FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Italian Autonomous Region of Valle d'Aosta at 'BBB+'; Outlook Stable

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Fitch Ratings - Milan - 06 Nov 2020: Fitch Ratings has affirmed the Autonomous Region of Valle d'Aosta's (VDA) Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDRs) at 'BBB+' with Stable Outlooks. A full list of rating actions is provided below.

The affirmation reflects VdA's 'Midrange' risk profile and 'aaa' debt sustainability assessment under Fitch's expectation that the debt payback ratio (net debt-to-operating balance) will remain below three years in our rating-case scenario of a contracting economy after the COVID-19 outbreak. The IDRs are notched down from our assessment of the region's standalone credit profile (SCP) of 'aa' as VdA's ratings are constrained at two notches above the sovereign IDRs (BBB-/Stable).

While Italian local and regional governments' (LRGs) most recently available 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 related to the pandemic 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

Risk Profile: 'Midrange'

VdA's 'Midrange' risk profile reflects five 'Midrange' key risk factors and one 'Stronger' key risk factor. The assessment considers a moderately low risk that VdA's capacity for payments of annual financial commitments may weaken below 6x during Fitch's 2020-2024 rating-case scenario.

Revenue Robustness: 'Midrange'

VdA is a special-statute region that is entitled to receive 100% of the tax revenue generated in its territory. This limits the region's dependence on state transfers, which accounted for 3% of its EUR1.35 billion operating revenue in 2019, while over 90% is composed of tax revenue.

Compared with ordinary regions, VdA's revenue base is more linked and directly connected with the local economy and less with government transfers. However, support from the central government granted in 2020 to all regions allowed VdA to reduce by EUR84 million of its EUR103 million contribution to the state budget to cover an expected tax revenue drop. It also received additional transfers from the central government, which almost doubled their amount with respect to 2019, to fund pandemic-related extra healthcare costs.

Over the last decade, VdA's revenue growth has been roughly in line with regional GDP growth except in 2015, when a decline in tax revenue was influenced by a revised attribution of excise duties on beer and energy and import duties. Fitch expects VdA's operating revenues to return to the 2019 level of around EUR1.35 billion in the medium term, or to decrease to EUR1.25 billion in Fitch's conservative scenario of prolonged macroeconomic stress. The latter scenario factors in slow tax revenue growth of 0.5% per year in 2023-2024 and no further support from the central government. Our conservative assumptions consider the region's small economic size as well as taxpayer concentration on few names, including the regional hydro company CVA (BBB+/Stable).

Revenue Adjustability: 'Midrange'

This assessment is supported by Fitch's estimate of VdA's revenue flexibility of about EUR70 million, or 5% of revenue, if the region raises the surcharge on personal income tax and regional business tax to the maximum possible levels and removes the relevant tax reliefs in place. Positively, the region has wealthy socio-economic indicators that underpin its tax-revenue flexibility, such as GDP per capita at roughly EUR39,000 (or 30% above the EU27 average), and a high employment rate of nearly 70%.

Tax-raising potential would cover more than 50% the peak-to-trough revenue fall in the economic slowdown experienced in 2015, when adjusted for changes in the funding system. However, Fitch considers it unlikely that VdA will raise taxes in the aftermath of the COVID-19 crisis to avoid stalling economic recovery.

Expenditure Sustainability: 'Midrange'

VdA has a solid record of cost control and balanced budget over the years, while being able to resize its cost structure between 2012 and 2014 to allow for a contribution to the national budget consolidation, which peaked at EUR250 million. As a special-statute region, VdA has a more diversified set of responsibilities, with healthcare covering about a quarter of total expenditure, versus 80% in ordinary regions. Other spending items include social services (7%), education and culture (7%), transport (6%) and support to the region's local governments (9%).

While support from the central state by reducing the region's contribution to the national budget to cover healthcare cost spikes related to the pandemic will continue in 2021, growth of VdA's operating expenditure is expected to slow to 0.5% per year in the medium term to mirror revenue growth. Fitch continues to factor in EUR20 million-EUR30 million capex for the region's casino company, which is currently under bankruptcy protection. Despite the casino company posting a balanced income statement in 2019, its activities in 2020/2021 could slow as a consequence of lockdown.

Expenditure Adjustability: 'Midrange'

The assessment is driven by VdA's moderate share of inflexible costs at around 70% of total expenditure (net of contribution to the state's budget), which comprises healthcare, education, staff, purchase of goods and services and debt service. While Fitch does not expect a downward revision of expenditure during the pandemic, we believe that the region will possibly expand the scope of expenditure to sustain the local economy and employment. Per capita expenditure is higher than the national average but the scope for reduction is constrained by VdA's role in regional economic development via its material support for local SMEs.

Liabilities and Liquidity Robustness: 'Stronger'

VdA operates under a prudent national and individual debt management framework. Borrowing is allowed only for capex and with amortising structures, no forex debt is permitted, debt service is capped at 20% of free revenue (not earmarked for healthcare) and medium-term debt service of around EUR35 million-EUR40 million is to be paid out of recurring revenue. This underpins the predictability of due liabilities over the medium term and Fitch's 'Stronger' assessment for this factor.

VdA's debt profile is conservative and almost entirely composed of two euro-denominated bonds. One of the two bonds amortises synthetically due to provisions to the sinking fund, with a EUR543 million bullet repayment in May 2021. The region also hedges against interest-rate risk via financial derivatives. VdA's direct debt of EUR569 million at end-2019 carries little risk and represents around 42% of operating revenue. Its EUR0.8 billion adjusted debt, including the debt of VdA's financial company Finaosta (EUR160 million) and guaranteed by the region and EUR25 million undrawn debt from Cassa Depositi e Prestiti (CDP, BBB-/Stable), is entirely covered by VdA's sinking fund and free cash at end-2019.

Liabilities and Liquidity Flexibility: 'Midrange'

VdA's average EUR400 million liquidity during 8M20 (end-2019: EUR420 million) covers debt service requirements by over 10x, cushioning the region's debt service capacity during the pandemic. Fitch prudently estimates the region will post around EUR100 million of free cash reserves in the forthcoming years, while in the more conservative scenario we expect the region to use up all its free cash reserves. Counterparty ratings on liquidity providers, including the sinking fund held at Deutsche Bank (BBB/Negative), cap this assessment at 'Midrange'.

Debt sustainability: 'aaa' category

VdA's debt sustainability assessment is resilient to Fitch's revised assumptions following the COVID-19 outbreak. Under the latest assumptions the operating balance declines 30% to EUR0.23 billion in the short term, while the central state partly covers the expected 2020-2021 tax revenue fall and pandemic-related costs. Under the conservative scenario of prolonged macroeconomic stress in the medium term the operating balance is further reduced to EUR0.2 billion.

Our assumptions of the operating balance, coupled with debt of EUR600 million by 2024 (including Finaosta's debt), lead to a debt payback of around three years from zero currently. Annual debt service for interest and principal could reach EUR35 million by 2024 (after declining to EUR25 million as VdA repays its EUR543 million bullet bond in 2021). However, VdA will maintain an operating balance that covers more than 6x its debt service and its fiscal debt burden (debt-to-operating revenue) will remain below 50%, underpinning sound debt service capability.

VdA is classified by Fitch as a type B LRG, as it covers debt service from cash flow on an annual basis. VdA is a special-statute region located in the north-west of Italy, with a diversified set of responsibilities funded with a fixed share (100% in most cases) of major national taxes pertaining to its territory as set out in the Italian constitution. VdA maintains a high degree of financial and fiscal autonomy (including taxation power, funding, ability to borrow and expenditure responsibilities), and bilateral consent is required for changes to funding and responsibilities. This protects the region from unilateral interferences from Italy's central government.

DERIVATION SUMMARY

The combination of VdA's 'Midrange' risk profile with a debt payback ratio of four years leads to a SCP in the 'aa' category. A high debt-service coverage ratio above 6x, debt-to revenue below 50% and peer comparison with other European regions lead to a SCP at the 'aa' level.

VdA's IDR is constrained at two notches above the sovereign's rating, reflecting the region's special autonomous status while also considering potential intervention by the state in case of sovereign stress, such as a request of moderate increase in VdA's contribution to state's budget of around EUR20 million.

VdA's Short-Term IDR is the higher of 'F1' or 'F2' mapped to the 'BBB+' Long-Term IDR. This is based on an estimated short-term liquidity coverage ratio (Fitch unrestricted cash and operating balance-to-debt service) above 5x on average in 2020-2022, 'Stronger' debt robustness and 'Midrange' debt flexibility.

KEY ASSUMPTIONS

Qualitative assumptions and assessments:

Risk Profile: 'Midrange'

Revenue Robustness: 'Midrange'

Revenue Adjustability: 'Midrange'

Expenditure Sustainability: 'Midrange'

Expenditure Adjustability: 'Midrange'

Liabilities and Liquidity Robustness: 'Stronger'

Liabilities and Liquidity Flexibility: 'Midrange'

Debt sustainability: 'aaa' category

Support: n/a

Asymmetric Risk: n/a

Sovereign Cap or Floor: Yes

Quantitative assumptions - issuer-specific

Fitch's rating case is a "through-the-cycle" scenario, which incorporates a combination of revenue, cost and financial risk stresses. It is based on 2014-2018 figures and 2019-2023 projected ratios. The key assumptions for the scenario include:

- Operating revenue to fall around 1.4% on average in 2020-2024 in rating case, versus substantially flat in base case;

- About 0.3% increase in operating spending on average in 2020-2024 in our rating case versus 0.7% in base case;

- Adjusted debt at EUR600 million in rating case versus around EUR350 million in base case.

RATING SENSITIVITIES

Factors That Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade:

- Negative rating action on the sovereign will lead to similar action on VdA's IDRs.

- Deterioration in the region's debt sustainability with a debt payback towards five years together with a weaker debt service coverage ratio would lead to a downward revision of the region's SCP.

- Further deterioration with a debt payback ratio above five years leading to a three-notch downward revision of the SCP would narrow the rating differential between VdA and the sovereign to one notch and consequently lead to a downgrade of the region's IDR to 'BBB'.

Factors That Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade:

- VdA's IDRs are partly constrained by the Italian sovereign ratings and hence will mirror rating action on the sovereign.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Sovereigns, Public Finance and Infrastructure 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].

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

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

RATING ACTIONS

ENTITY/DEBT	RATING			PRIOR
Valle d'Aosta,Autonomous Region of	LT IDR	BBB+ Rating Outlook Stable	Affirmed	BBB+ Rating Outlook Stable
•	ST IDR	F1	Affirmed	F1
•	LC LT IDR	BBB+ Rating Outlook Stable	Affirmed	BBB+ Rating Outlook Stable
• senior unsecured	LT	BBB+	Affirmed	BBB+

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

International Local and Regional Governments Rating Criteria (pub. 27 Oct 2020) (including rating assumption sensitivity)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Valle d'Aosta,Autonomous Region of	EU Issued

ADDITIONAL DISCLOSURES FOR UNSOLICITED CREDIT RATINGS

Valle d'Aosta,Autonomous Region of (Unsolicited)

With Rated Entity or Related Third Party Participation	Yes
With Access to Internal Documents	Yes
With Access to Management	Yes

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UNSOLICITED ISSUERS

ENTITY/SECURITY	ISIN/CUSIP/COUPON RATE	RATING TYPE	SOLICITATION STATUS
Valle d'Aosta,Autonomous Region of	-	Stand-Alone Credit Profile	Unsolicited

ENTITY/SECURITY	ISIN/CUSIP/COUPON RATE	RATING TYPE	SOLICITATION STATUS
Valle d'Aosta,Autonomous Region of	-	Short Term Issuer Default Rating	Unsolicited
Valle d'Aosta,Autonomous Region of	-	Long Term Issuer Default Rating	Unsolicited

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