S&P Global
Ratings

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Research Update:

Spain's Balearic Islands Affirmed At 'BBB+', Outlook Remains Stable

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Overview

- We expect the Balearic Islands' economy to suffer from a decline in tourism due to COVID-19 and associated restrictions in mobility, and the region will have to increase health care and social expenditure.
- However, we think higher revenue from the regional financing system and recovery fund announced by the central government will compensate for the lower own revenue and higher spending in 2020.
- We expect the region's tax-supported debt to remain high in an international context, although central government support continues to underpin its liquidity position.
- We are therefore affirming our 'BBB+' rating on Balearic Islands and maintaining our stable outlook.

Rating Action

On May 15, 2020, 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 Spain's regional financing system for normal-status regions and the fund for reconstruction announced by the central government should mitigate the effects of the COVID-19 pandemic on the Balearic Islands' financial accounts, including a drop in the region's own tax revenue and a spike in health care spending. We also consider that the region's cash position and contracted liquidity lines will adequately cover its debt service for the next 12 months.

Downside scenario

We could lower the ratings on the Balearic Islands if we thought that its revenue from the financing system and the recovery fund would not mitigate the region's revenue losses and additional spending, leading to a materially weaker budgetary performance than we currently envisage. In this scenario, the region's debt burden could increase materially beyond our expectations and its liquidity position could deteriorate.

We could also downgrade if we thought the economic impact of the COVID-19 pandemic on the Balearic Islands or Spain would greater or more prolonged than we currently anticipate.

Upside scenario

We could upgrade the Balearic Islands if both Spain's and regional economy recovered faster than we expect, and the region posted much stronger budgetary performance than in our base case. This would allow the region to reduce its debt burden more rapidly than in our current projections.

Rationale

We expect that risks for the Balearic Islands, arising from a loss in revenue and higher expenditure due to the COVID-19 pandemic, will be absorbed by higher revenue from the financing system and central government support. As a result of national and international lockdowns and travel restrictions related to the pandemic, the region will collect likely lower taxes, particularly real estate taxes, as well as fees and charges. At the same time, the region will face extra health care and social costs associated with COVID-19. However, we believe this will be mitigated by a marked revenue increase from the financing system, which contributes about 73% of the Balearic Islands' operating revenue, and by the recently announced recovery fund for Spanish regions. The latter could mean an increase in revenue of up to €16 billion for the regional sector.

Under this scenario, we expect the Balearic Islands' to post a still-moderate deficit after capital accounts of 4.5% of consolidated revenues in 2020. Slowly improving revenues and a widening budget gap will reverse the deleveraging trend we have observed since 2015. We also project that the region's tax-supported debt will increase to 223% of consolidated operating revenues by 2022. However, its liquidity position will continue to benefit from access to central government liquidity facilities and expected central government support, ensuring the region covers its financing needs.

The regional financing system and the central government's recovery fund will mitigate budgetary risks related to COVID-19

We expect the effects of the pandemic to hit Spain's economic performance in 2020, with national GDP contracting by 7.4%. However, we expect the economy to rebound strongly in 2021, with nominal GDP growth estimated at 6.9%. We believe that the Balearic Islands' economy could be under greater pressure than the nation as a whole, due to the importance of its services sector, which represents about 83% of the region's gross value added, and higher exposure to tourism. As of 2019, according to the regional statistics center, 25% of employment in the region related to tourism.

The pandemic's impact on economic activity and tax collection will be immediate through 2020 while restrictions on mobility remain in place in Spain and most European countries. We consequently foresee a drop in the Balearic Islands' own revenue, which however represent only about 27% of its operating revenue and will be covered by a larger contribution from the financing system and an expected share of the recovery fund.

About 73% of the region's revenue comes from the regional financing system. The central government has already communicated the advances for 2020 and settlements for 2018. With these two sources, Spanish regions' income from the financing system will increase by 7.3% on average in 2020, and by 8.9% for the Balearic Islands. Given that tax collection will be lower than expected, the system will likely generate a large negative settlement to be paid in 2022. We think the central government will allow regions to return this settlement over several years, as it did for negative settlements for 2008 and 2009.

In addition, the central government has announced a recovery fund for the regional tier of up to €16 billion. This fund is set to cover extra health care and social expenditure related to COVID-19, and about €5 billion of the fund will compensate regions for lost revenue from own taxes. We expect regions with higher exposure to the tourism sector, like the Balearic Islands, will see a larger drop in own taxes, and consequently could receive proportionally higher revenue from this fund.

We believe these measures are consistent with our view that the institutional framework under which Spanish normal-status regions operate is supportive. The central government has provided support to Spanish regions since 2012, including the Balearic Islands, via its liquidity facilities. We expect these facilities to remain available for Spanish regions, and the Balearic Islands in particular, allowing the region to fund its needs over 2020-2022.

We expect financial management to support gradual consolidation, despite economic challenges

Despite weaker budgetary performance in 2019, the region remains committed to gradual consolidation. We expect the central government will absorb most of the pandemic's impact, and allow the region to keep reducing its deficits after capital accounts through 2022. The weaker performance in 2019 was partly due to several one-off expenditures items amounting up to €93 million, and lower operating revenues related to the nonpayment of about €80 million (one month) of the value-added tax (VAT) transfer for 2017. However, the region managed to reduce its deficit in national accounting terms from 0.4% of GDP in 2018 to an adjusted 0.35% in 2019, although it did not comply with deficit targets.

We anticipate that the region's operating expenditure will increase by 6% on average in 2020 due to COVID-19 related costs. The region will need to hire new health care workers, or pay extra hours, while acquiring new equipment and supplies for hospitals.

In contrast, operating revenues are expected to increase by 7% compared with 2019. This large increase reflects higher revenue from the financing system and our estimate of revenues that Balearic Islands will receive from the reconstruction fund announced by the central government, which should offset budgetary risks related to COVID-19.

We also think that capital expenditure might be lower this year than in 2019 due to the regional government's decision to postpone it, or because of administrative and operational obstacles during the lockdown period. We estimate the deficit after capital accounts at 4.5% of total revenue in 2020.

We expect the Balearic Islands will continue with its budgetary consolidation process in 2021-2022, albeit slightly slower than before. We believe that, although economic activity will resume, tourism sectors might not fully recover in one year; therefore we project only a moderate decrease in deficits. In 2022, the region may see a lower revenue increase from the financing system due to the expected negative settlement related to 2020. We believe the central government will soften the impact by allowing the return of these funds to be spread out over several years.

Expected deficits over 2020-2022 will translate into a higher debt burden, since the region will finance its needs with new borrowing, most likely through the central government's facilities. We forecast that the tax-supported debt ratio will reach 223% of consolidated operating revenues by 2022, which we view as high in an international context and a constraint on the region's creditworthiness. Our tax-supported debt ratio includes the debt of the companies owned by the region, as well as guarantees and public-private partnerships.

In our view, the Balearic Islands' liquidity remains adequate. The region currently has credit lines totaling up to €450 million and a credit line from its tax agency of €200 million. We understand that the region could increase its credit lines beyond €800 million during 2020, if needed. Moreover, we expect the region to receive financing from the central government for the deficit incurred in 2019 and compensation in the form of a loan from the central government for the nonpayment of one month of VAT settlements for 2017. Moreover, the Balearic Islands will receive financial support through the recovery fund before the end of June.

The region had initially planned to finance part of its 2020 needs in the financial markets, but this has not yet occurred in the current economic environment. However, the Balearic Islands will still have strong access to external funding, thanks to the central government's liquidity mechanisms. We expect the region, may choose to finance its needs in the near-to-medium term through central government facilities and bank loans.

Key Statistics

Table 1

The Balearic Islands (Autonomous Community of) Selected Indicators

	--Fiscal year end Dec. 31--					
(Mil. €)	**2017**	**2018**	**2019**	**2020bc**	**2021bc**	**2022bc**
Operating revenues	3,618	3,916	3,962	4,238	4,117	4,234
Operating expenditures	3,296	3,470	3,778	4,019	3,885	3,954
Operating balance	322	446	184	220	232	280
Operating balance (% of operating revenues)	8.9	11.4	4.6	5.2	5.6	6.6
Capital revenues	41	41	91	82	87	91
Capital expenditures	596	703	648	494	504	513
Balance after capital accounts	(234)	(216)	(373)	(193)	(184)	(142)
Balance after capital accounts (% of total revenues)	(6.4)	(5.4)	(9.2)	(4.5)	(4.4)	(3.3)
Debt repaid	807	862	990	1,485	1,133	1,188
Gross borrowings	1,327	890	1,194	1,758	1,318	1,330
Balance after borrowings	286	(188)	(170)	80	0	(0)
Direct debt (outstanding at year-end)	8,246	8,425	8,486	8,759	8,944	9,086
Direct debt (% of operating revenues)	227.9	215.1	214.2	206.7	217.3	214.6

Table 1

The Balearic Islands (Autonomous Community of) Selected Indicators (cont.)

	--Fiscal year end Dec. 31--					
(Mil. €)	2017	2018	2019	2020bc	2021bc	2022bc
Tax-supported debt (outstanding at year-end)	9,082	9,126	9,095	9,360	9,526	9,649
Tax-supported debt (% of consolidated operating revenues)	251.0	228.4	225.1	217.3	227.4	223.9
Interest (% of operating revenues)	3.1	3.4	3.2	2.8	2.9	2.9
Local GDP per capita (single units)	26,284	26,764	N/A	N/A	N/A	N/A
National GDP per capita (single units)	24,972	25,766	26,532	24,502	26,142	27,702

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

The Balearic Islands (Autonomous Community of) Ratings Score Snapshot

Key rating factors	Scores
Institutional framework	3
Economy	2
Financial management	3
Budgetary perfomance	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, April 24, 2020. An interactive version is available at http://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

- COVID-19: Spanish Regions' Budgets Will Deteriorate In 2020, But Institutional Strengths Mitigate The Risks, April 7 2020
- Local Government Debt 2020: Low Growth And High Refinancing Are Fueling European Borrowing, March 2, 2020
- Public Finance System Overview: Spanish Normal Status Regions, Aug. 2, 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+/Stable/--
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. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352 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.