FitchRatings

RATING ACTION COMMENTARY

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

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Fitch Ratings - Milan - 29 Oct 2021: 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.

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 featuring prolonged economic stagnation post-pandemic. The 'BBB+' IDRs are five notches below the region's Standalone Credit Profile (SCP) of 'aa' as VdA's ratings are constrained at two notches above the sovereign's IDRs (BBB-/Stable).

KEY RATING DRIVERS

Risk Profile: 'Midrange'

VdA's 'Midrange' risk profile combines five key risk factors assessed at 'Midrange' (revenue robustness, revenue adjustability, expenditure sustainability, expenditure adjustability, and liabilities and liquidity flexibility) and one at 'Stronger' (liabilities and liquidity robustness).

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 4% of its EUR1.3 billion operating revenue in 2020 (2%-3% on average in 2016-2019), despite extraordinary additional transfers the state provided to all regions to fund pandemic-related healthcare costs.

Around 90% of VdA's operating revenue is composed of taxes, which makes the region's revenue base more linked to and directly connected with the local economy and less with government transfers compared with ordinary regions'. 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 a 5.5% tax-revenue decline and pandemic-related extraordinary expenditure.

Further state support, including transfers at more than double the EUR30 milliion-EUR40 million historical average, will help tackle second-round effects from the economic slowdown in 2021.

Fitch expects VdA's operating revenues to return to the 2019 level of around EUR1.35 billion in the medium term or, under Fitch's conservative scenario of prolonged macro-economic stress, to decrease below EUR1.3 billion. The latter factors in slow tax revenue growth of 0.5% per year in 2023-2025 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'

Fitch assesses VdA's ability to generate additional revenue in response to an economic downturn as 'Midrange', reflecting the region's high affordability and moderately stable revenues. VdA's leeway to increase revenue is just below EUR70 million, or 5% of revenue, by Fitch's calculation, by way of increasing the personal income tax surcharge and business tax to their legal maximum and removing all relevant tax reliefs, as well as raising charges and fees.

VdA's wealthy socio-economic indicators underpin 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 decline observed over the last 10 years, when adjusted for changes in the funding system. However, it unlikely that VdA will raise taxes post-pandemic to avoid thwarting its economic recovery.

Expenditure Sustainability: 'Midrange'

VdA has a strong ability to control costs, as evident by a balanced budget in the past 10 years, and by reducing its cost structure between 2012 and 2014 to allow for its contribution to the national budget consolidation when it 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%).

In 2020, despite a EUR84 million reduction of its EUR102 million contribution to the state budget, operating spending increased to over EUR1.05 billion (EUR1.02 billion in 2019), mainly to counteract the impact of the pandemic. VdA used own resources as well as central-government extraordinary transfers to meet increased healthcare costs (up 12% at almost EUR300 million), as well as to support the local economy via transfers to local governments (up 16% at EUR118 million).

Over the medium term, under Fitch's rating case, operating spending is expected to increase 0.5% yoy (2023-2025 average) to peak at EUR1.1 billion. This factors in stable healthcare spending, as reduced pandemic-related extra costs allow an increase in personnel expenditure to attract skilled medical staff, and further support to local governments.

Expenditure Adjustability: 'Midrange'

The assessment is driven by VdA's moderate share of inflexible costs at just below 70% of total expenditure (net of contribution to the state's budget), which comprises healthcare, education, staff and transfers to local governments. The region expanded the scope of expenditure to sustain the local economy and employment, as evident by the increase in 2020 not only in healthcare expenditure, but also in transfers to local governments and capex (up 27%).

Per capita expenditure is higher than the national average but we do not expect VdA to reduce operating expenditure from their 2020-2021 peaks as the scope for savings is constrained by VdA's role in regional economic development via its material support for local SMEs.

Liabilities & Liquidity Robustness: 'Stronger'

VdA operates under a prudent national and individual debt management framework. Borrowing is allowed only for capex and with amortising structures, solely in local currency, and with debt service capped at 20% of free revenue (not earmarked for healthcare). Medium-term debt service, which will be around EUR10 million in 2025 under Fitch's rating case, 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 is almost entirely composed of an euro-denominated bond (EUR22.2 million outstanding at end-2020), after the redemption in May 2021 of a EUR543 million bullet bond using provisions in a sinking fund.

VdA's estimated direct debt of around EUR23 million at end-2021 carries little risk and represents less than 2% of operating revenue. Its EUR220 million adjusted debt, including Fitch-estimated debt of VdA's financial company Finaosta (EUR200 million in 2021, up from EUR153 million in 2020) and guaranteed by the region, is entirely covered by VdA's EUR800 million unrestricted cash at end-2020 (inclusive of around EUR500 million provisions to the sinking fund).

Liabilities & Liquidity Flexibility: 'Midrange'

VdA's liquidity averaged around EUR0.6 billion during 8M21, which covered nearly 20x debt service requirements. Fitch prudently estimates around EUR200 million on average of free cash reserves in the forthcoming years and, in a more conservative scenario, assumes the region to use up all its free cash reserves. Counterparty ratings of liquidity providers cap this assessment at 'Midrange'.

Debt Sustainability: 'aaa category'

VdA's 'aaa' debt sustainability assessment is resilient to Fitch's assumption of the Italian economy remaining weak after the pandemic. Under our latest assumptions, the operating balance declines only marginally to EUR0.2 billion in the short term, while the central government partly covers an expected tax-revenue fall and pandemic-related costs in 2021 as it did in 2020. Under the conservative scenario of prolonged economic stagnation in the medium term, the operating balance is further reduced to EUR0.16 billion.

Our assumptions on the operating balance, coupled with debt of EUR350 million by 2025 (including Finaosta's debt), lead to a debt payback of 2.2 years, up from zero currently. Annual debt service for interest and principal could reach EUR15 million by 2025 (after declining to EUR5 million as VdA repaid its EUR543 million bullet bond in May 2021). However, VdA will maintain an operating balance that covers more than 10x its debt service and its fiscal debt burden (debt-to-operating revenue) will remain below 50%, underpinning its sound debt-service capability.

DERIVATION SUMMARY

The combination of VdA's 'Midrange' risk profile with a debt payback ratio of more than two years leads to a SCP in the 'aa' category. A high debt-service coverage ratio above 5x, debt-to revenue below 50% and peer comparison with other European regions lead to a final SCP at 'aa'.

VdA's IDRs are constrained at two notches above the sovereign's ratings, reflecting the region's special autonomous status while also considering potential intervention by the state in case of sovereign stress, such as a 10% increase in VdA's EUR100 million contribution to state's budget.

Short-Term Ratings

VdA's 'F1' Short-Term IDR is the higher of two options mapping to a 'BBB+' Long-Term IDR. This is based on an estimated short-term liquidity coverage ratio (Fitch-calculated unrestricted cash and operating balance-to-debt service) just below 20x on average in 2021-2023, 'Stronger' debt robustness, and 'Midrange' debt flexibility.

KEY ASSUMPTIONS

Qualitative assumptions:

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'

Support (Budget Loans): 'N/A'

Support (Ad Hoc): 'N/A'

Asymmetric Risk: 'N/A'

Sovereign Cap: 'BBB+'

Sovereign Floor: 'N/A'

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 2016-2020 figures and 2021-2025 projected ratios. The key assumptions for the scenario include:

- Operating revenue to fall on average around 0.3%

- Operating spending to rise on average 1.3%

- Net capital balance on average at a negative EUR170 million

- Adjusted debt at EUR350 million in 2025 and cost of debt at 3.5%

Issuer Profile

VdA is one of the four regions and two provinces in Italy whose special status is protected by the Italian Constitution. It has a diversified set of responsibilities funded with a fixed share (100% in most cases) of major national taxes. With 126,000 residents VdA is by far the smallest Italian region. It is wealthy by international standards, with GDP per capita at 25% above the EU27 and UK averages and an employment rate structurally above the national average.

VdA's economic activity is dominated by tourism to the highest Alpine peaks and by services, including the public sector. Fitch classifies the region as a 'Type B' regional government, as it covers debt service from cash flow annually.

RATING SENSITIVITIES

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

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

- Further deterioration in debt payback ratio to above five years leading to a two-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 IDRs 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 a positive rating action on the sovereign

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

PUBLIC RATINGS WITH CREDIT LINKAGE TO OTHER RATINGS

VdA's ratings are linked with Italy's.

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 Rating

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

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. 03 Sep 2021) (including rating assumption sensitivity)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

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Valle d'Aosta,Autonomous Region of	EU Issued, UK Endorsed

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