FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Flemish Community at 'AA'; Outlook Negative

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Fitch Ratings - Paris - 09 Jun 2023: Fitch Ratings has affirmed the Flemish Community's Long-Term Foreign-and-Local Currency Issuer Default Ratings (IDRs) at 'AA' with Negative Outlook. A full list of rating actions is below.

Fitch assesses the Flemish Community's Standalone Credit Profile (SCP) at 'aa+', reflecting a combination of a 'Stronger' risk profile and debt sustainability assessed at the upper end of the 'a' category under Fitch's rating case. The Long-Term Foreign-Currency IDR is one notch above that of Belgium (AA-/Negative) and reflects Fitch's view that the Flemish Community would have the ability to continue servicing its debt in some scenarios, despite a default of the sovereign.

KEY RATING DRIVERS

Risk Profile: 'Stronger'

Fitch assesses five out of six key risk factors at 'Stronger'. The 'Stronger' risk profile reflects Fitch's view that there is a negligible risk of the issuer's ability to cover debt service with the operating balance weakening unexpectedly over the scenario horizon (2023-2027) due to lower revenue, higher expenditure, or an unexpected rise in liabilities or debt-service requirements.

Revenue Robustness: 'Stronger'

The Flemish Community benefits from robust revenue sources, especially growing tax items.

In 2022, 57% of the Flemish Community's operating revenue comprised tax revenue collected at the national level and transferred by the federal government. These resources are protected by the Special Finance Act and the central government does not have the power to reduce them. The calculation of these resources is based on various demographic and economic indicators, including national GDP growth. They increase in line with GDP and population growth, which allows the Flemish Community to cover growing spending needs.

The community's own fiscal items accounted for 30% of operating revenue in 2022. These included a surcharge tax on personal income tax (PIT; 16%), and a wide range of regional taxes (14%). These own tax items have shown great resiliency during economic downturns, and we expect them to support the Flemish Community's growth in the coming years.

Revenue Adjustability: 'Stronger'

The Flemish Community benefits from high tax flexibility. Fitch believes that additional revenue stemming from an increase in taxes would cover more than 200% of a reasonable decline in revenue in an economic downturn, which Fitch estimates at around 2%.

Like other Belgian regions, the Flemish Community has the autonomy to determine 12 specific taxes, including property, inheritance and transfer duties, car registration, and on betting and gaming. An increase in tax rates to their maximum level could raise revenue by more than 4%.

In addition, since the sixth state reform, regions have had the power to determine the rate for about one-quarter of PIT through a surcharge system, which significantly increased their tax autonomy. A rate increase could raise operating revenue by a few percentage points.

Expenditure Sustainability: 'Stronger'

The Flemish Community's responsibilities are mostly non-cyclical, especially education, health, or transportation, while unemployment benefits are paid at the federal level. In an economic downturn, we would expect the Flemish Community to tighten spending in light of its record of budgetary discipline.

The region's goal is to return to a balanced budget by 2027, from a EUR2.2 billion deficit in 2022, according to European rules, which will lead to tight control of spending.

Expenditure Adjustability: 'Midrange'

Fitch estimates the Flemish Community's share of inflexible expenditure at 70%-90%, mainly comprising subsidies on education and training, welfare, public health and family. However, we see fewer restrictions on the Flemish Community to alter its spending than on local and regional governments in other decentralised countries, such as France.

Staff costs are a rigid cost item. This is especially the case in the context of high inflation due to the automatic indexation mechanism of wages. However, the overall share of staff costs remains moderate, at 14% of operating expenditure in 2022.

The share of capex in total spending remains modest, at 9% in 2022, offering limited flexibility for Flemish Community to reduce spending in case of need. The investment programme also includes a large committed infrastructure project (Antwerp's ring road).

Liabilities & Liquidity Robustness: 'Stronger'

The Flemish Community operates under a robust individual debt management framework, characterised by high data transparency on debt and off-balance sheet liabilities.

Fitch views the Flemish Community's liabilities as low risk. At end-2022, 89% of long-term debt was fixed rate. The debt amortisation schedule shows large peak repayments in 2027, 2031, 2032 and 2035, mostly of bonds. However, the risk of large bullet repayments is mitigated by the modest amount of these maturities in proportion to the Flemish Community's cash flow. The administration is also progressively smoothing its debt amortisation schedule.

Liabilities & Liquidity Flexibility: 'Stronger'

The Flemish Community has good access to liquidity in various forms. Its liquidity is backed by its bonds' eligibility to the European Central Bank's public-sector purchase programme. The EUR3.75 billion committed bank lines contracted with ING Belgium NV/SA (AA-/Stable) has been extended until 2024, with scope for an additional extension by two more years.

Debt Sustainability: 'a category'

We assess the Flemish Community's debt sustainability at the upper end of the 'a' category. Our rating case expects the debt payback ratio to be about 10x in 2025-2027 (2022: 10.5x), the coverage ratio (synthetic calculation) close to 1.3% and a fiscal debt burden of about 55%.

The Flemish Community's fiscal performance continued to improve in 2022, with operating balance reaching EUR2.45 billion, from EUR1.5 billion in 2021. The economic rebound and high level of inflation lifted operating revenue by 9%, above opex growth (7.3%). We expect the operating balance to remain stable in 2023, in a context of low GDP growth, and to then steadily return to its historical level of around EUR3.5 billion in 2026-2027. The pace of recovery will depend on economic growth after 2023, and the cost-cutting measures put in place by the region to comply with its fiscal target of a budget balance in 2027.

Net Fitch-adjusted debt increased by EUR4 billion in 2022 due to the large capital spending and an operating balance that remained below its pre-pandemic level. Our rating case expects debt to continue growing, reaching close to EUR35 billion at end-2027. This reflects a switch in debt management since 2015, with the Flemish Community directly financing some public entities rather than guaranteeing their debt, as well as the financing of large investments, especially the Antwerp ring road (more than EUR4 billion expected in 2023-2027).

DERIVATION SUMMARY

The Flemish Community's 'aa+' SCP reflects a combination of a 'Stronger' risk profile and debt sustainability assessed in the upper end of the 'a' category under Fitch's rating case. The IDR is one notch above the rating of Belgium and reflects Fitch's view that in some scenarios, the Flemish Community would have the ability to continue servicing its debt, despite a default of the sovereign.

However, Fitch also believes that a sharp deterioration in sovereign finances would likely have an impact on the Flemish Community, and that a default of the sovereign would have a significant impact on the Flemish Community, including a sharp increase in its cost of borrowing, although it would not necessarily lead to an immediate default by the Flemish Community itself.

Fitch also considers that the Flemish Community has a large incentive to support the federal government due to the importance of the services provided by the latter to the population, including unemployment benefits. This is why we consider that the Flemish Community cannot be rated more than one notch above the sovereign.

Debt Ratings

The Flemish Community's senior unsecured debt ratings are in line with its IDRs.

KEY ASSUMPTIONS

Risk Profile: 'Stronger'

Revenue Robustness: 'Stronger'

Revenue Adjustability: 'Stronger'

Expenditure Sustainability: 'Stronger'

Expenditure Adjustability: 'Midrange'

Liabilities and Liquidity Robustness: 'Stronger'

Liabilities and Liquidity Flexibility: 'Stronger'

Debt sustainability: 'a'

Support (Budget Loans): 'N/A'

Support (Ad Hoc): 'N/A'

Asymmetric Risk: 'N/A'

Sovereign Cap (LT IDR): 'AA'

Sovereign Cap (LT LC IDR) 'AA'

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 2018-2022 figures and 2023-2027 projected ratios. The key assumptions for the scenario include:

- Operating revenue growth on average at 3.7% a year

- Operating spending growth on average at 3.4 % a year

- Net capex on average at close to EUR4.6 billion a year

- Apparent cost of debt (consolidated level) at 2.5% (including 3.5% cost of new borrowing)

Liquidity and Debt Structure

Fitch-adjusted debt includes the Flemish Community's direct debt (EUR21.85 billion at end-2022, including EUR1.2 billion of an EU SURE loan) and "other Fitch-classified debt" items, totalling EUR3.9 billion at end-2022. The latter comprised EUR1.9 billion in public-private partnership debt, EUR1.3 billion of public institutions' debt, and EUR753 million that the Flemish Community will repay to the federal state over 16 years. However, in contrast with European system of accounts rules, it does not include the guaranteed debt of social-housing companies, which we view as self-funded, or that of hospital infrastructure.

Issuer Profile

The Flemish Community is a federated entity of the Belgian state, combining the responsibilities of a region, such as economy, and that of a community, such as welfare and education. It has a population of 6.7 million, representing 58% of the national population.

RATING SENSITIVITIES

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

A downgrade of Belgium would be reflected in the Flemish Community's ratings. The Flemish Community's Long-Term IDRs may also be downgraded if its payback ratio exceeds 13x on a sustained basis in our rating case. This could happen if GDP growth in the coming years is lower than that in our rating case.

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

An upgrade of the Flemish Community is unlikely given that the Outlook on Belgium is Negative. The Outlook would be revised to Stable if the Outlook on the sovereign was revised to Stable, all other things unchanged.

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

Discussion Note

Committee date: 07 June 2023

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.

PUBLIC RATINGS WITH CREDIT LINKAGE TO OTHER RATINGS

The Flemish Community's ratings are linked to Belgium'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
Flemish Community	LT IDR Affirmed	AA Rating Outlook Negative	AA Rating Outlook Negative

	ST IDR	F1+	Affirmed	F1+
	LC LT IDR	AA Rating Outlook Negative	Affirmed	AA Rating Outlook Negative
	LC ST IDR	F1+	Affirmed	F1+
senior unsecured	LT	AA	Affirmed	AA
senior unsecured	ST	F1+	Affirmed	F1+

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

ENDORSEMENT STATUS

Flemish Community	EU Issued, UK Endorsed

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International Public Finance   Supranationals, Subnationals, and Agencies   Europe

Belgium