MOODY'S
PUBLIC SECTOR EUROPE

CREDIT OPINION
15 September 2017

Rate this Research

Flanders, the Community of

Update to Key Credit Factors

RATINGS

Flanders, the Community of

Domicile	Belgium
Long Term Rating	Aa2
Type	LT Issuer Rating - Dom Curr
Outlook	Stable

Please see the ratings section at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

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Summary Rating Rationale

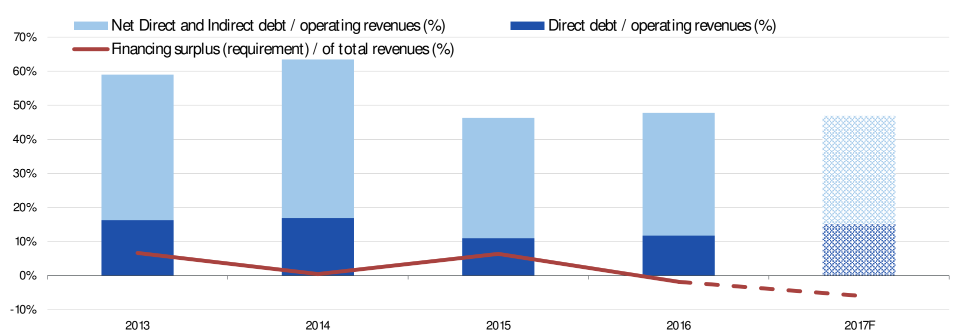
The Aa2 debt and issuer rating of the Community of Flanders' (Flanders or Flemish Community) Aa2 debt rating and the Prime-1 short-term rating of its Treasury notes reflect (i) the administration's sound financial performance and commitment to fiscal consolidation; (ii) its moderate debt-to-revenue ratio and strong debt affordability ratio, as well as (iii) the region's strong and diversified economy, within the context of relatively muted growth prospects.

National Peer Comparison

In a national peer comparison, the Community of Flanders is rated at the top of the range for Moody's rated Belgian regions and communities, which spans from A2 to Aa2. Flanders' rating reflects the strong financial performance of the region with significant access to financing, together with the Belgian institutional framework for regions and communities that shields the regions from decisions taken at the federal level that would be detrimental to its finances. The institutional framework for Belgian sub-sovereigns is well established and is protected from sudden changes, as any modification in the existing framework requires (i) a two-thirds majority vote in the federal parliament; and (ii) a majority in the parliament of each linguistic group.

The region's high GDP and income per capita, both from a pan-European perspective and compared with other Belgian federated entities, also supports the Flemish Community's capacity to generate revenues and, ultimately, the region's creditworthiness.

Exhibit 1
Flanders' lighter debt burden provides headroom for capital investment borrowing



2017F: Figures based on Budget and estimated data
Source: Flanders' consolidated realised accounts and budget, Moody's calculations

Credit Strengths

- » Strong track record of budgetary discipline and continued commitment to fiscal consolidation
- » Modest debt burden and ample access to liquidity
- » Strong and diversified economic base

Credit Challenges

- » Shift in debt management strategy driving an increase in debt, albeit from a low base
- » Subdued growth and inflation prospects

Rating Outlook

The stable outlook on the Community of Flanders reflects the sovereign rating's stable outlook and Flanders' strong financial performance.

Factors that Could Lead to an Upgrade

An upgrade of the rating would require a similar change in the sovereign rating together with a reduction of the Flemish community's debt burden

Factors that Could Lead to a Downgrade

Should the sovereign be downgraded, this would have negative implications for Flanders. Should the Flemish Community fail to achieve its budgetary targets for a prolonged period of time and post large deficits leading to higher debt burden, this would exert downward pressure on the region's rating.

Key Indicators

Exhibit 2

The Community of Flanders Key Indicators

Key Indicators						
Flanders, the Community of						
	2012	2013	2014	2015	2016	2017B
Gross operating balance / operating revenues (%)	11.7	9.6	8.2	6.5	7.3	6.3
Interest expenses / operating revenues (%)	0.7	0.6	0.6	0.4	1.2	1.1
Discretionary Own Source revenues / operating revenues (%)	19.7	20.5	20.3	34.4	35.4	34.7
Capital spending / total expenditure (%)	10.7	9.6	11.8	9.5	13.7	14.5
Financing surplus (requirement) / of total revenues (%)	1.1	6.6	0.5	6.4	-1.8	-5.9
Direct debt / operating revenues (%) [1]	25.3	16.3	16.9	10.9	11.7	15.2
Net Direct and Indirect debt / operating revenues (%) [1]	67.4	59.0	63.5	46.3	47.8	46.9

2017B = 2017 data is budget data
[1] 2017 Direct debt; 2017 net debt and indirect debt are estimates
Source: Flanders' consolidated realized accounts and budget, Moody's calculations

Detailed Rating Considerations

The rating assigned to Flanders combines the baseline credit assessment (BCA) of aa2 for the region and the high likelihood of extraordinary support coming from the national government in the event that the entity faced acute liquidity stress.

Baseline Credit Assessment

Strong budgetary discipline and continued commitment to fiscal consolidation

The Flemish Community remains committed to targeting a nominal budget balance, after adjusting for a large capital project (the Antwerp Ring Road), and two other significant payments that are linked to the transfer of responsibilities from the central government (reimbursements to the central government, and contributions to hospital infrastructure). Concretely, this means that Flanders is committed to running operating surpluses, and will borrow primarily to fund capital investments. Fiscal results from 2016 reflect this commitment, as the gross operating balance strengthened to 7.3% of revenue year-on-year, while the financing balance deteriorated to -1.8% of revenue. Looking forward, we expect Flanders to hold this stance as the budget provides for further capital borrowing, and a financing deficit of 5.9% of revenue, while the operating surplus remains relatively high at 6.3% of revenue.

Concurrently, Flanders continues to contribute to fiscal consolidation at the general government level. Belgium's federal government, regions and communities signed a cooperation agreement to implement the European Union's Fiscal Compact. This agreement adds a budgetary `golden rule' to Belgian law under which the country must converge towards its medium-term budgetary objective of a structural fiscal balance of zero percent of GDP. The Flemish Community's contribution to both ageing costs and national fiscal consolidation efforts can be seen in the indexation formulas of certain transfers, which will lead to these transfers growing more slowly in relation to GDP than previously. As these contributions are already integrated into multi-year budgets, we do not expect a return to large financing surpluses of the past. The Flemish Community's commitment to fiscal consolidation remains a significant credit strength for the region.

Modest debt burden and ample access to liquidity

The implementation of the Sixth State reform led to an effective deleveraging in terms of the Flemish Community's debt metrics. The addition of €10 billion of revenues led to a decline of the Community's direct debt as a percent of operating revenues from 16.9% in 2014 to 10.9% in 2015. A proportional impact can be seen on the level of total debt (including direct, indirect debt, and guarantees of the region) to operating revenues, which declined from 63.5% in 2014 to 46.3% in 2015, despite an increase of approximately €350 million of total debt in the same time period. Debt metrics deteriorated moderately in 2016, with direct debt increasing to 11.7% of revenue and total debt rising to 47.8% of revenue. Overall, this represents a modest debt burden, for example, in comparison to rated peers in Germany where net direct and indirect debt is can reach well over 100% of revenue.

The Flemish Community's direct debt is affordable, as interest expenses are 1.1% of total revenues in 2016. The structure of the debt portfolio is relatively prudent, with 79% of the total outstanding as of year-end 2016 at fixed rates, and an average time to maturity of 10 years and four months.

Moreover, we note in particular that the region's liquidity profile is particularly strong with a Belgian commercial paper program of €1.5 billion and a €3.25 billion credit line. The region's access to external funding is also supported by its €10 billion EMTN programme.

Strong and diversified economic base

Accounting for just under 60% of total GDP, the FC is Belgium's economic engine. Its economy is characterised by a high degree of openness (providing 83.8% of total Belgian exports in 2016), an innovative industrial structure, a strong entrepreneurial culture and sophisticated infrastructure. Chemicals, textiles, plastics and rubber, automobile and food products remain its core industries. One of the FC's competitive advantages remains its harbors, led by Antwerp which is home to the second largest port in Europe.

This economic diversification provides the Flemish government with a relatively low unemployment rate (4.9% as of Q1 2017), a dynamic tax base and, if need be, a significant pool of resources to tap. With an annual disposable income per inhabitant of €20,100, the Flemish Region has the highest wealth level in Belgium (same indicator for both Brussels-Capital and Walloon region points to €17,300). We, however, note that given the already high average taxation level in Belgium and the competitiveness pressures the country faces, there is low scope for increasing taxation. Indeed, recent reforms such as the “tax shift” provides tax relief for individuals and prescribes lower social security contributions for employers in order to boost purchasing power and reduce labor costs. While this will initially result in some lost revenues for the Belgian federal and regional governments, the policy should, in aggregate, support the competitiveness of the Belgian economy in the medium term.

Shift in debt management strategy driving an increase in debt, albeit from a low base

Like many other European government entities, Flanders transitioned to the latest European System of National and Regional Accounts (ESA 2010). In the case of the Flemish Community, the implementation of ESA 2010 widened the scope of what should be counted as part of the regional government, hence in accounting terms, the FC responsibilities are now broader. As a result, the regional authorities have decided to directly fund some of these entities, specifically those related to social housing, instead of issuing guarantees as had been done in the past. While the savings in terms of borrowing cost is not insignificant, this represents a substantial change in approach to debt management, as prior to the region's financial assistance of KBC, the Flemish Community had minimal direct debt.

At the same time, Flanders increased capital expenditures by 56%, from €3.4 billion to €5.8 billion in 2016, and plans to maintain that higher level of capital spending in 2017. Borrowing to finance this deficit will go towards social housing, followed by schools, and community care facilities. In 2018, work will begin on the Antwerp Ring Road, a capital investment over a number of years which the Flemish Community currently estimates will cost about €3.5 billion.

As a result of this shift in debt management strategy, as well as the Flemish Community's program of capital expenditure, we expect the region's direct debt to increase significantly in the medium term, while the level of guaranteed debt should decline. Preliminary projections show Flanders' direct debt doubling over four years, from an estimated €6.4 billion (15.2% of revenue) in 2017 to €12.9 billion (28.9% of revenue) in 2020. Total net direct and indirect debt (including guarantees and debt of consolidated entities) is projected to reach 52.1% of revenue. While this increase in debt represents a significant shift in the Flemish Community's profile, debt metrics would remain in-line with rated peers. Nevertheless, the increase in volume of debt introduces new challenges for managing the greater debt burden.

Subdued growth and inflation prospects

The strength of Flanders' creditworthiness is weighed down by muted projections for Belgian growth overall. The IMF estimates that Belgium's economy grew by 1.2% in real terms in 2016, and projects growth of 1.6% in 2017. The continued relatively subdued performance of the Belgian economy acts as a drag on the region's fiscal consolidation efforts both for own-source revenues and transfers from the federal government. More than half of the region's revenue is generated from taxes shared with the national government (namely personal income tax, PIT), with the amount indexed to the previous year's amount plus inflation and GDP growth. We expect the projected low growth and inflation environment to continue challenging fiscal consolidation efforts and foster some budgetary adjustments throughout the year.

Extraordinary Support Considerations

Moody's assigns a high likelihood of extraordinary support from the national government, reflecting Moody's assessment of the reputation risk for the federal government if the FC were to default, as well as indications of support stemming from the federal government's commitment to enable federated entities to reach sound financials.

Rating Methodology and Scorecard Factors

In the case of the Flemish Community the BCA matrix generates an estimated BCA of aa3, compared with the BCA of aa2 assigned by the rating committee.

The matrix-generated BCA of aa3 reflects (1) an idiosyncratic risk score of 2 (presented below) on a 1 to 9 scale, where 1 represents the strongest relative credit quality and 9 the weakest; and (2) a systemic risk score of Aa2. In the case of the Flemish Community, the systemic risk of Aa2 exceeds the sovereign bond rating by one notch (Belgium, Aa3 stable), which reflects the strong financial performance of the region with significant access to financing together with its protective institutional framework. The one notch differential between the BCA assigned and the matrix-generated BCA reflects our positive assessment of region's long history of conservative financial management exemplified by the constant delivery of ambitious annual budgets.

The idiosyncratic risk scorecard and BCA matrix, which generate estimated baseline credit assessments from a set of qualitative and quantitative credit metrics, are tools used by the rating committee in assessing regional and local government credit quality. The credit metrics captured by these tools provide a good statistical gauge of stand-alone credit strength and, in general, higher ratings can be expected among issuers with the highest scorecard-estimated BCAs. Nevertheless, the scorecard-estimated BCAs do not substitute for rating committee judgments regarding individual baseline credit assessments, nor is the scorecard a matrix for automatically assigning or changing these assessments. Scorecard results have limitations in that they are backward-looking, using historical data, while the assessments are forward-looking opinions of credit strength. Concomitantly, the limited number of variables included in these tools cannot fully capture the breadth and depth of our credit analysis.

Exhibit 3

Flanders, the Community of

Baseline Credit Assessment	Score	Value	Sub-factor Weighting	Sub-factor Total	Factor Weighting	Total
Scorecard						
Factor 1: Economic Fundamentals						
Economic strength	5	101.75	70%	3.8	20%	0.76
Economic volatility	1		30%			
Factor 2: Institutional Framework						
Legislative background	1		50%	3	20%	0.60
Financial flexibility	5		50%			
Factor 3: Financial Performance and Debt Profile						
Gross operating balance / operating revenues (%)	3	7.21	12.5%	2.75	30%	0.83
Interest payments / operating revenues (%)	1	0.91	12.5%			
Liquidity	1		25%			
Net direct and indirect debt / operating revenues (%)	3	47.80	25%			
Short-term direct debt / total direct debt (%)	5	21.00	25%			
Factor 4: Governance and Management - MAX						
Risk controls and financial management	1			1	30%	0.30
Investment and debt management	1					
Transparency and disclosure	1					
Idiosyncratic Risk Assessment						**2.49(2)**
Systemic Risk Assessment						**Aa2**
Suggested BCA						**aa3**

Source:

Methodology: Regional and Local Governments, January 2013 (147779)

Ratings

Exhibit 4

Category	Moody's Rating
FLANDERS, THE COMMUNITY OF	
Outlook	Stable
Issuer Rating -Dom Curr	Aa2
Senior Unsecured -Dom Curr	Aa2
Commercial Paper -Dom Curr	P-1

Source: Moody's Investors Service

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