Research Update:

Balearic Islands Outlook Revised To Stable On Expected Gradual Economic Recovery; 'BBB+' Rating Affirmed

May 13, 2022

PRIMARY CREDIT ANALYST

Marta Saenz
Madrid
+ 34 91 788 7231
marta.saenz
@spglobal.com

SECONDARY CONTACT

Alejandro Rodriguez Anglada
Madrid
+ 34 91 788 7233
alejandro.rodriguez.anglada
@spglobal.com

ADDITIONAL CONTACTS

Manuel Becerra
Madrid
+34 914233220
manuel.becerra
@spglobal.com

Jaime F Vara de Rey
Madrid
0034 669475678
jaime.vara.de.rey
@spglobal.com

Overview

- The Balearic Islands posted stronger budgetary results in 2021 than we anticipated thanks to substantial support from the central government, EU fund inflows, and a strong economic recovery, including in the tourism sector.
- Despite budgetary challenges in 2022, we expect the region will be able to maintain an adequate liquidity position supported by its access to central government funding.
- We revised our outlook on the Balearic Islands to stable from negative and affirmed our long-term issuer credit rating at 'BBB+'.

Rating Action

On May 13, 2022, S&P Global Ratings revised its outlook on the Autonomous Community of the Balearic Islands to stable from negative, and affirmed the 'BBB+' long-term issuer credit rating.

Outlook

The stable outlook reflects our view that the region's tourism sector will continue to recover over our forecast period to 2024, since pandemic-related restrictions have been mostly eliminated. This should support budgetary performance. It also reflects that although the region will face some budgetary challenges in 2022, it will continue to have access to central government liquidity mechanisms to finance all of its funding needs.

Downside scenario

We could lower our ratings on the Balearic Islands if the region's budgetary performance is materially weaker than we currently project. This would likely imply a deterioration of the region's liquidity position and an interruption on its leverage reduction path.

Upside scenario

We could upgrade the Balearic Islands if we saw a strong commitment from management to control expenditure growth. This would likely translate into a stronger budgetary performance than we currently project.

Rationale

We revised our outlook to stable from negative because we see lower risks to the Balearic Islands' economy arising from the pandemic. Mobility restrictions have been mostly eliminated in Europe, enabling a strong, gradual recovery in tourism, a cornerstone of the regional economy. The region posted a stronger budgetary performance in 2021 than we previously anticipated, posting a balance after capital accounts of 7.7% of total revenue.

We foresee budgetary challenges in 2022 due to lower central government support and lower revenue from the financing system. However, we expect budgetary performance to gradually improve thereafter. At the same time, we expect the region will continue to finance its needs with central government funding, limiting refinancing risks.

Although we acknowledge some degree of uncertainty in our assumptions due to the Russia-Ukraine conflict and its consequences for the economy, we expect the Balearic Islands to benefit from high levels of EU funds, which will indirectly support the region's economic growth.

Despite lower central government support, the ongoing recovery of the tourism sector will support economic growth.

We think central government support has been key in mitigating the pandemic's impact on the Balearic Islands' accounts, preventing the region from posting high deficits. The region received direct transfers of €439 million in 2020 and €329 million in 2021. The region also received €855 million out of the Spanish government's €7 billion fund to support small and midsize enterprises and the self-employed affected by the pandemic. The Balearic Islands, along with the Canary Islands, received the largest relative share of these funds to compensate for their exposure to the tourism sector. We think these funds demonstrate the supportive institutional framework under which Spanish normal-status regions operate.

We do not foresee any further pandemic-related funding from the central government in 2022, which we think will put some pressure on Spanish regions' budgetary performance. The central government decided to provide some support to regions by condoning the negative settlement of the financing system due in 2022 for those regions that had one. However, the Balearic Islands do not benefit from this support measure because the region posted a positive settlement of €538 million due to the structure of its funding. This has meant a decline of 7.4% of its revenue from the financing system when compared to 2021.

We note positively that the region will receive €69 million including interest as compensation for the loss of one month's worth of VAT in 2017, due to a change in the tax collection system. This affected all Spanish regions, and the central government decided to compensate them for it after one of the regions successfully demanded it in court. In addition, the region will start receiving a new transfer from the central government to compensate the region for the additional costs that its insular nature imposes. This is a recurring transfer, and will therefore structurally support the

Balearic Islands' performance going forward.

We expect the region's economic growth to remain relatively solid, in line with Spain's, over the forecast period. We think the Russia-Ukraine conflict will only have a limited direct impact on the Balearic Islands, since only about 0.73% of international tourists come to the region from these countries. In 2021, the region's economy grew by 8.9%, and the tourism sector has recovered about 51% of the international visitors it had in 2019. We expect this recovery to continue in 2022 as the pandemic eases, restrictions are lifted, and vaccination rates across Europe remain high.

Management's commitment toward budgetary consolidation will be key to maintaining a gradual budgetary performance recovery after challenges in 2022.

We expect a deterioration in budgetary performance in 2022 because of the decline in revenue from the central government and a high execution of the EU funds not spent during 2021.

From 2023, we think budgetary performance will gradually recover thanks to economic growth, which should support tax revenue growth. However, we think the sustainability of the region's accounts will also be tightly linked to management's control of expenditure growth, and its ability to cut back on pandemic-generated expenses over the coming years.

We note positively that the central government will send the Balearic Islands a recurrent transfer because of its special regime, which will support revenue growth over our forecast period. As such, this transfer will account for about €182 million in 2022 (including arrears from previous years), and will be slightly above €100 million per year going forward, with the possibility of an update after five years.

Budgetary performance dynamics on the capital side will be marked by the evolution of EU funds, which we understand will be a priority for the region. The Balearic Islands is the Spanish region that has executed the highest proportion of allocated funds so far. However, part of the 2022 deterioration in budgetary execution figures is explained by the unspent EU funds received in 2021, which the region will execute over 2022. EU funds will create some variability in budgetary figures between years, since the calendars of payments and execution do not perfectly match. That said, the funds will have a neutral effect on national accounting deficit figures, the official benchmark for regional performance.

The Balearic Islands' cash position improved at the beginning of 2022 as a direct consequence of its overfinancing in 2021 and the inflows from EU funds. However, we expect cash to decrease over the coming years as the region spends EU funds. Nevertheless, this decrease should be gradual, since new EU funds should continue to arrive. In any case, we think the region's strong access to central government liquidity mechanisms supports its own liquidity. The region has already requested about €611 million of financing in 2022. The region can also count on €450 million in committed credit lines with domestic banks and a €200 million credit line from its regional tax agency.

The region contained its debt growth during 2021, demonstrating its commitment to reducing leverage. As such, we expect the region's tax-supported debt ratio to stabilize at about 204% of consolidated operating revenue by 2024. The region has refinanced several old loans with the central government to take advantage of the low-interest-rate environment, achieving some interest savings. Although we foresee interest rates rising under the current economic environment, we think the Balearic Islands are protected from risk in this context, given that 93% of its debt is at fixed rates, with no exchange-rate risk, since all of it is denominated in euros.

Key Statistics

Table 1

Key Statistics -- Balearic Islands

Selected Indicators

Mil. €	2019	2020	2021	2022bc	2023bc	2024bc
Operating revenues	3,961.8	4,493.3	5,712.4	4,373.2	4,453.4	4,625.1
Operating expenditures	3,778.1	4,061.1	4,915.1	4,242.9	4,311.9	4,389.8
Operating balance	183.7	432.1	797.3	130.3	141.5	235.4
Operating balance (% of operating revenues)	4.6	9.6	14.0	3.0	3.2	5.1
Capital revenues	91.0	86.8	263.9	309.0	321.3	123.4
Capital expenditures	648.1	605.9	601.7	741.4	685.2	511.0
Balance after capital accounts	(373.3)	(87.0)	459.4	(302.1)	(222.5)	(152.3)
Balance after capital accounts (% of total revenues)	(9.2)	(1.9)	7.7	(6.5)	(4.7)	(3.2)
Debt repaid	990.3	3,002.1	2,690.1	1,889.3	1,191.1	959.3
Gross borrowings	1,193.9	3,276.5	2,649.7	1,989.3	1,414.0	1,112.0
Balance after borrowings	(169.7)	187.4	419.1	(202.1)	0.4	0.4
Direct debt (outstanding at year-end)	8,486.4	8,760.8	8,720.5	8,820.5	9,043.3	9,196.0
Direct debt (% of operating revenues)	214.2	195.0	152.7	201.7	203.1	198.8
Tax-supported debt (outstanding at year-end)	8,973.1	9,304.4	9,271.3	9,297.3	9,452.2	9,588.4
Tax-supported debt (% of consolidated operating revenues)	222.1	203.9	160.3	209.1	208.8	204.1
Interest (% of operating revenues)	3.2	2.4	1.0	1.7	1.5	1.5
Local GDP per capita (single units)	28,522.0	22,048.0	N/A	N/A	N/A	N/A
National GDP per capita (single units)	26,511.6	23,703.5	25,382.7	27,978.2	29,545.7	30,767.0

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

Ratings Score Snapshot -- Balearic Islands

Key rating factors

Institutional framework	3
Economy	2
Financial management	3

Table 2

Ratings Score Snapshot -- Balearic Islands (cont.)

Budgetary perfomance	3
Liquidity	3
Debt burden	4
Stand-alone credit profile	bbb+
Issuer credit rating	BBB+

S&P Global Ratings bases its ratings on non-U.S. local and regional governments (LRGs) on the six main rating factors in this table. In the "Methodology For Rating Local And Regional Governments Outside Of The U.S.," published on July 15, 2019, we explain the steps we follow to derive the global scale foreign currency rating on each LRG. The institutional framework is assessed on a six-point scale: 1 is the strongest and 6 the weakest score. Our assessments of economy, financial management, budgetary performance, liquidity, and debt burden are on a five-point scale, with 1 being the strongest score and 5 the weakest.

Key Sovereign Statistics

- Sovereign Risk Indicators, April 11, 2022

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- Criteria | Governments | International Public Finance: Methodology For Rating Local And Regional Governments Outside Of The U.S., July 15, 2019
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- Spain Outlook Revised To Stable From Negative On Balanced Growth; 'A/A-1' Ratings Affirmed, March 18, 2022
- Institutional Framework Assessments For International Local And Regional Governments, March 7, 2022
- Public Finance System Overview: Spanish Normal Status Regions, July 16, 2020

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 Affirmed; Outlook Action

	To	From
Balearic Islands (Autonomous Community of) (The)		
Issuer Credit Rating	BBB+/Stable/--	BBB+/Negative/--
Ratings Affirmed		
Balearic Islands (Autonomous Community of) (The)		
Senior Unsecured	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. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352 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; or Stockholm (46) 8-440-5914