FitchRatings

RATING ACTION COMMENTARY

Fitch Upgrades Autonomous Community of Basque Country to 'A'; Stable Outlook

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Fitch Ratings - Madrid - 08 Apr 2022: Fitch Ratings has upgraded the Autonomous Community of Basque Country's Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDRs) to 'A' from 'A-'. The Outlook is Stable. A full list of rating actions is below.

The upgrade reflects the region's better-than-expected 2021 preliminary results. Its sound budgetary performance drove our upward revision of Basque Country's Standalone Credit Profile (SCP) to 'a+' from 'a-'. Its debt payback ratio improved to between six and nine years in the medium term, from between 11 and 13 in our previous review, after it reported in 2021 its highest operating balance of the last 10 years. The SCP, which is in line with international peers', reflects our 'High Midrange' assessment of risk profile and an 'a' debt-sustainability assessment. Fitch does not apply any asymmetric risk.

The SCP is two notches above the Spanish sovereign's 'A-' IDRs, which under Fitch criteria, allows Basque Country's IDR to be one notch above the sovereign's IDR.

The Stable Outlook reflects Fitch's expectation that Basque Country's operating performance and debt metrics will remain in line with the IDRs and 'A'-rated peers' in the medium term.

KEY RATING DRIVERS

Risk Profile: 'High Midrange'

Basque Country's 'High Midrange' risk profile reflects a combination of two 'Strong' and four 'Midrange' attributes on six key risk factors. This assessment reflects Fitch's view of a low risk, relative to international peers, that the region's ability to cover debt service with its operating balance will weaken unexpectedly over the forecast horizon, either because of lower-than-expected revenue or higher-than-expected expenditure, or because of an unanticipated rise in liabilities or debt-service requirements.

Revenue Robustness: 'Stronger'

Basque Country's revenue is mostly made up of transfers (99%) usually from strong counterparties (Historical Territories), whose revenue consists of a diversified basket of direct and indirect taxes. Most of these taxes (97%) are linked to GDP, which we expect to grow due to sound economic prospects. However, during 2021, 88% of the transfers came from Historical Territories, and another 10% from the central government due to exceptional allocations to alleviate the pandemic effect and from the national recovery and resilience plan.

Basque Country's revenue growth has outpaced national GDP growth over the last five years and the region's socio-economic indicators are above the national average. We maintain our 'Stronger' assessment on revenue robustness despite its moderate volatility, which mostly stems from GDP growth.

Fitch rating case expects Basque Country's revenue growth to normalise to an average of around 2.4% for the next five years after a sharp revenue recovery in 2021 (21%).

Revenue Adjustability: 'Midrange'

Basque Country's tax rates are not capped by the central government. The region can cover a reasonable decline of revenue in an economic downturn by removing some fiscal benefits of the Historical Territories and by raising taxes afforded by their above-national average socio-economic profiles. However, Basque Country must have consent from Historical Territories for any changes to fiscal policies, including taxes. Historical Territories have tax-setting powers for around 50% of revenue forming the transfers received by Basque Country.

Expenditure Sustainability: 'Midrange'

The region has demonstrated moderate control over expenditure growth, which has tracked, if not slower than, revenue growth since 2012. In line with the central-government rule on spending control, expenditure growth has been well below revenue growth for the last five years, partly due to expenditure items that are moderately cyclical and hence unlikely to grow in an economic downturn.

The Basque Country's responsibilities are moderately correlated to the economic cycle. They are non-cyclical in nature, essentially education and health (65% of total expenditure).

Expenditure Adjustability: 'Midrange'

Under the Budgetary Stability Law, central government control over public administrations is strong and has been strengthened in recent years. This has resulted in a gradual narrowing of Basque Country's overall deficit since 2012 and record surpluses since 2017.

Fitch assesses the region's ability to reduce spending in response to shrinking revenue as 'Midrange'. This is evident by a high proportion of low-flexibility items at 70%-90%, including the region's main spending responsibilities such as education and healthcare, which are very inflexible.

Basque Country has a good level of essential public services, and its expenditure on healthcare and education represents 65% of total expenditure, excluding debt repayment, while the national average is almost at 70%.

During 2020 and 2021 the central government put in place a non-refundable direct endowment to alleviate the economic impact of the pandemic for autonomous communities. With EUR16 billion in 2020 and EUR13.4 billion in 2021, it covered regional health spending, education-related needs and compensated for lost tax revenue. Basque Country receives part of these funds from the central government as an aid to meet such additional spending, but is not eligible for other funds dedicated to compensating revenue loss due to their different institutional framework.

Liabilities & Liquidity Robustness: 'Stronger'

Autonomous communities have a solid national framework for debt and liquidity management. Our assessment also reflects Basque Country's conservative debt structure, with no short-term debt, and some bullet debt related to bonds but which is generally covered by the region's operating balance.

The average cost of debt was low at 1.3% in 2021 and the region has extended the life of its debt to 8.5 years in 2021 from 5.4 years at-end 2019. This improvement was attributed to refinancing of some debt maturities and early debt redemption financed with its 2019 budget surplus.

The share of floating-debt-rate is around 22% of total debt, above the average of autonomous communities, as it allows the region to prepay at a low cost compared with fixed-rate debt. Interest-rate exposure is mitigated by the region's access to financial products to cover risk under a rising interest-rate scenario. Basque Country has no recourse to the state liquidity-support mechanism.

Off-balance sheet liabilities are low in comparison with direct debt, representing around 7% of overall debt in 2021. They are mostly made to public companies providing public transportation, fairgrounds, the finance institute of the region, gas and social housing.

Liabilities & Liquidity Flexibility: 'Midrange'

Basque Country's unrestricted liquidity available at end-2021 was sufficient to cover short- and long-term debt servicing in 2022. At end-2021, the region had availability of EUR1,200 million short-term credit lines, contracted with counterparties rated mostly at 'BBB-' and 'A-'.

Basque Country also has strong access to financial markets (62% debt issued in bonds) and institutional lenders (around 9% debt contracted with European Investment Bank). Additionally, the government of Spain (A-/ Stable) has since 2012 provided liquidity support to autonomous communities at low cost, mitigating liquidity risk and reducing the likelihood of default.

Debt Sustainability: 'a category'

Spanish autonomous communities are deemed a type A local and regional government (LRG) in Fitch's criteria, given that their main spending responsibilities cover health, education and social spending, with a material share of general government expenditure and debt and fiscal imbalances. As such, their primary debt sustainability metric is the economic liability burden (net adjusted debt (+ pro-rata share of central government debt/regional GDP), which is strongly related to variations of central government debt.

Fitch has revised its rating case by incorporating Basque Country's preliminary budget results and has revised its main rating case assumptions according to our recent expectations both of central government debt and GDP growth. Under its revised rating case for 2022-2026, Fitch projects economic liability burden to improve below 92%, from 94% in the previous rating case, corresponding to the middle-to-low end of the 'a' rating category, following limited new debt and stable central government debt in relation to national GDP.

The main secondary metric, the debt payback ratio, has fully rebound from the economic downturn triggered by the pandemic (2020: 46x) to its 2019 level. Fitch expects a slight deterioration in 2022, following the end of exceptional funds from central government, to stabilise at 6x-9x. Fitch looks at the last three to four years of its rating case for the underlying trend of debt metrics. The synthetic debt service coverage is in the 'a' band of 1.5x-2x.

Basque Country's debt stabilised at between EUR8.6 billion and EUR9.2 billion during 2016 to 2019, before increasing to EUR10.6 billion at end-2021. We expect it to increase to around EUR11.3 billion in 2026 under our rating case, driven by capital deficits.

DERIVATION SUMMARY

Fitch assesses Basque Country's SCP in the 'a' category, reflecting a 'High Midrange' risk profile and our 'a' debt sustainability assessment. The 'a+' SCP factors in an improvement of the economic liability burden with strong recovery in the debt payback ratio of 6x-9x during the last four years of our rating case. The secondary metrics, synthetic debt service coverage and fiscal debt burden, also improved and remain in line with direct peers'. Fitch does not apply any asymmetric risk. The SCP is two notches above the Spanish sovereign's 'A-' IDRs, which under Fitch criteria, results in Basque Country's IDRs being one notch above the sovereign's IDRs.

Short-Term Ratings

Basque Country's Short-Term IDR is 'F1+' consistent with the region's Long-Term IDR, reflecting 'Stronger' debt robustness, 'Midrange' debt flexibility and a liquidity coverage ratio higher than 2.0x.

Debt Ratings

Basque Country's senior unsecured debt is upgraded to 'A' from 'A-', in line with the upgrade of the region's IDRs. Basque Country's bonds account for 62% of direct debt.

KEY ASSUMPTIONS

Qualitative assumptions, their respective change since the last review on 29 October 2021, and weight on the rating decision:

Risk Profile: 'High Midrange'

Revenue Robustness: 'Stronger'

Revenue Adjustability: 'Midrange'

Expenditure Sustainability: 'Midrange'

Expenditure Adjustability: 'Midrange'

Liabilities and Liquidity Robustness: 'Stronger'

Liabilities and Liquidity Flexibility: 'Midrange'

Debt sustainability: 'a, Improved with High weight'

Support (Budget Loans): 'N/A, Unchanged with Low weight'

Support (Ad Hoc): 'N/A, Unchanged with Low weight'

Asymmetric Risk: 'N/A, Unchanged with Low weight'

Sovereign Cap: 'N/A, Unchanged with Low weight'

Sovereign Floor: 'N/A, Unchanged with Low weight'

Quantitative assumptions - Issuer Specific

Fitch's rating case is a "through-the-cycle" scenario, which incorporates a combination of revenue, cost and financial risk stresses. It is based on 2017-2021 figures and 2022-2026 projected ratios. The key assumptions for the scenario include:

-Nominal average growth of operating revenue at 2.4% in the next five years, as lower transfers from the central government are offset by growth of tax collection

-Nominal average growth of operating expenditure at 2.4% in the next five years, due to inflation and available resources from higher tax revenue

-Net capital balance deficit on average at EUR1,104 million in the next five years to maintain and further develop infrastructure in line with the recovery and resilience national plan

-Average cost of debt at 1.7% in the next five years

Quantitative assumptions - Sovereign Related

Figures as per Fitch's sovereign actual for [2021] and forecast for [2023], respectively (no weights and changes since the last review are included as none of these assumptions was material to the rating action):

- -- GDP per capita (US dollar, market exchange rate):29,954, -

- -- Real GDP growth (%): 5.1, 3.5

- -- Consumer prices (annual average % change): 3, 1.2

- -- General government balance (% of GDP): -7.4, -4.5

- -- General government debt (% of GDP): 119.2, 114.6

- -- Current account balance plus net FDI (% of GDP): 1.1, 1.5

- -- Net external debt (% of GDP): 83, 75.8

- -- IMF development classification: DM

- -- CDS market-implied rating: 'A-'

Liquidity and Debt Structure

Fitch-adjusted net debt at EUR8.4 billion reflects general administration financial debt including the debt stock of the autonomous bodies (EUR10.6 billion at end-2021) less unrestricted cash. The region had unrestricted cash of EUR2.2 billion at end-2021.

Basque Country's overall debt increased extraordinarily in 2020 and 2021 to EUR11.3 billion from EUR8.6 billion at end-2019 as a consequence of the pandemic.

Issuer Profile

With a population of 2.2 million people, the Basque Country has an above-national-average economic profile with GDP per capita 28% higher than national average in 2020. The industrial sector is strong in the region, comprising 21% of its GDP, and unemployment (8.4%) is lower than Spain's national average (13.3%).

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to negative rating action/downgrade:

Basque Country's IDRs could be downgraded following a downgrade of the Spanish sovereign ratings. Deterioration of the payback ratio to above 11 years on a sustained basis in Fitch's rating case would also trigger a downgrade.

Factors that could, individually or collectively, lead to positive rating action/upgrade:

Basque Country's IDRs could be upgraded following a sustained improvement of the payback ratio to below five years under Fitch's rating case.

ESG Considerations

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg

Discussion Note

Committee date: 05/04/2022

There was an appropriate quorum at the committee and the members confirmed that they were free from recusal. It was agreed that the data was sufficiently robust relative to its materiality. During the committee no material issues were raised that were not in the original committee package. The main rating factors under the relevant criteria were discussed by the committee members. The rating decision as discussed in this rating action commentary reflects the committee discussion.

Best/Worst Case Rating Scenario

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

References for Substantially Material Source Cited as Key Driver Rating

The principal sources of information used in the analysis are described in the Applicable Criteria.

RATING ACTIONS

ENTITY / DEBT	RATING			PRIOR
Basque Country, Autonomous Community of (The)	LT IDR	A Rating Outlook Stable	Upgrade	A- Rating Outlook Stable
	ST IDR	F1+	Upgrade	F1
	LC LT IDR	A Rating Outlook Stable	Upgrade	A- Rating Outlook Stable
senior unsecured	LT	A	Upgrade	A-

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

International Local and Regional Governments Rating Criteria (pub. 03 Sep 2021) (including rating assumption sensitivity)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Basque Country, Autonomous Community of (The)	EU Issued, UK Endorsed

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