

## CREDIT OPINION

18 April 2018

### Update

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#### RATINGS

##### Basque Country (The)

|                  |                             |
|------------------|-----------------------------|
| Domicile         | Spain                       |
| Long Term Rating | A3                          |
| Type             | LT Issuer Rating - Fgn Curr |
| Outlook          | Stable                      |

Please see the [ratings section](#) at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

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## The Basque Country (Spain)

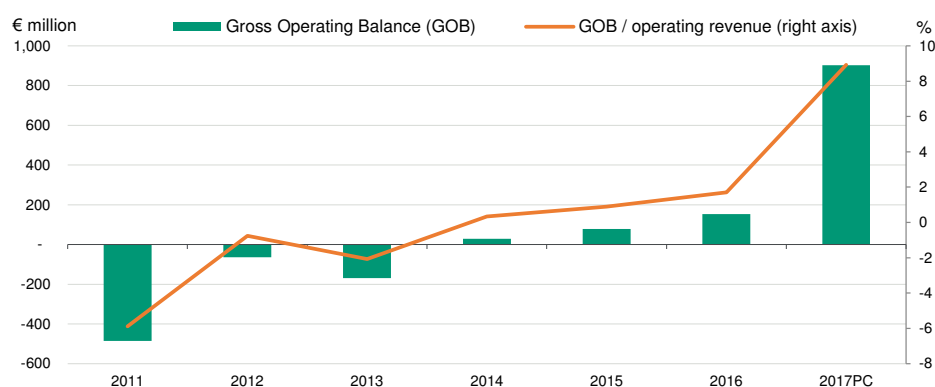
Update following upgrade to A3 stable

### Summary

The credit profile of the [Basque Country \(A3 stable\)](#) exceeds the Spanish sovereign rating by one notch, reflecting the region's unique tax regime and its solid institutional framework, as well as its improved fiscal performance in recent years. The Basque Country benefits from good access to capital markets. Its debt stock was equivalent to 103% of operating revenue as of year-end 2017, and the region has always complied with the deficit limit targets set by the central government.

Exhibit 1

#### The Basque Country's operating performance has improved in recent years



PC= Pre-closing; B=Budget.

Source: Moody's Investors Service

### Credit strengths

- » A high degree of fiscal flexibility because of the region's unique legal status
- » Good access to capital markets
- » Strong fiscal performance
- » A strong and diverse economic base

### Credit challenges

- » Rising debt levels

## Rating outlook

The outlook is stable, reflecting the stable outlook on the [Government of Spain's](#) (Baa1 stable) rating.

## Factors that could lead to an upgrade

A strengthening of Spain's sovereign credit profile, leading to an upward adjustment in the sovereign rating, would likely have the same effect on the Basque Country's rating.

## Factors that could lead to a downgrade

Any downgrade of Spain's rating would likely have implications for the Basque Country's rating. Large financing deficits covered by a rapid increase in debt, would exert downward pressure on the region's rating.

## Key indicators

Exhibit 2

### The Basque Country

|  | 2011  | 2012 | 2013  | 2014  | 2015  | 2016  | 2017PC | 2018B |
|--|-------|------|-------|-------|-------|-------|--------|-------|
| Gross Operating Balance as a % of Operating Revenue        | -5.9  | -0.8 | -2.1  | 0.3   | 0.9   | 1.7   | 8.9    | 4.4   |
| Capital Expenses as a % of Total Expenses                  | 12.8  | 14.0 | 11.6  | 10.7  | 8.7   | 9.4   | 10.1   | 10.6  |
| Self Financing Ratio                                       | 0.0   | 0.4  | 0.3   | 0.4   | 0.4   | 0.5   | 1.1    | 0.6   |
| Financing Surplus(Deficit) as % of Total Revenues          | -14.2 | -8.6 | -8.6  | -6.9  | -6.0  | -5.3  | 0.9    | -4.3  |
| Interest Expenses as a % of Operating Revenue              | 1.8   | 2.3  | 2.7   | 2.9   | 2.6   | 2.2   | 1.8    | 2.4   |
| Gross Borrowing Need as a % of Total Revenues              | 16.1  | 10.6 | 10.9  | 12.2  | 13.7  | 11.4  | 5.5    | 15.5  |
| Net Direct and Indirect debt as a % of Operating Revenue * | 77.4  | 92.2 | 108.8 | 110.6 | 113.8 | 114.4 | 103.3  | 112.2 |

PC= Pre-closing; B=Budget.

Sources: Moody's Investor Service, Issuer

## Detailed credit considerations

On 17 April 2018, we upgraded the Basque Country's rating by one notch to A3 from Baa1. The upgrade followed our upgrade of the Government of Spain's rating to Baa1 from Baa2 on 13 April 2018, and reflects the region's integration within the wider Spanish economy and its exposure to similar improving medium-term economic prospects.

The credit profile of the Basque Country, as expressed in the region's A3 rating, combines (1) a Baseline Credit Assessment (BCA) of a3, and (2) a very high likelihood of receiving extraordinary support from the three Basque provinces in the event the entity faced acute liquidity stress.

### Baseline Credit Assessment

#### A high degree of fiscal flexibility derived from the region's unique legal status

The region and its three constituent provinces (Guipuzcoa, Alava and Biscay) benefit from a unique tax regime under the Spanish Constitution and the Basque Country's Statute of Autonomy. The three Basque provinces set and collect their own taxes, and redistribute the bulk of the proceeds to the Basque Country and its municipalities under pre-established agreements with the central government. Close relationships between the three Basque provinces and the Basque Country are formalised through the Basque Financial Council (Consejo Vasco de Finanzas Públicas).

The three Basque provinces make an annual payment, or cupo, to the central government in recognition of services provided by the Spanish state. The cupo is set through negotiations between the central government and the region every five years, and is independent of the Basque Country's annual financial performance.

The share of tax revenue transferred to the region is usually negotiated for a five-year period, and is set according to the Basque Country's administrative workload. Generally, the region receives 70% of total tax revenue raised in the Basque provinces. The

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methodology for calculating this share has changed little since its inception in 1985, ensuring a relatively stable and predictable revenue stream. We are not aware of any indications that this arrangement is likely to change in the near future.

### **The Basque Country benefits from good access to capital markets**

The Basque Country benefits from a good relationship with financial institutions, and easily covered its funding needs in 2017. The region has financed close to 44% of its requirements via bond issuances, raising €326 million in 2017 (73% or €806 million in 2016). The region also contracted a €200 million bank loan with the [European Investment Bank](#) available in full as of today.

In addition, in 2016 and 2017, the region restructured part of its debt portfolio, reducing its interest costs and extending the due dates of several bonds and bank loans. As a result, the region's average funding cost dropped to 2% from close to 3% in 2015.

In 2018, the Basque Country will have to raise around €1.2 billion, a large proportion of which we expect to be covered by bond issuances. The Basque country plans to issue its first sustainable bond in 2018.

### **Strong fiscal performance**

The Basque Country's gross operating balance (GOB)-to-operating revenue ratio fell to an average of -3% between 2011 and 2013, weighed down by the economic crisis. However, the region's GOB has improved significantly since 2014, reaching a surplus of €903 million, or 8.9% of operating revenue in 2017, up from 1.7% in 2016. The improvement was largely the result of a 12.5% increase in taxes collected by the three Basque provinces, the proceeds of which were redistributed to the Basque Country. The increase in tax collection was a consequence of far-reaching fiscal reform adopted by the provinces in 2014.

The improvement in the GOB counteracted the 21% decrease in capital revenue during the year, leading to a financing surplus of 0.9% of operating revenue in 2017 (-5.5% in 2016), the region's first surplus since 2008. The increase in capital revenue compensated for an 11% increase in capital spending, reflecting a 38% increase in central government transfers because of construction of the Basque Country's high speed railway (the Basque "Y").

As calculated under the European System Accounts, the Basque Country had a surplus-to-GDP ratio of 1.5% in 2017 (-0.62% in 2016). As one of the four regions to post a surplus in 2017, it complied amply with the 2017 deficit target of -0.6% of GDP. The deficit ceiling for 2018 has been set at 0.4%, and we believe the Basque Country is unlikely to need further consolidation efforts to achieve this target.

### **A strong and diverse economic base**

Situated on the north coast of Spain, the Basque Country is the country's second-wealthiest region (after Madrid), with a GDP per capita of €33,088 in 2017, well above the Spanish average of €24,999.

The Basque Country's economy is diverse and has traditionally benefitted from a strong industrial base. The economy is driven by automotive sector exports to the rest of Europe, and is home to one of the world's leading shipyards. In 2017, the regional GDP grew by 3.1%, in line with the national average of 3.1%. As in other Spanish regions, economic improvement has led to a fall in unemployment. The Basque Country's unemployment rate stood at 10.6% as of year-end 2017, down from 12.3% in 2016. This was the second-lowest rate among those of the Spanish regions, just above that of Navarra, and far below the national average of 16.6% (18.6% in 2016).

### **Rising debt levels**

Although the region's net direct and indirect debt stock has historically been low, it has increased rapidly since the onset of the euro area sovereign debt crisis, rising to €10.4 billion in 2017 from €6.3 billion in 2011. Direct debt increased by €317 million in 2017, increasing the total direct debt stock to €9 billion.

In 2017, the Basque Country reported indirect debt incurred by non-self-supporting entities equivalent to 9% of operating revenue, a decrease of 11% from that in the previous year. Guarantees decreased to €451 million in 2017 from €535 million in 2016, and were largely directly to the public administration or through mutual-guarantee companies (Sociedades de Garantía Recíproca), which we believe pose very limited risk.

The region's ratio of net direct and indirect debt to operating revenue saw a reversal in 2017, decreasing to 103.3% from 114.4% in 2016, as the economic recovery led to faster operating revenue growth. The Basque Country's debt burden remained well below the national average of 204% in 2017. We expect this trend to continue in 2018 on the back of higher operating revenue and lower funding needs.

The Basque Country has a strong cash position, with cash reserves forecast to reach around €844 million as of year-end 2017. The region also has €800 million in credit line facilities available, which were not drawn as of year-end 2017. These reserves and credit lines would allow the Basque Country to cover all its financing needs for the next 12 months (including annual debt repayments of €1.1 billion). It has a substantially stronger position than its national peers.

#### Extraordinary support considerations

We view the Basque Country as having a very high likelihood of receiving extraordinary support from the three Basque provinces (Guipuzcoa, Alava and Biscay) in the event that the Basque Country faced acute financial distress. The very high likelihood of support reflects the unique institutional framework of the Basque Historical Territories (Territorios Forales), as the three provinces are also known. Given the three province's atypical fiscal regime in Spain, we view reputational risk as an incentive for them to provide support to the Basque Country in the event of financial distress.

## Rating methodology and scorecard factors

The assigned BCA of a3 is above the scorecard-indicated BCA of baa1. The matrix-generated BCA of baa1 reflects (1) an Idiosyncratic Risk score of 2 (presented below) on a 1 to 9 scale, where 1 represents the strongest relative credit quality and 9 the weakest; and (2) a Systemic Risk score of A3. In the case of the Basque Country, the Systemic Risk of A3 exceeds the sovereign bond rating by one notch, which reflects the fiscal flexibility derived from its unique institutional framework.

For details about our rating approach, please refer to [Rating Methodology: Regional and Local Governments](#), 16 January 2018.

Exhibit 3

### The Basque Country

#### [Regional and local governments](#)

| Baseline Credit Assessment                              | Score | Value  | Sub-factor Weighting | Sub-factor Total | Factor Weighting | Total          |
|---|-------|--------|----------------------|------------------|------------------|----------------|
| Scorecard   |       |        |                      |                  |                  |                |
| <b>Factor 1: Economic Fundamentals</b>                  |       |        |                      |                  |                  |                |
| Economic strength                                       | 1     | 132.23 | 70%                  | 2.2              | 20%              | 0.44           |
| Economic volatility                                     | 5     |        | 30%                  |                  |                  |                |
| <b>Factor 2: Institutional Framework</b>                |       |        |                      |                  |                  |                |
| Legislative background                                  | 1     |        | 50%                  | 2                | 20%              | 0.40           |
| Financial flexibility                                   | 3     |        | 50%                  |                  |                  |                |
| <b>Factor 3: Financial Performance and Debt Profile</b> |       |        |                      |                  |                  |                |
| Gross operating balance / operating revenues (%)        | 3     | 5.71   | 12.5%                | 3                | 30%              | 0.90           |
| Interest payments / operating revenues (%)              | 3     | 2.06   | 12.5%                |                  |                  |                |
| Liquidity   | 1     |        | 25%                  |                  |                  |                |
| Net direct and indirect debt / operating revenues (%)   | 7     | 103.26 | 25%                  |                  |                  |                |
| Short-term direct debt / total direct debt (%)          | 1     | 7.20   | 25%                  |                  |                  |                |
| <b>Factor 4: Governance and Management - MAX</b>        |       |        |                      |                  |                  |                |
| Risk controls and financial management                  | 1     |        |                      | 1                | 30%              | 0.30           |
| Investment and debt management                          | 1     |        |                      |                  |                  |                |
| Transparency and disclosure                             | 1     |        |                      |                  |                  |                |
| <b>Idiosyncratic Risk Assessment</b>                    |       |        |                      |                  |                  | <b>2.04(2)</b> |
| <b>Systemic Risk Assessment</b>                         |       |        |                      |                  |                  | <b>A3</b>      |
| <b>Suggested BCA</b>                                    |       |        |                      |                  |                  | <b>baa1</b>    |

The above scorecard includes 2017 pre-closing figures.

Source: Moody's Investors Service

## Ratings

Exhibit 4

| Category                    | Moody's Rating |
|-----------------------------|----------------|
| <b>BASQUE COUNTRY (THE)</b> |                |
| Outlook                     | Stable         |
| Issuer Rating               | A3             |
| Senior Unsecured -Dom Curr  | A3             |

Source: Moody's Investors Service

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