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Research Update:

Austrian State of Styria Outlook Revised To Stable On Consolidation Efforts And Improved Liquidity; 'AA/A-1+' Affirmed

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Overview

- Styria's newly passed budget for 2019/2020 aims to gradually reduce its still-elevated deficit after capital accounts to levels compliant with the Austrian national stability pact by containing expenditure growth.
- While implementing structural reforms will remain challenging, we consider that the Austrian economy's strong current performance and resulting positive dynamics for the state's tax revenues provide significant support to Styria's consolidation efforts.
- Additionally, Styria has strengthened its liquidity management by adding committed credit lines and installing cash-pooling agreements with key state-owned enterprises.
- We are therefore revising our outlook on Styria to stable from negative, and affirming our 'AA/A-1+' issuer credit ratings.

Rating Action

On Feb. 1, 2019, S&P Global Ratings revised its outlook on the Austrian State of Styria to stable from negative, and affirmed its 'AA/A-1+' long- and short-term issuer credit ratings.

Outlook

The stable outlook reflects our expectation that, thanks to a politically backed focus on limiting expenditure growth and a benign macroeconomic backdrop, Styria's government will manage to largely achieve its budgetary consolidation objectives.

Downside scenario

We could lower our rating if Styria deviated significantly from its clearly communicated political ambition of budgetary consolidation and fails to reduce deficits as planned. This could result either from the administration weakening its focus on containing expenditure growth, or from meaningful deterioration in the macroeconomic environment reducing tax revenue growth below current expectations. If Styria faced difficulties aligning expenditures with actual revenues and implementing the steps outlined in its budgetary plan, we could also revise our assessment of the state's financial management downward.

Upside scenario

We could consider taking a positive rating action on Styria if the state meaningfully outperformed its financial planning, characterized by sustainable surpluses after capital accounts and a quick reduction of outstanding debt volumes. However, given the continuing challenge for Styria to contain structural expenditure growth, we regard such developments as unlikely over the next 24 months.

Rationale

Since 2016, Styria has posted sizable deficits after capital accounts, been noncompliant with the Austrian national stability pact's deficit target, and experienced rising debt. However, the state's financial management has now obtained parliamentary approval for a consolidation-focused budget for 2019/2020 that aims to limit expenditure growth and gradually reduce deficits, with the goal of balancing the budget by 2021. Although we make some conservative adjustments to the state's budgetary planning, we expect strong overall budgetary performance and believe that Styria will manage to markedly reduce its deficits.

The Austrian economy's outstanding performance and the resulting positive dynamics for the state's tax revenues support Styria's consolidation efforts, although implementing required structural reforms will remain challenging. Accordingly, we forecast that the state's debt ratio, although comparatively high if one includes unfunded pension obligations, should remain stable.

Styria has overhauled its liquidity-management strategy by adding committed bank credit lines, installing cash-pooling agreements with key state-owned enterprises, and smoothing its maturity profile by refinancing some shorter-dated debt with ultra-long, fixed-rate instruments. These steps, combined with the existing access to financing from the Austrian federal debt management agency and the capital market, in our view, result in exceptional liquidity.

Styria also displays lower contingent liabilities than most of its Austrian peers, since it owns only a residual 25% stake in local lender Landes-Hypothekenbank Steiermark--the pending sale of which is scheduled to close in first-quarter 2019.

Budgeted consolidation efforts are supported by positive economic developments

The very positive macroeconomic conditions in Austria currently support the state's consolidation efforts. For Austria, we forecast real GDP growth of 3.0% in 2018 and 2.0% in 2019. Styria's future tax revenues--which are collected at the national level and then distributed to the states primarily based on relative population--should benefit from this positive backdrop.

In general, we observe an advanced economic structure in Styria, particularly in the core region around its capital Graz. Styria has succeeded in attracting a number of leading, technology- and knowledge-focused, export-oriented companies, led by automotive supplier Magna International. This has resulted in comparatively low local unemployment of only 5.9% (Austrian national definition) and an estimated GDP per capita of about €38,500 for 2018. However, it also requires the state to undertake the capital expenditures required to maintain an appropriate level of infrastructure for the fast-growing population of its central area.

The well-established and robust institutional framework for Austrian states affords Styria good predictability regarding future resources and requirements. This was illustrated by the outcome of the dispute with the federal government in 2018 over who bears the cost of the abolishment of the so-called "Pflegeregress," that is, the states' recourse to an individual's assets to pay for the cost of elderly care. The federal government essentially agreed to fully reimburse states for the cost, demonstrating that states' legal option to initiate a consultation mechanism in response to federal laws that give rise to new expenditures is a powerful tool to dispute fiscally detrimental changes. As such, we do not believe that the federal government's still very unspecific ideas for further cuts in taxes and social contributions for the years beyond 2020 will overburden Styria or its Austrian peers.

Styria's financial management has demonstrated political strength by successfully negotiating and obtaining the required parliamentary approval for its consolidation-focused budget for 2019/2020. Essentially, the budget requires almost all government departments to cut planned expenditure volumes by 6%-8% compared with previous planning, with the exception of a few specific areas. Full implementation of the new budget, which we consider a challenge, would limit overall expenditure growth to below projected revenue growth and gradually reduce the currently elevated deficits to levels compatible with the Austrian national stability pact by 2020. By agreeing to bring forward the publication date for 2019 results to April 2020, which is ahead of the next state election in May of that year, Styria's financial management has increased its political commitment to actually execute its budgetary plan.

The state's only average budgetary flexibility, however, makes budgetary consolidation challenging, in our view. Shared taxes and transfers determined by the federal government constitute 70% of Styria's operating revenues and are not controlled by its financial management. Similarly, personnel costs, representing about 50% of operating expenditures, are also quasi-fixed. Selling assets (such as the state's 75% stake in local utility ESTAG, or €2.8 billion remaining housing loan receivables) would not solve the state's structural issues and is, as we understand, not on the current political agenda. The agreed sale of Styria's remaining 25% stake in local lender Landes-Hypothekenbank Steiermark, which is scheduled to close in the first-quarter of this year, is an exception, but only yields €52 million of revenues.

Gradual return to more moderate deficits forecast

We understand that Styria's actual budgetary performance in 2018 exceeded initial budgetary planning by about €90 million, which is roughly in line with our previous base case and mainly due to good tax collection. Applying our cash-focused calculation approach, we estimate that this will result in an operating surplus of about 5.9% of operating revenues and a deficit after capital accounts of 5.2% of total revenues for 2018.

Over 2019-2022, we expect that Styria will achieve operating margins of 6.5%-7.6% of operating revenues, and deficits after capital accounts of 1.8%-3.0% of total revenues. We base our forecast on the assumption that Austria's economic performance will remain strong and that Styria will largely achieve the targeted restraint on expenditure growth, although we allow for some slippage in our modelling. As such, we consider that Styria should be able to make significant progress toward compliance with the Austrian national stability pact's deficit target.

Commensurate with the state's predicted budgetary performance and operating revenue growth, we anticipate Styria's ratio of tax-supported debt to operating revenues will remain broadly stable at about 90%. Adding the net present value of the state's unfunded pension obligations, which we estimate at roughly €3 billion, we consider the resulting total to be high in an international comparison. The composition of Styria's debt portfolio was further simplified in recent months. The state refinanced maturing debt previously incurred by its hospital company's financing arm, KIG (€500 million in 2017), and its real estate holding vehicle, LIG (€200 million in 2018), with funds borrowed directly through its budget. Furthermore, €355 million of near-term maturities of direct debt were refinanced in 2018 with ultra-long, fixed-rate debt sourced from the Austrian federal debt management agency, OeBFA.

Styria has strengthened its liquidity management by adding four committed bank credit lines totaling €300 million, and by installing cash-pooling agreements with two key state-owned enterprises. While previously a sufficiently sized cash-advance facility provided by OeBFA acted as the state's pivotal liquidity-management tool, we understand that management intends to actively use the newly established instruments in order to source short-term liquidity when required. Calculating a coverage ratio of debt service over the coming 12 months with committed commercial bank credit lines and existing cash in excess of 100%, and additionally taking into consideration Styria's established access to funding from OeBFA and the Austrian capital market, we now consider the state's liquidity exceptional.

Our ratings also benefit from Styria's comparatively low volume of contingent liabilities. Despite the agreed, but not yet closed, sale of Styria's 25% stake in Landes-Hypothekenbank Steiermark, we continue to include about €800 million of remaining grandfathered guarantees for debt issued by the bank in our assessment of the state's contingent obligations. However, we view a call on these guarantees as unlikely and understand that, following completion of the sale, it is foremost the contractual obligation of the bank's future sole owner (Raiffeisen-Landesbank Steiermark AG) to ensure its proper capitalization. Furthermore, we consider that Styria's 75% stake in local utility ESTAG, about 40 other much smaller participations, and various granular guarantees granted create contingent liability risk that is only limited in size and probability.

Key Statistics

Table 1

State of Styria Key Statistics

	--Fiscal year ending Dec. 31--						
(Mil. €)	**2016**	**2017**	**2018bc**	**2019bc**	**2020bc**	**2021bc**	**2022bc**
Operating revenues	4,970	5,179	5,354	5,473	5,636	5,768	5,933
Operating expenditures	4,756	4,835	5,039	5,117	5,235	5,341	5,485
Operating balance	214	344	316	356	401	427	448
Operating balance (% of operating revenues)	4.3	6.6	5.9	6.5	7.1	7.4	7.6
Capital revenues	340	228	205	261	215	220	222
Capital expenditures	856	811	811	780	791	775	781
Balance after capital accounts	(302)	(239)	(290)	(163)	(175)	(128)	(111)
Balance after capital accounts (% of total revenues)	(5.7)	(4.4)	(5.2)	(2.8)	(3.0)	(2.1)	(1.8)
Debt repaid	436	330	604	480	546	551	536
Gross borrowings	728	1,019	992	643	721	679	647
Balance after borrowings	(37)	(50)	(102)	0	0	0	0
Modifiable revenues (% of operating revenues)	29.3	29.6	30.7	32.4	32.1	30.3	30.3
Capital expenditures (% of total expenditures)	15.3	14.4	13.9	13.2	13.1	12.7	12.5
Direct debt (outstanding at year-end)	3,513	4,255	4,632	4,784	4,947	5,064	5,163
Direct debt (% of operating revenues)	70.7	82.2	86.5	87.4	87.8	87.8	87.0
Tax-supported debt (outstanding at year-end)	4,508	4,672	4,843	4,966	5,111	5,207	5,286
Tax-supported debt (% of consolidated operating revenues)	74.9	90.2	90.5	90.7	90.7	90.3	89.1
Interest (% of operating revenues)	1.0	2.0	1.7	1.9	1.9	1.8	1.8
Local GDP per capita (single units)	35,800	36,856	38,360	39,584	40,648	41,742	N/A
National GDP per capita (single units)	40,945	42,164	43,903	45,314	46,541	47,802	N.M.

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.M.--Not meaningful.

Ratings Score Snapshot

Table 2

State of Styria Ratings Score Snapshot	
Key rating factors	
Institutional framework	Very predictable and well balanced
Economy	Very strong
Financial management	Strong
Budgetary flexibility	Average
Budgetary performance	Strong
Liquidity	Exceptional
Debt burden	High
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 rating.

Key Sovereign Statistics

Sovereign Risk Indicators, Dec. 13, 2018. Interactive version available at http://www.spratings.com/sri

Related Criteria

- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- Criteria - Governments - International Public Finance: Methodology For Rating Non-U.S. Local And Regional Governments, June 30, 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, Oct. 15, 2009
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Energie Steiermark, Nov. 9, 2018
- Institutional Framework Assessments For International Local And Regional Governments, Nov. 6, 2018
- Austria 'AA+/A-1+' Ratings Affirmed; Outlook Stable, Sept. 14, 2018
- Public Finance System Overview: Austrian States, Sept. 6, 2018
- Default, Transition, and Recovery: 2017 Annual International Public

Finance Default Study And Rating Transitions, June 11, 2018

- Banking Industry Country Risk Assessment: Austria, May 30, 2018
- Austrian State of Styria 'AA/A-1+' Ratings Affirmed; Outlook Remains Negative, Feb. 2, 2018

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

Outlook Action; Ratings Affirmed

	To	From
Styria (State of)		
Issuer Credit Rating	AA/Stable/A-1+	AA/Negative/A-1+

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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.