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Research Update:

Spanish Region The Balearic Islands Upgraded To 'BBB+' On Improved Finances; Outlook Positive

Primary Credit Analyst:

Ines Olondriz, Madrid (34) 91-788-7202; ines.olondriz@spglobal.com

Secondary Contacts:

Alejandro Rodriguez Anglada, Madrid (34) 91-788-7233; alejandro.rodriguez.anglada@spglobal.com
Marta Saenz, Madrid + 34 91 788 7231; marta.saenz@spglobal.com

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Overview

- On the back of its strong commitment to budget consolidation, the Balearic Islands' government exceeded its fiscal target for the second year in a row in 2017.
- We are therefore raising our long-term issuer credit rating on the Balearic Islands to 'BBB+' from 'BBB'.
- The outlook is positive.

Rating Action

On May 18, 2018, S&P Global Ratings raised its long-term issuer credit rating on Spain's Autonomous Community of the Balearic Islands to 'BBB+' from 'BBB'. The outlook is positive.

Outlook

The positive outlook reflects the possibility that, over the next two years, the Balearic Islands maintains a structurally strong financial performance that allows it to build up some budgetary flexibility and improve its liquidity position or, alternatively, accelerate its deleveraging path faster than our base-case expectation.

Downside Scenario

We could revise our outlook to stable if, over the next two years, we no longer considered the Balearic Islands likely to strengthen its budgetary flexibility and liquidity or reduce its debt burden beyond our base case.

Rationale

The upgrade reflects our view that the Balearic Islands' government is strongly committed to budgetary consolidation. The region's budgetary performance is improving more rapidly than expected. The region reduced its deficit in budgetary terms to 6.4% of total revenues in 2017, compared with our expectation of 7.9%. Furthermore, the region posted a surplus in national accounting terms--which includes all the region's public entities that consolidate under the European System of Accounts--that accounted for 0.48% of the regional GDP, versus a target of negative 0.60%.

Committed financial management and a favorable economic environment are fostering improvements

The Balearic Islands' government, in place since the 2015 regional elections, has persistently pursued a consolidation path, outperforming the official deficit targets in 2016 and 2017. This strict adherence to achieving, and sometimes exceeding the official fiscal goals, led us to believe that the region's financial management is better equipped for implementation of tight financial policy when needed than previously.

The Balearic Islands is one of Spain's wealthier regions, with GDP per capita at 103% of the Spanish average based on 2017 data from the national statistics office. However, the region does not benefit fully from its wealth, since it is a net contributor to the equalization transfers in the Spanish public finance system. As such, we consider the national GDP per capita for our assessment of the economies of Spain's normal-status regions.

In our opinion, Spain's strong nominal GDP growth, set to continue over 2018-2020, will also translate into higher revenues for the regions, underpinning the Balearic Islands' budgetary consolidation.

Still, we think that the regional financing system continues to suffer from some weaknesses. In our view, the main drawback is the difficulty in matching revenues and expenditures, particularly in the low points of the economic cycle. The reform of the regional financing system is now overdue, in our opinion. Technical works have started, but we do not have visibility about the timing or shape of an eventual reform, which continues to be postponed because of political instability in the country. Overall, we continue to deem this reform to be crucial to ensuring the long-term sustainability of Spanish regional finances.

Absent a financing reform, Spain's central government has provided support to the regional tier, in the form of liquidity facilities since 2012. The facilities have gradually evolved to meet practically all of the funding needs of those regions that adhere to them, including the Balearic Islands, on very favorable terms.

Financial performance exceeded our forecasts, but debt burden remains very high

Robust tax revenue growth thanks to favorable economic development and the regional government's cost containment helped the region achieve a very solid operating surplus of 8.9% of operating revenues in 2017, improving from 5.0% in 2016. Over this period, operating revenues rose by 10.4% due to higher revenues from the regional financing system, as well as increased own tax revenues thanks to economic growth. At the same time, operating expenditures increased by much less (5.8%).

We expect continued robust operating balances and improving financial results over 2018-2020. Operating surpluses should average 9.4% of operating revenues, and deficits after capital accounts should disappear by 2020.

We believe the region's ability to cut expenditures to absorb potential revenue deviations is still limited, mainly due to pressures on the health care system. However, the region may gradually gain budgetary flexibility if its financial results continue to improve.

The Balearic Islands' tax-supported debt is still very high in a global context, and it constrains the region's creditworthiness. However, we think the region will start reducing its tax-supported debt in absolute terms in 2018. Moreover, we think that strong revenue growth will rapidly relieve the debt burden during our forecast horizon. We estimate tax-supported debt as a percentage of consolidated operating revenues to decline to 207% by 2020 from 246% in 2017 and the peak of 297% in 2014. About 72% of the region's debt at year-end 2017 is with the central government.

Our tax-supported debt figure includes direct debt, the debt of the region's public sector, guarantees and some public-private partnerships. We believe the Balearic Islands have low contingent liabilities.

The region's liquidity position is still a rating weakness. Although our debt service coverage ratio (which factors in our calculation of cash and available credit lines with the 12 months of debt service ending May 31, 2019, of about €1.1 billion) has improved to over 60% from slightly below 40% in our previous base case, we note that this ratio may deteriorate again in light of the higher debt maturities that the region faces in 2020.

We believe that the central government-sponsored liquidity facilities will remain available to meet the region's debt service obligation in a timely fashion, which limits refinancing risk, in our view. We understand that the region has requested the central government's authorization to fund part of its 2018 needs in the capital markets to increase the average life of the region's debt. We do not know if and when the central government will allow the region to do so.

Continued access to central government support has also enabled the Balearic Islands to reduce its period of payment to suppliers in 2017, in compliance with legal limits.

Key Statistics

Table 1

Autonomous Community of the Balearic Islands Key Statistics

(Mil. €)	--Fiscal year end Dec. 31--					
	2015	2016	2017	2018bc	2019bc	2020bc
Operating revenues	2,976	3,263	3,602	3,852	3,993	4,132
Operating expenditures	3,019	3,101	3,281	3,536	3,614	3,699
Operating balance	(44)	162	321	316	378	432
Operating balance (% of operating revenues)	(1.5)	5.0	8.9	8.2	9.5	10.5
Capital revenues	19	20	41	42	43	45
Capital expenditures	473	447	596	451	467	476
Balance after capital accounts	(498)	(265)	(234)	(92)	(45)	1
Balance after capital accounts (% of total revenues)	(16.6)	(8.1)	(6.4)	(2.4)	(1.1)	0.0
Debt repaid	504	712	807	872	1,007	1,489

Table 1

Autonomous Community of the Balearic Islands Key Statistics (cont.)

(Mil. €)	--Fiscal year end Dec. 31--					
	2015	2016	2017	2018bc	2019bc	2020bc
Gross borrowings	1,176	1,276	1,327	785	1,052	1,488
Balance after borrowings	174	300	286	(180)	0	(0)
Modifiable revenues (% of operating revenues)	54.9	56.1	60.7	55.9	55.9	55.9
Capital expenditures (% of total expenditures)	13.5	12.6	15.4	11.3	11.4	11.4
Direct debt (outstanding at year-end)	7,462	7,868	8,246	8,159	8,204	8,203
Direct debt (% of operating revenues)	250.8	241.1	228.9	211.8	205.5	198.5
Tax-supported debt (outstanding at year-end)	8,712	8,930	9,082	8,890	8,834	8,734
Tax-supported debt (% of consolidated operating revenues)	285.1	266.9	246.8	226.1	216.8	207.2
Interest (% of operating revenues)	5.0	3.3	3.1	3.0	2.9	2.8
Local GDP per capita (€)	24,102	24,870	N/A	N/A	N/A	N/A
National GDP per capita (€)	23,251	24,085	25,010	26,028	26,961	27,902

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.

Ratings Score Snapshot

Table 2

Autonomous Community of the Balearic Islands Ratings Score Snapshot

Key rating factors

Institutional framework	Evolving but balanced
Economy	Strong
Financial management	Satisfactory
Budgetary flexibility	Weak
Budgetary performance	Strong
Liquidity	Adequate
Debt burden	Very high
Contingent liabilities	Low

*S&P Global Ratings bases its ratings on local and regional governments on the eight main rating factors listed in the table above. Section A of S&P Global Ratings' "Methodology For Rating Non-U.S. Local And Regional Governments," published on June 30, 2014, summarizes how the eight factors are combined to derive the our foreign currency rating on the government.

Key Sovereign Statistics

Sovereign Risk Indicators – April 10, 2018. An interactive version is also available at <http://www.spratings.com/sri>.

Related Criteria And Research

Related Criteria

- Criteria - Governments - International Public Finance: Methodology For Rating Non-U.S. Local And Regional Governments - June 30, 2014
- Criteria - Governments - International Public Finance: Methodology And Assumptions For Analyzing The Liquidity Of Non-U.S. Local And Regional Governments And Related Entities And For Rating Their Commercial Paper Programs - October 15, 2009
- Criteria - Governments - International Public Finance: Methodology And Assumptions: The Impact Of PPP Projects On International Local And Regional Governments: Refined Accounting Treatment - December 15, 2008
- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009

Related Research

- Sovereign Risk Indicators - April 10, 2018. An interactive version is also available at <http://www.spratings.com/sri>.
- Research Update: Spain Long-Term Ratings Raised To 'A-' On Economic Growth And Budgetary Consolidation; Outlook Positive - March 23, 2018
- Institutional Framework Assessments For Non-U.S. Local And Regional Governments - September 21, 2017
- Spanish Region Risk Indicators: July 2017 - July 21, 2017
- Research Update: Spain's Autonomous Community of the Balearic Islands 'BBB' Rating Affirmed; Outlook Stable - May 26, 2017
- Default, Transition, and Recovery: 2016 Annual Non-U.S. Local And Regional Government Default Study And Rating Transitions - May 8, 2017
- Why We Don't Equalize Our Ratings On Spanish Normal-Status Regions With Those On The Sovereign - January 19, 2017

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

Rating		
	To	From
The Balearic Islands (Autonomous Community of)		
Issuer Credit Rating		
Foreign and Local Currency	BBB+/Positive/--	BBB/Stable/--
Senior Unsecured		
Local Currency	BBB+	BBB

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. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

Additional Contact:

International Public Finance Ratings Europe; PublicFinanceEurope@spglobal.com

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