Research Update:

State Of Upper Austria Outlook Revised To Negative On Risks To Budgetary Performance; 'AA+/A-1+' Ratings Affirmed

November 20, 2020

Overview

- The State of Upper Austria will experience significant revenue losses over our 2020-2023 forecast horizon, due to the COVID-19 pandemic and its effect on tax receipts.
- The state government is now proposing a supplementary expenditure program from 2021 to stimulate local economic recovery.
- We expect both factors to visibly weigh on budgetary performance and the debt burden, and see a risk that more negative macroeconomic developments and more rigorous execution of the state's spending plans could lead to even weaker results than we currently assume.
- We are therefore revising the outlook to negative from stable, and affirming our 'AA+/A-1+' ratings on Upper Austria.

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Rating Action

On Nov. 20, 2020, S&P Global Ratings revised its outlook on the State of Upper Austria to negative from stable. We also affirmed the 'AA+/A-1+' long- and short-term issuer credit ratings on the state.

Outlook

The negative outlook reflects the risk that the COVID-19 fallout and the state's newly proposed stimulus program could stress Upper Austria's fiscal indicators more than we anticipate at this point. Currently, we predict that Upper Austria's budgetary performance will fall severely in 2020 before gradually recovering, albeit only to levels clearly below those seen in the very strong 2018-2019 period. We explicitly acknowledge the risk that budgetary performance could remain weaker for longer.

Downside scenario

We could lower our ratings on Upper Austria over the next 24 months if the effect of macroeconomic developments on tax revenue or higher-than-anticipated actual spending under the state's newly proposed stimulus program implied operating margins below 5% or deficits after capital accounts above 5% beyond 2022. This could weaken our assessment of financial management, since it would possibly signal a more permanent departure from the state's historically strong focus on budgetary consolidation.

Upside scenario

We could revise the outlook to stable if, over the next 24 months, Upper Austria confirms a budgetary performance trajectory that promises to meet or exceed our current base-case projections with greater certainty.

Rationale

Tax revenue losses induced by the COVID-19 pandemic will push up Upper Austria's outstanding debt. However, we expect it will remain low in comparison with that of many other European regional governments. Upper Austria's budgetary performance will also suffer markedly from the pandemic. That said, we currently assume a sufficiently swift recovery to a level that can still be labelled as strong. Budgetary performance falling short of this expectation presents the greatest risk to the current rating. This could materialize from negative macroeconomic developments or from the state's financial management achieving a higher execution rate under its newly announced stimulus plan than we currently predict.

Our ratings on Upper Austria remain supported by the general strength of the Austrian economy, despite the effects of COVID-19, a beneficial institutional framework for regional governments, and the state's easy access to ample liquidity provided by the Austrian federal debt management agency Österreichische Bundesfinanzierungsagentur (OeBFA). In addition, we continue to take into account state financial management's strong track record of budgetary consolidation. However, we think that the latter may be severely deemphasized during the current pandemic.

Tax revenue losses from COVID-19 will be exacerbated by stimulus spending

The pandemic will result in sizeable revenue losses for Upper Austria through the tax-sharing system. We currently predict that Austria's national real GDP will decline by 6.7% in 2020, followed by growth of 4.1% in 2021. This will directly weigh on Upper Austria's budgetary receipts because the Austrian fiscal system collects taxes nationally and then distributes revenue to the states according to their relative population. We estimate that tax revenue losses could total €380 million, or 7% of adjusted operating revenue, for Upper Austria in 2020 on the back of the general economic contraction, the central government's payment holiday for taxpayers, and a reduced rate for the lower income tax bracket introduced by the federal stimulus package from July. Due to collection and distribution mechanics, the revenue loss will likely exceed €400 million in 2021, before then gradually being absorbed over several years. We have increased our projection for revenue losses from May, spurred by the tax rate reductions introduced at the federal level during the summer (see "State of Upper Austria 'AA+/A-1+' Ratings Affirmed; Outlook Stable," published May 22, 2020, on RatingsDirect, for our previous forecast).

Despite the economic contraction, we expect Austria's national GDP per capita will remain at €42,300 (equivalent to $48,200) in 2020, with Upper Austria slightly exceeding the national value. This continues to signal a very strong economy and clearly supports our ratings on Upper Austria, given the described link between state revenue and the national fiscal intake.

Although we generally consider the Austrian institutional framework for local and regional governments very predictable and supportive, we understand that the scheduled update to the national fiscal equalization mechanism (Finanzausgleich) has been postponed. This mechanism determines the allocation of shared taxes between the federal, state, and local levels, and it was originally scheduled to be renegotiated by 2022. Given uncertainty about fiscal developments and limited resources for renegotiations, the existing formula might continue for two additional years.

The task of sizing an appropriate fiscal response to the pandemic may be a litmus test for the commitment of Upper Austria's financial management to budgetary consolidation. In recent years, the state has built a strong track record of implementing structural reforms and focusing on fiscal sustainability. However, its government has just proposed a quite sizeable local economic stimulus program, which calls for additional budget-financed expenditure of €1.2 billion over 2021-2025. Similar to what we observe elsewhere, we assume that not all of the listed projects will be implemented. In any case, financing the program as tax revenue falls sharply will require significant net new borrowing, which the state has so far always tried to avoid. Consequently, Upper Austria has already suspended its debt brake rule for the duration of the pandemic. Assuming adoption of the stimulus plan in parliament in December, it then remains to be seen if and when the state will be able to return to truly balanced budgets.

Budgetary performance will only gradually recover from COVID-19 and debt will rise markedly

For 2020, we project that Upper Austria's operating margin will fall by about 10 percentage points to merely 0.5%, while its balance after capital accounts will turn deeply negative at a deficit of 8.4% of total revenue. This is primarily caused by the previously mentioned estimated tax revenue shortfall of €380 million versus the original 2020 budget. Moreover, Upper Austria authorized additional expenditure of €133 million--currently not fully disbursed--for COVID-19 emergency relief under its first supplementary budget in spring 2020 and a further €119 million for its municipalities under a second budgetary amendment.

We anticipate that budgetary performance will bottom out in 2021 and then gradually recover, until Upper Austria returns to an operating margin above 5% and a deficit after capital accounts below 5% by 2023. Our forecast incorporates the latest available tax estimate from the Austrian federal finance ministry with only marginal adjustments. Furthermore, we assume less than full implementation of the newly announced state stimulus plan, which we attribute to delays in planning and execution. For example, we only capture €100 million of program-related expenditure for 2021 in our modelling, while the state plan forecasts €190 million. Higher execution of projects under the stimulus plan, next to adverse macroeconomic developments, present the biggest risks to our forecast of budgetary performance, and hence for the overall rating.

Our overall assessment of budgetary performance as average reflects ongoing payments for unfunded, pay-as-you-go, pension liabilities that, although not excessively large, will weigh on results for the foreseeable future.

We believe that Upper Austria's total consolidated debt will rise in response to the predicted deficits toward 45% of consolidated operating revenue by 2022, from just 26% at year-end 2019.

The major part of this increase will be recorded in the state's core budget, while we anticipate those guarantees, leasing contracts, and loans incurred by state participations that we consolidate will remain rather stable. All of Upper Austria's outstanding direct debt has been sourced from the Austrian federal debt management agency OeBFA and is denominated in euros. The state faces no maturities of long-term debt until 2023. We add the risk from contingent liabilities to our overall debt assessment, partially because Upper Austria is the majority owner of Oberoesterreichische Landesbank AG, a local credit institution.

We continue to assess Upper Austria's overall liquidity as exceptional, primarily based on its continuing access to funding from OeBFA. In addition, Upper Austria could borrow directly in the capital market or utilize its established access to commercial bank lending, for example, via Oberoesterreichische Landesbank. The state is legally entitled to borrow from OeBFA for planned drawings of funds, given that it has followed all required procedures in this respect. Furthermore, Upper Austria maintains an overdraft-type facility with the agency to cover short-term liquidity needs. We view the possibility of financing via OeBFA as a key credit strength of Austrian states. Due to current circumstances, Upper Austria has already registered its, very conservatively calculated, 2021 funding needs with the agency, which we consider a surrogate for already contracted funding. Together with the expected gradual repayment of more than €300 million of excess liquidity that was placed with closely related companies in 2019, we calculate a debt service coverage ratio that is broadly stable at about 100%.

Environmental, social, and governance (ESG) credit factors for this rating action change:

- Health and safety

Key Statistics

Table 1

Upper Austria (State of) Selected Indicators

(Mil. €)	2018	2019	2020bc	2021bc	2022bc	2023bc
Operating revenues	5,587	5,826	5,467	5,531	5,821	6,062
Operating expenditures	5,045	5,207	5,442	5,468	5,590	5,736
Operating balance	542	619	25	62	230	326
Operating balance (% of operating revenues)	9.7	10.6	0.5	1.1	4.0	5.4
Capital revenues	261	61	146	93	58	59
Capital expenditures	687	589	641	625	627	604
Balance after capital accounts	116	91	(470)	(470)	(339)	(220)
Balance after capital accounts (% of total revenues)	2.0	1.5	(8.4)	(8.4)	(5.8)	(3.6)
Debt repaid	72	85	83	68	67	155
Gross borrowings	185	75	253	374	379	375
Balance after borrowings	229	(234)	(177)	0	0	(0)
Direct debt (outstanding at year-end)	628	621	797	1,103	1,415	1,745

Table 1

Upper Austria (State of) Selected Indicators (cont.)

(Mil. €)	2018	2019	2020bc	2021bc	2022bc	2023bc
Direct debt (% of operating revenues)	11.2	10.7	14.6	19.9	24.3	28.8
Tax-supported debt (outstanding at year-end)	1,662	1,503	1,802	2,273	2,612	2,942
Tax-supported debt (% of consolidated operating revenues)	29.7	25.8	33.0	41.1	44.9	48.5
Interest (% of operating revenues)	0.1	0.1	0.1	0.1	0.1	0.1
Local GDP per capita (single units)	44,600	45,898	43,227	45,531	46,737	48,022
National GDP per capita (single units)	43,720	45,004	42,344	44,629	45,817	47,083

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.

Ratings Score Snapshot

Table 2

Upper Austria (State of) Ratings Score Snapshot

Key rating factors	Scores
Institutional framework	2
Economy	1
Financial management	1
Budgetary performance	3
Liquidity	1
Debt burden	3
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 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. 12, 2020. An interactive version is available at http://www.spratings.com/sri

Related Criteria

- Criteria | Governments | International Public Finance: Methodology For Rating Local And Regional Governments Outside Of The U.S., July 15, 2019
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- Institutional Framework Assessments For International Local And Regional Governments, Nov. 5, 2020
- European Economic Snapshots: A Second COVID-19 Wave Is Dampening The Recovery, Oct. 14, 2020
- Oberoesterreichische Landesbank AG, Oct. 6, 2020
- Austria Rating Affirmed At 'AA+/A-1+'; Outlook Stable, Sept. 11, 2020
- Comparative Statistics: European Local And Regional Government Risk Indicators, June 30, 2020
- State of Upper Austria 'AA+/A-1+' Ratings Affirmed; Outlook Stable, May 22, 2020
- COVID-19 Will Test The Financial Flexibility Of LRGs In Germany, Switzerland, And Austria, April 27, 2020
- Energie AG Oberoesterreich, March 5, 2020
- Local Government Debt In Germany, Switzerland, And Austria For 2020, March 2, 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

Outlook Action; Ratings Affirmed

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