FitchRatings

Fitch Revises Outlook on Autonomous Community of Basque Country to Positive; Affirms at 'A-'

Link to Fitch Ratings' Report(s):

Autonomous Community of the Basque Country - Rating Action Report

Fitch Ratings - Madrid - 19 July 2019:

Fitch Ratings has revised the Outlook on the Autonomous Community of Basque Country's Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDRs) to Positive from Stable and affirmed the IDRs at 'A-'.

The Outlook revision reflects the better than expected performance according to preliminary 2018 results, which led to an improvement in debt sustainability metrics under Fitch's rating case. This could lead to a reassessment of Basque Country's SCP to 'a+', from 'a' currently, which would positively impact the IDR.

Basque Country's 'a' SCP is the result of the combination of our 'High Midrange' assessment of risk profile set against a 'a' debt sustainability assessment and alignment with international peers for the notch-specific SCP. Fitch does not apply any asymmetric risk. The 'A-' IDR reflects the rating cap that applies to Basque Country, according to which the SCP has to be at least two notches above the sovereign to upgrade its IDR to 'A'.

Basque Country is a Spanish autonomous community classified by Fitch as a Type A Local and Regional Government (LRG), whose main spending responsibilities cover health, education and social spending, with a material share of general government expenditure and debt and displaying vertical fiscal imbalances. Basque Country has an above-than-average economic profile, with a population of 2.2 million inhabitants and GDP per capita 32% above Spain's average and 21% above EU-28 average in 2018.

Key Rating Drivers

The revision of the Outlook reflects the following factors and their relative weights:

High weight for Debt sustainability assessment at 'a';

Fitch uses the economic liability ratio (net adjusted debt (+a pro-rata share of central government debt/regional GDP) as the primary metric for Type A LRG debt sustainability analysis.

Basque Country's economic liability burden significantly improved to 71% in 2018, down from 79% in 2014, as net adjusted debt grew moderately compared with GDP growth. In our rating case scenario, we expect this ratio to remain close to 71% in the medium term.

Basque Country's payback ratio improved to six years in 2018, down from 27 years in 2014, as a result of a sharp improvement in the operating balance, to EUR1.3 billion in 2018, from EUR280 million in 2014. Operating revenue grew a high 19.7% in 2014-2018, driven by the improving economic environment and the renegotiation of institutional transfers with the national government, while opex grew by 7.8% following the application of cost control policies. In our rating case scenario, based on prudent assumptions, we expect Basque Country's operating balance to remain structurally above EUR670 million in the medium term and the payback ratio in the 12x-14x range.

However, the coverage ratio should remain low at below 1x in the coming years in our rating case, as we expect rapid amortisation of the debt.

The combination of the primary and secondary metrics justify the region's debt sustainability 'a' assessment.

Low weight for Key Risk Factors and Risk profile, which is assessed as High Midrange.

Basque Country's risk profile is High Midrange, reflecting the combination of four key risk factors assessed at Midrange and two at Stronger.

Revenue Robustness Assessed as Strong

Basque Country's revenues are mostly made up of transfers (98%) from strong counterparties (Historical Territories), the sources of which are a diversified basket of taxes including direct and indirect taxes they collect. Most of these taxes (97%) are linked to GDP evolution, which is expected to remain positive due to economic growth prospects. Basque Country's revenue has grown above GDP for the last 10 years and its socio-economic position is above the national average. Revenue Robustness remains Stronger despite its moderate volatility. Fitch's rating case expects Basque Country to grow on average 2.9% for the next five years.

Revenue Adjustability Assessed as Midrange

Basque Country has no cap on the rates by the central government. The reasonable decline of revenues could be covered by retracting some of the fiscal benefits in place for the historical territories while there would be affordability for additional taxation given the average socio-economic position. However, revenue has recently been increased and additional increases could be optimistic in the medium term. There is a government body whose function is to harmonise fiscal pressure in the region in which Basque country forms agreements with the historical territories regarding fiscal policies. Historical territories have tax-setting powers for around 50% of the revenues forming the transfers received by Basque Country.

Expenditure Sustainability Assessed as Midrange

Under the Budgetary Stability Law (BSL), the central government control of the public administrations is strong and has been strengthened in recent years. This has resulted in a gradual reduction in Basque Country's overall deficit to record surpluses since 2017, even if it has failed on occasion to meet some BSL targets The region has demonstrated moderate control of expenditure growth prospects that evolve in line with revenue growth after some up and downs recorded before2012 mainly due to the effect of changes in the institutional transfers and a deep economic crisis. Basque Country has moderate control of expenditure growth prospects. However, the region's expenditure has grown below revenue growth for the last five years and has complied with the rule of expenses (set by the central government).

Expenditure items are moderately cyclical and unlikely to grow in an economic downturn.

Expenditure Adjustability Assessed as Midrange

Fitch assesses the region's ability to reduce spending in response to shrinking revenue as midrange. This is evidenced by a high proportion of low-flexibility items (representing above 90% in 2016) including the region's main spending responsibilities such as education and healthcare, which are considered inflexible.

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

The share of workforce expenses account for 20% of total expenditure excluding debt service. Healthcare public company personnel expenses are not included in this, with additional expenses of around 15%.

Liability and Liquidity Robustness Assessed as Strong

Autonomous communities have a solid national framework for debt and liquidity management. The factor also reflects Basque Country's conservative debt structure with no short-term debt, some bullet debt related with bonds, low average cost of debt at 1.7% in 2018. Amortisation is rapid with life of debt at 5.5 years, which is reflected in the low coverage ratio (debt service has been higher than the operating balance since 2014, except in 2017).

Off-balance sheet liabilities are low, representing only 0.8x the operating balance in 2018. They are mostly made of public companies providing social housing, fairgrounds, gas and the region's finance institute.

Liability and Liquidity Framework (Flexibility) assessed as Midrange

Basque Country's unrestricted liquidity available at end-2018 did not fully cover debt servicing maturing in 2019. At end-2018, it had EUR800 million available short-term debt, contracted with counterparties rated mostly in the 'BBB' and 'A' category. Basque Country has also strong access to financial markets (44% debt issued in bonds) and institutional lenders (10% debt hired with European Investment Bank).Additionally, since 2012 the national government (A-/Stable) has provided state support mechanisms to the autonomous communities at advantageous financial conditions, mitigating a region's liquidity risk and reducing the likelihood of default.

Derivation Summary

Based on the risk profile assessment and debt sustainability metrics, Fitch assesses Basque Country's SCP at 'a'.

Basque Country can be rated above the sovereign but the rating leeway for that requires its SCP to be at least two notches above the sovereign to impact the IDR.

The Positive Outlook reflects Fitch's view that Basque Country's SCP could be reassessed at 'a+' in the next two years, which would lead to an upgrade of the IDR.

Basque Country's Short-Term IDR is 'F1' reflecting its Long-Term IDR and that debt robustness and flexibility of debt structure are considered 'Midrange'.

Key Assumptions

Fitch's key assumptions within our rating case for the issuer include:

- Nominal growth of operating revenue at 2.9 % in the next five years

- Nominal growth of operating expenditure at 4.5% in the next five years

- Nominal growth of capital expenditure to grow 2.6% annually.

- Cost of debt to gradually grow from 2.0% to 2.4%.

RATING SENSITIVITIES

The IDR could be upgraded if the payback ratio remains structurally below 13x in the medium term in Fitch rating case scenario. This would positively impact the assessment of the SCP. An upgrade of the sovereign IDR would prompt similar action on Basque Country's IDR.

The Outlook could be revised to Stable if the positive sensitivity is not fulfilled.

RATING ACTIONS

ENTITY/DEBT	RATING		PRIOR
Basque Country, Autonomous Community of	LT IDR		A- ⭘

(The)	A- Affirmed		
	ST IDR F1 Affirmed		F1
	LC LT IDR A- Affirmed		A-
senior unsecured	LT A- Affirmed		A-

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Applicable Criteria

Rating Criteria for International Local and Regional Governments (pub. 09 Apr 2019)
Short-Term Ratings Criteria (pub. 02 May 2019)

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