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Research Update:

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

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Overview

- The Spanish Autonomous Community of the Balearic Islands is gradually improving its budgetary performance and continues to receive access to liquidity support from the central government.
- The region's high debt burden constrains 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 region's economic and budgetary performance will be in line with our base-case scenario in 2017-2019, and that the region will continue to receive financial support from the central government.

Rating Action

On May 26, 2017, S&P Global Ratings affirmed its 'BBB' long-term issuer credit rating on Spain's Autonomous Community of the Balearic Islands. The outlook remains stable.

Outlook

The stable outlook reflects our view that the Balearic Islands will gradually reduce its deficit after capital accounts to below 6% by 2019, in light of Spain's solid economic growth that is fueling tax bases. As a result, we also expect the islands' debt burden will decline in 2017-2019, although debt remains high in an international comparison. Furthermore, we believe that the region will continue to fund its needs through central government-sponsored liquidity facilities.

Downside Scenario

We could lower our rating on the Balearic Islands by one notch if, contrary to our expectations, the region's budgetary performance deteriorated to structural operating deficits and deficits after capital accounts above 10% of total revenues. Under this scenario, we would expect the region's tax-supported debt to jump to above 270% of consolidated operating revenues.

Upside Scenario

We could raise the rating on the Balearic Islands if it posted stronger budgetary performance than in our base case, with positive operating balances and deficits after capital accounts structurally below 5% of total revenues. Under this scenario, we could revise upward our assessment of the region's financial management.

Rationale

We have updated our base-case for the Balearic Islands, extending our forecast horizon to 2019. We believe the region will reduce its deficits over 2017-2019, based on the currently supportive economic backdrop and its control of its expenditures. At the same time, we assume the region will continue benefitting from the central government's liquidity facilities to cover its funding needs.

Institutions, ongoing economic recovery, and enhanced budgetary control underpin the region's improvements

Our view of the institutional framework of Spain's normal-status regions, including the Balearic Islands, 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. We also note the regions' 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 a clear improvement in performance, regions continue posting high deficits and accumulating debt. In February 2017, the central government set up a working group on the reform, which must submit a report within six months to the Fiscal and Financial Policy Council (the coordinating body between the central government and the regions). However, we do not expect such a reform to be approved before the end of the year, given the complex political situation in Spain, with a minority government and a fragmented national parliament.

We expect Spain's economy will expand over 2017-2019, with nominal GDP growth rates above 3.5% on average. Given the equalization features of the regional financing system, we take into account national GDP per capita for our assessment of the economies of Spain's normal-status regions.

The Balearic Islands is one of Spain's wealthier regions, with GDP per capita at 103.8% of the Spanish average based on 2016 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 the strong equalization transfers in the Spanish public finance system.

We still see the Balearic Islands' financial management as a rating weakness, based on the region's weak budgetary performance in the past, which led to accumulation of very high debt. On the positive side, though, we acknowledge that the region complied with the deficit target in 2016 and has improved its budgeting and control of expenditures.

The region is improving its budgetary performance, although it remains constrained by hefty debt

The region posted a deficit after capital accounts of 8.1% of total revenues in 2016, less than half of 16.6% in 2015. In our opinion, this improved performance followed an increase in operating revenues, which grew by 9.6% in 2016 compared with 2015, while the region's operating expenditures remained controlled. The increase in 2016 operating revenues is explained by higher revenues from the regional financing system, as well as higher own tax revenues fueled by economic growth.

We anticipate that the region will continue to show positive operating balances and gradually reduce its deficit after capital accounts to slightly below 6% by 2019. In our view, improving budgetary performance will hinge on favorable economic conditions translating into higher revenues. We believe the region's ability to cut expenditures is limited.

Although deficits will continue to increase the Balearic Islands' already very high tax-supported debt in nominal terms, we expect tax-supported debt will decline to 254% of consolidated operating revenues by the end of 2019 from 267% at the end of 2016. This is a very high level of debt in an international comparison, and remains one of the highest among Spain's regions. However, the region owes about 70% of debt to the central government. We expect this proportion will increase in 2017-2019, given our view that the region will cover all its borrowing needs through central government-sponsored liquidity facilities. We expect these facilities will remain available for all Spanish normal-status regions.

Access to such support, together with higher revenues, has enabled the Balearic Islands to reduce its period of payment to suppliers to 29 days as of Feb. 28, 2017, from 70 days as of Dec. 31, 2015.

Still, we believe that the region's capacity to generate cash remains weak. According to our estimates, its cash and available credit lines cover less than 40% of its debt service for the 12 months ending May 31, 2018 (about €1.2 billion). Nevertheless, we take into account that debt service is fully covered by the central government, which limits refinancing risk, in our view.

We believe the Balearic Islands have low contingent liabilities, arising from its public-sector companies. We already fully consolidate these companies' debt in our calculations of tax-supported debt for the islands.

Key Statistics

Table 1

Autonomous Community of the Balearic Islands Key Statistics

	--Fiscal year ending Dec. 31--				
(Mil. €)	**2015**	**2016**	**2017bc**	**2018bc**	**2019bc**
Operating revenues	2,976	3,260	3,413	3,532	3,645
Operating expenditures	3,019	3,100	3,372	3,457	3,509
Operating balance	(44)	160	41	74	136
Operating balance (% of operating revenues)	(1.5)	4.9	1.2	2.1	3.7
Capital revenues	19	20	93	97	35

Table 1

Autonomous Community of the Balearic Islands Key Statistics (cont.)

	--Fiscal year ending Dec. 31--				
(Mil. €)	**2015**	**2016**	**2017bc**	**2018bc**	**2019bc**
Capital expenditures	473	447	413	424	381
Balance after capital accounts	(498)	(267)	(279)	(252)	(211)
Balance after capital accounts (% of total revenues)	(16.6)	(8.1)	(7.9)	(7.0)	(5.7)
Debt repaid	504	712	808	861	986
Gross borrowings	1,176	1,284	1,086	1,113	1,197
Balance after borrowings	174	305	0	0	0
Modifiable revenues (% of operating revenues)	54.9	57.3	55.9	56.0	56.1
Capital expenditures (% of total expenditures)	13.5	12.6	10.9	10.9	9.8
Direct debt (outstanding at year-end)	7,462	7,868	8,147	8,399	8,610
Direct debt (% of operating revenues)	250.8	241.3	238.7	237.8	236.2
Tax-supported debt (outstanding at year-end)	8,712	8,930	9,073	9,303	9,491
Tax-supported debt (% of consolidated operating revenues)	285.1	267.1	259.3	256.9	254.0
Interest (% of operating revenues)	5.0	3.3	3.6	3.6	3.5
Local GDP per capita (single units)	24,102	24,870	N/A	N/A	N/A
National GDP per capita (single units)	23,157	23,982	24,882	25,712	26,522

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

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	Average
Liquidity	Less than adequate
Debt burden	Very high
Contingent liabilities	Low

*S&P Global Ratings bases its ratings on local and regional governments 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 our foreign currency rating on the government.

Key Sovereign Statistics

Sovereign Risk Indicators - April 10, 2017. 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
- Criteria - Governments - International Public Finance: Methodology And Assumptions: The Impact Of PPP Projects On International Local And Regional Governments: Refined Accounting Treatment - December 15, 2008

Related Research

- 2016 Annual Non-U.S. Local And Regional Government Default Study And Rating Transitions - May 8, 2017
- Sovereign Risk Indicators - April 10, 2017. An interactive version is also available at http://www.spratings.com/sri.
- Kingdom of Spain Outlook Revised To Positive On Strong And Balanced Economic Performance; 'BBB+/A-2' Ratings Affirmed - March 31, 2017
- Spanish Region of the Balearic Islands Upgraded To 'BBB' On Improved Budgetary Performance And Debt; Outlook Stable - Nov. 25, 2016
- Why We Don't Equalize Our Ratings On Spanish Normal-Status Regions With Those On The Sovereign - Jan. 19, 2017
- Spanish Regions' Healthcare Spending Underscores Asymmetries And Hinders Budgetary Convergence - Sept. 27, 2016
- For Spain's Normal-Status Regions, Recovery Is Still Far Off - Sept. 8, 2016
- Spanish Regions' Risk Indicators: July 2016 - July 4, 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 agreed that the budgetary performance had improved. All other key rating factors were unchanged.

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

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