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Research Update:

Outlook On Spain's Balearic Islands Revised To Stable On Continued Fiscal Consolidation; 'BBB-' Rating Affirmed

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Overview

- The Spanish Autonomous Community of The Balearic Islands is performing in line with our base-case expectations and fiscal targets, and continues to have access to liquidity support from the central government.
- The region's high debt burden and still-high deficits after capital expenditures constrain its creditworthiness, in our opinion.
- We are revising our outlook on the Balearic Islands to stable from negative and affirming our 'BBB-' long-term rating.
- The stable outlook reflects our expectation that the Balearic Islands will continue gradually reducing its deficit levels and stabilizing its debt metrics over 2015-2016.

Rating Action

On May 30, 2014, Standard & Poor's Ratings Services revised its outlook on the Spanish Autonomous Community of the Balearic Islands to stable from negative. At the same time, we affirmed our 'BBB-' long-term issuer credit rating on the region.

Rationale

The rating on the Balearic Islands mainly reflects our opinion of the institutional framework for Spanish regions as "evolving but sound." We also view the Balearic Islands' relatively wealthy economy as a supportive rating factor.

We consider the Balearic Islands' budgetary flexibility to be comparable with that of other Spanish normal-status regions, with which it shares a common institutional framework. We also think that the Balearic Islands has moderate contingent liabilities associated with the ongoing restructuring of its large sector of fully or partially owned companies.

In our view, the Balearic Island's negative budgetary performance constrains the rating. We also regard the region's financial management as a "negative" rating factor, reflecting its recent track record of negative budgetary performance with large deficits. In our opinion, the Balearic Islands' extremely high tax-supported debt and our view of its "negative" liquidity further constrain the rating.

We view the institutional framework for Spanish normal-status regions as "evolving but sound," as described in our criteria. In our opinion, the legal reforms passed by Spain's central government, including enhanced monitoring and enforcement mechanisms, are largely fostering budgetary consolidation in Spain's regional tier, in line with our expectations. Also, the central government continues to provide substantial budgetary and financial support to all normal-status regions that require it. The central government is further supporting regions by gradually reducing the interest it charges for its loans, passing through its own lower costs of financing. We estimate this indirectly benefits regions that finance independently by giving them more leverage in their own negotiations and reducing their financing costs.

Although Spanish law states that the regional financing system should be revisited from 2014, we think that the reform will take longer than initially expected. The central government has subjected the reform of the regional financing system to the fiscal reform in Spain requested by the EU, which is still under study. Since the timing and impact of a reform in the financing system is still unknown, we do not factor it into our base-case budgetary forecasts or into our assessment of the institutional framework. We will evaluate the implications of the reform once we gain more visibility about the proposed changes. In the absence of a full reform, however, we anticipate that the central government could transfer additional resources to the regions that have the lowest financing to strengthen their financial positions.

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

Compared with our December 2013 base case for the Balearic Islands, because we have revised up our forecasts for Spanish GDP, we now project that moderate revenue growth will facilitate its budgetary consolidation process. We estimate real GDP growth of 1.3% in 2014, 1.8% in 2015, and 2.3% in 2016, versus our previous estimates of 0.8% in 2014 and 1.2% in 2015. While revenues for 2014 are largely set and determined by the financing system, we think the Balearic Islands may enjoy an improved economy as of 2015, which will support revenue expansion.

In 2013, the Balearic Islands performed roughly in line with our base case. The region outperformed our expectations in terms of operating balance, with a surplus of 0.6% of operating revenues against our expectation of a moderate deficit of 1.8%, but it posted a slightly higher deficit after capital expenditures, of 13.3% of total revenues against our expectation of 11.5%. In 2012 the Balearic Islands posted an operating deficit of 22% of operating revenues and a deficit after capital expenditures of 41% of total revenues. These budgetary execution data were affected by the inclusion of expenditures from previous years that were financed by the central government. Excluding these expenditures, the operating deficit would have been 7% of operating

revenues, and the balance after capital expenditures would have been 19.6% of total revenues.

We expect a moderate decline in nominal terms in the region's operating revenues in 2014, due largely to the effect of the current financing system. However, we expect revenues to resume growth, with an average rate of 3.1% between 2015 and 2016, which compares favorably with our previous estimate of 2% growth in 2015. In our view, the Balearic Islands could offset potential revenue decreases by using its budgetary flexibility, which we consider to be similar to that of other Spanish normal-status regions. For example, the Balearic Islands could raise rates on the taxes over which it has regulatory leeway or further reduce its investments.

In our base case, we assume the Balearic Islands' operating expenditures will grow slower than its operating revenues, at about 1.1% on average between 2015 and 2016. This would lead to a progressive rebalancing of the region's accounts. While we expect the Balearic Islands to post a moderate operating deficit of about 1.4% of operating revenues in 2014, due to lower revenues from the financing system, we expect the region will return to positive operating balances as of 2015 and beyond.

We expect the Balearic Islands to post declining deficits after investments as well, dropping to 10.9% in 2014 from 13.3% of total revenues in 2013, and reaching 3.3% in 2016. In 2013, the Balearic Islands cut its deficit to 1.28% of the regional GDP, down from 1.82% in 2012 and 4.19% in 2011. The region complied with its individual deficit target of 1.47% of GDP. Our base-case forecast reflects our expectation that the Balearic Islands will continue to reduce its deficits, sufficiently limiting operating expenditure growth and moderating capital expenditures to post results roughly in line with its fiscal targets.

Continued, although declining, deficits will push up the region's already high tax-supported debt, albeit at a slower pace than in previous years. We expect the Balearic Islands' tax-supported debt to reach 275.6% of consolidated operating revenues by 2015, only slightly above our previous estimate of 274% (from 255% in 2012). However, we assume that expanding revenues and gradually amortizing debt from the region's public sector will reduce debt to about 270% of consolidated operating revenues by 2016. This level is in line with our highest debt benchmark, but we think that the associated risk is mitigated by the central government's sponsorship of the facilities used to contract all net new indebtedness.

Our rating on the Balearic Islands also reflects our "negative" assessment of its financial management. We take into account the region's track record of budgetary deviations, as well as the size, complexity, and poor performance of its public-sector companies. We believe the Balearic Islands has low contingent liabilities arising from the ongoing restructuring process of these same companies, which is progressing in line with the region's plans. We already fully consolidate these companies' debt in our tax-supported debt for the islands.

Liquidity

Our view of the Balearic Islands' liquidity as "negative" for the rating is based on our opinion of the region's "very negative" debt service coverage ratio and "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 about 15% of the the region's debt service for the next 12 months. We estimate the region's debt service for June 2014 to May 2015 at €909 million.

Our view of the Balearic Islands' "strong" access to external liquidity encompasses that the central government is in a position to continue providing the islands' with strong liquidity support through the liquidity facility known as the Fondo de Liquidez Autonómica (FLA). The government has earmarked FLA funding for regional debt repayment and financing of the authorized deficits.

Outlook

The stable outlook reflects our expectation of the Balearic Islands' continued performance in line with our base case. We expect the region to continue reducing its deficit levels and stabilizing its debt metrics between 2015 and 2016.

We could lower the rating on the Balearic Islands if the region performed in line with our downside scenario. This would imply a very slow reduction of deficits. If this happens, we would likely revise downward our assessment of the region's budgetary flexibility, which could result in a one-notch downgrade of the Balearic Islands.

We could upgrade the Balearic Islands if the region reported higher revenues than in our base case, for example as the result of a favorable reform of the financing system combined with continued cost containment. This would lead to an ongoing trend of positive operating balances and positive balances after capital expenditures in 2015, which would lead to a gradual reduction in the tax-supported debt ratio. Under this upside case, we could also revise up our view on the region's financial management.

Published Rating Factor Scores

Table 1

Autonomous Community of The Balearic Islands -- Summary Of Published Rating Factor Scores*	
Rating factor	Score
Institutional framework	Evolving but sound
Financial management	Negative
Liquidity	Negative

*Standard & Poor's ratings on local and regional governments are based on, among other things, a scoring system that covers eight main rating factors. We publish our scores for the three rating factors above.

Key Statistics

Table 2

Autonomous Community of The Balearic Islands -- Financial Statistics						
--Financial year ending Dec. 31--						
(Mil. €)	--Actual--			--Base-case scenario--		
	2011	2012	2013	2014	2015	2016
Operating revenues	2,200.3	2,601.6	2,701.8	2,634.9	2,711.4	2,802.0
Operating expenditures	2,635.5	3,180.7	2,687.0	2,671.9	2,705.1	2,736.0
Operating balance	(435.2)	(579.1)	14.9	(36.9)	6.3	66.1
Operating balance (% of operating revenues)	(19.8)	(22.3)	0.6	(1.4)	0.2	2.4
Capital revenues	165.3	41.5	41.5	113.0	90.0	90.0
Capital expenditures	483.0	557.8	419.9	374.7	295.2	250.2
Balance after capital accounts	(752.8)	(1,095.3)	(363.5)	(298.6)	(198.9)	(94.1)
Balance after capital accounts (% of total revenues)	(31.8)	(41.4)	(13.3)	(10.9)	(7.1)	(3.3)
Debt repaid	214.8	482.8	487.6	766.7	778.9	830.7
Balance after debt repayment and onlending	(967.6)	(1,578.1)	(851.2)	(1,065.3)	(977.8)	(924.8)
Balance after debt repayment and onlending (% of total revenues)	(40.9)	(59.7)	(31.0)	(38.8)	(34.9)	(32.0)
Gross borrowings	565.2	1,668.8	1,292.8	1,065.3	977.8	924.8
Balance after borrowings	(402.5)	90.7	441.6	0.0	0.0	(0.0)
Operating revenue growth (%)	(12.8)	18.2	3.9	(2.5)	2.9	3.3
Operating expenditure growth (%)	(10.5)	20.7	(15.5)	(0.6)	1.2	1.1

Table 2

Autonomous Community of The Balearic Islands -- Financial Statistics (cont.)						
Modifiable revenues (% of operating revenues)	55.6	58.4	50.7	51.3	51.2	51.1
Capital expenditures (% of total expenditures)	15.5	14.9	13.5	12.3	9.8	8.4
Direct debt (outstanding at year-end)	3,686.8	4,992.6	5,797.8	6,096.4	6,295.3	6,389.4
Direct debt (% of operating revenues)	167.6	191.9	214.6	231.4	232.2	228.0
Tax-supported debt (% of consolidated operating revenues)	247.8	255.1	269.9	277.6	275.6	268.9
Interest (% of operating revenues)	5.6	8.9	8.6	9.3	9.6	9.6
Debt service (% of operating revenues)	15.3	27.5	26.7	38.4	38.3	39.3

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. Base case reflects Standard & Poor's expectations of the most likely scenario.

Table 3

Autonomous Community of The Balearic Islands -- Economic Statistics					
--Year ended Dec. 31--					
	2009	2010	2011	2012	2013
Population*	1,095,426	1,106,049	1,113,114	1,119,439	1,111,674
Population growth (%)	N.M.	1.0	0.6	0.6	(0.7)
Nominal GDP (mil. €)	25,980.3	25,737.3	25,967.9	25,892.8	26,061.4
GDP per capita (€)	24,169.0	23,829.0	23,769.0	23,596.0	23,446.0
GDP (real) growth (%)	(4.3)	(1.3)	1.0	(0.8)	(0.4)

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, Eurostat, and Experian Limited. *Figures for Jan. 1. N.M.--Not meaningful.

Key Sovereign Statistics

- Ratings on Spain Raised To 'BBB/A-2' On Improved Economic Prospects; Outlook Stable, May 23, 2014

Related Criteria And Research

Related Criteria

- Methodology For Rating International Local And Regional Governments, Sept. 20, 2010

Related Research

- Increasing Market Funding Eases Liquidity Pressures For Many Spanish Regions, March 31, 2014
- Institutional Framework Assessments For International Local And Regional Governments, Jan. 13, 2014
- Spain's Balearic Islands 'BBB-' Rating Affirmed On Expectation Of Continued Fiscal Consolidation; Outlook Negative, Dec. 5, 2013
- Spanish Regional Ratings Rely On Central Government Support Absent Reforms To The Regional Financing System, June 19, 2013
- 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 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.

Ratings List

Ratings Affirmed; Outlook Action

	To	From
The Balearic Islands (Autonomous Community of)		
Issuer Credit Rating	BBB-/Stable/--	BBB-/Negative/--
Senior Unsecured	BBB-	BBB-

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