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## Research Update:

# Spanish Region of The Balearic Islands Upgraded To 'BBB' On Improved Budgetary Performance And Debt; Outlook Stable

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## Research Update:

# Spanish Region of The Balearic Islands Upgraded To 'BBB' On Improved Budgetary Performance And Debt; Outlook Stable

## Overview

- We expect that, in 2016, the Spanish Autonomous Community of The Balearic Islands will post a significantly better budgetary outcome than we projected and reduce its still-very-high debt burden to below 270% of consolidated revenues.
- Therefore, we are raising our long-term rating on the Balearic Islands to 'BBB' from 'BBB-'.
- The stable outlook reflects our expectation that the region's economic and budgetary performance will be in line with our base-case scenario over 2016-2018, and that the region will continue to receive financial support from the central government.

## Rating Action

On Nov. 25, 2016, S&P Global Ratings raised to 'BBB' from 'BBB-' its long-term issuer credit rating on the Autonomous Community of The Balearic Islands in Spain. The outlook is stable.

## Rationale

The upgrade is based on our view that the Balearic Islands' tax-supported debt will decline and remain below our threshold of 270% of consolidated operating revenues through 2018. This results from our expectation of a lower deficit after capital accounts in 2016 and higher tax collection than we expected so far this year. We now assess the region's budgetary performance as weak compared with very weak previously.

The rating on the Balearic Islands is primarily underpinned by 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 the Balearic Islands' contingent liabilities as low.

Despite the improvement we expect in budgetary performance, we continue to assess the region's financial management as weak based on past deficits and a still-very-high debt burden. 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. We factor in our view of the Balearic Islands' less-than-adequate liquidity, based on the region's very low internal capacity to generate cash, which is mitigated by its strong access to central government liquidity facilities.

The long-term rating is at the same level as our 'bbb' assessment of the Balearic Islands' stand-alone credit profile (SACP).

Our view of the institutional framework of Spain's normal-status regions as evolving but balanced hinges on the strong support that regions receive from the central government. Since 2012, 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 financial and fiscal conditions. The Balearic Islands has used the central government liquidity facilities since their inception. On the positive side, we also factor in improved transparency on budgetary performance and period of payment to suppliers.

However, we think that the system still suffers from some weaknesses. In our view, the main drawback is the difficulty in matching revenues and expenditures, due to rigid expenses alongside revenues that are sensitive to the economic cycle. Despite some improvements since the onset of the financial crisis in 2008, regions continue posting high deficits and accumulating debt. We think the central government has not applied the full range of coercive measures to regions that do not comply with fiscal targets 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 fragmentation in Spain following the June 2016 election, we view as unlikely that the regional financing system will undergo any major reform within our forecast horizon through 2018. In any case, we do not think that such a reform would be detrimental to the Balearic Islands.

The Balearic Islands is one of Spain's wealthier regions, with GDP per capita at 104.7% of the Spanish average, based on 2015 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 will post an operating surplus of 5.7% of operating revenues and an overall deficit after capital accounts of 6.9% of total revenues in 2016, compared with our previous estimates of 0.1% and 11.2%. We believe that the region will likely comply with the central government's official deficit targets for the first time in 2016.

We anticipate that the Balearic Islands' operating revenues will grow by 11.6% in 2016 compared with 2015, due mainly to more dynamic economic growth in the islands and some fiscal measures adopted by the new regional government following the 2015 elections. Revenues from the financing system will increase by 6%. As of 2017, we expect operating revenues will amount to €3.4 billion, in line with the region's draft budget for the year.

In our base-case scenario, we anticipate that the exceptional conditions linked to the central government's liquidity facilities and the increase in operating revenues will allow the Balearic Islands to increase spending, mainly on personnel costs and subsidies. As a consequence, we think the Balearic Islands' operating balance will

continue on the positive side (1.4% of operating revenues in 2017 and 1.9% in 2018), but slightly lower than our estimate of 5.7% in 2016.

We also expect the Balearic Islands will maintain capital expenditures above €400 million annually to sustain regional economic activity in 2016-2018, resulting in deficits after capital expenditures of 7.5% of total revenues on average.

We view the Balearic Islands' budgetary flexibility as weak in an international context, given its limited ability to cut expenditures. We believe the region's leeway lies in additional revenues from potential system reform rather than political willingness to cut spending.

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 decline below 270% of consolidated operating revenues in 2016, due to higher revenues than we expected. Consequently, we have removed our negative adjustment to the SACP, reflecting the region's improved debt burden. The region owed more than 60% of its debt to the central government as of June 30, 2016, according to the Bank of Spain. We expect this proportion will increase over 2016-2018, as the islands continue to fund their needs with the central government's liquidity facilities.

We believe the Balearic Islands has low contingent liabilities, arising from its public-sector companies. We fully consolidate these public-sector companies' debt in our calculations 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 improvement in the budgetary performance in 2016 compared with our previous estimate, we continue to take into account the region's historically high deficits and debt accumulation. In addition, the region's average payment periods are currently among the longest of all Spanish regions.

## **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 €1.2 billion.

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 facility, Fondo de Financiación de las Comunidades Autónomas. This support underpins our ratings on Spanish normal-status regions, including the Balearic Islands.

## Outlook

The stable outlook reflects our expectation that the Balearic Islands' economic and budgetary performance will be in line with our base-case scenario over 2016-2018, and that the region will continue to receive financial support from the central government.

We could downgrade the Balearic Islands by one notch if, contrary to our expectations, the region's budgetary performance deteriorates to a deficit after capital accounts exceeding 10% of total revenues, propelling tax-supported debt above 270% of consolidated revenues by 2018.

We could upgrade the Balearic Islands if it performed in line with our upside case. Under this scenario, we assume stronger budgetary performance than in our base case, which would lead us to improve our view on the region's financial management.

## Key Statistics

Table 1

Autonomous Community of the Balearic Islands Financial Statistics						
	--Fiscal year ending Dec. 31--					
(Mil. €)	2013	2014	2015	2016 bc	2017 bc	2018 bc
Operating revenues	2,702	2,687	2,976	3,320	3,401	3,517
Operating expenditures	2,687	2,831	3,019	3,130	3,355	3,451
Operating balance	15	(144)	(44)	191	46	66
Operating balance (% of operating revenues)	0.6	(5.4)	(1.5)	5.7	1.4	1.9
Capital revenues	42	101	19	29	91	94
Capital expenditures	420	707	473	452	415	435
Balance after capital accounts	(364)	(750)	(498)	(232)	(277)	(275)
Balance after capital accounts (% of total revenues)	(13.3)	(26.9)	(16.6)	(6.9)	(7.9)	(7.6)
Debt repaid	488	678	504	714	808	688
Balance after debt repayment and onlending	(851)	(1,428)	(1,002)	(946)	(1,085)	(963)
Balance after debt repayment and onlending (% of total revenues)	(31.0)	(51.2)	(33.5)	(28.3)	(31.1)	(26.7)
Gross borrowings	1,293	1,611	1,176	1,242	1,156	963
Balance after borrowings	442	183	174	295	71	(0)
Operating revenue growth (%)	3.9	(0.6)	10.8	11.6	2.4	3.4
Operating expenditure growth (%)	(15.5)	5.3	6.7	3.7	7.2	2.9
Modifiable revenues (% of operating revenues)	50.7	54.7	54.9	51.7	55.6	55.6
Capital expenditures (% of total expenditures)	13.5	20.0	13.5	12.6	11.0	11.2

**Table 1**

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

(Mil. €)	--Fiscal year ending Dec. 31--					
	2013	2014	2015	2016 bc	2017 bc	2018 bc
Direct debt (outstanding at year-end)	5,798	6,756	7,258	7,786	8,134	8,409
Direct debt (% of operating revenues)	214.6	251.5	243.9	234.5	239.2	239.1
Tax-supported debt (% of consolidated operating revenues)	269.9	295.5	277.8	262.0	263.0	259.6
Interest (% of operating revenues)	8.6	8.8	5.0	4.0	4.0	4.6
Debt service (% of operating revenues)	26.7	34.0	22.0	25.5	27.8	24.1

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.

**Table 2**

**Autonomous Community of the Balearic Islands Economic Statistics**

	--Fiscal year ended Dec. 31--				
	2011	2012	2013	2014	2015
Population, as of July 1	1,095,500	1,104,300	1,112,700	1,120,500	1,129,200
Population growth (%)	(1.0)	0.8	0.8	0.7	0.8
GDP per capita (€)	23,762	23,372	23,220	23,498	24,394
Real GDP growth (%)	(0.3)	(1.0)	(1.6)	1.2	3.2
Unemployment rate (%)	25.5	24.3	22.7	18.9	17.0

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. Sources typically include national statistical offices, Eurostat, and Experian Limited.

## 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	Weak
Liquidity	Less than adequate
Debt burden	Very high
Contingent liabilities	Low

\*S&P Global Ratings bases its ratings on local and regional governments are based on the eight main rating factors listed in the table above. Section A of S&P Global Ratings' "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 government's foreign currency rating.

## Key Sovereign Statistics

Sovereign Risk Indicators, Oct. 13, 2016. An interactive version is also available at <http://www.spratings.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
- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009

### Related Research

- Sovereign Risk Indicators - October 13, 2016
- Kingdom of Spain 'BBB+/A-2' Ratings Affirmed; Outlook Stable - September 30, 2016
- Spain's Autonomous Community of the Balearic Islands Outlook Revised To Positive; 'BBB-' Rating Affirmed - March 4, 2016
- Public Finance System Overview: Spanish Normal-Status Regions - July 29, 2015
- 2015 Annual International Public Finance Default Study And Rating Transitions - June 30, 2016

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/Stable/--	BBB-/Positive/--
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](http://www.standardandpoors.com) for further information. Complete ratings information is available to subscribers of RatingsDirect at [www.globalcreditportal.com](http://www.globalcreditportal.com) and at [spcapitaliq.com](http://spcapitaliq.com). All ratings affected by this rating action can be found on S&P Global Ratings' public Web site at [www.standardandpoors.com](http://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; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

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