Research Update:

Balearic Islands Outlook Revised To Positive On Potential Improved Performance; 'BBB+' Affirmed

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Overview

- After weaker results in 2022, we expect the Spanish Autonomous Community of the Balearic Islands to return to an operating surplus above 5% by 2024, driven mostly by high revenue from the regional financing system.
- The Balearic Islands' debt remains high, although thanks to a higher revenue base and a lower debt intake in 2022, debt ratios will decline by 2025.
- The region will continue to benefit from its access to central government liquidity mechanisms, which we expect will finance most of its needs over 2023-2025.
- We revised our outlook to positive from stable and affirmed our 'BBB+' long-term issuer credit rating on the Balearic Islands.

Rating Action

On May 12, 2023, S&P Global Ratings revised its outlook to positive from stable on the Autonomous Community of the Balearic Islands. We also affirmed the 'BBB+' long-term foreign currency on the region.

Outlook

The positive outlook reflects that the Balearic Islands could structurally improve its budgetary performance due to a combination of higher revenue from the regional financing system, and tight control over spending (growth).

Upside scenario

We could upgrade the Balearic Islands in the next two years if we see a consistency in management's commitment to tight spending policy over electoral cycles, especially when revenue from the financing system moderates. This would translate into stronger budgetary performance than we currently project.

Downside scenario

We could revise our outlook back to stable in the next two years if the region accelerates expenditure growth, as anticipated, implying a significant weakening of budgetary performance. This would also lead to a weaker liquidity position and a slower deleveraging path.

Rationale

We revised our outlook on the Balearic Islands to positive from stable to reflect the possibility that the region's budgetary performance may improve beyond our current expectations, supported by higher revenue from the central government and tighter control on expenditure growth from its financial management.

We believe that higher revenue from the financing system will allow the region to improve its operating margin over 2023 and 2024. High spending pressure and likely lower transfers from the central government from 2025 could bring the operating surplus below 5% of operating revenue. Nevertheless we expect the region's financial management to establish tighter cost policies to prevent the region from posting operating deficits.

In our view, the region's high debt burden will continue to weigh on its creditworthiness. We forecast tax-supported debt will reach 171% of consolidated operating revenue by 2025.

However, we note that the Balearic Islands benefits from a supportive institutional framework, which includes access to central government liquidity mechanisms to cover all its financing needs, mitigating the risk arising from such indebtedness.

The Balearic Islands will benefit from large regional financing system resources in 2023 and 2024

The supportive nature of the institutional framework in which Spanish normal-status regions operate was proven by the central government's large transfers to the regional tier in 2020 and 2021. These shielded the regions from budgetary pressures and supported their economic recovery througout the pandemic.

However, as the pandemic faded, extraordinary COVID-19 support was discontinued in 2022, leading to a transition year with a general weakening in performance. Amid this difficult context, the Balearic Islands was one of only two regions to post surpluses, significantly outperforming the regional average.

The Balearic Islands should benefit from strong revenue growth in 2023. In 2023, and despite the lower expected economic growth compared to 2022, the central government has decided to increase advances from the regional financing system 15.4% for the Balearic Islands. The region will also benefit from a large settlement that the system generated in 2021 with effect in 2023, of €884 million (representing about 17% of our estimated operating revenues for the year).

Revenue prospects also remain favorable for 2024. Spain generated a record high tax collection in 2022, with year-on-year value-added tax and personal income tax receipts increasing 14% and 16%, respectively, compared to 2021. However, advances expanded at a lower rate than the real tax collection warranted in 2022, and therefore the Balearic Islands is entitled to a positive settlement. In turn, we think high revenue from the financing system is likely in 2024 via a large positive settlement.

Conversely, we might expect revenue to expand more slowly in 2025 due to an anticipated lower settlement from the financing system in 2023, given that advances expanded quite strongly. So far, S&P Global Ratings estimates Spain's real GDP growth will slow to 1.1% in 2023 from 5.5% in 2022.

Moreover, the region also benefits from its new special fiscal regime, agreed with the central government in 2022 for the 2023-2028 period. In this agreement, the Balearic Islands benefits from a direct transfer from the central government, or "Factor de Insularidad", to compensate for transport and infrastructure projects. The fiscal tax regime also includes benefits from the corporate tax for foreign direct investments and deductions to personal income tax for nonresidents. The region expects this special fiscal tax regime to attract foreign investments and therefore support economic activity.

We believe that the Balearic Islands' economy will continue to grow over 2023, supported by large EU funds from the Recovery and Resilience Facility and the tourism sector, which continues to recover from the pandemic. In 2022, tourist arrivals reached 96.5% of 2019 levels, while tourist spending already surpassed pre-pandemic levels. We expect a continued recovery in the unemployment rate, which rose to 14.9% at year-end 2021 and declined to 12.9% in 2022, although still 2 percentage points higher than the national average.

We forecast budgetary performance will improve in 2023-2024, although commitment to fiscal consolidation will be key to maintaining it from 2025 onwards

We expect the Balearic Islands to maintain a stable budgetary performance over the forecast period, with operating margins close to 5% of operating revenues over the forecast. The region's balance after capital accounts will weaken, albeit temporarily, as the region intensifies is capital spending from EU grants.

We expect budgetary performance to improve over 2023 and 2024, supported by rising state transfers. In our view, higher revenue would help management offset expenditure pressures arising from inflation, ongoing countercyclical measures to support local economic activity, and pandemic costs which became structural. In its 2023 budget, the region has included some subsidy increases and fiscal deductions for families, which in our view could add pressure to the operating margin.

The region's capital account dynamics are marked by the evolution of EU funds, especially those from the RRF. This will mean large inflows in 2021-2023, while we expect execution to pick up from year-end 2023. This will temporarily deteriorate the region's balance after capital accounts. However, the overall effect of these funds will be neutral over 2021-2026, since regions can only spend what they are allocated.

We believe that performance from 2025 could be constrained by lower revenue growth from the financing system and, without cuts, high operating expenditure. Revenue from the financing system will be particularly high in the next two years, although we expect it will normalize and expand in line with Spain's nominal GDP from 2025. We believe operating performance sustainability will be linked to financial management practices, such as controlling expenditure growth amid less dynamic revenue growth.

Upcoming regional elections limit our view on the medium-term policy priorities of the region's financial management. However, we expect the Balearic Islands to maintain its current commitment toward fiscal consolidation, shown in its compliance with the reference deficit target rate in 2022, while also displaying prudent liquidity and debt management.

We expect the region's debt burden to remain high in an international context, with our tax-supported debt ratio expected to reach 171% of consolidated operating revenue by 2025. The region reduced its debt burden in 2022 to correct overfinancing from 2021. It also continued refinancing operations last year, enabling a decline in its interest burden for the forecast period. This included the substitution of old loans from the central government with commercial bank loans at lower interest rates. We estimate the region will gradually increase its interest bill over the forecast due to the ongoing high interest rate environment. However, the Balearic Islands' outstanding debt is somewhat shielded from immediate interest rate volatility because about 87% is at fixed rates. We estimate the region will use central government liquidity mechanisms in 2023 to finance its needs.

We view the Balearic Islands' liquidity as adequate. Although the region currently has large cash reserves, we expect a gradual decline in the cash position as it intensifies capital spending from the RRF funds. However, our view on the region's liquidity continues to be supported by its access to central government funding and the total of €650 million in credit lines.

Key Statistics

Table 1

Balearic Islands (Autonomous Community of) (The) Selected Indicators

	2020	2021	2022	2023bc	2024bc	2025bc
Operating revenues	4,493	5,705	4,617	5,036	5,224	5,319
Operating expenditures	4,061	4,908	4,426	4,815	4,949	5,049
Operating balance	432	797	191	221	275	271
Operating balance (% of operating revenues)	9.6	14.0	4.1	4.4	5.3	5.1
Capital revenues	87	264	701	436	306	305
Capital expenditures	606	602	621	847	945	878
Balance after capital accounts	(87)	459	271	(190)	(364)	(302)
Balance after capital accounts (% of total revenues)	(1.9)	7.7	5.1	(3.5)	(6.6)	(5.4)
Debt repaid	3,002	2,690	1,180	1,153	959	895
Gross borrowings	3,277	2,650	1,102	1,205	1,009	945
Balance after borrowings	187	418	192	(138)	(314)	(252)
Direct debt (outstanding at year-end)	8,815	8,752	8,674	8,726	8,776	8,826
Direct debt (% of operating revenues)	196.2	153.4	187.9	173.3	168.0	165.9
Tax-supported debt (outstanding at year-end)	9,297	9,235	9,093	9,075	9,071	9,109
Tax-supported debt (% of consolidated operating revenues)	203.7	159.9	196.9	180.2	173.7	171.2
Interest (% of operating revenues)	2.4	1.0	1.1	1.2	1.3	1.3
Local GDP per capita (single units)	21,551	24,866	N/A	N/A	N/A	N/A

Table 1

Balearic Islands (Autonomous Community of) (The) Selected Indicators (cont.)

	2020	2021	2022	2023bc	2024bc	2025bc
National GDP per capita (single units)	23,620	25,462	28,017	29,596	30,579	31,813

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. N.A.--Not available. N.M.--Not meaningful.

Ratings Score Snapshot

Table 2

Balearic Islands (Autonomous Community of) (The) Ratings Score Snapshot

Key rating factors	Scores
Institutional framework	3
Economy	2
Financial management	3
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 10, 2023. An interactive version is available at http://www.spratings.com/sri

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

- Spanish Regional Finances Should Pick Up After A Weak 2022, May 3, 2023
- Institutional Framework Assessments For Local And Regional Governments Outside Of The U.S., March 22, 2023
- Spain, March 20, 2023
- Institutional Framework Assessment: Spanish Normal Status Regions, July 21, 2022

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+/Positive/--	BBB+/Stable/--
Ratings Affirmed		
Balearic Islands (Autonomous Community of) (The)		
Senior Unsecured	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