Research Update:

Spanish Region The Balearic Islands Affirmed At 'BBB+'; Outlook Positive

May 17, 2019

Overview

- We expect the Autonomous Community of the Balearic Islands to continue reducing its deficit and its debt burden through 2021, on the back of currently supportive economic growth.
- The region has structurally improved its liquidity while maintaining access to the central government's liquidity facilities.
- We are affirming our 'BBB+' long-term rating on the Balearic Islands and maintaining our positive outlook.

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Rating Action

On May 17, 2019, S&P Global Ratings affirmed its 'BBB+' long-term issuer credit rating on the Spanish Autonomous Community of the Balearic Islands. The outlook remains positive.

Outlook

The positive outlook indicates that we could upgrade the Balearic Islands over the next 12 months if the new management resulting from the May elections maintains a structurally strong financial performance that allows the buildup of some budgetary flexibility. We could also raise the ratings if the Balearic Islands accelerates its deleveraging path more than we project in our base case.

Downside Scenario

We could revise our outlook to stable over the next 12 months if we considered that the new government resulting from the May elections was unlikely to strengthen the Balearic Islands' budgetary flexibility or reduce its debt burden beyond our base case. We could also take a negative rating action if the region's liquidity position deteriorates materially.

Rationale

We affirmed our long-term issuer credit rating on the Balearic Islands because we expect the region to continue to shrink its deficit over 2019-2021, although its 2018 results were slightly weaker than our estimate. This was due to some one-off litigations and extraordinary costs resulting from floods the islands suffered last year. We also consider the region's debt very high, especially compared with peers'. However, contrary to our previous expectations, we believe the region will be able to maintain cash and available credit lines exceeding 40% for debt servicing over the next 12 months, even in 2020, when we estimate the region's debt service will peak at €1.5 billion.

We see ongoing budgetary consolidation and improved liquidity projections, but debt remains very high

We have updated our base-case assumptions for the Balearic Islands, taking into account the 2018 budgetary results, as well as the region's 2019 budget. Based on this information, along with our expectations of continued (albeit slower) economic growth in Spain, we expect the region's budgetary performance will gradually strengthen through 2021, although 2018 results were slightly weaker than expected.

We estimate continued robust operating margins at 8.1% of operating revenue on average over 2019-2021, but lower than the 11.2% posted in 2018. We project that operating revenue will increase by 3.8% on average, while operating expenditure will increase by 4.6% over the same period. We expect the region will focus on strengthening its social services, in particular health care and education.

We believe the Balearic Islands will determine the size of its investment program to be commensurate with the official deficit targets. We anticipate capital expenditure will average €468 million over 2019-2021, while capital revenue will be about €46 million. Consequently, we project the budget deficit will decline to 0.5% of total revenue by 2021 from 5.6% in 2018. The Balearic Islands will go through regional elections on May 26, 2019, and we have no visibility on the outcome. Nevertheless, we do not expect a new administration to deviate from the current path.

In 2018, the region posted a deficit of 5.6% of total revenue, higher than the 2.4% we expected. This was due to two one-off items. First, the region faced legal claims of more than €150 million. Second, the region covered about €22 million of damage caused by floods in the second half of 2018. According to preliminary data, the region posted a 2018 deficit of 0.39% of regional GDP in national accounting terms--which includes all of the region's public entities that consolidate under the European System of Accounts--versus a deficit target of 0.4%.

We think that the region's ability to cut expenditure to absorb potential revenue declines is still limited, mainly due to pressure on the health care system. However, we acknowledge management's efforts to bring health care budgets in line with actual expenditure. The region may gradually gain budgetary flexibility if its financial results continue to improve.

The Balearic Islands' debt burden is still very high in a global context, and we believe this constrains its creditworthiness. We expect the region's tax-supported debt will decline to 201% of consolidated operating revenue by 2021, compared with 227% in 2018. The region's direct debt represents 92% of the total, while the remainder comprises the debt of the region's satellite companies, guarantees, and public-private partnerships. We believe the Balearic Islands have low contingent liabilities.

We estimate the region's liquidity sources (cash and available credit lines) for the 12 months ending May 30, 2020, will cover 52% of debt servicing for the same period. We expect this ratio to remain above 40% over the next two years, despite the region's debt maturities peaking in 2020 at €1.5 billion.

The region issued a nine-year, €400 million bond in February 2019, after the central government set up a procedure to allow the best-performing regions to return to market funding. We expect the region will gradually increase its bond issuance and reduce its recourse to the central government's financial facility through 2021.

Despite this, we believe central-government-sponsored liquidity facilities will remain available to meet the region's debt servicing needs in a timely fashion, if required, which limits refinancing risk. We note that the region owed 74% of its debt to the central government at year-end 2018.

The Balearic Islands benefit from Spain's economic recovery and stronger fiscal rules, despite a lack of regional financing system reforms

We project Spain's economy will expand by 2.1% in 2019, before slowing down to 1.8% on average over 2020-2021, and the Balearic Islands will be no exception. At the same time, we assume rising inflation of 1.5% on average, which will support fiscal revenue growth.

The region's wealth is slightly above the national average. The Balearic Islands' GDP per capita stands at 103.5% of Spain's, based on 2018 data from the national statistics office. However, the region does not benefit fully from its wealth, since it is a net contributor to the equalization transfers in the Spanish public finance system. Therefore, we consider the national GDP per capita figures when evaluating the economy of Spain's normal-status regions.

In the current environment of expanding revenue, the expenditure rule, which establishes limits on annual nominal expenditure growth, has become the key driver of budgetary consolidation, and is now a more stringent constraint than deficit targets. We see the increased relevance of the expenditure rule in supporting our expectation of budgetary consolidation for Spanish regions, including the Balearic Islands, during the forecast period.

The push to comply with these expenditure growth limits led 13 of Spain's 17 regions, including the Balearic Islands, to outperform the deficit target in 2018, with five regions posting surpluses.

In our view, the main drawback of the regional financing system is the difficulty in matching revenue and expenditure in the low points of the economic cycle. We think a reform of the system, which is crucial to ensuring the long-term sustainability of Spanish regional finances, is overdue. However, we do not expect a reform in 2019, taking into account the electoral cycle in Spain, with general elections in April 2019, and regional elections in most regions, including the Balearic Islands, in May 2019.

Despite this lack of financing reform, Spain's central government has provided liquidity support to the regions since 2012, covering practically all of their funding needs, if needed. Starting in 2018, several of the regions that have made use of such support have gradually started returning to market-based funding, including the Balearic Islands.

Key Statistics

Table 1

The Balearic Islands (Autonomous Community of) Key Statistics

	--Fiscal year end Dec. 31--					
(Mil. €)	2016	2017	2018	2019bc	2020bc	2021bc
Operating revenue	3,263	3,618	3,907	4,087	4,227	4,369
Operating expenditure	3,101	3,296	3,468	3,793	3,890	3,968
Operating balance	162	322	439	294	337	402
Operating balance (% of operating revenue)	5.0	8.9	11.2	7.2	8.0	9.2
Capital revenue	20	41	41	45	46	48
Capital expenditure	447	596	703	463	468	473
Balance after capital accounts	(265)	(234)	(223)	(125)	(84)	(23)
Balance after capital accounts (% of total revenue)	(8.1)	(6.4)	(5.6)	(3.0)	(2.0)	(0.5)
Debt repaid	712	807	862	994	1,482	1,131
Gross borrowings	1,276	1,327	890	1,118	1,566	1,154
Balance after borrowings	300	286	(195)	0	0	0
Modifiable revenue (% of operating revenue)	56.3	61.0	60.9	63.1	63.1	63.1
Capital expenditure (% of total expenditure)	12.6	15.3	16.9	10.9	10.7	10.6
Direct debt (outstanding at year-end)	7,868	8,246	8,425	8,420	8,504	8,527
Direct debt (% of operating revenue)	241.1	227.9	215.6	206.0	201.2	195.1
Tax-supported debt (outstanding at year-end)	8,930	9,082	9,042	9,036	9,028	8,967
Tax-supported debt (% of consolidated operating revenue)	266.8	246.2	226.8	216.9	209.6	201.4
Interest (% of operating revenue)	3.3	3.1	3.4	3.0	3.2	3.1
Local GDP per capita (€)	25,063	25,772	N/A	N/A	N/A	N/A
National GDP per capita (€)	24,090	25,067	25,896	26,804	27,666	28,539

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. dc--Downside case represents some but not all aspects of S&P Global Ratings' scenarios that could be consistent with a downgrade. uc—Upside case represents some but not all aspects of S&P Global Ratings' scenarios that could be consistent with an upgrade. 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	Satisfactory
Budgetary flexibility	Weak
Budgetary performance	Strong
Liquidity	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 11, 2019. Interactive version available at http://www.spratings.com/sri

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, Oct. 15, 2009
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria - Governments - International Public Finance: Methodology And Assumptions: The Impact Of PPP Projects On International Local And Regional Governments: Refined Accounting Treatment, Dec. 15, 2008

Related Research

- Sovereign Risk Indicators, April 11, 2019
- Spanish Regions: Back To Bond Markets As Consolidation Continues, April 8, 2019
- Spain 'A-/A-2' Ratings Affirmed; Outlook Positive, March 22, 2019
- Public Finance System Overview: Spanish Normal Status Regions, Aug. 2, 2018
- Ready, Set, Go: Spanish Regions Could Soon Get The Green Light To Seek External Funding, July 25, 2018
- Peer Comparison: Spanish Regions' Creditworthiness Continues To Improve, Although

Asymmetries Remain, June 18, 2018

- 2017 Annual International Public Finance Default Study And Rating Transitions, June 11, 2018

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+/Positive/--
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. 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; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.