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RATING ACTION COMMENTARY

Fitch Revises Outlook on Autonomous Community of Madrid to Positive; Affirms at 'BBB'

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Fitch Ratings - Barcelona - 11 Nov 2022: Fitch Ratings has revised the Outlook on the Autonomous Community of Madrid's Long-Term Foreign and Local Currency Issuer Default Ratings (IDR) to Positive from Stable and affirmed the IDRs at 'BBB'. Fitch has affirmed the Short-Term Foreign Currency IDR at 'F2'.

The revision of the Outlook reflects improved debt metrics under Fitch's rating case scenario. We assess Madrid's risk profile at a better-than-average 'Midrange', which allows the Standalone Credit Profile (SCP) to be higher than comparable peers, combined with Fitch's expectation of a moderate economic liability burden and improving debt payback.

KEY RATING DRIVERS

Risk Profile: 'Midrange'

Madrid's SCP is assessed in the 'bbb' category, reflecting the combination of a 'Midrange' risk profile, and the 'a' debt sustainability assessment. The notch-specific SCP factors in the region's better-than-average Midrange risk profile and that two key risk factors are 'Stronger' and four 'Midrange'. Fitch caps Madrid's risk profile at 'Midrange' given the low influence of one of the 'Stronger' key risk factors in its Risk Profile, due to the funding system under the common regime in which the region operates.

Revenue Robustness: 'Midrange'

The dependence on a 'A-' rated counterparty for a material proportion of the region's revenue drives the assessment of Madrid's revenue framework. Madrid's operating revenue is mostly composed of taxes and transfers from the central government (70% of total revenue in 2021), and diversified self-collected taxes.

Revenue from the central government is moderately correlated with economic cycles, but a decline in national GDP would affect revenue with a two-year lag due to the funding system, which causes moderate volatility of Madrid's revenue.

Revenue Adjustability: 'Stronger'

In 2021, 37% of Madrid's operating revenue came from the funding system in the form of transfers (VAT and special taxes), which the regional government does not have legal control of. Madrid has legal control of self-collected taxes. These represented 65% of operating revenue in 2021 and include personal income tax, the major tax contributor (50% of operating revenue in 2021), with no cap on rates by the state.

Like all autonomous communities, Madrid has unlimited control of tax revenues (40% of operating revenue) under Spanish's institutional framework, allowing the assessment of its revenue adjustability as 'Stronger'. Given its strong regional socioeconomic profile, Madrid's ability to increase taxes is not limited. There are no legal caps on tax rates.

Expenditure Sustainability: 'Midrange'

Madrid has moderate expenditure control, given that 65% of its operating expenditure (opex) comprises inflexible items, such as healthcare and education. In 2017-2021, opex CAGR was 5.8%, which is lower than operating revenue (7.8%), because the state's allocations significantly increased during this period, including Covid-19 funds of EUR3.3 billion in 2020 and EUR1.8 billion in 2021 from the central government.

Madrid's spending responsibilities are moderately correlated with the economic cycle and are non-cyclical, as they mostly comprise education and health spending. Cyclical spending -mostly social spending and employment-related to support the labour market -is 11.6% of the region's total spending (totex), and tends to grow when unemployment rises.

Expenditure Adjustability: 'Midrange'

The Budgetary Stability Law enables the central government to control the regional administration's spending and has been strengthened in recent years. Prudential rules set by the central government help maintain the fiscal balance and have resulted in a gradual reduction of Madrid's overall deficit, although it has failed to meet stability targets on several occasions. These targets were put on hold between 2020 and 2023 due to the pandemic and replaced by a reference deficit target of 1.1% of GDP for 2021 (0.6% for 2022 and 0.3% for 2023).

This factor also reflects a moderate proportion of mandatory and inflexible items, including education, health and staffing costs (36% of totex). Autonomous communities cannot reduce their number of civil servants, and the central government controls remuneration and headcount.

Liabilities & Liquidity Robustness: 'Stronger'

This assessment is underpinned by the solid national framework for debt and liquidity management with strict prudential borrowing limits, such as a debt objective at 22.8% of GDP for 2021, although this was suspended because of the pandemic.

Madrid has a conservative debt structure, moderate average cost of debt at 1.9% in 2021 and low short-term debt (representing 0.5% of direct debt in 2021). The average maturity life of debt is longer (8.4 years in 2021) than other autonomous communities, and it has low exposure to rising interest rates (share of floating rates is low at 11.5% in 2021).

Madrid is well established in the capital and financial international markets and its lending comprises bank loans from a few institutions (37% of outstanding debt at end-2021) and long-term bonds (64%). Madrid is one of the few Spanish regional governments that has not utilised state support mechanisms, even in difficult years. We do not expect the region to make use of them in our rating-case.

Liabilities & Liquidity Flexibility: 'Midrange'

In our rating case, we assume Madrid's available unrestricted liquidity to be low in 2022, covering 78% of short-and long-term debt servicing maturing this year. At end-2021, the autonomous community had EUR1.7 billion in available credit lines and current accounts, contracted with counterparties mostly rated 'BBB-'and 'A-'. In 2021, the central government authorised a EUR1 billion commercial paper programme for Madrid, and it had EUR982 million available at year-end.

Madrid has strong access to capital markets and banks to fund its annual deficit, and consequently, it is one of the few Fitch-rated Spanish regional governments that has not utilised the state's regional liquidity fund (FLA). In November 2022, it had covered most of its funding needs for the year, of which EUR1 billion came from a sustainable bond with 10-year maturity.

Debt Sustainability: 'a category'

As type A local and regional government, Madrid's primary debt sustainability metric is the economic liability burden (net adjusted debt + a pro-rata share of central government debt/regional GDP), which we expect to be slightly below 90% in 2026 in our rating case scenario (2021: 94.8%), in line with the 'a' category.

In 2022, we expect operating revenue to improve as Madrid will benefit from dynamic tax revenues collected by the state (tax allocation, up 6.4% compared with 2021) as well as from some exceptional items: complete compensation from the state of the negative 2020 tax settlement (EUR496 million) and EUR383 million compensation for 2017 VAT (the region collected only 11 months due to a change in the tax system). Pandemic-related expenditure also declined in 2022 (around EUR850 million compared with EUR2.2 billion in 2021). We expect that around EUR150 million of Covid-19-related spending will structurally remain in Madrid's operating expenses, mostly made up of staff costs.

We expect the positive dynamic of operating revenue will continue over our rating case since 2022 preliminary data on national tax collection is higher than expected. We expect Madrid's net adjusted debt to decrease below EUR30 billion by 2025 (2021: EUR33.5 billion) as the capital balance will remain negative at around -EUR1.4 billion, supported by capital revenues from European and national support plans. As a result, the payback ratio is close to 8x in 2025-2026 in our rating case scenario.

DERIVATION SUMMARY

Fitch assesses Madrid's SCP in the 'bbb' category, reflecting a combination of a better-than-average 'Midrange' risk profile, and 'a' debt sustainability assessment. The revision of the Outlook to Positive reflects the improvement in debt metrics under Fitch's rating case scenario, and especially a moderate economic liability burden improving to below 90% in

2024-2026, while the debt payback will remain between 10 and 7 years in 2024-2026. Peer comparison is factored in and Fitch does not apply any asymmetric risk.

Short-Term Ratings

Madrid's Short-Term IDR is 'F2', reflecting a low share of short-term debt (representing 0.5% of direct debt in 2021), strong availability of credit lines, and access to state mechanisms

Debt Ratings

The senior unsecured outstanding debt has been affirmed at 'BBB', the same level as Madrid's Long-Term IDR.

KEY ASSUMPTIONS

Qualitative assumptions and assessments and their respective change since the last review 13 May 2022 and weight in the rating decision:

Risk Profile

Midrange, Unchanged with Low weight

Revenue Robustness

Midrange, Unchanged with Low weight

Revenue Adjustability

Stronger, Unchanged with Low weight

Expenditure Sustainability

Midrange, Unchanged with Low weight

Expenditure Adjustability

Midrange, Unchanged with Low weight

Liabilities and Liquidity Robustness

Stronger, Unchanged with Low weight

Liabilities and Liquidity Flexibility

Midrange, Unchanged with Low weight

Debt Sustainability

a, Improved with High weight

Budget Loans (Notches)

N/A, Unchanged with Low weight

Ad-Hoc Support (Notches)

N/A, Unchanged with Low weight

Asymmetric Risks (Notches)

N/A, Unchanged with Low weight

Floor

N/A, Unchanged with Low weight

Risk Profile:

Revenue Robustness:

Revenue Adjustability:

Expenditure Sustainability:

Expenditure Adjustability:

Liabilities and Liquidity Robustness:

Liabilities and Liquidity Flexibility:

Debt sustainability:

Support (Budget Loans):

Support (Ad Hoc):

Asymmetric Risk:

Sovereign Cap:

Sovereign Floor:

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 in case of economic slowdown but did not factor in the risk of exceptional events. It is based on 2017-2021 figures and 2022-2026 projected ratios.

- Nominal average growth of operating revenue at 5.9% in the next five years, high weight

- Nominal average growth of operating expenditure at 5.4% in the next five years, high weight

- Net capital balance at around a negative EUR1.3 billion on average in the next five years, high weight

- 2.6% average cost of debt in the next five years, high weight.

Quantitative assumptions - Sovereign Related

Figures as per Fitch's sovereign actual for 2021 and forecast for 2023, respectively (no weights and changes since the last review are included as none of these assumptions was material to the rating action):

- GDP per capita (US dollar, market exchange rate): 30,117.78; 28,533.73

- Real GDP growth (%): 5.13; 1.74

- Consumer prices (annual average % change): 3.01; 5.24

- General government balance (% of GDP): -6.87; -3.98

- General government debt (% of GDP): 118.44; 114.40

- Current account balance plus net FDI (% of GDP):28,414.90; -10,441.88

- Net external debt (% of GDP): 74.19; 82.82

- IMF Development Classification: DM

- CDS Market Implied Rating: A

Liquidity and Debt Structure

Fitch's overall adjusted debt includes Madrid's financial debt (EUR32.4 billion at end-2021) and the social housing agency's debt (EUR4 million), as well as 'other-Fitch classified debt', 'guarantees issued' and the 'majority-owned GRE debt and other contingent liabilities'.

Other Fitch classified debt includes capitalised payments for public-private partnership in roads, train, metro, hospitals, and from Consorcio Regional de Transportes de Madrid.

The 'majority-owned GRE debt and other contingent liabilities' includes debt of the regional operator of metro lines, Metro de Madrid and of the water companies (Canal Isabel and Canal Isabel II Gestion). Guarantees issued include one to Metro of Madrid.

Net adjusted debt corresponds to the difference between overall adjusted debt and the year-end available cash viewed as "unrestricted" by Fitch. Fitch considers that the restricted cash corresponds to the gap between receivables (net of provisions for difficult-to-collect revenue) and payables.

Issuer Profile

Madrid is a single-province region in the centre of Spain, with a population close to 6.7 million (14.1 % of the national population) and 19.3% of the national GDP in 2020. The regional economy is mainly driven by services, which account for 85% of employment. Madrid has a stronger-than-national-average economic profile, as it is Spain's political, administrative and economic hub. This is reflected by higher GDP per capita, lower unemployment rate and poverty rate. Madrid's responsibilities include health, education and social care.

RATING SENSITIVITIES

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

The Outlook could be revised to Stable if the economic liability burden remains above 90% on a sustained basis in our rating case scenario

Factors that could, individually or collectively, lead to positive rating action/upgrade:

Madrid's IDR could be upgraded if its economic liability burden remains structurally below 90%, and its payback ratio remains structurally below 13 years in our rating case scenario.

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 MINUTES SUMMARY Committee date: 8 November 2022

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.

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
Madrid, Autonomous Community of	LT IDR	BBB Rating Outlook Positive	Affirmed	BBB Rating Outlook Stable
	ST IDR	F2	Affirmed	F2
	LC LT IDR	BBB Rating Outlook Positive	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

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Madrid, Autonomous Community of	EU Issued, UK Endorsed

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