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Research Update:

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

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Overview

- The Autonomous Community of the Balearic Islands in Spain is gradually reducing its deficits, and continues to benefit from liquidity support from the central government.
- 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 rating on the Balearic Islands.
- The stable outlook reflects our expectation that the Balearic Islands will continue gradually reducing its deficits and stabilizing its debt metrics over 2015-2016.

Rating Action

On Nov. 21, 2014, Standard & Poor's Ratings affirmed its 'BBB-' long-term issuer credit rating on Spain's Autonomous Community of the Balearic Islands. The outlook remains stable.

Rationale

The rating on the Balearic Islands mainly reflects our opinion of the institutional framework for Spanish regions as evolving but balanced. 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 view the Balearic Islands' budgetary flexibility as weak. We previously regarded the region's budgetary flexibility as average, in line with most other normal-status regions in Spain, with which it shares a common institutional framework.

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.

We think that 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. At the same time, 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 on its own lower costs of financing. We assume this indirectly benefits self-financing regions by giving them more leverage in their own negotiations and reducing their financing costs. These developments are in line with our expectations and support our view of the institutional framework for normal-status regions as evolving but balanced.

We no longer believe that the financing system for Spain's normal-status regions will be reformed in 2015. We understand the central government has postponed this reform to avoid opening up a politically sensitive debate during 2015, when national and regional elections are due. In our view, the central government is also aware of its limited ability to provide additional resources to the system, which it has done in the past in order to reach agreements with regions.

However, in the absence of a full reform, we note that the government is providing indirect support to the regions. Among other measures, the central government has decided to lower interest rates on its loans to the regional tier through Spain's regional liquidity fund, Fondo de Liquidez Autonómica (FLA), while also deferring for 20 years (up from 10) the settlements arising from the financing system over 2008-2009. These measures benefit disproportionately the regions with the weakest finances. We view this as evidence of the central government's continued willingness to support the regional tier.

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.

We continue to expect the Balearic Islands to gradually improve its budgetary performance over our forecast period to 2016.

We expect higher operating revenues than in our previous base case. This increase in resources is due to a large positive settlement from 2013 (to be cashed in during 2015), combined with a 5.5% increase in advances from the financing system, and the deferral for 20 years of the region's negative settlements from 2008 and 2009. Thereafter, we expect the Balearic Islands' revenues to continue growing in line with nominal GDP.

We also expect the Balearic Islands to benefit from lower interest expenditures, due to the central government's decision to lower interest on its debt instruments for the fourth quarter of 2014 and full-year 2015.

Nevertheless, we also expect that the Balearic Islands will make use of this additional leeway to expand operating expenditures and investments beyond our previous forecasts. Given the regional government's stance on spending, we have revised down our view of the islands' budgetary flexibility, which we now view as weak instead of average. We consider that the commitments the regional government has assumed in the context of the 2015 draft budget, including an expansion of expenditures and a reduction in taxes, limit the regional government's margin for maneuver, should it wish to reverse this stance.

As a result, we have revised down our expectations of operating balances. Whereas we previously expected the Balearic Islands to post positive operating balances in 2015 and 2016, we now think it likely that the islands will post a small operating surplus in 2014, but return to small operating deficits in 2015 and 2016.

We also expect that the Balearic Islands will invest higher amounts than in our previous base case. We therefore anticipate that the Balearic Islands' budgetary deficits will gradually contract, but we now think this adjustment will be slower than we previously thought, reaching a deficit of about 8.7% of total revenues in 2016, compared with our previous estimate of a 3.3% deficit. Nevertheless, the Balearic Islands may comply with or post only moderate deviations from its official deficit targets over 2014-2016, as a consequence of positive national accounting adjustments.

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 have revised upward our estimate of tax-supported debt for the Balearic Islands in 2014, to account for the impact of the supplier debt refinancing program for 2014, as well as higher expected deficits. While this pushes up our tax-supported debt estimate for the region in nominal terms, our higher revenue forecast mitigates the impact on tax-supported debt ratios. Thus, we now expect the Balearic Islands' tax-supported debt to reach 285% of consolidated operating revenues by 2016, up from our previous estimate of 270%. This level is above our highest debt benchmark, although the associated risk is mitigated by the fact that over half of outstanding debt is owed to the central government.

Our rating on the Balearic Islands also reflects our assessment of its 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 despite having a level of indebtedness clearly above that of Spanish peers.

We believe the Balearic Islands has low contingent liabilities, arising from the ongoing restructuring of its fully or partially owned companies, which is progressing in line with the region's plans. We already fully consolidate these companies' debt in our tax-supported debt figures for the islands.

Liquidity

Our view of the Balearic Islands' liquidity as less than adequate is based on our opinion of the region's weak debt service coverage, mitigated in our view by 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 December 2014 to November 2015 at €927 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 FLA. The government has earmarked FLA funding for regional debt repayment and financing of the authorized deficits. The government has confirmed FLA funding for 2015, and it is sufficiently endowed in the central government's budget, in our view. We expect FLA funding will remain available thereafter if it is required.

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 2016, albeit at a higher level than we previously expected.

We could lower the rating on the Balearic Islands if the region performed in line with our downside scenario. This would include a budgetary performance clearly below our base case, resulting in persistent negative operating balances, and a failure to reduce deficits and comply with deficit targets. In this case, we could revise down our view on the Balearic Islands' financial management, and lower the rating by one notch.

We could upgrade the Balearic Islands if the region reported higher revenues than in our base case, and if we expected that it would be able to maintain its debt ratios structurally below our highest debt benchmark of 270% of consolidated operating revenues.

Key Statistics

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Table 1

Autonomous Community Of The Balearic Islands -- Financial Statistics

	--Year ending Dec. 31--					
(Mil. €)	**2011**	**2012**	**2013**	**2014bc**	**2015bc**	**2016bc**
Operating revenues	2,200	2,602	2,702	2,701	2,815	2,878
Operating expenditures	2,635	3,181	2,687	2,695	2,839	2,897
Operating balance	(435)	(579)	15	5	(24)	(20)
Operating balance (% of operating revenues)	(19.8)	(22.3)	0.6	0.2	(0.9)	(0.7)
Capital revenues	165	42	42	51	81	83
Capital expenditures	483	558	420	390	375	322
Balance after capital accounts	(753)	(1,095)	(364)	(334)	(318)	(259)
Balance after capital accounts (% of total revenues)	(31.8)	(41.4)	(13.3)	(12.1)	(11.0)	(8.7)
Debt repaid	215	483	488	781	719	833
Gross borrowings	565	1,669	1,293	1,480	1,038	1,092
Direct debt (outstanding at year-end)	3,687	4,993	5,798	6,496	6,815	7,074
Direct debt (% of operating revenues)	167.56	191.90	214.59	240.55	242.08	245.82
Tax-supported debt (outstanding at year-end)	5,682	6,869	7,538	7,972	8,253	8,482
Tax-supported debt (% of consolidated operating revenues)	247.8	255.1	269.9	285.5	283.7	285.2
Interest (% of operating revenues)	5.6	8.9	8.6	9.0	7.3	7.4
Debt service (% of operating revenues)	15.3	27.5	26.7	37.9	32.8	36.3

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

Table 2

Autonomous Community Of The Balearic Islands -- Economic Statistics

	--Year ended Dec. 31--				
	2009	**2010**	**2011**	**2012**	**2013**
Population (000s) on July 1	1,075	1,080	1,093	1,097	1,112
Population growth (%)	1.5	0.5	1.1	0.4	1.3
Nominal GDP (mil. €)	25,980	25,737	25,968	25,893	26,061
GDP per capita (€)	24,169	23,829	23,769	23,596	23,446
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, 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

- Ratings On Spain Affirmed At 'BBB/A-2'; Outlook Stable, Nov. 14, 2014

Related Criteria And Research

Related Criteria

- 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, Nov. 14, 2014
- Outlook On Spain's Balearic Islands Revised To Stable On Continued Fiscal Consolidation; May 30, 2014
- Institutional Framework Assessments For International Local And Regional Governments, Jan. 1, 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 Affirmed

The Balearic Islands (Autonomous Community of)

Issuer Credit Rating	BBB-/Stable/--
Senior Unsecured	BBB-

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