Research Update:

Spain's Autonomous Community of Navarre 'AA-' Rating Affirmed; Outlook Stable

March 24, 2023

PRIMARY CREDIT ANALYST

Alejandro Rodriguez Anglada
Madrid
+ 34 91 788 7233
alejandro.rodriguez.anglada
@spglobal.com

SECONDARY CONTACT

Marta Saenz
Madrid
+ 34 91 788 7231
marta.saenz
@spglobal.com

ADDITIONAL CONTACT

Sovereign and IPF EMEA
SOVIPF
@spglobal.com

Overview

- Navarre's budgetary performance in 2022 was stronger than we anticipated, thanks to solid tax performance and an agreement with the central government that boosted revenue.
- We expect Navarre to reduce debt faster than we previously anticipated, while liquidity remains solid.
- We affirmed our 'AA-' long-term issuer credit rating on Navarre.
- The stable outlook reflects that on the sovereign, along with our expectation that Navarre will maintain balanced budgets and gradually reduce debt over our forecast period to 2025

Rating Action

On March 24, 2023, S&P Global Ratings affirmed its 'AA-' long-term issuer credit rating on Navarre. The outlook is stable

Outlook

The stable rating outlook mirrors that on Spain (unsolicited; A/Stable/A-1). It also reflects our expectation that Navarre will continue to post balanced budgets and gradually reduce its debt burden.

Downside scenario

We would downgrade Navarre if we downgrade Spain, or if we no longer consider that Navarre meets our conditions to be rated above the sovereign. We could also downgrade Navarre if its financial performance materially deviates from our base-case scenario, including structural deficits, for example because of a weaker economy or lack of commitment to maintaining strong budgetary outcomes. This could, in turn, result in a deterioration of liquidity.

Upside scenario

We could upgrade Navarre if we upgrade Spain and the region continues to perform in line with our expectations, which point to balanced budgets and a gradual reduction of debt.

Rationale

Our rating on Navarre can be above that on Spain because we estimate that the region's credit characteristics would make it more resilient than the sovereign in a stress scenario. However, in our view, Navarre is not immune to Spain's country risk; therefore, we rate it only up to a maximum of two notches above the sovereign.

Our rating on Navarre is now one notch below the region's stand-alone credit profile (SACP), which we now assess at 'aa', up from 'aa-' previously. The SACP is not a rating, but a measure of the intrinsic creditworthiness of a local or regional government (LRG) before considering any constraint arising from the sovereign rating.

Navarre benefits from high fiscal autonomy but is more exposed than normal-status regions to the economic cycle

Navarre--along with Spain's other special-status entities, the Basque Country and Bizkaia--has unique tax powers compared with the rest of Spain's LRGs. These include legislative power over personal income and corporate taxes, which enables such entities to benefit from their comparatively wealthy economies. Unlike normal-status regions, special-status entities like Navarre have their own tax administrations that collect most taxes. Navarre then transfers a portion of them to Spain's central government in compensation for the services it provides in the region.

Navarre's special status implies a bilateral relationship with the government, and different treatment compared with normal-status regions. Among other things, Navarre bilaterally negotiates its deficit targets with the central government. Late in 2022, Navarre successfully concluded a bilateral negotiation with the central government to renew its financial agreement for the period 2020-2024. Given the technical and political complexity of such negotiations, it is typical for them to conclude with a delay versus the theoretical date. While new agreements are negotiated, the previous ones remain valid, giving the region financial stability.

This agreement was concluded on what we see as favorable terms for Navarre. The agreement implies that Navarre would have new revenue sources from new taxes, and a change in the formulas used to determine its share of existing taxes. Although the agreement also implies a higher gross transfer of resources to the central government, the net impact for Navarre is still positive because the new revenue sources more than compensate for it. The favorable terms of this agreement, in our view, will contribute to shoring up Navarre's budgetary performance during our forecast period to 2025.

Navarre received support from the Spanish central government to cope with the pandemic's negative effects on its accounts. Spain's central government provided pandemic-related support on a voluntary basis, without any request from Navarre. Also, this support did not involve any conditions or restrictions about the use of funds, which we view as consistent with the ability of special-status regions to maintain a rating above the sovereign.

Navarre's economy is wealthier, more competitive, and more export oriented than Spain's. The region's GDP per capita was about 122% of the national average at year-end 2021, having recovered markedly after the pandemic. With regional statistics data, Navarre's Nominal GDP at year-end 2021 had already reached pre-pandemic levels. Industry is a much bigger part of Navarre's economy than in other regions, representing 31.5% of gross value added, compared with Spain's 16.9% as of year-end 2021. In addition, its industrial sector features high value-added, export-oriented companies. This makes the economy more resilient to external shocks, in our view. Navarre is much less dependent on tourism than other Spanish regions, and therefore was comparatively less affected by pandemic-driven restrictions on mobility. In our view, Navarre's economic strength is a positive factor, particularly because it boosts its tax bases, which it directly benefits from thanks to the institutional arrangements that define its relationship with the central government.

In our opinion, Navarre's financial management team demonstrates sound experience and is aware of the region's main external risks--especially regarding financial relationships with the central government, as the successful conclusions of its negotiations illustrate.

Stronger-than-expected performance in 2022, with balanced budgets expected through to 2025

Navarre's budgetary performance was stronger than we anticipated in 2022, according to our preliminary estimates, with a positive operating balance of about 9.6% of operating revenue and a balance after capital accounts of close to 5% of total revenue. The key driver of the region's performance was the agreement with the central government to update Navarre's financial relationship with it. Because of the agreement, we estimate Navarre will have structurally higher operating revenue. This is due to the inclusion of new taxes in the agreement, as well as a favorable redefinition of the formulas governing the sharing of indirect taxes, particularly value-added tax. Navarre will also have higher operating expenditure because of a larger transfer to the state. However, we estimate that the outcome of the negotiation is that Navarre gains additional resources that should support its performance in the years ahead.

We expect Navarre to face some pressure on the expenditure side in 2023, due to inflation. However, we note that one of the key components of expenditure (personnel) will evolve in line with the centrally determined wage increase, which is 2.5% for 2023. Given that this increase remains below inflation, we estimate it provides the region's budget with some leeway to adjust other spending components. Overall, we expect Navarre to maintain sound operating balances, of close to €500 million per year, or about 8% of operating revenues.

On the capital side, Navarre continues to benefit from access to EU funds, within the framework of the Recovery and Resilience facility. Capital expenditure associated with these funds were somewhat delayed in 2022 compared to our expectations, reflecting the administrative and operational complexity linked to their execution. Therefore, we expect some deterioration in the balance after capital accounts in 2023-2025 as Navarre catches up on spending the EU funds received in previous years.

However, we do not expect this impact will be sufficient to translate into deficits, but rather expect continued (albeit small) budget surpluses. This may lead to some deterioration of Navarre's budgetary metrics between 2023 and 2025. However, we note that the overall effect of EU funds from the recovery and resilience facility is neutral for budgetary performance. While there may be temporary mismatches in the recognition of revenue versus expenditure execution, ultimately there is a good match between the two. Moreover, such distortions will be eliminated when calculating Navarre's performance in national accounting terms, the central government's official benchmark.

We believe Navarre can maintain similarly strong budgetary metrics in 2024-2025, barring a fundamental change in the economic outlook, for example, because of the Russia-Ukraine conflict. Should the region's performance be in line with our base case, this would lead to a gradual reduction of tax-supported debt ratios, partly spurred by relatively strong revenue growth in nominal terms due to inflationary pressures.

We also expect Navarre will use the surplus generated in 2022 to reduce debt in 2023, refinancing only a fraction of its maturities. Coupled with revenue expansion and the gradual amortization of its public-sector entities' debt, this should enable a material debt reduction in relative terms to about 53% of consolidated operating revenue by 2025, absent any major changes in the economic outlook. This is a faster reduction of the region's debt ratios than we previously envisaged, leading to a debt position that we would view as strong in an international context. In our view, Navarre's contingent liabilities are limited to guarantees, representing only about 1% of operating revenue, and therefore unlikely to have any material impact on its finances even in a scenario of full materialization.

Navarre's liquidity was exceptionally high in 2022 due to the excess funding (considering the accumulated surplus), and the continued receipt of EU funds. Although we expect Navarre's cash position to diminish as it spends the EU funds, we still expect the region to maintain a very strong liquidity position in the coming years. Furthermore, we expect Navarre to continue taking a proactive approach to debt and liquidity management, refinancing its loans when there are available market windows, as it did in 2021, for example. These policies allowed Navarre to contain the average cost of debt to about 1.4% at year-end 2022, despite interest rates rising through the year.

Key Statistics

Table 1

Navarre (Autonomous Community of)--Selected Indicators

	--Fiscal year end Dec. 31--					
Mil. €	**2020**	**2021**	**2022**	**2023bc**	**2024bc**	**2025bc**
Operating revenue	4,036	4,676	5,288	5,539	5,688	5,880
Operating expenditure	3,952	4,119	4,780	4,993	5,195	5,393
Operating balance	83	557	508	547	493	487
Operating balance (% of operating revenue)	2.1	11.9	9.6	9.9	8.7	8.3
Capital revenue	41	157	214	326	271	212
Capital expenditure	345	339	440	662	669	595
Balance after capital accounts	(221)	375	283	211	95	104
Balance after capital accounts (% of total revenue)	(5.4)	7.8	5.1	3.6	1.6	1.7
Debt repaid	290	607	381	222	234	261
Gross borrowings	648	150	407	58	200	225
Balance after borrowings	138	(81)	308	47	61	67
Direct debt (outstanding at year-end)	3,264	2,809	2,836	2,672	2,638	2,601
Direct debt (% of operating revenue)	80.9	60.1	53.6	48.2	46.4	44.2
Tax-supported debt (outstanding at year-end)	3,875	3,403	3,394	3,265	3,195	3,131

Table 1

Navarre (Autonomous Community of)--Selected Indicators (cont.)

	--Fiscal year end Dec. 31--					
Mil. €	**2020**	**2021**	**2022**	**2023bc**	**2024bc**	**2025bc**
Tax-supported debt (% of consolidated operating revenue)	95.2	72.1	63.6	58.4	55.7	52.8
Interest (% of operating revenue)	1.6	1.6	0.8	0.6	0.7	0.8
Local GDP per capita (€)	28,822	31,024	N/A	N/A	N/A	N/A
National GDP per capita (€)	23,620	25,462	28,017	29,596	30,579	31,813

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

Navarre (Autonomous Community of)--Ratings Score Snapshot

Key rating factors	**Scores**
Institutional framework	3
Economy	1
Financial management	2
Budgetary perfomance	1
Liquidity	1
Debt burden	2
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

Full Analysis: Spain, March 20, 2023

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

- Sovereign Risk Indicators, Dec. 12, 2022
- Institutional Framework Assessments For Local And Regional Governments Outside Of The U.S., Dec. 1, 2022
- Institutional Framework Assessment: Spanish Special Status Entities, 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

Ratings Affirmed	
Navarre (Autonomous Community of)	
Issuer Credit Rating	AA-/Stable/--

Ratings Affirmed

Senior Unsecured	AA-

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