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Research Update:

Spain's Autonomous Community of The Balearic Islands Outlook Revised To Positive; 'BBB-' Rating Affirmed

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Overview

- We expect the Spanish Autonomous Community of the Balearic Islands will gradually improve its budgetary performance and reduce its still-very-high debt burden relative to consolidated operating revenues.
- Therefore, we are revising our outlook on the Balearic Islands to positive from stable and affirming our 'BBB-' long-term issuer credit rating.
- The positive outlook reflects our view that we could upgrade the Balearic Islands over the next two years if the region's tax-supported debt declines to below 270% of consolidated revenues.

Rating Action

On March 4, 2016, Standard & Poor's Ratings Services revised its outlook on Spain's Autonomous Community of the Balearic Islands to positive from stable. At the same time, we affirmed our 'BBB-' long-term issuer credit rating on the islands.

Rationale

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 islands' strong economy as a supportive rating factor. We assess that the Balearic Islands has low contingent liabilities.

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 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. However, we believe both factors are improving compared with levels in previous years.

The long-term rating is at the same level as the Balearic Islands' stand-alone credit profile (SACP), which we assess at 'bbb-'.

Following the large fiscal imbalances caused by Spain's economic crisis that started in 2008, the central government introduced new laws to foster fiscal discipline and increase transparency and accountability. The 2012 Budgetary Stability Law gives the

government legal tools to demand and enforce budgetary discipline at the regional level, which were previously lacking.

As a result of these reforms, Spanish regions, including the Balearic Islands, embarked on a path of budgetary consolidation, although their relative ability to comply with deficit targets has differed considerably. In our opinion, the central government has refrained from applying the full range of coercive measures to noncompliant regions as a result of the delay in the reform of the regional financing system. This is a key reform for regional long-term financial sustainability, in our view. Given the political uncertainty in Spain following the December 2015 election, we do not expect that the regional financing reform will be tackled in the immediate future. We do not think that such a reform would be detrimental to the Balearic Islands.

Following several years of firm cost cuts, regional budgetary consolidation efforts are now benefiting from Spain's economic recovery, which is boosting revenues. In our opinion, however, this is not a substitute for a structural reform of the system.

While demanding regional budgetary adjustment, the central government has sponsored liquidity facilities to help regions fund their financial needs and clear or reduce their arrears, requiring them to adhere to a financial and fiscal conditionality program. Liquidity support has been reliable, timely, and sufficient. We expect the central government's support will cover virtually all of the normal-status regions' funding needs as of 2016. The central government's ability and willingness to provide extraordinary support to regions is strong, in our opinion, supporting our overall view of the institutional framework for normal-status regions as evolving but balanced. The Balearic Islands has used the central government liquidity facilities since their inception in 2012.

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.

We estimate the Balearic Islands posted an operating deficit of 1.7% of operating revenues and an overall deficit after capital accounts of 15.9% of total revenues in 2015, compared with 5.4% and 26.9%, respectively, in 2014. However, 2014 figures were distorted by the inclusion of expenditures originated in previous years, mostly related to health care. Our estimate for an overall deficit at 15.9% of total revenues in 2015 is higher than the 11.8% we anticipated in our previous base case, mainly due to higher capital expenditures and lower capital revenues than we initially expected.

We continue to believe that the Balearic Islands may reduce its deficits and gradually stabilize its accounts. The relative recovery in Spain's economy, together with the tax reform passed by the new administration that resulted from the May 2015

elections, should lead to an improvement in the Balearic Islands' operating revenues, thanks to larger tax bases. However, we think the region will also increase expenditures, but at a slower pace than revenues, mainly in welfare services to compensate for strong cost cuts in previous years.

We think the Balearic Islands will close the operating deficit in 2016 and achieve an operating surplus of about 3.5% of operating revenues by 2018, broadly in line with our previous expectations. In our previous base case we anticipated a decline in the deficit after capital accounts to 5.5% of total revenues by 2017, but now we expect a more gradual reduction in the overall deficit to 7.6% by 2018 because we think investments will decline less than we anticipated previously.

In our view, the Balearic Islands has weak budgetary flexibility, based on our perception of its limited capacity to cut spending further. In our base-case assumptions, we include that the region's budgetary improvement will primarily stem from increasing revenues and moderating 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, however, we expect the Balearic Islands' tax-supported debt will start declining in 2015 and reach about 270% of consolidated operating revenues by 2018. This level is our highest debt benchmark, although the associated risk is mitigated by the large portion of outstanding debt owed to the central government. We believe the Balearic Islands has low contingent liabilities, arising from its public sector. We already fully consolidate the public-sector companies' debt in our calculation 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. Although we expect an improvement in the region's budgetary performance over our 2016-2018 forecast period, we take into account the region's track record of budgetary deviations. In addition, the region's average payment periods are above average among Spanish regions. A new government took office following the regional elections in May 2015. We understand that the new administration is committed to budgetary consolidation and think the region will maintain its strong payment culture.

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, which we estimate at €754 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 liquidity facilities, Fondo de Financiación de las Comunidades Autónomas. We think this fund is sufficiently endowed in the central government's 2016 budget to cover the regions' debt service. This support underpins our ratings on Spanish normal-status regions, including the Balearic Islands.

Outlook

The positive outlook reflects our view that we could upgrade the Balearic Islands over the next two years if the region's tax-supported debt declined to below 270% of consolidated revenues. This could result from lower deficits after capital accounts or higher revenues than we currently expect.

We could revise the outlook to stable and affirm our rating if we observed that the region's performance translates into a level of tax-supported debt structurally above 270% of consolidated operating revenues.

Key Statistics

Table 1

| Autonomous Community of the Balearic Islands Financial Statistics | | | | | | | | | | |
|---|-------|--------|--------|--------|--------|--------|--------|--------|--------|--------|
| --Fiscal year ending Dec-31-- | | | | | | | | | | |
| (Mil. €) | 2013 | 2014 | 2015bc | 2016bc | 2017bc | 2018bc | 2015uc | 2016uc | 2017uc | 2018uc |
| Adjusted operating revenues | 2,702 | 2,687 | 2,955 | 3,123 | 3,249 | 3,397 | 2,965 | 3,183 | 3,312 | 3,462 |
| Adjusted operating expenditures | 2,687 | 2,831 | 3,006 | 3,119 | 3,183 | 3,279 | 2,979 | 3,118 | 3,180 | 3,274 |
| Operating balance | 15 | (144) | (51) | 4 | 67 | 118 | (14) | 66 | 133 | 188 |
| Operating balance (% of adj. operating revenues) | 0.55 | (5.36) | (1.71) | 0.11 | 2.06 | 3.48 | (0.47) | 2.06 | 4.00 | 5.43 |
| Adjusted capital revenues | 42 | 101 | 19 | 37 | 38 | 40 | 19 | 37 | 38 | 40 |
| Adjusted capital expenditures (capex) | 420 | 707 | 441 | 393 | 398 | 418 | 421 | 393 | 398 | 418 |
| Balance after capital accounts | (364) | (750) | (473) | (352) | (293) | (260) | (417) | (290) | (227) | (190) |

Table 1

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

| | --Fiscal year ending Dec-31-- | | | | | | | | | |
|---|-------------------------------|---------|---------|---------|--------|--------|---------|--------|--------|--------|
| (Mil. €) | 2013 | 2014 | 2015bc | 2016bc | 2017bc | 2018bc | 2015uc | 2016uc | 2017uc | 2018uc |
| Balance after capital accounts (% of adj. total revenues) | (13.25) | (26.91) | (15.90) | (11.15) | (8.91) | (7.56) | (13.97) | (9.02) | (6.78) | (5.42) |
| Adjusted direct debt repayment | 488 | 678 | 504 | 714 | 782 | 688 | 504 | 714 | 782 | 688 |
| Adjusted gross borrowings | 1,293 | 1,611 | 1,176 | 1,066 | 1,075 | 947 | 921 | 1,004 | 1,009 | 877 |
| Modifiable revenues (% of adj. operating revenues) | 50.68 | 54.72 | 56.74 | 53.72 | 53.73 | 53.74 | 54.81 | 54.60 | 54.61 | 54.62 |
| Capex (% of total expenditures) | 13.52 | 19.99 | 12.79 | 11.18 | 11.11 | 11.30 | 12.39 | 11.18 | 11.12 | 11.31 |
| Direct debt Adjusted | 5,798 | 6,756 | 7,258 | 7,611 | 7,903 | 8,163 | 7,258 | 7,549 | 7,776 | 7,965 |
| Direct debt (% of adj. operating revenues) | 214.59 | 251.45 | 245.60 | 243.70 | 243.22 | 240.33 | 244.80 | 237.13 | 234.76 | 230.06 |
| Tax-supported debt | 7,538 | 8,209 | 8,617 | 8,939 | 9,201 | 9,433 | 8,617 | 8,877 | 9,074 | 9,235 |
| Tax-supported debt (% of cons. operating revenues) | 269.94 | 295.49 | 283.93 | 278.87 | 275.89 | 270.57 | 283.03 | 271.82 | 267.03 | 260.00 |
| Interests (% of adj. operating revenues) | 8.65 | 8.81 | 5.08 | 4.87 | 4.86 | 4.80 | 4.16 | 4.73 | 4.68 | 4.58 |
| Debt service (% of adj. operating revenues) | 26.69 | 34.04 | 22.14 | 27.74 | 28.92 | 25.04 | 21.16 | 27.16 | 28.28 | 24.44 |

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. bc--Base case reflects Standard & Poor's expectations of the most likely scenario. uc--Upside case reflects Standard & Poor's expectations within its upside scenario.

Table 2

| Autonomous Community of the Balearic Islands Economic Statistics | | | | | |
|---|-------------------------------------|-------------|-------------|-------------|-------------|
| | --Fiscal year ended Dec-31-- | | | | |
| | 2010 | 2011 | 2012 | 2013 | 2014 |
| Population as of Jan. 1 (000s) | 1,106 | 1,113 | 1,119 | 1,112 | 1,103 |
| Population growth (%) | 1.0 | 0.6 | 0.6 | (0.7) | (0.7) |
| Nominal GDP (mil. €) | 26,195 | 26,208 | 26,166 | 25,838 | 26,329 |
| GDP per capita (€) | 24,084 | 23,924 | 23,694 | 23,220 | 23,498 |
| GDP (real) growth (%) | (0.4) | (0.3) | (0.5) | (1.6) | (1.2) |

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

Sovereign Risk Indicators, Dec. 14, 2015. An interactive version is available at www.spratratings.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

Related Research

- Sovereign Risk Indicators, Dec. 14, 2015. An interactive version is available at www.spratings.com/sri
- Kingdom of Spain Upgraded To 'BBB+' On Reforms; Outlook Stable, Oct. 2, 2015
- Public Finance System Overview: Spanish Normal-Status Regions, July 29, 2015
- Default, Transition, and Recovery: 2014 Annual International Public Finance Default Study And Rating Transitions, June 8, 2015
- Spain's Autonomous Community of the Balearic Islands 'BBB-' Rating Affirmed; Outlook Remains Stable, April 17, 2015

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.

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