Fitch Revises Outlook on French Department of Savoie to Negative; Affirms at ‘AA’

Fitch Ratings has revised the Outlook on the department of Savoie’s Long-Term Foreign-and Local-Currency Issuer Default Ratings (IDRs) to Negative from Stable and affirmed the IDRs at ‘AA’. Fitch has also affirmed the Short-Term Foreign-Currency IDR at ‘F1+’. A full list of rating actions is below.

The revision of the Outlook on Savoie reflects the revision of the Outlook of the French state to Negative from Stable on 15 May 2020.

We also maintained Savoie’s stand-alone credit profile (SCP) at ‘aaa’ as we expect the department’s payback ratio to remain structurally below 5x in the medium in our rating case scenario, despite the economic consequences from the coronavirus.

Under EU credit rating agency (CRA) regulation, the publication of local and regional governments' reviews is subject to restrictions and must take place according to a published schedule, except where it is necessary for CRAs to deviate from this in order to comply with their legal obligations. Fitch interprets this provision as allowing us to publish a rating review in situations where there is a material change in the creditworthiness of the issuer that we believe makes it inappropriate for us to wait until the next scheduled review date to update the rating or Outlook/Watch status. The next scheduled review date for Fitch's rating on Savoie is 12 June 2020, but Fitch believes that developments in the country warrant such a deviation from the calendar and our rationale for this is laid out below.

KEY RATING DRIVERS
The rating action reflects the following key rating drivers and their relative weights:

HIGH WEIGHT
Sovereign cap
The revision of the Outlook on Savoie reflects the revision of the Outlook of the French state to Negative from Stable on 15 May 2020.

French local and regional governments (LRGs) may not be rated above the French state (AA/Negative). This reflects the high influence the French state has on the French LRGs’ responsibilities and finances. As a result, a downgrade of the sovereign would result in a downgrade of Savoie.

LOW WEIGHT

Risk Profile: High Midrange
Fitch assesses Savoie’s risk profile at High Midrange, reflecting a mix of Stronger and Midrange Attributes on the six key risk factors. The “High Midrange” risk profile reflects a limited risk that the department’s cash flow available for debt service will contract beyond reasonable downturn expectations.

Revenue Robustness: Stronger
Savoie benefits from robust revenue, mainly made of stable transfers and predictable tax items. These include the property tax which is based on the fiscal value of properties, the tax on insurance contracts, which has a low volatility through the economic cycle, and the fuel

tax whose proceeds are mostly guaranteed by the French state (AA/Negative) with a low counterparty risk. The counterparty risk of transfers is also low as most of them are made by the French state, which benefits from a high rating.

Property transfer duties (28% of estimated operating revenue) are the main source of potential volatility as they are linked to the real-estate transactions. The latter grew by 66% in 2015-2019, but we expect them to significantly decrease in 2020 due to the consequences of the coronavirus pandemic and containment measures. We factor the drop in proceeds and the potential volatility of this tax item into our rating case scenario. We also expect CVAE proceeds (6%) to be significantly hit by the pandemic in 2021-2022 as they are driven by local companies' value-added, recorded one or two years earlier.

The replacement of the share of property tax by a share of national collected VAT as of 2021, as included in the Finance Bill for 2020, will increase the share of tax items linked to GDP growth (national GDP in the case of VAT versus local GDP for CVAE). However, the departments will still benefit from a minimum level of proceeds guaranteed by the French state (amount of property tax received in 2020). This change in revenue breakdown will increase the potential volatility of revenue, but should not lead to a lower assessment of the department's revenue robustness.

Revenue Adjustability: Midrange
As a result of the replacement of the property tax by VAT proceeds, Savoie will lose almost all its rate-setting power and tax flexibility as of 2021, like other French departments.

However, Fitch believes that French departments benefit from cost pass-through mechanisms with the French state as their counterparty: they are responsible for public policies decided at the national level, especially for social spending, and tend to receive greater financial support from the French state when cost increase. Fitch expects the French state to continue supporting the departments if the latter face a sustained increase in social spending, and the full removal of their fiscal flexibility would make support from the French state even more likely in our view.

The support mechanisms from the French state were not sufficient to cover the increase in spending in the past and do not benefit from a constitutional guarantee. A 'Stronger' assessment of the rating factor is therefore ruled out. However, the track record of financial support and our expectation that such support would continue in case of need justify, in our view, a 'Midrange' assessment of the factor for all French departments.

Expenditure Sustainability: Stronger
Savoie exercises good control over its operating expenditure. Between 2015 and 2019, operating expenditure declined by 0.4% a year on average (including the transfers of transportation's competencies to the region in 2017-2018) compared to a 2% average annual growth in operating revenue. Excluding the transfers of competencies, operating expenditure would have increased by 0.9% a year on average.

The department also aims to comply with the prudential rules set by the French state, under the Finance Programming Bill for 2018-2022, which cap the department's current expenditure growth at 1.2% a year. However, these rules have been put on hold in the context of the coronavirus crisis and include some exceptions relative to social spending.

The department has responsibility over the social benefits. This is a counter-cyclical item which tends to grow when unemployment rises, and we expect it to increase significantly in 2020-2021 due to the economic recession triggered by the coronavirus pandemic. However, the weight of this spending item remains moderate in the department's budget in comparison with the average of French departments (8% of operating spending in 2019 versus close to 18% on average).

Expenditure Adjustability: Midrange
Savoie's operating expenditure is mainly made of rigid mandatory transfers, especially social subsidies, social accommodation fees, transfer to middle schools, or transfer to the fire brigade. Staff costs (26% of operating spending in 2019) are also a rigid spending item as most of the department's employees have the status of civil servants. Cost-cutting measures remain possible, as evidenced by the good control exercised by the department over operating spending in recent years.

The department has more flexibility on its capital expenditure programme as a significant share may be postponed in case of need. The share of capex in total expenditure is high for a French department, at 21% in 2019 versus an average of around 14% for French departments. This reflects the geographical features of the department which has a very large road network. Overall, we estimate the share of non-flexible items to be between 70% and 90% of total spending.

We consider that the level of service and investment within the department is high, and that the affordability to reduce it is strong in an international perspective.

Liabilities and Liquidity Robustness: Stronger
Savoie operates under a robust national and individual management framework. At end-2019, Savoie's carried little risk: 80% was fixed rated while 97% was considered as risk-free by national regulation.

Debt service is structurally well covered by the operating balance (2019: 3.2x). The department's debt amortisation profile is fairly smooth until 2028, with an annual average capital repayment of EUR11 million, and shows three peaks in 2029, 2031 and 2036 close to EUR20 million, due to some private placements issued. However, the risk of bullet repayments is mitigated, in Fitch's view, by the modest amount of these maturities in absolute terms and as a proportion of Savoie's cash flows.

Off-balance sheet liabilities (guarantees plus public-sector entities' debt) are significant, representing 7x the department's operating balance in 2018. However, 91% was related to low-risk social housing sector, especially OPAC (67% of total) which exhibits sound debt ratios.

Liabilities and Liquidity Flexibility: Stronger
Fitch considers that there is a strong framework for emergency liquidity support from the state. There is there is a cash-pooling between French LRGs and French state as their liquidity is deposited at the national Treasury. French LRGs may benefit from cash advances from the French state in case of need as the latter may transfer to some tax items proceeds in advance. This limits the risk of liquidity short-fall. The counterparty risk of this mechanism is low due to the high sovereign rating (AA/Negative).

The department has also abundant access to liquidity under various forms, including EUR28 million from committed lines contracted with counterparties rated in the 'A' category. Like other French LRGs, the department has also access to some institutional lenders, especially the Caisse des Depots et Consignations (AA/Negative), which may support them in case of problems with commercial banks.

Debt Sustainability: 'aaa' category

Fitch assesses Savoie's debt sustainability in the 'aaa' category. In our rating case scenario, we expect the payback ratio (net adjusted debt/operating balance) to be close to 4x in the medium term (2019: 0.8x), the coverage ratio (Fitch's synthetic ratio calculation) around 3x, and the fiscal debt burden at around 60%.

Savoie shows exceptionally strong debt sustainability metrics with a payback ratio at below 1x in 2019 and a synthetic coverage ratio of about 16x. The payback ratio improved in recent years (2016: 2.6x), reflecting both a sharp improvement in operating balance, to EUR131 million in 2019 from EUR80 million in 2016, and a decrease in net adjusted debt to EUR100 million at end-2019 from EUR211 million at end-2016. The department did not take any new loans over 2017-2019 and repaid some loans in advance.

The improvement in operating balance was mainly driven by the strong increase in property transfer duties, to EUR143 million in 2019 from EUR86 million in 2015. This was also due to the growth in other tax items, and a tight control exercised over operating spending. In our rating case scenario, operating balance would vary between EUR65 million and EUR75 million a year in 2020-2024, a result of our assumptions of drop in tax items and increase in social benefits.

We expect Savoie to maintain a high capital expenditure programme in the coming years, especially relative to middle schools infrastructure and road maintenance. In our rating case scenario, we expect the department's capital expenditure be close around EUR120 million a year on average in 2020-2024, at around 20%-25% of total expenditure, and the capital balance to be close to –EUR100 million a year. Accordingly, in our scenario, we expect the department's net adjusted debt to grow to around EUR270 million at end-2024, from EUR100 million at end-2019, as the department would increase its capital expenditure in a context of lower tax revenue received.

Savoie is a French department located in the French Alps and has a population of around 430,000. Savoie's economy has a significant focus on tourism, which reflects the department's position as one of Europe's main ski resort areas, including some of Europe's outstanding ski resorts. This sector will be particularly hit by the coronavirus pandemic, which explains why our rating case assumptions are more conservative with Savoie compared to some other Fitch-rated departments.

Its main responsibilities are social spending, education (middle schools) and road maintenance. It is classified by Fitch as a Type B LRG, meaning that it is required to cover debt service from cash flow on an annual basis.

RATING DERIVATION

Savoie’s stand-alone credit profile (SCP) is assessed at 'aaa' reflecting a combination of a 'High Midrange’ risk profile and debt sustainability metrics assessed in the 'aaa' category under Fitch's rating case scenario. The final rating is capped by the sovereign rating and the department’s negative outlook mirrors that of the sovereign. There is no other rating factor affecting the rating.

KEY ASSUMPTIONS

Qualitative assumptions and assessments and their respective change since the last review on 13 December 2019 and weight in the rating decision:

Qualitative Assumptions and assessments:
Risk Profile: High Midrange, unchanged with low weight
Revenue Robustness: Stronger, unchanged with low weight
Revenue Adjustability: Midrange, unchanged with low weight
Expenditure Sustainability: Stronger, unchanged with low weight
Expenditure Adjustability: Midrange, unchanged with low weight
Liabilities and Liquidity Robustness: Stronger, unchanged with low weight
Liabilities and Liquidity Flexibility: Stronger, unchanged with low weight
Debt sustainability: ‘aa’ category, unchanged with low weight
Support: N/A, unchanged with low weight
Asymmetric Risk: N/A, unchanged with low weight
Sovereign Cap: Yes, lowered with high weight

Quantitative assumptions – issuer specific

Fitch's rating case scenario is a "through-the-cycle" scenario, which is based on the 2015-2019 figures and 2020-2024 projected ratios. It incorporates a combination of revenue, cost and financial risk stresses in case of economic slowdown. Fitch revised its rating case scenario's assumptions to reflect the economic consequences of the coronavirus on French departments’ debt sustainability metrics.

The revised key assumptions for Savoie include:

- yoy 1.5% decrease in operating revenue on average in 2020-2024, including a sharp reduction in property transfer duties proceeds in 2020 by 30%-35% and stable proceeds in 2022-2024; and a drop in CVAE proceeds by 20% over 2021-2022;
- yoy 1.5% increase in operating spending on average in 2020-2024;
- net capital balance of close to –EUR100 million on average in 2020-2024;
- 2.2% cost of debt and 15-year maturity for new debt.

Quantitative assumptions – sovereign related

Figures as per Fitch’s sovereign actual for 2018 and forecast for 2021, respectively:
GDP per capita (US dollar, market exchange rate): 42,764; 40,632; low weight
Real GDP growth (%): 1.7; 4.1; high weight
Consumer prices (annual average % change): 2.1; 0.7; low weight
General government balance (% of GDP): -2.3; -6.8; high weight
General government debt (% of GDP): 98.3; 115.5; high weight
Current account balance plus net FDI (% of GDP): -3.1; -3.9; low weight
Net external debt (% of GDP): 36.3; 48.4; low weight
IMF Development Classification: EM
CDS Market Implied Rating: AA-

Material changes in revenue and cost profiles are occurring across the French LRGs' sector and likely to worsen in the coming weeks and months as economic activity suffers and some forms of government restrictions are maintained. Fitch's ratings are forward-looking in nature, and we will monitor developments in the sector for their severity and duration, and incorporate revised rating case qualitative and quantitative assumptions based on performance expectations and assessment of key risks.

RATING SENSITIVITIES

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

The Outlook would be revised back to Stable if the Outlook on the sovereign was revised to Stable, all other things remaining unchanged.

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

A deterioration of the payback ratio to 7.5x on a sustained basis in our rating case scenario could lead to a downgrade. This could notably happen if the drop in tax revenue resulting from the pandemic is larger than currently expected and not matched by a lower amount of expenditure. A downgrade of the sovereign would also be reflected in the region's ratings.

COMMITTEE MINUTE SUMMARY

Committee date: 25 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.

ESG CONSIDERATIONS

ESG credit relevant is a score of 3, meaning that ESG issues are credit-neutral. Given the mission of the issuer and the institutional framework, these issues are minimally relevant to the rating.

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