Fitch Ratings

RATING ACTION COMMENTARY

Fitch Downgrades Autonomous Province of Trento to 'BBB+' on Sovereign Rating Action; Outlook Stable

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Link to Fitch Ratings' Report(s):
Autonomous Province of Trento - Rating Action Report

Fitch Ratings - Milan - 08 May 2020: Fitch Ratings has downgraded the Autonomous Province of Trento's (PAT) Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDRs) to 'BBB+' from 'A-'. The Outlooks are Stable. A full list of rating action is below.

The downgrade reflects the recent downgrade of the Italian sovereign (BBB-Stable) as PAT's ratings are constrained at two notches above the sovereign. The Outlooks mirror that on the sovereign.

PAT's standalone credit profile (SCP) remains 'aaa' despite expectations of tax revenue declining between 5% and 10% in 2020 in a rating scenario of a contracting economy after the COVID-19 outbreak.

While Italian LRGs' most recently available issuer data may not have indicated performance impairment, material changes in revenue and cost profiles are occurring across the sector and likely to worsen in the coming weeks and months as economic activity suffers and some form of government restrictions are maintained or broadened. Fitch's ratings are forward-looking in nature, and we will monitor developments in the sector for their severity and duration, and incorporate revised base- and rating-case qualitative and quantitative inputs based on performance expectations and assessment of key risks.

KEY RATING DRIVERS

HIGH

Sovereign Cap

PAT's IDRs are constrained at two notches above the sovereign's rating, reflecting the risk of possible interference by the state in case of macroeconomic or financial stress of sovereign finances and the subsequent risk of weakening predictability of intergovernmental relations. This is balanced by PAT's financial autonomy and budgetary flexibility, with room to partly absorb rising spending, while contributions to national consolidation efforts are subject to bilateral agreement.

MEDIUM

Debt sustainability: 'aaa'

This assessment remains unchanged in our revised assumptions following the COVID-19 outbreak, which envisage the operating balance almost halving in 2020-2024 versus 2018-2019 (EUR1.1 billion) amid GDP falling by about 10% in 2020 followed by stagnation in 2021. Together with adjusted debt hovering towards EUR2.3 billion, around 50% of revenue (EUR1.2 billion in 2019), this leads to a debt-to-operating balance ratio (payback) at 3.4x, against 2019 value of 0.8x. Borrowing and depletion of reserves will fund the EUR6.5 billion capex Fitch expects over 2020-2024 to sustain the local economy after the pandemic and for socio-economic infrastructure.

Even if debt service for interest and principal increases towards EUR270 million, the debt service cover with the operating balance will remain reasonably good at 2.5x.

PAT is classified by Fitch as a type B local and regional government (LRG), as it covers debt service from cash flow on an annual basis. PAT is an autonomous province located in the north of Italy, with a diversified set of responsibilities funded with a fixed share of major national taxes as set in the Italian constitution. PAT maintains a high degree of financial and fiscal autonomy (including taxation power, funding, ability to borrow and expenditure responsibilities), and bilateral consent is required on changes to funding and responsibilities. This protects the region from unilateral interferences by Italy's central government.

LOW

Risk Profile: 'High-Midrange'

The assessment features low risk that PAT's capacity for payments of annual financial commitments weakens below 2x during Fitch's 2020-24 rating scenario. The risk profile, or debt tolerance, reflects four attributes out of the six key risk factors evaluated as 'Stronger' - revenue robustness, revenue adjustability, expenditure adjustability, liabilities & liquidity robustness - and the remaining two as 'Midrange' - expenditure sustainability and liabilities & liquidity flexibility.

Revenue Robustness: 'Stronger'

Robustness: Fitch expects PAT's revenue to rebound to EUR4.5 billion over the medium term, recovering the VAT, personal income tax and corporate income tax contraction in 2020/21, which may fall by up to EUR0.5 billion, or 10% in Fitch's conservative rating case scenario to test rating resiliency. Revenue performance is underpinned by good socio-economic wealth indicators with GDP per capita nearly 25% above the EU average and high employment rate close to 70%.

The special autonomous status entitles PAT to receive shares of national taxes, ranging from 90% of personal income tax and corporate income tax to 80% of VAT. This limits dependence on transfers from the state, which account for about 3% of operating revenue, although Fitch expect the state and PAT may agree to cover the revenue drop during the COVID-19 crisis by lowering PAT's contributions to the national budget, currently about EUR380 million, or nearly 8% of revenue.

PAT's revenue is relatively stable, with an average nominal CAGR in 2015-2019 of about 1.5% deflated growth rate in 2015-2019, above Italy's average GDP real growth (just about 1%). Revenue troughs and spikes in 2015 and 2017 were driven by accounting changes, primarily the recording of personal income tax pertaining to PAT collected outside its territory, rather than by GDP and revenue sensitivity to it.

Revenue Adjustability: 'Stronger'

Fitch calculates PAT's potential revenue flexibility at 8% of its tax revenue, when raising the PIT surcharge at the maximum possible level of 3.33% (1.23% is the current rate for the median income bracket) as well as regional business tax (actual rate 2.68% against 4.82% maximum) and removing the relevant tax relief in place. PAT's flexibility is underpinned by its wealthy socio-economic indicators such as GDP per capita at EUR38,000; median household income at EUR33,600; low employment rate at 5%

With its flexibility, around EUR350 million, PAT could cover two and a half times the maximum revenue decline of EUR140 million experienced in 2015, or nearly 1x Fitch's operating revenue decline expected in 2020 baseline scenario, although it is unlikely PAT will raise taxes in the aftermath of COVID-19 crisis in order to avoid adverse effects on the economic recovery.

Expenditure Sustainability: 'Midrange'

PAT's control of spending translates into a pace of growth closely correlated with revenue, leading to relative stability of the operating balance at around EUR1 billion when adjusted for the accounting treatment of the contribution to the national budget. As part of capital spending is funded via operating balance, PAT's management has undertaken a spending review to maintain a healthy or 20% operating margin.

Budgetary flexibility is supported by PAT's set of responsibilities, which is more diversified compared with Italy's 15 regions with an ordinary statute of autonomy, as well as compared with some other Italian regions with a special status of autonomy. Healthcare accounts for nearly 80% for ordinary regions but is only about a third of spending for PAT (versus, for e.g. 50% in Sicily), adding to spending predictability, as functions such as funding of education, local transport and social housing are relatively non-cyclical.

Expenditure Adjustability: 'Stronger'

Fitch deems PAT has a moderate share of rigid costs as the latter only account for about 70%, including spending for healthcare (35%), education (25%) and local authorities (15%), and nearly a third of the EUR1.5 annual billion capital spending could be delayed if necessary. Nevertheless, Fitch does not expect a downward revision of expenditure over the next few years. To tackle the pandemic will imply spending rise in transfers to sustain the local economy and employment.

Higher-than-national average per-capita spending supports curtailment potential. Spending in the healthcare sector, for instance, fell in 2012-2015 to close to EUR2,000 per capita, then rebounded to PAT's more standard level of EUR2,200 (EUR1,900 nationally). PAT's network of subsidiaries also display propensity to modulate costs and capex thanks to a good level of transport, health and other socio-economic infrastructure in the province, as shown by the aggregated debt, or direct risk, spiking at EUR1.8 billion in 2015.

Liabilities and Liquidity Robustness: 'Stronger'

Trento's debt framework largely mirror the national prudential regulation - borrowing is allowed only for capex, at amortising structures, with no foreign-currency debt exposure, debt service capped at 20% of free revenue and a general rule requiring spending to be budgeted only if backed by revenue, which underpins the predictability of due liabilities over the medium term, hence 'Stronger' assessment for this factor.

PAT is formally debt-free as it borrows through its financial arm Cassa del Trentino (CdT, BBB/Negative), fully backed by the Province through an unconditional, irrevocable and at first demand guarantee. CdT's debt was around EUR1 billion at end-2019 (21% PAT operating revenue) and 45% is made up of with European Investment Bank, Cassa Depositi e Prestiti (BBB-/Stable) and Region Trentino Alto Adige, and 55% by bonds.

CdT has 100% debt at fixed rates, fully amortising, while PAT's other Fitch classified debt of about EUR250 million at end-2019 includes Patrimonio del Trentino's and Trentino Trasporti's debt backed by PATs' first-demand guarantee, monitored by the Province to remain within debt limits.

Liabilities and Liquidity Flexibility: 'Midrange'

PAT's liquidity at end-2019 amounts to EUR2.5 billion, with Fitch's calculated free cash reserves of EUR300 million while the remaining part is restricted to future investments. PAT's treasury bank Unicredit (BBB/Negative) is committed to advancing liquidity lines up to EUR0.5 billion (1/10 of the budget), or 3/10 for about EUR1.5 billion when provincial companies are also considered, limiting any unexpected refinancing risk.

DERIVATION SUMMARY

PAT's SCP is assessed at 'aaa', reflecting a combination of a 'High-Midrange' risk profile and debt sustainability metrics also in the 'aaa' category under Fitch's rating case scenario. The SCP remains in the 'aaa' category even under our revised assumptions due to the coronavirus disruption.

PAT's IDRs are constrained at two notches above the sovereign's rating, reflecting its financial autonomy and strong economy while also considering potential interference in its finances by the state in case of sovereign or macroeconomic stress.

PAT's Short-Term IDR is assessed at the higher possible level of 'F1' amid a short-term liquidity coverage ratio (Fitch unrestricted cash and operating balance/debt service) estimated at 3x on average in 2020-2022, debt robustness assessed as Stronger and debt flexibility assessed as Midrange.

KEY ASSUMPTIONS

Qualitative Assumptions and assessments and their respective change since the last review 15 November 2019 and weight in the rating decision:

Risk Profile: High-Midrange, unchanged with low weight

Revenue Robustness: Stronger, unchanged with low weight

Revenue Adjustability: Stronger, unchanged with low weight

Expenditure Sustainability: Midrange, unchanged with low weight

Expenditure Adjustability: Stronger, unchanged with low weight

Liabilities and Liquidity Robustness: Stronger, unchanged with low weight

Liabilities and Liquidity Flexibility: Midrange, unchanged with low weight

Debt sustainability: 'aaa' category, unchanged with medium weight

Support: n/a

Asymmetric Risk: n/a

Sovereign Cap or Floor: Yes, lowered with high weight

Quantitative assumptions - issuer specific

Fitch's rating case scenario is a "through-the-cycle" scenario, which incorporates a combination of revenue, cost and financial risk stresses. It is based on the 2015-2018 figures, 2019 preliminary figures and 2020-2024 projected ratios. The key assumptions for the scenario include:

- -1.3% decrease in operating revenue on average in 2020-2024, versus +0.2% in baseline scenario across the same period;

- 0.8% increase in operating spending on average in 2020-2024, versus 1.6% in baseline scenario across the same period;

- Adjusted debt reaching EUR2.3 billion in rating scenario versus EUR1.1 billion in baseline scenario.

Quantitative assumptions - sovereign related (note that no weights are included as none of these assumptions was material to the rating action)

Figures as per Fitch's sovereign estimates for 2019 and forecast for 2021, respectively:

- GDP per capita (US dollar, market exchange rate): 32,979; 31,362

- Real GDP growth (%): 0.3%; 3.7%

- Consumer prices (annual average % change): 0.6%; 0.5%

- General government balance (% of GDP): -1.6%; -6.6%

- General government debt (% of GDP): 134.8%; 157.4%

- Current account balance plus net FDI (% of GDP): 2.1%; 1.1%

- Net external debt (% of GDP): 48.9%; 51.6%

- IMF Development Classification: DM

- CDS Market Implied Rating: BB+

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to negative rating action/downgrade:

Any negative action on the sovereign's ratings will be mirrored on PAT's IDRs.

PAT's Long-Term IDRs could be downgraded if the payback would increase above nine years (plus a fiscal debt burden above 100%) on a sustained basis in our rating case scenario. This would lead to a multiple-notch lowering of PAT's SCP to 'a', and subsequently a smaller leeway of one-notch above the sovereign's ratings.

The same output would emerge following a revision of PAT's risk profile to 'Midrange' together with a worsening of the payback close to nine years.

Factors that could, individually or collectively, lead to positive rating action/upgrade:

As PAT's IDRs are constrained by the Italian sovereign ratings, changes to Italy's IDRs would be mirrored on PAT's ratings.

COMMITTEE MINUTE SUMMARY

Committee date: 6 May 2020

There was an appropriate quorum at the committee and the members confirmed that they were free from recusal. It was agreed that the data was sufficiently robust relative to its materiality. During the committee no material issues were raised that were not in the original committee package. The main rating factors under the relevant criteria were discussed by the committee members. The rating decision as discussed in this rating action commentary reflects the committee discussion.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Public Finance issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

SUMMARY OF FINANCIAL ADJUSTMENTS

Direct debt includes the debt incurred via Cassa del Trentino as well the debt repayment considers the one of CdT (followed by an equivalent adjustment of capital transfers).

Other Fitch classified debt includes Patrimonio del Trentino's and Trentino Trasporti's debt backed by PAT's first demand guarantee.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

The highest level of ESG credit relevance, if present, is a score of 3. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity(ies), either due to their nature or to the way in which they are being managed by the entity(ies). For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

RATING ACTIONS

ENTITY/DEBT	RATING		
Trento, Autonomous Province of	LT IDR	BBB+	Downgrade
•	ST IDR	F1	Affirmed
•	LC LT IDR	BBB+	Downgrade

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Rating Criteria for International Local and Regional Governments (pub. 13 Sep 2019) (including rating assumption sensitivity)

ADDITIONAL DISCLOSURES

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