

Research Update:

Basque Country Outlook Revised To Stable After Similar Action On Spain; 'AA-' Rating Affirmed

March 25, 2022

Overview

- We revised our outlook on Spain to stable on March 18, 2022.
- The Basque Country outperformed our budgetary expectations in 2021, thanks to stronger economic recovery from the pandemic, and posted a surplus of 3.8% of total revenue.
- We expect performance to trend downwards again in 2022 due to current economic conditions and high capital execution of EU funds, but we expect management to stabilize the budget again by 2023.
- Our ratings on the Basque Country are capped at two notches above our long-term rating on Spain (unsolicited A/Stable/A-1). We therefore revised our outlook to stable from negative and affirmed our 'AA-' long-term issuer credit rating on the Basque Country.

Rating Action

On March 25, 2022, S&P Global Ratings revised its outlook on the Autonomous Community of the Basque Country to stable from negative. At the same time, we affirmed our long-term issuer credit rating on the Basque Country at 'AA-'.

Outlook

The stable outlook on the Basque Country reflects that on Spain.

Downside scenario

We could lower our rating on the Basque Country if we downgrade Spain or if we believe the region no longer meets our conditions to be rated above the sovereign. We could also downgrade the Basque Country if the region's budgetary performance deteriorates significantly beyond our expectations, whether because of management's lack of commitment to gradually stabilize its budgetary outcomes or because of a weaker economic scenario over our forecast horizon.

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Upside scenario

We could raise our ratings on the Basque Country if we took the same action on Spain and at the same time the region posted structural surpluses after capital accounts higher than 5% of its total revenue, with a lower debt burden.

Rationale

We revised our outlook on the Basque Country to stable from negative, following a similar action on Spain ("Research Update: Spain Outlook Revised To Stable From Negative On Balanced Growth; 'A/A-1' Ratings Affirmed," published March 18, 2022).

Our rating on the Basque Country is higher than that on Spain because, in our view, the region's creditworthiness would make it more resilient than the sovereign in a stress scenario. However, we believe that the Basque Country is highly sensitive to Spain's country risk, and therefore we rate it no more than two notches above the sovereign. Our rating on the region is at the same level as 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.

The institutional framework under which the Basque Country operates allows the region to recover more rapidly from economic shocks

Special-status regions suffered the immediate consequences of the pandemic in 2020 since their own tax administration collects the bulk of taxes. They do not participate in the regional financing system, which is based on advances from taxes collected, allowing the central government to soften the impact of economic cycles on regional revenue. This framework makes special-status regions more vulnerable to economic shocks, but also allows faster economic recovery.

Accordingly, the region has benefitted from higher tax collection from the historical provinces during 2021, driven by higher economic growth than we expected.

The central government continued to provide budgetary support to Spanish regions in 2021, including special-status regions. The government decided to finance half of the reference deficit target set for regions in the form of direct transfers. For the Basque Country, this has meant an additional €645 million in operating transfers to finance budgetary needs over the year. These transfers are not subject to conditions and are voluntary in nature, and we therefore believe that they do not interfere with the Basque Country's ability to be rated above the sovereign. Similarly, we believe this is a temporary measure from the central government and does not warrant a change in our institutional framework assessment. For 2022, we do not expect Basque Country will receive any further funds from the central government.

While we believe that economic risks from the pandemic are being tackled, as demonstrated by Spain's real GDP growth of 5.0% in 2021 and Basque Country's GDP growth of 5.7%, we believe economic forecasts could be somewhat hampered by the conflict in Ukraine, although it is too soon to assess the impact on the Basque Country's accounts. We understand that the Basque Country's exposure to Russian activity is limited, although it could be affected by higher inflation and the increase in energy prices.

Despite these challenges, we continue to believe that the Basque Country's economy enjoys stronger socioeconomic indicators than the national average. The Basque Country's GDP per

capita is one of the highest in Spain at €30,401 in 2020, compared with Spain's €23,703 for the same year. Moreover, its unemployment rate is structurally below that of the sovereign at 11%, versus 16% for Spain, at year-end 2021.

Despite some budgetary pressures in 2022, we expect a return to balanced budgets, strong liquidity, and moderate debt

The Basque Country's budgetary results for 2021 were much stronger than we anticipated in our previous base case. The region posted an operating surplus of 9.7% of operating revenue and a balance after capital accounts of 3.8% of total revenue. Tax collection from the historical provinces grew 14% compared with 2020 and is currently above pre-pandemic levels. Moreover, the region benefited from support from the central government to continue mitigating the effects of the pandemic and received large EU transfers from the Next Generation EU package.

While we expect economic growth will continue, we believe this will not be sufficient to compensate for the loss of pandemic-related central government transfers. Therefore, we estimate a small decline of 1% in operating revenue in 2022. At the same time, due to the conflict in Ukraine and rising prices in the energy sector, we expect operating expenditure to increase by 3.1%.

We expect capital accounts will be driven by EU fund dynamics. As such, the Basque Country is entitled to receive €426 million from the React EU fund and €481 million from the Recovery and Resilience program. While it already received about 80% of the React EU funds in 2021, it did not execute all capital investments due to the administrative burden and lack of visibility on the recipient of the funds. Therefore, we assume a catch up impact as the region will have to execute these funds over the following year, explaining our estimated deficit of 2% of total revenue for 2022.

We view the Basque Country's management as strong and capable of returning to balanced budgets by 2023, based on conservative budgeting assumptions, contained expenditure measures, and the ability to make use of EU funds in a timely manner.

Thanks to the surplus generated in 2021, the region further increased its liquidity buffer, and therefore we continue to view its liquidity as exceptional. Moreover, the region continues to enjoy strong access to external funding. The region issued €1.2 billion in 2021, including a €1 billion sustainable bond, and we believe it will continue to use this strategy to cover future financing needs. We believe management's funding strategy for 2022 will be to fund all debt repayments, likely through a bond issuance of €500 million, and use part of its liquidity buffer to cover its expected budgetary deficit in 2022. In any case, we expect liquidity will remain a strength for the Basque Country's creditworthiness over our forecast period.

We also expect tax-supported debt ratios will remain stable over 2021-2024, at about 86% of consolidated operating revenue by 2024, a decline from 104% in 2020. This decline is supported by a stronger revenue base, expected balanced budgets, and a decline in debt at some of the region's government-related entities.

Key Statistics

Table 1

Autonomous Community of the Basque Country Selected Indicators

Mil. €	--Year ended Dec. 31--					
	2019	2020	2021	2022bc	2023bc	2024bc
Operating revenues	10,696	10,125	12,236	12,113	12,454	12,703
Operating expenditures	9,520	10,060	11,044	11,386	11,687	11,962
Operating balance	1,177	64	1,192	727	767	741
Operating balance (% of operating revenues)	11.0	0.6	9.7	6.0	6.2	5.8
Capital revenues	83	119	416	370	277	231
Capital expenditures	1,009	1,124	1,131	1,347	1,025	955
Balance after capital accounts	251	(941)	476	(250)	19	17
Balance after capital accounts (% of total revenues)	2.3	(9.2)	3.8	(2.0)	0.1	0.1
Debt repaid	1,360	687	668	746	852	706
Gross borrowings	871	2,103	1,165	746	852	706
Balance after borrowings	(238)	475	973	(250)	19	17
Direct debt (outstanding at year-end)	8,645	10,065	10,597	10,597	10,597	10,597
Direct debt (% of operating revenues)	80.8	99.4	86.6	87.5	85.1	83.4
Tax-supported debt (outstanding at year-end)	9,223	10,622	11,039	11,005	11,005	11,005
Tax-supported debt (% of consolidated operating revenues)	85.0	103.7	89.1	89.7	87.3	85.6
Interest (% of operating revenues)	1.7	1.4	1.2	1.2	1.2	1.2
Local GDP per capita (single units)	33,938	30,401	N/A	N/A	N/A	N/A
National GDP per capita (single units)	26,512	23,703	25,383	27,978	29,546	30,767

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. N/A--Not applicable. N.A.--Not available. N.M.--Not meaningful.

Ratings Score Snapshot

Table 2

Autonomous Community of the Basque Country Ratings Score Snapshot

Key rating factors

Institutional framework	3
Economy	1
Financial management	2
Budgetary performance	2
Liquidity	1
Debt burden	3

Table 2

Autonomous Community of the Basque Country Ratings Score Snapshot (cont.)

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

- Research Update: Spain Outlook Revised To Stable From Negative On Balanced Growth; 'A/A-1' Ratings Affirmed, March 18, 2022

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- 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. 20, 2013
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- Research Update: Spain Outlook Revised To Stable From Negative On Balanced Growth; 'A/A-1' Ratings Affirmed, March 18, 2022
- Institutional Framework Assessments For International Local And Regional Governments, March 7, 2022
- Local And Regional Governments Outlook 2022: Long-Term Challenges Resurface As The Pandemic Eases, Feb. 3, 2022
- Sovereign Risk Indicators, Dec. 13, 2021; a free interactive version is available at <http://www.spratratings.com/sri>
- Public Finance System Overview: Spanish Special Status Entities, July 28, 2020

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

Ratings Affirmed; Outlook Action

	To	From
Basque Country (Autonomous Community of) (The)		
Issuer Credit Rating	AA-/Stable/--	AA-/Negative/--

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://www.standardandpoors.com/en_US/web/guest/article/-/view/sourceId/504352 Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; or Stockholm (46) 8-440-5914

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