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Research Update:

Spain's Basque Country Rating Raised To 'AA-' From 'A+' After Sovereign Upgrade; Outlook Stable

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Overview

- We raised our unsolicited long-term sovereign rating on Spain to 'A' from 'A-' on Sept. 20, 2019.
- Spain's Autonomous Community of the Basque Country is posting budgetary surpluses in line with our base-case scenario, in which we assume a gradual reduction in the region's debt and a strong liquidity position.
- 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.
- As a result, we are raising our long-term credit rating on the Basque Country to 'AA-' from 'A+'.
- The outlook is stable.

Rating Action

On Sept. 27, 2019, S&P Global Ratings raised its long-term issuer credit rating on Spain's Autonomous Community of the Basque Country to 'AA-' from 'A+'. The outlook is stable.

Outlook

The stable outlook on Basque Country reflects our expectation that the region will commit to keep balanced accounts after capital investments while maintaining an exceptional liquidity position over our horizon to 2021.

Upside scenario

We could raise our rating on the Basque Country if we raised that on Spain and the region's debt reduction path strengthened, generating continuous surpluses. This assumes the region continues to meet our conditions to be rated above the sovereign.

Downside scenario

We could lower our rating on the Basque Country if the region posted structural deficits after capital accounts that could lead to a higher debt burden and lower liquidity position. We could also lower the rating if we downgraded Spain or if we believed that the region no longer met our conditions to be rated above the sovereign.

Rationale

Our rating on the Basque Country can be above that of Spain because, in our view, the region's credit characteristics would make it more resilient than the sovereign in a stress scenario. However, we believe the Basque Country has a high sensitivity to Spain's country risk, and therefore can rate it no more than two notches above the sovereign. Our rating on the region is at the same level 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 were 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 entities, including Navarre and the three historical Basque territories, have legislative power over personal-income and corporate taxes. The three historical territories have their own tax administrations, collecting 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 Basque Country government signed an agreement that settled longstanding differences in calculating the region's transfers to the state. We expect the agreement will positively affect the region's liquidity to 2021, while eliminating uncertainties regarding transfers to the state until that year.

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 economy and the resulting large tax base. In our opinion, the region'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.

We view the Basque Country's financial management as strong. In our opinion, the region's financial management demonstrates sound skills, shows a strong credit culture, and is aware of the region's main external risks, in particular regarding financial relationships with the central government. Unlike in previous years, the Basque Country's minority government was not able to pass the budget for 2019. However, we don't think this will have a negative impact on the region's finances. New elections will take place during 2020, although the timing has not yet been announced. 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 liquidity continues to improve

We expect the Basque Country will maintain solid operating performance and balances after capital accounts throughout our forecast period through 2021, in line 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.

We estimate that the Basque Country will maintain a solid operating balance above 9% of operating revenue. We expect operating expenditure will expand faster than operating revenue in 2019, mainly due to significant growth in personnel expenses. The growth includes the wage increase that the central government approved for all public administrations, some measures in the region to improve the conditions of its personnel, and litigation related to personnel of Basque Country's health care entity. From 2020, we expect the region will rein in operating expenditure so that it increases less than operating revenue.

We project that Basque Country will adapt its capital expenditure as needed to post surpluses after capital accounts, averaging about 0.7% of total revenue over our forecast horizon to 2021.

In our view, the region could absorb some revenue deviations by adjusting tax rates or fiscal benefits, because its budgetary flexibility is greater than that of most Spanish regions, owing to its special fiscal regime and wealthier economy. According to data from the Spanish statistics office (INE), the region's GDP per capita is 132% the Spanish average and the region's unemployment rate at 8.6% as of June 30, 2019, compares favorably with the national rate of 14.0%. We also believe the region could delay capital investments if necessary, given its high infrastructure endowment.

We estimate that the region's tax-supported debt will decline to about 80% of consolidated operating revenue by the end-2021, from its peak of 104% in 2016. This follows surpluses and increased operating revenue. 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 nonself-supporting public-sector companies, as well as some guarantees that Basque Country provides to third parties. Together, these items represented about 7% of the region's tax-supported debt at year-end 2018. We believe 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 region has actively pursued debt renegotiation and made early repayments to progressively flatten its debt maturity profile, easing pressure on liquidity.

Now, we view the Basque Country's liquidity position as exceptional. We estimate that the region's cash will exceed 130% of debt service according to contractual terms and conditions for the next 12 months. Adding available credit lines, the debt service coverage ratio is about 200%. Despite our expectation that the region will use part of its cash to repay about €400 million of debt early, we estimate the debt service coverage ratio, including credit lines, will remain above 100% over our forecast horizon.

The Basque Country 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 second sustainable bond issuance in 2019 (€600 million at 10 years at Spanish Treasury plus 10 basis points).

Key Statistics

Table 1

Autonomous Community of the Basque Country -- Selected Indicators

	--Fiscal year ended Dec. 31--					
(Mil. €)	**2016**	**2017**	**2018**	**2019bc**	**2020bc**	**2021bc**
Operating revenues	9,092	10,158	10,321	10,510	10,887	11,262
Operating expenditures	8,837	9,145	9,154	9,561	9,873	10,206
Operating balance	255	1,012	1,167	949	1,014	1,056
Operating balance (% of operating revenues)	2.8	10.0	11.3	9.0	9.3	9.4
Capital revenues	238	159	150	144	149	154
Capital expenditures	925	1,008	1,005	1,025	1,076	1,130
Balance after capital accounts	(431)	163	313	69	87	81
Balance after capital accounts (% of total revenues)	(4.6)	1.6	3.0	0.6	0.8	0.7
Debt repaid	572	654	1,215	1,231	833	768
Gross borrowings	1,106	975	1,269	790	746	687
Balance after borrowings	103	484	367	(372)	0	0
Direct debt (outstanding at year-end)	8,765	9,082	9,134	8,693	8,606	8,525
Direct debt (% of operating revenues)	96.4	89.4	88.5	82.7	79.0	75.7
Tax-supported debt (outstanding at year-end)	9,632	9,885	9,834	9,414	9,321	9,215
Tax-supported debt (% of consolidated operating revenues)	103.7	95.9	94.0	88.3	84.5	80.8
Interest (% of operating revenues)	2.2	1.8	1.7	1.8	1.6	1.5
Local GDP per capita (€)	31,588	32,970	34,079	N/A	N/A	N/A
National GDP per capita (€)	23,984	24,972	25,766	26,698	27,585	28,474

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. dc--Downside case represents some but not all aspects of S&P Global Ratings' scenarios that could be consistent with a downgrade. uc—Upside case represents some but not all aspects of S&P Global Ratings' scenarios that could be consistent with an upgrade. N/A--Not applicable.

Ratings Score Snapshot

Table 2

Autonomous Community of The Basque Country -- Ratings Score Snapshot

Key rating factors	Scores
Institutional Framework	3
Economy	1
Financial management	2
Busgetary performance	1
Liquidity	1
Debt burden	3
Stand-alone credit profile	aa-
Issuer credit rating	AA-

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

- Spain Ratings Raised To 'A/A-1' From 'A-/A-2' On Economic Resilience; Outlook Stable, Sept. 20, 2019

Related Criteria

- Criteria | Governments | International Public Finance: Methodology For Rating Local And Regional Governments Outside Of The U.S., July 15, 2019
- Criteria | Governments | International Public Finance: Methodology: Rating Non-U.S. Local And Regional Governments Higher Than The Sovereign, Dec. 15, 2014
- General Criteria: Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- 2018 Annual International Public Finance Default And Rating Transition Study, Aug. 19, 2019
- Local And Regional Governments: Are All Central Governments Equally Supportive?, July 22, 2019
- Sovereign Risk Indicators, July 11, 2019. Interactive version available at http://www.spratings.com/sri

- Spanish Regions Financial Metrics Have Improved, Yet Disparities Remain, June 27, 2019
- Spanish Regions: Back To Bond Markets As Consolidation Continues, April 8, 2019
- Spain's Autonomous Community of the Basque Country 'A+' Rating Affirmed; Outlook Positive, March 29, 2019
- Public Finance System Overview: Spanish Special Status Entities, 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

	To	From
Upgraded; Outlook Action		
The Basque Country (Autonomous Community of)		
Issuer Credit Rating	AA-/Stable/--	A+/Positive/--
Upgraded		
The Basque Country (Autonomous Community of)		
Senior Unsecured	AA-	A+