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Research Update:

Spain's Autonomous Community of the Balearic Islands 'BBB-' Rating Affirmed; Outlook Remains Stable

Primary Credit Analyst:

Alejandro Rodriguez Anglada, Madrid (34) 91-788-7233; alejandro.rodriguez.anglada@standardandpoors.com

Secondary Contact:

Lorenzo Pareja, Madrid (34) 91-389-6962; lorenzo.pareja@standardandpoors.com

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Overview

- The Spanish Autonomous Community of the Balearic Islands benefits from the strengthening of liquidity support from the central government, which now covers all the region's borrowing needs for 2015 at subsidized interest rates.
- The Balearic Islands deviated from deficit targets in 2014, but we expect that improved revenues, due to economic growth, and lower interest expenditures may assist the region in improving its performance over our forecast period for 2015-2017.
- The region's very high debt burden and still-high deficits after capital expenditures constrain its creditworthiness, in our opinion.
- We are affirming our 'BBB-' long-term issuer credit rating on the Balearic Islands.
- The stable outlook reflects our expectation that the Balearic Islands will continue to gradually reduce its deficits and stabilize its debt metrics over 2015-2017.

Rating Action

On April 17, 2015, Standard & Poor's Ratings Services affirmed its 'BBB-' long-term issuer credit rating on the Spanish Autonomous Community of the Balearic Islands. The outlook remains stable.

Rationale

The 'BBB-' long-term rating on the Balearic Islands is equivalent to its stand-alone credit profile (SACP). The SACP is not a rating but a means of assessing the intrinsic creditworthiness of an LRG under the assumption that there is no sovereign rating cap. The SACP results from the combination of our assessment of an LRG's individual credit profile and the institutional framework in which it operates.

The rating on the Balearic Islands primarily reflects our opinion of the evolving but balanced institutional framework in which Spanish regions operate. We also view the Balearic Islands' strong economy as a supportive rating factor. We assess that the Balearic Islands has low contingent liabilities, associated with the ongoing restructuring of its large sector of fully or partially owned companies.

We believe that the region has weak financial management, reflected in a very weak budgetary performance. We also regard the Balearic Islands' budgetary flexibility as weak, given what we view as a limited ability to cut expenditures when compared with other Spanish normal-status regions.

In our opinion, the Balearic Islands' very high tax-supported debt, surpassing our highest benchmark, and our view of its less-than-adequate liquidity constrain its rating.

In our view, the central government has postponed the reform of the regional financing system to avoid a politically sensitive debate in 2015, when national and regional elections are due. In the absence of a full reform, however, at the end of 2014, the central government increased its liquidity support to the regional tier by widening the scope of its facilities and lowering their interest rates. The central government created a new facility called the Financing Fund for Autonomous Communities ("Fondo de Financiación para las Comunidades Autónomas"; FFCA). The fund contains two main sections: a new FLA ("Fondo de Liquidez Autonómica") for regions that do not comply with targets on deficit, debt, and payment period to suppliers, and the FF ("Facilidad Financiera"), for regions that meet such targets.

The previous FLA created in 2012 covered the maturities of capital market instruments and loans from nonresidential financial entities, as well as the authorized deficit and negative settlements arising from the regional financing system during 2008 and 2009. The FFCA extends coverage to maturities on loans from resident financial institutions, as well as deficits that exceed the target.

The central government subsidizes the interest regions incur from using the FFCA. Under the new facility, FLA loans signed in 2015 carry a 0% interest rate for the first year, while loans taken this year under the new FF incur no interest for the first three years. Thereafter, these loans bear a 0.834% interest rate until maturity. The reduced interest rates also apply to previous central government liquidity facilities.

The Balearic Islands used the FLA over 2012-2014, and the central government has granted the region use of the FF in 2015, given that the region met official deficit targets in 2013. Because the Balearic Islands did not comply with the deficit and supplier-payment period targets in 2014, we estimate that the region will likely fall under the FLA again in 2015.

The Balearic Islands is one of Spain's wealthier regions, with GDP per capita at 105% of the Spanish average based on 2014 data from the Instituto Nacional de Estadística, the national statistics office. However, the region does not benefit fully from its high relative wealth, as it is a net contributor to strong equalization transfers in the Spanish public finance system.

In 2014, the Balearic Islands deviated from official deficit targets and posted a deficit in budgetary terms of 27% of total revenues, compared with our previous base-case estimate of 12.1%. However, this figure is distorted by the inclusion of expenditures originated in previous years, mostly related to health care, which were financed in 2014. These deficits had already been registered in national accounting terms, but not in budgetary terms. Therefore, after national accounting adjustments, the Balearic Islands' deficit was €458 million (or 1.7% of regional GDP), compared with our estimate budgetary deficit of €750 million.

Nevertheless, we note that the Balearic Islands' deficit in national accounting terms has amply surpassed the official target of 1% of regional GDP, and is larger than in 2013, when the region posted a deficit of 1.23% of GDP.

We continue to believe that the Balearic Islands may reduce its deficits and gradually stabilize its accounts. Despite the 2014 deviation from the deficit targets, we take into account that a relative recovery in Spain's economy should lead to an improvement in the Balearic Islands' operating revenues, thanks to larger tax bases. Additionally, the central government's subsidized financing with 0% interest rates should provide substantial relief to the region. Given the large proportion of debt the region owes the central government (about 50% of total debt outstanding as of year-end 2014), the impact of this measure will be disproportionately positive for the islands when compared with other regions that did not resort to FLA with the same intensity in recent years.

As a result, we expect the Balearic Islands may improve its operating performance in 2015, posting a small operating deficit of about 0.8% of operating revenues, and reduce their deficit after capital accounts to about 12% of total revenues. This is roughly in line with our previous estimates, of about 0.9% operating deficit and deficit after capital accounts of 11% of total revenues for 2015.

We believe that the Balearic Islands' operating balance will gradually improve and may turn positive by 2017, as it did in 2013. We expect deficits after capital accounts to continue declining, although the region will likely continue to deviate from official deficit targets.

In our view, the Balearic Islands has weak budgetary flexibility, based on our perception of its limited capacity to cut spending further. Our base-case assumptions include that the region's budgetary improvement will primarily stem from a revenue increase and moderation of expenditure growth, rather than outright cuts.

Deficits will continue to increase the Balearic Islands' already very high tax-supported debt in nominal terms. In relative terms, we expect the Balearic Islands' tax-supported debt to reach about 287% of consolidated operating revenues by 2017. This level is above our highest debt benchmark, although the associated risk is mitigated by the large portion of outstanding debt owed to the central government by the end of 2015. We believe the Balearic Islands has low contingent liabilities, arising from the ongoing restructuring of its public sector, which is progressing in line with the region's plans. We already fully consolidate these public-sector companies' debt in our calculations of tax-supported debt for the islands.

Our rating on the Balearic Islands also reflects our assessment of the region's financial management as weak. We take into account the region's track record of budgetary deviations, as well as its decision to resume expenditure increases although its debt clearly exceeds that of its Spanish peers.

Liquidity

We view the Balearic Islands' liquidity as less than adequate. This reflects our view of the region's weak debt-service coverage ratio, mitigated by our assessment of the region's strong access to external liquidity.

In our assessment of the region's debt-service coverage ratio, we factor in our estimate of the Balearic Islands' internal cash generation capacity and available credit lines. Our main liquidity ratio (which reflects our base-case scenario of average cash over the next 12 months and available credit lines) covers less than 40% of the region's debt service for the next 12 months. We estimate the region's debt service for April 2015 to March 2016 at €522 million.

Our view of the Balearic Islands' strong access to external liquidity incorporates our assumption that the central government will continue providing strong liquidity support to the regional tier through its new liquidity facility FFCA. We think this fund is sufficiently endowed in the central government's 2015 budget to cover the regions' debt service. This support underpins our ratings on Spanish normal-status regions, including the Balearic Islands.

Outlook

The stable outlook reflects our expectation that the Balearic Islands will continue to reduce its deficit levels and stabilize its debt metrics between 2015 and 2017, albeit at a higher level than we previously expected.

We could lower the rating on the Balearic Islands if we no longer had visibility on the region's ability to continue reducing its deficits during our rating horizon. This would imply protractedly negative operating balances and meaningful deviations from the deficit targets. This performance would lead us to consider reassessing our view of the Balearic Islands' financial management and lowering the rating by one notch, all else being equal.

We could upgrade the Balearic Islands if the region reported higher revenues than in our base case, returned to positive operating balances ahead of our expectations, and complied with deficit targets. This performance would lead us to think that the region could maintain its debt ratios structurally below our highest debt benchmark of 270% of consolidated operating revenues.

Key Statistics

Table 1

Autonomous Community of the Balearic Islands Financial Statistics							
--Fiscal year ending Dec. 31--							
(Mil. €)	2012	2013	2014	2015b	2015bc	2016bc	2017bc
Adjusted operating revenues	2,602	2,702	2,687	2,862	2,842	2,925	3,020
Adjusted operating expenditures	3,181	2,687	2,831	2,921	2,865	2,901	2,948
Operating balance	(579)	15	(144)	(59)	(22)	24	73

Table 1

Autonomous Community of the Balearic Islands Financial Statistics (cont.)							
	--Fiscal year ending Dec. 31--						
(Mil. €)	2012	2013	2014	2015b	2015bc	2016bc	2017bc
Operating balance (% of adjusted operating revenues)	(22.26)	0.55	(5.36)	(2.07)	(0.79)	0.83	2.40
Adjusted capital revenues	42	42	101	116	91	94	97
Adjusted capital expenditures	558	420	707	503	415	350	340
Balance after capital accounts	(1,095)	(364)	(750)	(447)	(346)	(232)	(171)
Balance after capital accounts (% of adjusted total revenues)	(41.44)	(13.25)	(26.91)	(15.02)	(11.81)	(7.69)	(5.48)
Adjusted direct debt repayment	483	488	678	611	611	834	896
Adjusted gross borrowings	1,669	1,293	1,611	1,058	1,058	1,066	1,067
Modifiable revenues (% of adjusted operating revenues)	58.40	50.68	54.72	53.76	54.29	54.19	54.22
Capital expenditures (% of total expenditures)	14.92	13.52	19.99	14.70	12.65	10.77	10.35
Direct debt adjusted	4,993	5,798	6,756	6,943	7,202	7,434	7,605
Direct debt (% of adjusted operating revenues)	191.90	214.59	251.45	242.57	253.39	254.18	251.80
Tax-supported debt	6,869	7,538	8,209	8,363	8,622	8,824	8,965
Tax-supported debt (% of consolidated operating revenues)	255.09	269.94	295.49	282.91	293.66	292.03	287.32
Interests (% of adjusted operating revenues)	8.92	8.65	8.81	6.68	4.39	2.54	2.52
Debt service (% of adjusted operating revenues)	27.48	26.69	34.04	28.04	25.90	31.04	32.18

The data and ratios above result in part from Standard & Poor's own calculations, drawing on national as well as international sources, reflecting Standard & Poor's 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. b--Budget. bc--Base case, reflecting Standard & Poor's expectations of the most likely scenario.

Table 2

Autonomous Community of the Balearic Islands Economic Statistics					
	--Fiscal year ended Dec. 31--				
	2010	2011	2012	2013	2014
Population as of July 1 (000)	1,088	1,096	1,104	1,113	1,122
Population growth (%)	0.9	0.7	0.8	0.8	0.8
Nominal GDP (million €)	26,195	26,208	26,166	26,287	26,845
GDP per capita (€)	24,084	23,924	23,694	23,624	23,931
GDP (real) growth (%)	0.2	0.3	(0.5)	(0.5)	1.9

The data and ratios above result in part from Standard & Poor's own calculations, drawing on national as well as international sources, reflecting Standard & Poor's independent view on the timeliness, coverage, accuracy, credibility, and usability of available information. Sources typically include national statistical offices, and Eurostat.

Ratings Score Snapshot

Table 3

Autonomous Community of the Balearic Islands Ratings Score Snapshot

Key rating factors

Institutional framework	Evolving but balanced
Economy	Strong
Financial management	Weak
Budgetary flexibility	Weak
Budgetary performance	Very weak
Liquidity	Less than adequate
Debt burden	Very high
Contingent liabilities	Low

*Standard & Poor's ratings on local and regional governments are based on eight main rating factors listed in the table above. Section A of Standard & Poor's "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 rating.

Key Sovereign Statistics

See "Ratings On Spain Affirmed At 'BBB/A-2'; Outlook Stable," published on April 10, 2015.

Related Criteria And Research

Related Criteria

- Criteria - Governments - International Public Finance: Methodology For Rating Non-U.S. Local And Regional Governments - June 30, 2014

Related Research

- Ratings On Spain Affirmed At 'BBB/A-2'; Outlook Stable, April 10, 2015
- Institutional Framework Assessments For Non-U.S. Local And Regional Governments, Feb. 5, 2015
- Spain's Autonomous Community of the Balearic Islands 'BBB-' Rating Affirmed; Outlook Remains Stable, Nov. 21, 2014
- International Local And Regional Governments Default And Transition Study: 2012 Saw Defaults Spike, March 28, 2013

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

	Ratings	
	To	From
The Balearic Islands (Autonomous Community of)		
Issuer credit rating		
Foreign and Local Currency	BBB-/Stable/--	BBB-/Stable/--
Senior Unsecured		
Local Currency	BBB-	BBB-

Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at spcapitaliq.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following Standard & Poor's 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@standardandpoors.com

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