S&P Global
Ratings

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Research Update:

Spanish Region of The Balearic Islands Outlook Revised To Stable; 'BBB+' Ratings Affirmed

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PRIMARY CREDIT ANALYST

Marta Saenz
Madrid
+ 34 91 788 7231
marta.saenz
@spglobal.com

SECONDARY CONTACT

Ines Olondriz
Madrid
(34) 91-788-7202
ines.olondriz
@spglobal.com

ADDITIONAL CONTACT

EMEA Sovereign and IPF
SovereignIPF
@spglobal.com

Overview

- We expect the Balearic Islands to post higher-than-expected deficits in 2019 due to lower operating revenues and one-off expenditure items.
- According to our current base case, the Balearic Islands' tax-supported debt ratio will decline slower than anticipated, although we believe the region will return to declining deficits through 2020-2021.
- We are therefore revising our outlook on the Balearic Islands to stable from positive, and affirming our 'BBB+' long-term issuer credit ratings.

Rating Action

On Nov. 15, 2019, S&P Global Ratings revised its outlook to stable from positive on the Spanish Autonomous Community of the Balearic Islands, and affirmed its 'BBB+' long-term issuer credit rating.

Outlook

The stable outlook reflects our expectation that the Balearic Islands will gradually reduce its budgetary deficits by 2021 on the back of Spain's economic growth. As a result, although the region's tax-supported debt will remain high in an international comparison, the ratio will decline by 2021. Furthermore, we believe that the region will continue to fund its needs mainly through central government 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 over 2019-2021 deteriorated from the levels in our current base-case scenario, which could cause a worsening of the region's liquidity position.

Upside scenario

We could raise the rating if the Balearic Islands posted stronger budgetary performance than in our base case, with deficits after capital accounts structurally below 5% of total revnenues. This would lead to a stronger liquidity position, allowing the region to reduce its tax-supported debt ratio more rapidly than our current projections.

Rationale

We have revised our outlook to stable from positive because we understand that, due to several budget deviations, the region's budgetary execution for 2019 will be worse than the projections in our previous base-case scenario. The region received about €80 million less than expected of VAT collection and faced two one-off expenditure items related to litigations (€68 million) and the floods in the region during the fourth quarter of 2018 (€24 million). These unexpected expenses, together with expenditure pressure on health care expenses, prompted the deviations from the initial budget as well as our previous base case. However, we believe that the region will be able to maintain cash and available credit lines exceeding 40% for debt servicing over 2019-2020.

Despite weaker projections for 2019, the region's new management will likely support gradual consolidation, which will be backed by Spain's economic growth and the budgetary stability law

The socialist party has ruled the region in coalition with Podemos and Més, both left-wing parties, since the May 2019 regional elections. We currently lack full visibility on the government's financial strategy. However, we assume that it will remain committed to reducing the region's deficits over our forecast horizon to 2021 given the stringent conditions of the budgetary stability law. The new government presented the 2020 budget to the parliament on Oct. 31, 2019, and we expect the budget will be approved before the end of the year.

We believe that Spanish regions operate under a supportive institutional framework. Spain's central government has provided support to regions, including the Balearic Islands, via liquidity facilities since 2012. This support counterbalances the lack of reform in the regional financing system. We believe that the system's main drawback is the difficulty in matching revenue and expenditure in the economic cycle's low points. We have no visibility on the timing and share of an eventual reform. The political instability in Spain, with two general elections in 2019 (April and November), as well as the regional elections in May in most regions, including the Balearic Islands, have further delayed reform. We believe authorities have not optimized the favorable economic cycle to reach a broad political agreement on a new regional financing system. Amendments to the system are crucial to ensure the long-term sustainability of the finances of Spanish local and regional governments, in our view.

We believe that the financing system for Spanish normal-status regions redistributes 75% of taxes among regions. This is why we think the Balearic Islands' economy is strongly linked with that of Spain. Moreover, the region is a net contributor to the equalization system.

We expect the Balearic Islands to benefit from Spain's economic growth, translating into higher revenues over our forecast period. We estimate Spain's nominal GDP to expand at 3.6% on average over 2019-2021, and that the Balearic Islands' economy will follow a similar trajectory.

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 finances system.

A gradually narrowing deficit will help the region to maintain adequate liquidity and reduce its still-high tax-supported debt

Our updated base-case assumptions, based on the region's latest budget execution as of August 2019, are lower than our previous estimates due to the budget deviations in the first half of the year. We now estimate the region will post an operating margin of 6.4% in 2019, versus our previous estimate of 7.2% and the 11.2% recorded in 2018. The region has received lower operating revenues than expected due to a central government decision to modify VAT tax collection. Also, the region had to face litigation payments related to an urban development law and extraordinary expenses to cover the consequences of the floods that occurred across the Balearic Islands in late 2018. These deviations totaled about €92 million. Moreover, we anticipate that healthcare expenses will rise by 8% in 2019, and personnel expenditure will likely increase by 7%. We estimate the region will post a deficit after capital accounts of 7.7% in 2019, compared with 5.6% in 2018.

Consequently, we believe that, in 2019, the region might not comply with the central government's fiscal targets, mainly related to the deficit and expenditure growth. We therefore understand that it is already drafting a rebalancing plan to address these deviations from budget and targets. This plan is mandated by the central government to those regions that have not complied with the deficit targets, and it is subject to revision by the ministry.

Despite our weaker base-case projections for 2019, we expect the region to continue posting solid operating margins of about 7.7% of operating revenues over 2020-2021 and to further reduce its deficit after capital accounts to 3.7% of total revenues by 2021.

We continue to believe that the region's ability to cut expenditure is limited, mainly due to pressure on the health care system. However, we acknowledge that the Balearic Islands could become more flexible if its financial results improved beyond our base case.

The Balearic Islands' debt burden is high in a global context, and we believe this constrains the region's creditworthiness. Because we expect the region will post higher deficits in 2019, our tax-supported debt estimate will remain in line with 2018 levels of 233% of consolidated operating revenues.

However, in light of our expectation of a gradual strengthening in budgetary performance, we expect the region's tax-supported debt ratio to fall to 220% of consolidated operating revenues by 2021. The region's direct debt represents about 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 has low contingent liabilities.

We estimate the region's liquidity sources (cash and available credit lines) for the next 12 months will cover 42% of debt servicing for the same period. In our view, this ratio could improve gradually if our base-case projection of lower deficits for 2020-2021 materializes. The region's highest maturity of €1,482 million comes due in 2020.

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. However, given our expectation that the region will not meet the central government's fiscal targets for 2019, we assume the region will mainly fund its 2020 needs through the central government liquidity facilities. We note that the region owed 74% of its debt to the central government as of end-June 2019, which limits the refinancing risks.

Key Statistics

Table 1

Autonomous Community of The Balearic Islands Selected Indicators

(Mil. €)	2016	2017	2018	2019bc	2020bc	2021bc
Operating revenues	3,263	3,618	3,907	3,957	4,134	4,276
Operating expenditures	3,101	3,296	3,468	3,706	3,824	3,934
Operating balance	162	322	439	251	310	342
Operating balance (% of operating revenues)	5.0	8.9	11.2	6.4	7.5	8.0
Capital revenues	20	41	41	82	85	88
Capital expenditures	447	596	703	645	581	590
Balance after capital accounts	(265)	(234)	(223)	(312)	(186)	(160)
Balance after capital accounts (% of total revenues)	(8.1)	(6.4)	(5.6)	(7.7)	(4.4)	(3.7)
Debt repaid	712	807	862	990	1,482	1,131
Gross borrowings	1,276	1,327	890	1,301	1,668	1,291
Balance after borrowings	300	286	(195)	0	0	0
Direct debt (outstanding at year-end)	7,868	8,246	8,425	8,607	8,792	8,952
Direct debt (% of operating revenues)	241.1	227.9	215.6	217.5	212.7	209.4
Tax-supported debt (outstanding at year-end)	8,930	9,082	9,145	9,223	9,317	9,392
Tax-supported debt (% of consolidated operating revenues)	273.6	251.0	234.0	233.1	225.4	219.7
Interest (% of operating revenues)	3.3	3.1	3.4	3.3	3.2	3.1
Local GDP per capita (single units)	25,483	26,284	26,764	N/A	N/A	N/A
National GDP per capita (single units)	23,984	24,972	25,766	26,695	27,568	28,467

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	Scores
Institutional framework	3
Economy	2

Table 2

Autonomous Community of The Balearic Islands Ratings Score Snapshot (cont.)

Key rating factors	Scores
Financial management	3
Budgetary performance	4
Liquidity	3
Debt burden	4
Stand-alone credit profile	bbb+
Issuer credit rating	bbb+

S&P Global Ratings bases its ratings on non-U.S. local and regional governments (LRGs) on the six main rating factors in this table. In the "Methodology For Rating Local And Regional Governments Outside Of The U.S.," published on July 15, 2019, we explain the steps we follow to derive the global scale foreign currency rating on each LRG. The institutional framework is assessed on a six-point scale: 1 is the strongest and 6 the weakest score. Our assessments of economy, financial management, budgetary performance, liquidity, and debt burden are on a five-point scale, with 1 being the strongest score and 5 the weakest.

Key Sovereign Statistics

Sovereign Risk Indicators, Oct. 10, 2019. An interactive version of the Sovereign Risk Indicators can be found at
www.spratings.com/SRI
.

Related Criteria

- Criteria | Governments | International Public Finance: Methodology For Rating Local And Regional Governments Outside Of The U.S., July 15, 2019
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Spain Ratings Raised To 'A/A-1' From 'A-/A-2' On Economic Resilience; Outlook Stable, Sept. 20, 2019
- Default, Transition, and Recovery: 2018 Annual International Public Finance Default And Rating Transition Study, Aug. 19, 2019
- Global Ratings List: Local And Regional Governments 2019, Aug. 2, 2019
- Institutional Framework Assessments For International Local And Regional Governments, July 4, 2019
- Peer Comparison: Spanish Regions Financial Metrics Have Improved, Yet Disparities Remain, June 27, 2019
- Economic Growth And Stricter Fiscal Rules Are Supporting The Positive Rating Trend For Spanish Regions, June 27, 2019
- Spanish Regions: Back To Bond Markets As Consolidation Continues, April 8, 2019

- Spanish Municipalities' And Regions' Credit Story Since The Crisis: What You Need To Know, Feb. 11, 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

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; Outlook Action

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