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Research Update:

Spain's Autonomous Community of the Basque Country 'A+' Rating Affirmed; Outlook Positive

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Overview

- Spain's Autonomous Community of the Basque Country has posted better budgetary results in 2018 than we expected, having structurally improved its liquidity.
- High fiscal autonomy and sound financial management make the Basque Country more resilient than Spain in a stress scenario, and we therefore rate the region two notches higher than Spain.
- We are affirming our 'A+' long-term issuer credit rating on the Basque Country and maintaining our positive outlook.

Rating Action

On March 29, 2019, S&P Global Ratings affirmed its 'A+' long-term issuer credit rating on Spain's Autonomous Community of the Basque Country. The outlook remains positive.

Outlook

The positive outlook on Basque Country reflects that on Spain (unsolicited A-/Positive/A-2).

Upside scenario

We could raise our rating on the Basque Country over the next 12 months if we raise our rating on Spain, assuming the region continues to meet our conditions to be rated above the sovereign and performs in line with our base-case scenario.

Downside scenario

We could revise the outlook on the Basque Country to stable over the next 12 months if we did the same on Spain.

Rationale

Our rating on the Basque Country can be above that on Spain because, in our view, the region's credit characteristics would make it more resilient than the sovereign in a stress scenario. However, we consider that the region has a

high sensitivity to Spain's country risk, and therefore can rate it no more than two notches above the sovereign. As a result of this limit, our rating on the Basque Country is one notch lower than its 'aa-' stand-alone credit profile (SACP).

The SACP is not a rating, but a measure of the intrinsic creditworthiness of a local or regional government before taking into account any constraint arising from the sovereign rating. Consequently, if we were to upgrade Spain, we would also upgrade the Basque Country, provided that the region's credit features remained broadly similar. We also align our outlook on the region with that on its sovereign for this reason.

A wealthy economy, strong fiscal autonomy, and sound management practices underpin the Basque Country's creditworthiness

The Basque Country, as a special-status regional government within Spain, benefits from greater fiscal autonomy than normal-status regions. Special-status regions, including Navarre and the three Basque historical territories, have legislative power over personal-income and corporate taxes. The three Basque historical territories have their own tax administrations, and collect taxes directly from citizens and corporations. They then transfer a portion of the tax receipts to Spain's central government in compensation for the services it provides in the region; the amount is calculated and governed by a bilateral agreement that the central government cannot change unilaterally. Any remaining resources are then redistributed among the Basque Country's regional government, historical territories, and municipalities, according to their respective areas of responsibility.

In 2017, the central government and the Basque Country's government signed an agreement that settled long-standing differences about the calculation of the Basque Country's transfers to the state. We expect the agreement will have a positive impact on the region's liquidity through 2021, while eliminating uncertainties regarding transfers to the state until 2021.

The Basque Country does not participate in Spain's equalization system for funding regions. As a result, it can benefit fully from the strength of its own economy and the resulting large tax base. In our opinion, the Basque Country's economy is wealthier, more competitive, and more export oriented than Spain's. The Basque Country's per capita GDP is about 30% higher than the national average, and its economic structure reflects the higher predominance of industry in the region. This results in higher productivity per employee, lower unemployment, and a more resilient economic structure than that of Spain as a whole.

In our opinion, the region's financial management demonstrates sound skills and awareness of the region's main external risks, in particular regarding financial relationships with the central government. Unlike in previous years, the regional minority government has not been able to reach an agreement to pass the budget for 2019. However, we don't think this will have a negative

impact on the region's finances, thanks to continued economic growth in the region, which boosts its fiscal base. Moreover, the region's commitment to budgetary stability and the application of the spending rule, which limits the rate of growth of expenditure, hedge against financial distress. The region manages its debt actively, which we view as key to its maintenance of a strong liquidity position.

Revenue growth supports budgetary surpluses and gradual debt reduction, while the liquidity situation continues to improve

We now expect more solid operating performance and balances after capital accounts throughout our forecast period through 2021 compared with our previous base case. We believe the region will outperform the official targets as a way to prevent intervention from the central government that could restrict its autonomy.

In our opinion, the Basque Country will maintain an operating surplus of about 10% of operating revenue over 2019-2021, although we expect more moderate growth of fiscal revenue than in 2018. We project an expansion of operating and capital expenditure through 2021. Still, we think that the region will be able to post slight surpluses after capital accounts over the same period.

According to preliminary data, the Basque Country achieved an operating margin of about 11.3% of operating revenue and a surplus after capital accounts of about 3.0% of total revenue in 2018. We expected much weaker results (operating margin of 3.5% and deficit after capital accounts of 3.4%) because we considered 2017 would be an extraordinarily high-revenue year as the region received the one-time payment of almost €470 million arising from the settlement agreed with the central government about transfers to the state. However, provincial taxes, which are distributed among the Basque Country's public administrations, increased by a solid 8.5%, more than expected. This strong growth was due to dynamic economic growth in the region and the introduction of advance payments on corporate tax. At the same time, the region maintained a firm grip on its expenditure, in our view.

In our view, the region could absorb some potential revenue deviations by adjusting tax rates or fiscal benefits, since its budgetary flexibility is greater than that of most Spanish regions, owing to its special fiscal regime and wealthier economy. We also estimate the region could delay capital investments if necessary, given its high infrastructure endowment.

The Basque Country's surpluses will allow the region to start deleveraging in nominal terms. Together with our assumption of increasing revenue, we estimate the Basque Country's debt burden will decline to 81% of consolidated operating revenue by year-end 2021 from our estimate of 94% at year-end 2018. In our debt projections, we have factored in an early repayment of debt amounting to €400 million by year-end 2019. Our tax-supported debt figure includes the debt of the region's non-self-supporting public-sector companies, as well as some guarantees that the region provides to third parties. Together, these items

represented about 7% of the region's tax-supported debt at year-end 2018. We consider that the Basque Country has low contingent liabilities because we include most of the debt of the companies it owns in our calculation of its tax-supported debt.

Rapid debt accumulation in 2008-2013 led to a gradual increase in annual debt maturities, particularly in 2018 and 2019. However, the Basque Country has actively pursued debt renegotiation and made early repayments to progressively flatten its debt maturity profile, easing pressure on the region's liquidity.

We currently estimate that the Basque Country's cash slightly exceeds 100% of debt service according to contractual terms and conditions for the next 12 months. If we add available credit lines, then the debt service coverage ratio is over 145%. Despite our expectation that the region will use part of its 2018 surplus to repay about €400 million of debt early, we estimate the debt service coverage ratio, including credit lines, will remain above 120%. As a result, we now view the region's liquidity position as strong, compared with adequate in our last review.

The region has benefited from favorable market conditions in recent years, issuing bonds at very low overall cost and with tight spreads over comparable references of the Spanish treasury, as well as bank loans for which it has received ample excess offers. The region launched its first sustainable bond in 2018 (€500 million at 10 years at Spanish Treasury plus 15 basis points).

Key Statistics

Table 1

Autonomous Community of The Basque Country Selected Indicators

(Mil. €)	--Fiscal year ending Dec. 31--					
	2016	2017	2018	2019bc	2020bc	2021bc
Operating revenues	9,092	10,158	10,321	10,522	10,883	11,245
Operating expenditures	8,837	9,145	9,154	9,475	9,793	10,113
Operating balance	255	1,012	1,167	1,048	1,090	1,132
Operating balance (% of operating revenues)	2.8	10.0	11.3	10.0	10.0	10.1
Capital revenues	238	159	150	144	149	154
Capital expenditures	925	1,008	1,005	1,085	1,161	1,242
Balance after capital accounts	(431)	163	313	107	78	44
Balance after capital accounts (% of total revenues)	(4.6)	1.6	3.0	1.0	0.7	0.4
Debt repaid	572	654	1,215	1,231	833	768
Gross borrowings	1,106	975	1,269	806	755	724
Balance after borrowings	103	484	367	(318)	0	0
Modifiable revenues (% of operating revenues)	50.2	48.1	50.6	50.7	50.7	50.7

Table 1

Autonomous Community of The Basque Country Selected Indicators (cont.)

(Mil. €)	--Fiscal year ending Dec. 31--					
	2016	2017	2018	2019bc	2020bc	2021bc
Capital expenditures (% of total expenditures)	9.5	9.9	9.9	10.3	10.6	10.9
Direct debt (outstanding at year-end)	8,765	9,082	9,134	8,709	8,631	8,587
Direct debt (% of operating revenues)	96.4	89.4	88.5	82.8	79.3	76.4
Tax-supported debt (outstanding at year-end)	9,632	9,885	9,834	9,434	9,343	9,275
Tax-supported debt (% of consolidated operating revenues)	103.7	95.9	94.0	88.4	84.7	81.4
Interest (% of operating revenues)	2.2	1.8	1.7	1.5	1.4	1.4
Local GDP per capita (€)	31,588	32,969	34,123	N/A	N/A	N/A
National GDP per capita (€)	24,090	25,067	25,866	27,668	27,668	28,532

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 Basque Country Ratings Score Snapshot

Key rating factors	Assessment
Institutional framework	Evolving but balanced
Economy	Very strong
Financial management	Strong
Budgetary flexibility	Strong
Budgetary performance	Very strong
Liquidity	Strong
Debt burden	Moderate
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 our foreign currency rating on the government.

Key Sovereign Statistics

Spain 'A-/A-2' Ratings Affirmed; Outlook Positive, March 22, 2019

Related Criteria

- Criteria | Governments | International Public Finance: Methodology: Rating Non-U.S. Local And Regional Governments Higher Than The Sovereign, Dec. 15, 2014
- Criteria - Governments - International Public Finance: Methodology For Rating Non-U.S. Local And Regional Governments, June 30, 2014
- General Criteria: Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013
- 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

Related Research

- Spain 'A-/A-2' Ratings Affirmed; Outlook Positive, March 22, 2019
- Institutional Framework Assessments For International Local And Regional Governments, Nov. 6, 2018
- Default, Transition, and Recovery: 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 Basque Country (Autonomous Community of)	
Issuer Credit Rating	A+/Positive/--
Senior Unsecured	A+

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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.

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