: 1.58x, FY21: 1.56x), while free cash flow coverage of debt was relatively flat at 26.9% in FY21 (FY20: 26.7%). Conversely, operating cash flow coverage of net interest moderated slightly to 5.7x in FY21 (FY20: 6.2x) due to higher finance charges from the elevated debt and higher interest rate environment.

The structure of Lagos State's debt and strong access to capital serve to mitigate concerns regarding the overall quantum. In this regard, over 50% of debt is obtained on concessional terms from foreign financial institutions and commercial banks, which include long maturities and low interest rates. In addition, the State's short term debt is currently less than 15% of gross debt. Lagos State has demonstrated strong access to the Nigerian Capital Market, with over N380bn in long term bonds raised over the past five years. However, the high foreign currency exposure (41% of debt) is a major risk, although the State has indicated that it is in negotiations to convert some of these loans to local currency.

The liquidity assessment is considered moderate with days cash on hand above 60 days at FY21, supported by robust cash holding. The State's liquidity coverage of sources versus uses is estimated at 1.2x over the six-month period to December 2022 and 1x over the 18-month period to December 2023. This is predicated on anticipated strong operating cash flows and the assumption that a further N100bn in new bonds will be raised to meet budgeted capex and debt repayment.

Lagos State's existing bonds under the N500bn Bond Issuance Programme 3 ("the Programme") include Series 2 (Tranches II and IV), 3 and 4, following the early redemption of some bonds in 2021. The Bonds constitute direct, unconditional, unsubordinated, senior and unsecured obligations of the Issuer and rank *pari-passu* in all respects with all other Bonds issued by the Issuer under the Programme. The coupon and principal repayment obligations on the Bonds are serviced through monthly transfers into the Sinking Fund Account from the Consolidated Debt Service Account and the State's monthly federal allocations (backed by an Irrevocable Standing Payment Order) approved by the Federal Ministry of Finance, Budget, and Planning.

Based on GCR's analysis of the expected inflows (as reflected in each Series pricing supplement), both inflows will only provide 1x coverage of semi-annual interest payments during the moratorium and 1x cumulative debt service after the moratorium. As such, there is no additional credit enhancement offered by the contemplated inflows. Accordingly, the long-term ratings of the Bonds are equivalent to the Issuer's long term senior unsecured rating. GCR has reviewed the trustees report and transaction account bank statements dated 30 June 2022 and noted that the State has complied with the terms and conditions of the bonds as to interest and principal repayments.

Outlook Statement

The Stable Outlook reflects GCR's expectation that Lagos State will continue to report robust revenue growth and sound expenditure management, supporting relatively stable leverage metrics despite the expected rise in debt level.

Rating Triggers

Further upward rating movement is dependent on a meaningful strengthening of leverage metrics. In this regard, GCR would expect to see net debt to income fall below 1x, while cash flow coverage of debt improves to around 60%. As

Lagos State is likely to continue its robust capital development programme, this is dependent on sustained growth in IGR which underpins strong cash flows, that allows the State to fund a greater proportion of capex internally.

The ratings may come under pressure if income growth slows down and debt rises beyond anticipated level, resulting in a.) net debt to income above 1.6x, b.) free cash flow coverage of debt below 20%, and c.) and operating cash flow coverage of net interest below 4x. Furthermore, political events that hamper efficient operations of the State would also be negatively viewed.

Analytical Contacts

Primary analyst Lagos, Nigeria	Busola Akinrolabu Busola@GCRratings.com	Analyst: Corporate & Public Sector Ratings +234 1 9049462
Committee chair Johannesburg, ZA	Eyal Shevel Shevel@GCRratings.com	Sector Head: Corporate & Public Sector Ratings +27 11 784 1771

Related Criteria and Research

Criteria for the GCR Ratings Framework, January 2022
Criteria for Rating Local and Regional Governments, June 2019
GCR Ratings Scales, Symbols & Definitions, May 2022
GCR Country Risk Scores, August 2022

Ratings History

Rating class	Review	Rating scale	Rating	Outlook/Watch	Date
Long Term Issuer	Initial	National	A _(NG)	Stable Outlook	Sep 2011
Short Term Issuer	Initial	National	A1 _(NG)		March 2021
Senior Unsecured P3S2 T II N38.8bn Bonds	Initial	National	AA _{-(NG)}	Stable Outlook	Dec 2017
Senior Unsecured P3S2 T IV N5.3bn Bonds	Initial	National	AA _{-(NG)}	Stable Outlook	Jan 2018
Senior Unsecured P3S3 N100bn Bonds	Initial	National	A+ _(NG)	Stable Outlook	Dec 2019
Senior Unsecured P3S4 N137.3bn Bonds	Initial	National	A+ _(NG)	Positive Outlook	May 2022
Long Term Issuer	Last	National	A+ _(NG)	Positive Outlook	August 2021
Short Term Issuer	Last	National	A1 _(NG)		August 2021
Senior Unsecured P3S2 T II N38.8bn Bonds	Last	National	A+ _(NG)	Positive Outlook	August 2021
Senior Unsecured P3S2 T IV N5.3bn Bonds	Last	National	A+ _(NG)	Positive Outlook	August 2021
Senior Unsecured P3S3 N100bn Bonds	Last	National	A+ _(NG)	Positive Outlook	August 2021
Senior Unsecured P3S4 N137.3bn Bonds	Last	National	A+ _(NG)	Positive Outlook	May 2022

RISK SCORE SUMMARY

Rating Components and Factors	Risk scores
Operating environment	6.75
Country risk score	3.75
Sector risk score	3.00
Business profile	5.25
LRG profile	3.00
Operating performance	2.25
Management and governance	0.00
Financial profile	(3.25)
Leverage & capital structure	(2.25)
Liquidity	(1.00)
Comparative profile	0.00
Group support	0.00
Peer comparison	0.00
Total Risk Score	8.75

Glossary

Cash Flow	The inflow and outflow of cash and cash equivalents. Such flows arise from operating, investing and financing activities.
Cash	Funds that can be readily spent or used to meet current obligations.
Coverage	The scope of the protection provided under a contract of insurance.
Debt	An obligation to repay a sum of money. More specifically, it is funds passed from a creditor to a debtor in exchange for interest and a commitment to repay the principal in full on a specified date or over a specified period.
Exposure	Exposure is the amount of risk the holder of an asset or security is faced with because of holding the security or asset. For a company, its exposure may relate to a product class or customer grouping. Exposure may also arise from an overreliance on one source of funding. In insurance, it refers to an individual or company's vulnerability to various risks
Interest Cover	Interest cover is a measure of a company's interest payments relative to its profits. It is calculated by dividing a company's operating profit by its interest payments for a given period.
Issuer	The party indebted or the person making repayments for its borrowings.
Leverage	Regarding corporate analysis, leverage (or gearing) refers to the extent to which a company is funded by debt.
Liquidity	The speed at which assets can be converted to cash. It can also refer to the ability of a company to service its debt obligations due to the presence of liquid assets such as cash and its equivalents. Market liquidity refers to the ease with which a security can be bought or sold quickly and in large volumes without substantially affecting the market price.
Long Term Rating	See GCR Rating Scales, Symbols and Definitions.
Market	An assessment of the property value, with the value being compared to similar properties in the area.
Maturity	The length of time between the issue of a bond or other security and the date on which it becomes payable in full.
Operating Cash Flow	A company's net cash position over a given period, i.e. money received from customers minus payments to suppliers and staff, administration expenses, interest payments and taxes.
Rating Outlook	See GCR Rating Scales, Symbols and Definitions.
Short Term Rating	See GCR Rating Scales, Symbols and Definitions.
Short Term	Current; ordinarily less than one year.

SALIENT POINTS OF ACCORDED RATINGS

GCR affirms that a.) no part of the ratings process was influenced by any other business activities of the credit rating agency; b.) the ratings were based solely on the merits of the rated entity, security or financial instrument being rated; and c.) such ratings were an independent evaluation of the risks and merits of the rated entity, security or financial instrument.

The credit ratings have been disclosed to Lagos State Government. The ratings above were solicited by, or on behalf of, the rated entity, and therefore, GCR has been compensated for the provision of the ratings.

Lagos State Government participated in the rating process via tele-conferences and other written correspondence. Furthermore, the quality of information received was considered adequate and has been independently verified where possible. The information received from Lagos State Government and other reliable third parties to accord the credit ratings included:

- The audited financial results for the year ended 31 December 2021;
- Four years of comparative audited numbers;
- Budget performance report (summary) as at 30 June 2022;
- Approved budget for 2022;
- Debt facility details as of 30 June 2022; and
- The Joint Trustees' reports on the bonds for the period ended 30 June 2022.

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