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

Fitch Ratings has affirmed the Autonomous Community of Basque Country's Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDRs) at 'A-'. The outlook is Stable. Fitch has also affirmed the region's Senior Unsecured Bonds at 'A-'. Short-Term IDR affirmed at 'F1'.

While Basque Country's most recently available data may not have indicated performance impairment, material changes in central government's debt, revenue and costs are occurring across the sector and likely to worsen in the coming weeks and months as economic activity suffers and government restrictions are maintained or broadened. Fitch's ratings are forward-looking in nature, and we will monitor developments in the sector for their severity and duration, and incorporate revised base- and rating-case qualitative and quantitative inputs based on performance expectations and assessment of key risks.

The Spanish autonomous communities are considered a type A local and regional government (LRG) in Fitch's criteria, and as such, their primary debt sustainability metric is the economic liability burden (net adjusted debt (+a pro-rata share of central government debt/regional GDP) which is strongly related with variation on the central goverment debt.

Basque Country's SCP has been lowered to 'a-' from 'a' due to Fitch's expectation of higher economic liability burden at above 92% and weaker payback ratio around 16-17 years in a sustained basis in the rating case. The SCP reflects our 'High Midrange' assessment of risk profile set against a high 'a' debt sustainability assessment and alignment with international peers for the notch specific SCP. Fitch does not apply any asymmetric risk.

KEY RATING DRIVERS

Risk Profile: 'High Midrange'

Fitch has assessed Basque Country's risk profile at 'High Midrange', reflecting two strong and four midrange attributes on the six key risk factors.

Revenue Robustness: 'Strong'

Basque Country revenues are mostly made up of a transfers (98%) from Strong counterparties (Historical Territories) which revenue consists of a diversified basket of taxes which includes both direct and indirect taxes being collected by them. Most of these taxes (97%) are linked with the GDP evolution which is expected to remain positive due to economic growth prospects aside from 2020 development. Basque Country's revenue is growing above the national GDP over the last five years and its socio economic position is above the average. The revenue robustness keeps as stronger despite its moderate volatility. Fitch's rating case expects Basque Country's revenue to grow 1.6% average for the next five years besides the strong revenue fall expected in 2020 (-14%).

Revenue Adjustability: 'Midrange'

Basque Country's rates are not capped by the central government. The reasonable decline of revenues could be covered by retracting some of the fiscal benefits in place at the Historical

Territories while there would be affordability for additional taxation considering their above average socio-economic position. However, the ability to influence the revenue or taxes is not fully independent, there is a government body which function is to harmonize the fiscal pressure among the region in which Basque country form 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: ‘Midrange’
Under the Budgetary Stability Law (BSL), the central government control over the public administrations is strong and has been strengthened in recent years. This has resulted in a gradual reduction of Basque Country’s overall deficit to record surpluses since 2017, even if it has failed in some occasions with them. The region has demonstrated a moderate control over expenditure growth prospects which evolves in line with revenue growth after some ups and downs recorded prior to 2012 mainly by the effect of changes in the institutional transfers and a deep economic crisis. The region’s expenditure grew well below the revenue growth for the last five years and the region usually complies with spending control rule (set by the central government), partly as there are expenditure items which are moderately cyclical and unlikely to grow in an economic downturn.

Fitch rating case expects the operating margin to revert to positive values before 2021.

Expenditure Adjustability: ‘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 2018 including the region’s main spending responsibilities’ such as education and healthcare, which are considered very inflexible.
Basque Country has a good level of service in essential public services and its expenditure on healthcare and education represent 65% of the expenditure excluding debt repayment while the national average is almost at 70%.
The share of staff expenses account for 20% of total expenditure excluding debt service; healthcare public company personnel expenses account for another 15% of total expenses.

Liabilities and Liquidity Robustness: ‘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, and a low average cost of debt at 1.7% in 2019. Amortisation is rapid with average life of debt at 5.6 years, which is reflected in the low coverage ratio although the region is enlarging its life of debt along the last two years.

Off-balance sheet liabilities are low and are decreasing, representing only 0.6x the operating balance in 2019 (0.8x in 2018). They are mostly made of public companies providing social housing, fairgrounds, gas and the finance institute of the region.

Liabilities and Liquidity Flexibility: ‘Midrange’

Basque Country's unrestricted liquidity available at end-2019 does not fully cover short and long-term debt servicing maturing in one year (2020). At end-2019, the region had availability of EUR800 million short-term debt, contracted with counterparty's rates mostly in the BBB- and A- category. Basque Country has also strong access to financial markets (47% debt issued in bonds) and institutional lenders (around 10% debt hired with European Investment Bank). Additionally, the government of Spain ('A-') has provided since 2012 support mechanisms to the autonomous communities at advantageous financial conditions, mitigating a region's liquidity risk and reducing the likelihood of default

Debt sustainability: 'a' category
The Spanish autonomous communities are considered 'type A' LRGs in Fitch's criteria, given that its main spending responsibilities cover health, education and social spending, with a material share of general government expenditure and debt and fiscal imbalances. Their debt sustainability is measured by their economic liability burden, which is strongly related to central government debt. In this respect, Fitch expects the central government debt to increase due to the economic effect of the pandemic, resulting in a worsening of the autonomous communities' debt sustainability.

Fitch also expects the impact of the coronavirus pandemic to be on regional debt, revenue and cost for Basque Country. In our rating case, we expect operating revenues to drop in 2020 by 14%, as the region's revenue is exposed to the economic cycle which follows a similar evolution to that of national GDP growth. The region faces additional risk from health spending which is expected to increase in 2020 and 2021, to face the maximum capacity of healthcare systems required under this extraordinary situation of the coronavirus pandemic.

Under Fitch's previous rating case scenario, Basque Country's debt sustainability was assessed in the 'a' category as well, but its debt sustainability metrics were farther from the lower end of the category. The expected economic liability burden for 2023 has been deteriorated to 92%-93% from 79%-80% in our previous rating case.

Fitch has revised down its main rating case assumptions due to worsened economic forecast and also due to higher expected central government debt and deterioration of regional finances expectation. This reflects a higher economic liability burden at 92%-93% in 2024 on a sustained basis and a secondary metric, the debt payback ratio, to remain between 15 and 17 years in 2024. The actual debt service coverage (operating balance/debt servicing) remains weak well below 0.7 years in 2024.

Basque Country's overall debt has been steadily increasing since 2015 (from EUR8.2 billion to EUR8.6 billion at end-2019), notably due to capital balance deficits. In our rating case scenario, overall debt is expected to increase to a range around EUR 12.8bn –EUR13.4 billion in 2024, driven by a sharp deterioration of the operating balance in 2020 with a recovery starting in 2021.According to our scenario, investments plan, net of capital revenue contribute to a mere debt increase in the 2020-2024 of around EUR5bn.

RATING DERIVATION

Basque Country's SCP is assessed at the 'a' category, reflecting a combination of a 'High Midrange' risk profile and the 'a' debt sustainability assessment. The notch-specific has been revised downward to 'a-' from 'a' factoring a weakening economic liability burden and weaker payback ratio and fiscal debt burden, compared to direct peers. Fitch does not apply any asymmetric risk.

Basque Country's Short-Term IDR is 'F1' consistent with its LT IDR and as the debt robustness and flexibility of debt structure are considered 'Stronger' and 'Midrange' subsequently.

KEY ASSUMPTIONS
Qualitative Assumptions and assessments:
Risk Profile: High-Midrange
- Revenue Robustness: Strong
- Revenue Adjustability: Midrange
- Expenditure Sustainability: Midrange
- Expenditure Adjustability: Midrange
- Liabilities and Liquidity Robustness: Strong
- Liabilities and Liquidity Flexibility: Midrange

Debt sustainability: 'a' category.
Support: N/A
Asymmetric Risk: N/A

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 in case of economic slowdown but did not factor in the risk of exceptional events. It is based on 2015-2019 figures and 2020-2024 projected ratios. It incorporates a combination of revenue, cost and financial risk stresses in case of economic slowdown and takes into account the recent lockdown of the Spanish economy.
The key assumptions for the scenario include:

-Nominal average growth of operating revenue at 1.6% in the next five years

-Nominal average growth of operating expenditure at 2.6% in the next five years

-Net capital balance at a negative EUR915 million on average in the next five years

-2.1% average cost of debt in the next five years.

RATING SENSITIVITIES
Factors That Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade:
Basque Country's IDR could be downgraded following a downgrade of the sovereign rating of Spain. A deterioration of the economic liability burden above 100% or weakening of the payback ratio towards 25 years on a sustained basis in Fitch's rating case would also trigger a downgrade.

For Basque Country, a prolonged COVID-19 impact and much slower economic recovery lasting until 2025 would pressure tax receipts. Should Basque Country be unable to proactively reduce expenditure or supplement weaker receipts from increased central government transfers, this may lead to a revise downward on its SCP, which would result in a lower rating category.

Factors That Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade:
Basque Country's IDR could be upgraded following an improvement of an economic liability towards 80% accompanied by a payback improvement below 13 years with during the Fitch's rating case.

ESG CONSIDERATIONS
ESG credit relevance is a score of 3 - ESG issues are credit neutral. Given the missions of the issuer and the institutional framework, these issues are minimally relevant to the rating.

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