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Research Update:

Autonomous Community of The Balearic Islands Outlook Revised To Negative On Expected Weaker Performance; 'BBB+' Affirmed

November 13, 2020

Overview

- We expect central government financial and budgetary support will largely mitigate the effects of the COVID-19 pandemic on the Autonomous Community of the Balearic Islands in 2020.
- We believe the Balearic Islands could suffer more than other regions from the weak economic environment if the recovery takes longer than expected, due to its higher exposure to the tourism sector.
- We forecast increased deficits in 2021 and 2022, due to expected high operating expenses and lower revenue, which could eventually pressure the region's liquidity and already-high debt burden.
- We are therefore revising our outlook to negative from stable and affirming our 'BBB+' long-term rating.

PRIMARY CREDIT ANALYST

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

SECONDARY CONTACT

Alejandro Rodriguez Anglada
Madrid
(34) 91-788-7233
alejandro.rodriguez.anglada
@spglobal.com

ADDITIONAL CONTACT

EMEA Sovereign and IPF
SovereignIPF
@spglobal.com

Rating Action

On Nov. 13, 2020, S&P Global Ratings revised its outlook to negative from stable on Spain's Autonomous Community of the Balearic Islands (the Balearic Islands) and affirmed the 'BBB+' long-term issuer credit rating.

Outlook

The negative outlook reflects our expectation that the region's budgetary performance could deteriorate beyond our base case as a consequence of the effects of the COVID-19 pandemic.

Downside scenario

We could lower the rating on the Balearic Islands in the next 24 months if we think that the

COVID-19-related hit to the islands' tourism sector is more prolonged or severe than our current forecast. This would, in turn, deteriorate the region's budgetary performance, adding pressure to its liquidity levels and already-high debt burden.

Upside scenario

We could revise our outlook to stable in the next 24 months if we think that the likelihood of the region deviating from our current base case has lowered. This could be the case if the effects of the pandemic subside, in line with our expectations, leading to a recovery of the islands' economy that would avoid budgetary performance deterioration beyond our current estimates.

Rationale

We believe that COVID-19 will have a more pronounced impact on the Balearic Islands' economic performance than that of other Spanish regions due to its higher tourism exposure. We expect central government support will largely mitigate the effects of the pandemic in 2020, through increased revenue from the financing system and extraordinary support via the recovery fund. However, in our view, the hit will be partially delayed to 2021 and 2022.

We expect the region to post weaker budgetary performance in 2021, due to lower revenue from the financing system and continued high operating expenses. Moreover, in 2022, we believe the region will likely face a negative settlement from the regional financing system due to the recession in 2020. In turn, increased deficits could pressure the region's currently adequate liquidity and already high-debt burden.

The Spanish Central government is providing large support to its regions during the pandemic, mitigating immediate risks

As an early response to COVID-19, the Spanish central government provided support to its regions. Resources from the financing system increased by 7.3% on average in March 2020, despite mounting evidence of expected GDP and tax collection declines. The central government also provided early support measures in the form of ad-hoc transfers to cover some initial health care expenditure and school meals.

In June 2020, the government created a €16 billion COVID-19 fund, equivalent to 1.4% of our GDP estimate for Spain in 2020, to cover additional expenditure, mostly related to health care and education, and revenue losses.

More recently, on Sept. 30, 2020, the government also announced the suspension of fiscal rules (deficit targets, expenditure growth rates, and debt limits) for the regions in 2020 and 2021. The government also established a nonbinding reference deficit for 2021, set at 2.2% of regional GDP, but said it would cover half of this target through the creation of a new €13.5 billion fund, leading to an effective rate of 1.1% of regional GDP. However, we understand that the central government will continue to force regions to comply with its period of payment to suppliers, to prevent any liquidity tensions that could pressure regions' businesses.

We see this combined support as evidence of continued commitment from the government to centralize the virus burden on its own accounts, reinforcing our view of the supportive institutional framework under which Spanish normal status regions operate.

In this context, financial management and prudence are likely to weigh more heavily in our assessments going forward. We believe some regions might fully adopt the reference target, while others could decide to stay under it. We view the Balearic Islands' management as average overall, and we expect the region to remain within the reference target in 2021, in line with the recently approved budget.

Regions will also receive capital transfers from the ReactEU fund over the next three years. We are yet to have visibility on the distribution, but we understand that it will be subject to specific investment projects, which will require EU approval.

In our opinion, the Balearic Islands' exposure to tourism might increase risk in the medium-to-long term if pandemic recovery and travel normalization takes longer than our current forecast. The Balearic Islands' service sector represents 83% of its gross value added and 25% of employment is tourism related, according to the regional statistics center. Despite this comparative vulnerability, the region's GDP per capita remains slightly above the national average, based on 2019 year-end data. However, its unemployment rate is rising above the national average and in third-quarter 2020 stood at 16.3% of the active population, compared with 13.3% nationwide.

We expect weaker performance in 2021 and 2022, which could further pressure the region's liquidity and already-high debt burden

We expect central government support will largely mitigate the direct effects of the COVID-19 pandemic on the region's accounts in 2020. The region's revenue from the financing system has increased 8.9% this year, while it is also expected to receive a large portion of the central government's €16 billion fund in compensation for revenue losses and extra health care and education expenses. We expect the region to post a deficit of 3.3% of total revenue in 2020, compared with 9.2% in 2019. This forecast is supported by our expectation that the region's capital accounts execution will be lower due to the pandemic, and shutting down of the economy during the lockdown months.

In 2021, the region will receive further support from the central government's €13.4 billion fund, although we estimate it will likely be less than in 2020. Furthermore, the region will receive 0.4% lower revenue from the financing system, as announced by the Ministry of Finance. We believe that the pandemic will still be a concern during first-half 2021, which could imply a delay to regional tax recovery, given its exposure to tourism. Moreover, we expect operating expenses will remain high--as anticipated in the region's budget for 2021--to support the health care system and social economy. Therefore, we see limited ability to cut expenses and view the region's budgetary flexibility as limited. In our view, this combination of lower expected revenue and a difficulty cutting expenditure will lead to weaker budgetary performance in 2021 than 2020.

We believe performance in 2022 will depend on the strength of the economic recovery, which will in turn determine the level of resources from the financing system as well as the islands' own revenue. However, we do not currently have visibility of any potential new support package from the central government for the year. At the same time, we expect the region will face a large negative settlement from the financing system in 2022, due to poorer performance in 2020. This might be larger than that seen by other regions given the islands' exposure to tourism, which we expect will mean a stronger decline in 2020 revenue. In our view, the central government will allow regions to return the negative settlement over several years, but think it will still moderate revenue growth prospects for 2022. Moreover, we do not expect meaningful expenditure cuts to compensate for revenue dynamics, meaning increased deficits.

Higher deficits in 2021 and 2022 will increase the Balearic Islands' direct debt, which we already view as high. We recognize that the region has sought to absorb debt from its government-related entities, which should mean a decline in line with the amortization schedule. However, we expect the region's tax-supported debt will reach 228% of consolidated operating revenue by 2022, which is very high compared with that of international peers.

The region's liquidity remains adequate, although weakening due to a high debt amortization schedule and expected increased deficits. The region has not enlarged its credit lines in 2020, although it has authorization from the Ministry of Finance to do so if deemed necessary. Currently the Balearic Islands has €450 million of credit lines and a €200 million credit line taken by its tax agency.

We expect the region to finance most of its needs in 2020 and 2021 through central government liquidity mechanisms. This would mean about 70% of its debt is held by the central government, which mitigates the risk that the high debt burden would otherwise imply.

Environmental, social, and governance (ESG) credit factors for this credit rating change:

- Health and safety

Key Statistics

Table 1

The Balearic Islands (Autonomous Community of) Selected Indicators

	2017	2018	2019	2020bc	2021bc	2022bc
Operating revenues	3,618	3,916	3,962	4,428	4,311	4,288
Operating expenditures	3,296	3,470	3,778	4,086	4,088	4,096
Operating balance	322	446	184	342	223	192
Operating balance (% of operating revenues)	8.9	11.4	4.6	7.7	5.2	4.5
Capital revenues	41	41	91	77	108	152
Capital expenditures	596	703	648	570	599	629
Balance after capital accounts	(234)	(216)	(373)	(151)	(267)	(285)
Balance after capital accounts (% of total revenues)	(6.4)	(5.4)	(9.2)	(3.4)	(6.1)	(6.4)
Debt repaid	807	862	990	1,478	1,133	1,188
Gross borrowings	1,327	890	1,194	1,656	1,400	1,473
Balance after borrowings	286	(188)	(170)	27	(0)	0
Direct debt (outstanding at year-end)	8,246	8,425	8,486	8,664	8,931	9,216
Direct debt (% of operating revenues)	227.9	215.1	214.2	195.7	207.2	214.9
Tax-supported debt (outstanding at year-end)	9,082	9,126	9,095	9,258	9,496	9,761
Tax-supported debt (% of consolidated operating revenues)	251.0	228.4	225.1	209.1	220.3	227.6
Interest (% of operating revenues)	3.1	3.4	3.2	2.7	2.5	2.5
Local GDP per capita (single units)	26,284	27,682	28,143	N/A	N/A	N/A

Table 1

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

	2017	2018	2019	2020bc	2021bc	2022bc
National GDP per capita (single units)	24,971	25,810	26,520	23,580	25,907	27,460

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. N.A.--Not available. N.M.--Not meaningful.

Ratings Score Snapshot

Table 2

The Balearic Islands (Autonomous Community of) Ratings Score Snapshot

Key rating factors	Score
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, Oct. 12, 2020. An interactive version 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: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- Institutional Framework Assessments For International Local And Regional Governments, Nov. 5, 2020
- Public Finance System Overview: Spanish Normal Status Regions, July 16, 2020
- Credit FAQ: How Central Government Support Will Limit COVID-19's Impact On Spanish Regions' Finances, June 24, 2020
- Spain's Balearic Islands Affirmed At 'BBB+', Outlook Remains Stable, May 15, 2020

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+/Negative/--	BBB+/Stable/--
Senior Unsecured	BBB+	