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Research Update:

Basque Country Ratings Raised To 'A+' Following Spain's Upgrade; Outlook Positive

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Table Of Contents

Overview

Rating Action

Outlook

Rationale

Key Statistics

Ratings Score Snapshot

Key Sovereign Statistics

Related Criteria And Research

Ratings List

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Basque Country Ratings Raised To 'A+' Following Spain's Upgrade; Outlook Positive

Overview

- We raised our unsolicited long-term sovereign ratings on Spain to 'A-' on March 23, 2018, and assigned a positive outlook.
- In our view, the Basque Country's high fiscal autonomy and sound financial management make it more resilient than Spain in a stress scenario; therefore we rate the Basque Country two notches higher than Spain.
- We are raising our long-term ratings on the Basque Country to 'A+' from 'A' and assigning a positive outlook.

Rating Action

On April 6, 2018, S&P Global Ratings raised its long-term issuer credit ratings on Spain's Autonomous Community of the Basque Country to 'A+' from 'A'. The outlook is positive.

Outlook

The positive outlook on Basque Country reflects that on Spain (unsolicited A-/Positive/A-2).

Upside Scenario

We could raise our rating on the Basque Country over the next two years if we raise our rating on Spain, assuming the region continues to meet our conditions to be rated above the sovereign and performs in line with our base-case scenario.

Downside Scenario

We could revise the outlook on the Basque Country to stable over the next two years if we did the same on Spain.

Rationale

The upgrade results from our corresponding rating action on Spain on March 23, 2018 (see "Spain Long-Term Ratings Raised To 'A-' On Economic Growth And Budgetary Consolidation; Outlook Positive," published on RatingsDirect). Our rating on the Basque Country can be higher than that on Spain because, in our view, the region's credit characteristics would make it more resilient than the sovereign in a stress scenario. However, we consider that the region has a high sensitivity to Spain's country risk, and therefore rate it only up to two notches above the sovereign. As a result of this limit, our rating on the Basque Country is one notch lower than its stand-alone credit profile (SACP), which we now assess at 'aa-' rather than 'a+', due to the region's strengthened liquidity. 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 Spain were upgraded, we would also upgrade the Basque Country, provided that the region's credit features remained broadly similar; for this reason, we align our outlook on the region with that on its sovereign.

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 regions, including Navarre and the three Basque historical territories, have legislative power over personal-income and corporate taxes. The three Basque historical territories have their own tax administrations, and collect 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 the Basque Country's government signed an agreement that settled long-standing differences about the calculation of the Basque Country's transfers to the state. As a consequence, the Basque Country benefited from one-time additional resources last year. In addition, we expect the agreement will have a positive impact on the region's liquidity over the next five years, while eliminating uncertainties regarding transfers to the state until 2021.

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 bases. In our opinion, the Basque Country'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.

In our opinion, the region's financial management is professional, clearly identifies the region's main external risks, and shows a strong credit culture. Over the past decade, various Basque Country governments have shown their ability to reach across party lines to approve regional budgets, which we view as a positive factor, underlining the stability and predictability of the region's creditworthiness.

Revenue growth supports budgetary consolidation and gradual debt reduction, while liquidity improves

We estimate that in 2017, the Basque Country achieved an operating surplus of about 9.5% of operating revenues and a surplus after capital accounts of about 1% of total revenues. This is the consequence of higher tax revenues combined with one-time revenues of almost €470 million arising from the settlement with the central government.

Given the one-time impact, we expect operating revenues will decrease in 2018, but remain markedly higher than in 2016. In our view, the Basque Country will moderate operating expenditure growth and increase capital expenditures only gradually.

We expect operating performance and balances after capital accounts will gradually improve throughout our forecast period 2018-2020 as the Basque Country closely follows (or outperforms) official deficit targets agreed with the central government. We believe the region is committed to complying with the official target as a way to prevent intervention from the central government that could restrict its autonomy.

In our opinion, the Basque Country's operating surplus will gradually approach 5% by the end of 2020, and the deficit after capital accounts could narrow to about 1.6% of total revenues that same year from about 3.4% this year.

In our view, the region could absorb some potential revenue deviations by adjusting tax rates or fiscal benefits, since its budgetary flexibility is greater than that of most Spanish regions, owing to its special fiscal regime and wealthier economy. We also estimate the region could delay capital investments if necessary, given its high infrastructure endowment.

The Basque Country's continued, albeit declining, deficits will further increase its nominal debt. However, because we assume revenues will increase, we estimate the Basque country's debt burden ratios peaked in 2016, at about 104% of consolidated operating revenues. We therefore expect tax-supported debt will reduce to about 100% of consolidated operating revenues in 2020. Our tax-supported debt figure includes the debt of the region's non-self-supporting public-sector companies, as well as some guarantees that the region provides to third parties. Together, these items represented about 8% of the region's tax-supported debt at year-end 2017.

Rapid debt accumulation in 2008-2013 led to a gradual increase in annual debt maturities. In 2018 and 2019, the Basque Country faces debt repayment of over €1 billion annually. In recent years, we have viewed these refinancing needs as the key challenge for the region's creditworthiness, expecting that such obligations could put pressure on the region's liquidity.

However, even though the Basque Country's debt repayments remain high, we see several factors that mitigate the risk. First, the Basque Country is actively pursuing debt renegotiation and making early repayments to progressively flatten its debt maturity profile. As a result, we think annual debt repayments have already peaked. Second, we saw a material improvement in the region's liquidity position in 2017, leading us to revise our liquidity assessment to adequate from less than

adequate. We currently estimate that the Basque Country's liquidity resources (cash and available credit lines) exceed 100% of debt service for the next 12 months. This improvement is partly due to the additional resources received from the central government, but also to increased tax collection and containment of expenditures. Third, we understand the Basque Country's agreement with the central government will provide it with additional cash resources of about €1 billion through 2021, which should reinforce the region's liquidity position.

At the same time, the Basque Country's government is actively managing its debt maturity schedule. The region has benefited from favorable market conditions in recent years, issuing bonds at very low overall costs and with tight spreads over comparable references of the Spanish treasury, as well as bank loans for which it has received ample excess offers.

We consider 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. We expect the region will continue restructuring and streamlining its companies.

Key Statistics

Table 1

Autonomous Community of the Basque Country Key Statistics

(Mil. €)	--Fiscal year end Dec. 31--					
	2015	2016	2017	2018bc	2019bc	2020bc
Operating revenues	8,750	9,069	10,129	9,729	10,085	10,434
Operating expenditures	8,644	8,854	9,171	9,385	9,635	9,911
Operating balance	105	215	958	344	450	523
Operating balance (% of operating revenues)	1.2	2.4	9.5	3.5	4.5	5.0
Capital revenues	185	234	160	265	275	285
Capital expenditures	842	918	1,009	949	964	979
Balance after capital accounts	(552)	(469)	109	(340)	(238)	(172)
Balance after capital accounts (% of total revenues)	(6.2)	(5.0)	1.1	(3.4)	(2.3)	(1.6)
Debt repaid	686	572	654	1,114	1,098	933
Gross borrowings	1,165	1,106	971	1,454	1,336	1,105
Balance after borrowings	(73)	65	426	0	0	0
Modifiable revenues (% of operating revenues)	49.4	50.1	47.6	49.6	49.6	49.6
Capital expenditures (% of total expenditures)	8.9	9.4	9.9	9.2	9.1	9.0
Direct debt (outstanding at year-end)	8,228	8,765	9,082	9,422	9,660	9,832
Direct debt (% of operating revenues)	94.0	96.6	89.7	96.8	95.8	94.2
Tax-supported debt (outstanding at year-end)	9,082	9,609	9,862	10,192	10,406	10,577
Tax-supported debt (% of consolidated operating revenues)	102.1	103.7	95.9	103.1	101.7	99.9
Interest (% of operating revenues)	2.6	2.2	1.8	1.8	1.7	1.7

Table 1

Autonomous Community of the Basque Country Key Statistics (cont.)

(Mil. €)	--Fiscal year end Dec. 31--					
	2015	2016	2017	2018bc	2019bc	2020bc
Local GDP per capita (€)	30,769	31,784	32,633	N/A	N/A	N/A
National GDP per capita (€)	23,251	24,085	25,010	26,023	26,919	27,798

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.

Ratings Score Snapshot

Table 2

Autonomous Community of the Basque Country Ratings Score Snapshot

Key rating factors	Assessment
Institutional framework	Evolving but balanced
Economy	Very strong
Financial management	Strong
Budgetary flexibility	Strong
Budgetary performance	Average
Liquidity	Adequate
Debt burden	Moderate
Contingent liabilities	Low

*S&P Global Ratings bases its ratings on local and regional governments on the eight main rating factors listed in the table above. Section A of S&P Global Ratings' "Methodology For Rating Non-U.S. Local And Regional Governments," published on June 30, 2014, summarizes how the eight factors are combined to derive the our foreign currency rating on the government.

Key Sovereign Statistics

Spain Long-Term Ratings Raised To 'A-' On Economic Growth And Budgetary Consolidation; Outlook Positive, March 23, 2018

Related Criteria And Research

Related Criteria

- Criteria - Governments - International Public Finance: Methodology For Rating Non-U.S. Local And Regional Governments - June 30, 2014
- General Criteria: Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions - November 19, 2013
- Criteria - Governments - International Public Finance: Methodology: Rating Non-U.S. Local And Regional Governments Higher Than The Sovereign - December 15, 2014
- Criteria - Governments - International Public Finance: Methodology And Assumptions

For Analyzing The Liquidity Of Non-U.S. Local And Regional Governments And Related Entities And For Rating Their Commercial Paper Programs - October 15, 2009

- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009

Related Research

- Spain Long-Term Ratings Raised To 'A-' On Economic Growth And Budgetary Consolidation; Outlook Positive - March 23, 2018
- Sovereign Risk Indicators - December 14, 2017. An interactive version is also available at <http://www.spratings.com/sri>.
- Institutional Framework Assessments For Non-U.S. Local And Regional Governments - September 21, 2017
- 2016 Annual Non-U.S. Local And Regional Government Default Study And Rating Transitions - May 8, 2017

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

Rating

To

From

The Basque Country (Autonomous Community of)

Issuer Credit Rating

Foreign and Local Currency

A+/Positive/--

A/Positive/--

Ratings List Continued...

Senior Unsecured

Local Currency

A+

A

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. 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; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

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