S&P Global
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Research Update:

Balearic Islands Upgraded To 'A-' On Improving Budgetary Performance And Debt Reduction; Outlook Stable

November 10, 2023

Overview

- We think the Balearic Islands' operating surplus will exceed our previous expectations, on the back of a large increase in revenue from the regional financing system.
- Although the Balearic Islands' debt remains high, we expect its deleveraging will accelerate thanks to expanding revenue and moderate debt intake.
- The Balearic Islands will continue to benefit from liquidity mechanisms from the central government, which we expect will finance most of the region's needs over 2023-2025.
- We therefore raised our long-term issuer credit rating on the Balearic Islands to 'A-' from 'BBB+'. The outlook is stable.

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Rating Action

On Nov. 10, 2023, S&P Global Ratings raised to 'A-' from 'BBB+' its long-term issuer credit rating on Spain's Autonomous Community of the Balearic Islands. The outlook is stable.

Outlook

The stable outlook reflects our expectation that the Balearic Island will leverage a favorable revenue trend to improve its operating performance, thereby offsetting the impact of cost increases. The stable outlook also reflects our expectation of a steady improvement of debt burden ratios over our 2023-2025 forecast horizon.

Upside scenario

We could upgrade the Balearic Islands if budgetary outcomes surpass our current expectations, with consistent surpluses after capital accounts. This, in turn, would likely enable the region to deleverage faster than we currently expect and give way to stronger liquidity metrics.

Downside scenario

We could downgrade the Balearic Islands if, despite expanding revenue, the region's management decided to increase expenditure in a way that interrupted deleveraging. This would likely compromise the region's flexibility to adjust its budgets in a less favorable revenue scenario, and it could imply liquidity pressure.

Rationale

The upgrade of the Balearic Islands to 'A-' from 'BBB+' reflects our expectation of stronger budgetary performance than we had previously anticipated. After a steep decline due to pandemic fallout, the Balearic Islands' economy has strongly recovered, with tourism inflows already surpassing pre-pandemic levels. We therefore expect notable revenue increases for the region over the next two years. We also expect the region's financial management to moderate expenditure growth, allowing a clear improvement of operating balances.

The region's debt burden remains high in an international context. But, we believe favorable budgetary dynamics, along with the management's decision to moderate the issuance of new debt, should allow the Balearic Islands to continue decreasing its debt burden ratios steadily to about 154% of consolidated operating revenue by end-2025, compared with about 223% in 2019, prior to the pandemic.

It is too soon to factor into our base case the implications of the potential debt write-off agreement with Catalonia if it is extended to the Balearic Islands. In talks to form a new central government following the inconclusive results of the July 2023 election, the current caretaker government run by the Socialist Party agreed with the Republican Left of Catalonia to absorb part of the debt Catalonia owes the central government. Other regions, including the Balearic Islands, would also benefit from this debt write-off. At this time, however, we do not have clarity on the specific amount or timing for the Balearic Islands.

In our view, the Balearic Islands continues to benefit from a supportive institutional framework. This includes access to central government liquidity mechanisms to cover all its financing needs.

A strong economic recovery and a supportive institutional framework gives the Balearic Islands' management flexibility to improve its finances

Economic forecasts for 2023-2024 point to a regional GDP growth stronger than the Spanish and eurozone averages, at close to 4.0% in 2023 and more than 2.5% in 2024. The Balearic Islands' real GDP contracted about 20% in 2020 due to pandemic fallout. This was higher than the Spanish average, but the region recovered strongly once mobility restrictions were lifted, with growth of over 11% in 2021 and over 14% in 2022, largely thanks to improving tourism inflows.

High inflation and increases in prices for flights and accomodations have yet to materially deter travelers from visiting the Balearic Islands. The region's tourism sector has proven resilient, with stays increasing 6.4% as of August 2023 from the same date in 2022. Spending has also risen 14.1% year on year.

Although the ongoing conflicts in Ukraine and the Middle East elevate uncertainty about the economy and security in Europe, the Balearic Islands appears to have limited exposure to these risks so far.

The economic recovery feeds through to stronger tax bases, especially in the key taxes included in the regional financing system: personal income tax (PIT), value added tax (VAT), and excises. We therefore expect the region's resources to continue growing in the coming years.

Against this backdrop, we see the institutional framework under which the region operates as supportive. Despite the adverse impact of the pandemic on the Balearic Islands' economy, strong central government support helped contain the fallout on the region's budgetary performance.

Moreover, the region benefits from its new special fiscal regime, agreed with the central government in 2022 for the 2023-2028 period. In this agreement, the Balearic Islands receives a direct transfer from the central government, or "Factor de Insularidad", to compensate for transport and infrastructure projects. The fiscal tax regime also includes benefits from the corporate tax for foreign direct investments and deductions to personal income tax for nonresidents. The region expects this special fiscal tax regime to attract foreign investments and therefore support economic activity.

We view the region's management as prudent and experienced. We expect the new government, which took office following the regional elections in May 2023, to remain committed to a gradual improvement in regional finances, leading to stronger debt metrics.

A clear improvement in operating performance is likely thanks to increasing revenue from the financing system

We expect an improvement in the Balearic Islands' operating performance over 2023-2025, with operating balances near 7% of operating revenues, above our previous expectation of about 5%.

We expect the Balearic Islands' revenue to materially expand further in 2024, following a large increase (over 20%) in revenue from the regional financing system.

The political stalemate at the central government level, following the inconclusive general elections in July 2023, has delayed the drafting of the 2024 budget. In the absence of an official communication from the central government on the expected resources from the regional financing system, regions, including the Balearic Islands, have resorted to their own estimates, alongside independent estimates from Spain's fiscal responsibility authority, AIReF, to plan next year's budget.

This situation generates uncertainty about the exact amount of revenue the Balearic Islands will receive. Nevertheless, it seems almost certain that revenue will materially grow. The Spanish economy continues to expand; we expect nominal GDP growth of about 3.6% for Spain as a whole in 2024. Very importantly, tax collection in 2022 rose more than expected, and this will lead to a large positive settlement of the regional financing system that regions will cash in during 2024.

Revenues from the regional financing system for 2025 are even more uncertain. However, given the strong performance of the Balearic Islands' economy so far this year, we think it is reasonable to expect a moderation in growth, rather than a reduction in revenue for the year.

The Balearic Islands' government has enacted some tax reduction measures on PIT, real estate transaction taxes, and inheritance taxes. This will lead to lower revenue, but we do not expect such measures to be material enough to alter the revenue growth trajectory.

Given this favorable revenue environment, we think the Balearic Islands' financial management will be able to meaningfully improve operating performance despite likely cost pressure. The region cannot fully control personnel expenditure, given that salary increases are centrally determined. Also, it faces the impact of inflation on costs, as contracts are gradually renewed. Nevertheless, we expect the regional government will moderate discretionary spending growth, to continue improving the structural balance between operating revenue and expenditure.

On the capital side, the Balearic Islands' accounts will be influenced by the timing of the cashing-in and spending of EU funds. Having received funds in advance in 2021 and 2022, the region is likely to step up execution of investments in 2023 and 2024. We assume this will cause an apparent deterioration in balances after capital accounts, but only in budgetary accounting terms. The official figures will adjust for those mismatches. In any case, and given that the revenue and expenditure associated with the Recovery and Resilience Facility (RRF) are matched over time, they will not generate any meaningful budgetary pressure on the region, but rather create an opportunity to expand investments and foster economic competitiveness and growth in the medium to long term, provided they are spent on productive projects.

We expect the region's debt burden, although clearly declining, will remain high in an international context. Considering that investments are largely financed by already-cashed-in EU funds, we do not believe the Balearic Islands will cover its gross financing needs in full. As such, we now expect tax-supported debt to reach about 154% of consolidated operating revenue by 2025, representing an improvement over our previous estimate of about 171%, primarily thanks to higher-than-expected revenue over the coming two years.

Given the less favorable interest rate environment, the Balearic Islands will experience a gradual increase in interest expenditure. This, however, starts at a very low level, with an effective interest rate of below 1%. We also note that the region's debt portfolio is well protected against interest rises, with close to 95% of all debt at fixed rates. The region is using the central government liquidity mechanisms in 2023 to finance its needs, and we expect it will continue to do so in 2024 and beyond.

We view the Balearic Islands' liquidity as adequate. Although the region currently has large cash reserves, we expect a gradual decline in the cash position as it intensifies capital spending from the RRF funds. However, our view on the region's liquidity continues to be supported by its access to central government funding and a total of €650 million in credit lines.

Key Statistics

Table 1

The Autonomous Community of Balearic Islands--Selected Indicators

	--Fiscal year ends Dec. 31--					
(Mil. €)	**2020**	**2021**	**2022**	**2023bc**	**2024bc**	**2025bc**
Operating revenues	4,493	5,705	4,617	5,276	5,615	5,766
Operating expenditures	4,061	4,908	4,426	4,904	5,212	5,369
Operating balance	432	797	191	372	403	397
Operating balance (% of operating revenues)	9.6	14.0	4.1	7.1	7.2	6.9
Capital revenues	87	264	701	437	311	310
Capital expenditures	606	602	621	894	979	914
Balance after capital accounts	(87)	459	271	(85)	(264)	(207)
Balance after capital accounts (% of total revenues)	(1.9)	7.7	5.1	(1.5)	(4.5)	(3.4)

Table 1

The Autonomous Community of Balearic Islands--Selected Indicators (cont.)

	--Fiscal year ends Dec. 31--					
(Mil. €)	**2020**	**2021**	**2022**	**2023bc**	**2024bc**	**2025bc**
Debt repaid	3,002	2,690	1,180	1,191	959	895
Gross borrowings	3,277	2,650	1,102	1,017	1,009	945
Balance after borrowings	187	418	192	(259)	(214)	(157)
Direct debt (outstanding at year-end)	8,815	8,752	8,674	8,500	8,550	8,600
Direct debt (% of operating revenues)	196.2	153.4	187.9	161.1	152.3	149.1
Tax-supported debt (outstanding at year-end)	9,297	9,235	9,093	8,859	8,843	8,881
Tax-supported debt (% of consolidated operating revenues)	203.7	159.9	196.9	167.9	157.5	154.0
Interest (% of operating revenues)	2.4	1.0	1.1	1.6	1.7	1.9
Local GDP per capita (single units)	21,551	24,866	N/A	N/A	N/A	N/A
National GDP per capita (single units)	23,620	25,462	27,979	29,848	30,839	32,052

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

The Autonomous Community of Balearic Islands--Ratings Score Snapshot

Key rating factors	
Institutional framework	3
Economy	2
Financial management	3
Budgetary perfomance	2
Liquidity	3
Debt burden	4
Stand-alone credit profile	a-
Issuer credit rating	A-

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

- Sovereign Risk Indicators, Oct. 9, 2023. An interactive version is available at http://www.spratings.com/sri

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
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- Spanish Regional Finances Should Pick Up After A Weak 2022, May 3, 2023
- Institutional Framework Assessments For Local And Regional Governments Outside Of The U.S., March 22, 2023
- Spain, March 20, 2023
- Institutional Framework Assessment: Spanish Normal Status Regions, July 21, 2022

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

Upgraded

	To	From
Balearic Islands (Autonomous Community of) (The)		
Issuer Credit Rating	A-/Stable/--	BBB+/Positive/--
Senior Unsecured	A-	BBB+