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PUBLIC SECTOR EUROPE

CREDIT OPINION
27 September 2019

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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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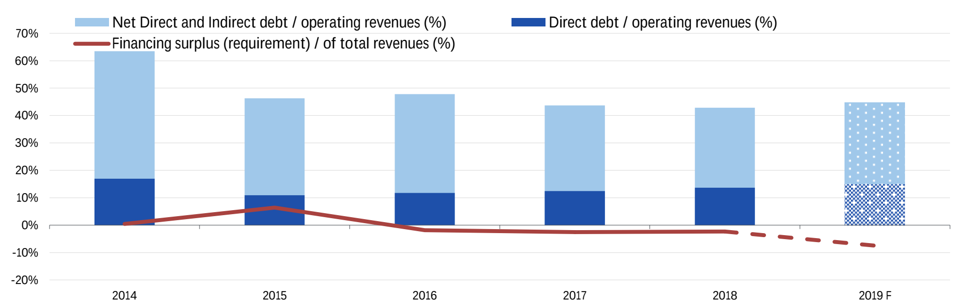
Flanders, the Community of

Update to credit analysis

Summary

The credit profile of the Community of Flanders (Aa2 stable, P-1), is strengthened by the community's sound financial performance and commitment to fiscal consolidation, as well as its moderate debt-to-revenue ratio, and strong debt affordability ratio. Challenges in Flanders' credit profile include a recent shift in debt management strategy and a rising direct debt burden (albeit from low levels). Moreover, the community is at the start of a large infrastructure project which poses implementation and development risk over the next decade.

Exhibit 1
Flanders' lighter debt burden provides headroom to borrow for capital expenditure



2019 F: 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

» Debt increasing, albeit from a low base

» Large infrastructure project poses implementation risks

Rating outlook

The stable outlook on the Community of Flanders reflects the sovereign rating's stable outlook (Belgium, Aa3 stable) and Flanders' strong financial performance.

Factors that could lead to an upgrade

Although an upgrade of the rating is currently unlikely in view of the stable outlook, an upgrade would require a similar change in the sovereign rating, together with a material reduction of Flanders' debt burden.

Factors that could lead to a downgrade

Although a downgrade of the rating is currently unlikely in view of the stable outlook, the following would place downwards pressure on the rating consistent: (1) failure to achieve budgetary targets, (2) growth of the debt burden to a level materially higher than currently projected. Furthermore, a downgrade of the sovereign would have negative implications for Flanders.

Key indicators

Exhibit 2

The Community of Flanders - Key Indicators

Flanders, the Community of	2014	2015	2016	2017	2018	2019 F
Gross operating balance / operating revenues (%)	8.2	6.5	7.3	8.3	7.9	4.7
Interest expenses / operating revenues (%)	0.6	0.4	1.2	1.3	1.2	1.2
Discretionary Own Source revenues / operating revenues (%)	20.3	34.4	35.4	34.6	33.8	33.5
Capital spending / total expenditure (%)	11.8	9.5	13.7	13.8	13.1	14.7
Financing surplus (requirement) / of total revenues (%)	0.5	6.4	-1.8	-2.5	-2.3	-7.5
Direct debt / operating revenues (%)	16.9	10.9	11.7	12.5	13.7	14.9
Net Direct and Indirect debt / operating revenues (%)	63.5	46.3	47.8	43.7	42.8	44.8

2019 F = Figures based on budget and estimated data (NB: we have adjusted the 2018 and 2019 F data so that the €1 billion reimbursement to the Federal government – which was recorded in 2018 in accounting terms – is expressed in cash terms, to reflect the fact that payments will be spread over a period of 16 years)
Source: Flanders' consolidated realised accounts and budget, Moody's calculations

Detailed credit 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

Flanders is currently being run by a caretaker government while the community awaits the formation of a formal government following the May 2019 elections. Whilst we expect a government to be formed by the end of the year, our assessment is that there is no immediate credit impact[1].

In 2018, Flanders' gross operating surplus remained stable at 7.9% of revenue, compared to 8.3% in the previous year. The Flemish authorities have a strong track record of budgetary discipline. We anticipate that the new government, once formed, will continue targeting a balanced budget, excluding large and growing capital expenditure projects. In practice, this means that we expect Flanders to continue running operating surpluses, and borrowing primarily to fund capital expenditure. Fiscal results from 2018 and the 2019 budget reflect this approach, as Flanders' financing deficit remained stable at -2.3% of revenue in 2018, and is projected at -7.5% in 2019. This year's operating surplus is budgeted to reach a lower but strong level of 4.7% 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 Gross Domestic Product (GDP). The Flemish Community's contribution can be seen in recurrent deductions made to federal grants, as well as in the indexation formulas of Personal Income Tax (PIT) and Value Added Tax (VAT) grants, 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 surpluses of the past.

Adjustments from the Sixth State reform continue to complicate the Flemish Community's accounts. The “autonomy factor”, which determines the share of PIT transferred to Flanders, was revised downward during its final review in 2018, with a retroactive effect. As a result, Flanders will pay back close to €1 billion of 2015-2017 revenues to the Federal Government. This €1 billion reimbursement appears in accounting terms as a one-off decrease in revenue in 2018, while in cash terms the payments will be spread over a period of 16 years (as reflected in Exhibit 2), softening the negative impact. Future budget performance will also be negatively impacted by the tax shift, which will result in lower PIT receipts.

Modest debt burden and ample access to liquidity

Stronger operating results than budgeted, combined with a lower capital spending than expected, resulted in a reduction of the overall Net Direct and Indirect Debt (NDID) to revenue ratio to 42.8% as of December 2018, down from 43.7% as of December 2017. Nonetheless, the direct debt component of this metric continued to grow (see Exhibit 1), mainly reflecting the shift in debt management strategy (see *Debt increasing, albeit from a low base*). Overall, Flanders' NDID as a percent of revenue represents a moderate debt burden in comparison, for example, to rated peers in Germany where this metric may exceed 100%.

The Flemish Community's direct debt is affordable, as interest expenses are 1.2% of total revenues in 2018. The structure of the debt portfolio is prudent, with 99% of the total outstanding at year-end 2018 at fixed rates, and an average time to maturity of 15 years and one month.

Moreover, we note in particular that the region's liquidity profile is strong, with a Belgian commercial paper program of €1.5 billion and a €3.25 billion credit line (which will increase to €3.75 billion in February 2020). 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, Flanders is Belgium's economic engine. Its economy is characterised by a high degree of openness (providing 79.9% of total Belgian exports in 2018), 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 Flanders 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 (3.4% as of Q1 2019), a dynamic tax base and, if need be, a significant pool of resources to tap. With an annual disposable income per inhabitant over €20,600, the Flemish Region has the highest wealth level in Belgium (the same indicator for both Brussels-Capital and Walloon region points to €17,600). 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.

Debt increasing, 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 community's 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 in 2009, the Flemish Community had minimal direct debt.

At the same time, Flanders has significantly increased capital spending, from €3.7 billion in 2015 to €7.4 billion budgeted in 2019. We anticipate that capital expenditure will remain high going forward as public investment levels, which have been structurally subdued in Belgium, pick up. Thus far, borrowing has funded capital expenditure primarily on social housing, schools and community care facilities.

As a result of this shift in debt management strategy and the 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. While this increase in debt represents a significant shift in the Flemish Community's profile, debt metrics would remain in line with rated peers. Total NDID (including guarantees and debt of consolidated entities) is projected to slightly increase as a percentage of revenue, to 44.8% in 2019, compared to 42.8% realised in 2018. Nevertheless, the increase in volume of debt introduces new challenges for managing the greater debt burden.

Large infrastructure project poses implementation risks

In 2018, work began on the Antwerp Ring Road (also known as the *Oosterweel* Link), a large infrastructure project, expected to start operating in 2026. The Flemish Community is managing this project through BAM (*Beheersmaatschappij Antwerpen Mobiel*), an entity which is 100% owned by the community. Currently, the Flemish authorities estimate the project will cost €3.8 billion, financed in part through a €1 billion loan from the European Investment Bank (EIB, Aaa stable). The first tranche of the EIB loan, amounting to €150 million, was released in April 2019. For the remaining portion, Flanders plans to borrow directly from the market to fund the project, and has already supported BAM through a €350 million equity injection in 2018. Authorities plan to use proceeds from the toll revenues to service debt from the construction, once the ring road is in use. A project of this size, duration and nature necessarily involves implementation and development risk, a key credit challenge for the community.

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 Flemish Community were to default, as well as indications of support stemming from the federal government's commitment to enable federated entities to reach sound financials.

ESG Considerations

How environmental, social and governance risks inform our credit analysis of the Community of Flanders

Moody's takes account of the impact of environmental (E), social (S) and governance (G) factors when assessing sub-sovereign issuers' economic and financial strength. In the case of the Community of Flanders, the materiality of ESG to its credit profile is as follows:

Environmental considerations are not material to Flanders' credit profile. As a northern European coastal region, its main exposures relate to flood and storm risks. Although these climate events could cause physical damage and economic disruption – particularly given Flanders' economic reliance on its large ports – we consider the community's finances to be strong enough to absorb such shocks. Furthermore, Flanders proactively mitigates these risks by investing €67 million a year in flooding protection, and €26 million a year: (1) in coastal protection against the "1000 year storm"; and (2) to protect against rising sea levels.

Social considerations are material to Flanders' credit profile given the community's responsibilities and demographic dynamics, which impact its expenditures (including those related to education and pensions).

Governance considerations are material to Flanders' credit profile. The community benefits from a high standard of governance and a strong track record of conservative financial management.

Further details are provided in the "Detailed credit considerations" section above. Our approach to ESG is explained in our cross-sector methodology General Principles for Assessing ESG Risks.

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 (1) our positive assessment of region's long history of conservative financial management, as well as (2) the protections provided by the Belgian constitution which prevent the federal government from unilaterally taking decisions that could negatively affect the financing of communities and regions.

For details about our rating approach, please refer to Rating Methodology: Regional and Local Governments, 16 January 2018

Exhibit 3

Scorecard

Flanders, the Community of						
Baseline Credit Assessment	**Score**	**Value**	**Sub-factor Weighting**	**Sub-factor Total**	**Factor Weighting**	**Total**
Scorecard						
Factor 1: Economic Fundamentals				3.8	20%	0.76
Economic strength	5	102.58	70%			
Economic volatility	1		30%			
Factor 2: Institutional Framework				3	20%	0.60
Legislative background	1		50%			
Financial flexibility	5		50%			
Factor 3: Financial Performance and Debt Profile				2.5	30%	0.75
Gross operating balance / operating revenues (%)	3	7.95	12.5%			
Interest payments / operating revenues (%)	3	1.23	12.5%			
Liquidity	1		25%			
Net direct and indirect debt / operating revenues (%)	3	42.82	25%			
Short-term direct debt / total direct debt (%)	3	12.43	25%			
Factor 4: Governance and Management - MAX				1	30%	0.30
Risk controls and financial management	1					
Investment and debt management	1					
Transparency and disclosure	1					
Idiosyncratic Risk Assessment						**2.41(2)**
Systemic Risk Assessment						**Aa2**
Suggested BCA						**aa3**

Source: Community of Flanders, Moody's Investors Service

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

Endnotes

1 Please refer to Election outcome confirms fragmented political landscape, no immediate credit impact.

REPORT NUMBER 1196048

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Americas	1-212-553-1653
Asia Pacific	852-3551-3077
Japan	81-3-5408-4100
EMEA	44-20-7772-5454

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