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Research Update:

Canton of Basel-City Upgraded To 'AAA' On Greater Predictability Despite Tax Reforms; Outlook Stable

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Overview

- We believe that the management of Basel-City has built sufficient financial headroom to weather revenue losses coming from the national tax reform.
- We estimate that revenue shortfalls might result in small deficits from 2020, but will not lead to sustained debt accumulation.
- We are raising the long-term rating on Basel-City to 'AAA' from 'AA+'.
- The outlook is stable.

Rating Action

On Nov. 9, 2018, S&P Global Ratings raised its long-term issuer credit rating on the canton of Basel-City to 'AAA' from 'AA+'. At the same time, we affirmed our 'A-1+' short-term issuer credit rating. The outlook is stable.

We also raised to 'AAA' from 'AA+' our issue ratings on Basel-City's senior unsecured debt.

Outlook

The stable outlook on Basel-City reflects our expectation that the canton will be in good shape to digest the effects of the imminent corporate tax reform in Switzerland. We believe that the prudent cantonal management will keep temporary deficits small, leading to an overall stable debt burden for the canton over the next two years.

Downside scenario

All other things remaining equal, we could lower the rating if the cantonal management fails to exercise budgetary discipline and loosens its grip on financial performance. In addition, pressure on the ratings would build if the cantonal bank were to call upon the canton for support. However, we currently view this scenario as unlikely.

Rationale

The upgrade reflects our expectation that the canton is well prepared to face the upcoming challenges to its budgetary performance. A benign economic environment with sound tax revenues will enable the management to absorb the projected impact from the TP17 Swiss corporate tax reform without a substantial debt increase. In addition, the ongoing adaptions to the Swiss equalization system will help Basel-City to post only small deficits after capital accounts from 2020. The rating also benefits from the canton's excellent liquidity situation and high flexibility to alter its tax rates if unforeseen developments occur. We regard the canton's moderate but potentially sizable contingent liabilities from its stake in a commercial bank as a weakness.

Sound preparedness for upcoming challenges to cantonal finances

The institutional framework under which Swiss cantons operate provides equalization transfers to economically weaker cantons. Basel-City is one of only seven cantonal contributors to weaker cantons due to its very favorable economic and financial profile. Following a system evaluation, the federal government, together with the cantons, is aiming to reduce the total distributions payable under the equalization system for donor cantons like Basel-City by 2020. For 2019, the canton is obliged to pay Swiss franc (CHF) 125 million (about €110 million or equivalent to 2.9% of operating revenues) to other cantons. The Swiss cantons' institutional framework is mature and extremely predictable, in our view, with major reforms being planned well in advance and widely discussed, notably between the Confederation and the cantons, and among the cantons themselves.

The Swiss Confederation is currently preparing a nationwide corporate tax reform (TP17 or STAF, see "Related Research" below), which might take effect by 2020 if approved both in a national referenda and a cantonal vote. In short, the reform provides for the discontinuation of certain tax privileges of foreign holdings, domiciliary, and mixed companies. Basel-City receives a considerable amount of taxes from these special-status companies, and so is particularly affected by the reform.

Following various changes in the details of the reform, including increased transfers from the confederation and compensating measures on the social security side, we currently have more information on the likely financial effects of the reform on the canton. We believe that the cantonal management has created enough headroom in the cantonal finances to deal with the effects of the upcoming reform, indicating managerial strength. Our base-case scenario assumes more optimistic growth rates for revenues than the canton, which regularly outperforms its budgetary plans. We understand that a merger of hospitals with the neighboring canton of Basel-Country is under discussion, which could lead to efficiency gains in the medium term.

Basel-City is one of the wealthiest regions in the world. Wealth, measured by

GDP per capita, which we estimate at about CHF170,000 (equivalent to €150,000), is more than twice the national average and also exceptionally high in an international comparison. The city is home to some of the largest corporations in the pharmaceutical and chemical sector globally, which has proven to be relatively resilient over recent years. Ongoing diversification within the life science industry reduces the canton's exposure to a single subsector or product cycle. Moreover, the canton's tax revenues do not exhibit elevated volatility from the sector.

Upcoming small deficits will not increase moderately high debt

We expect Basel-City's budgetary performance to remain sound in 2018 and 2019. However, we believe that the upcoming tax code changes might lead to small deficits of 1.8% to 3.1% from 2020 to 2022, which is a structural deterioration to the surplus after capital accounts achieved recently. However, the canton's overall sound budgetary path will not be altered in our base-case, since past surpluses have built up sufficient headroom to cope with the temporary decrease in budgetary performance. In addition, Basel-City has consistently outperformed its financial plans, especially with the help of higher-than-budgeted tax revenues and sound budgetary discipline to keep expenditures under control. We note that the canton enjoys high flexibility to alter its tax rates if unforeseen developments arise. The canton reports a comfortably high share of modifiable operating revenues, at 86%, which also includes modifiable municipal taxes and is therefore higher than for most national peers. We estimate capital expenditures will increase to about 9% of total expenditures by 2022, reflecting the canton's current ambitious investment plan, which includes improvements to traffic infrastructure and harbor facilities.

We project Basel-City's stock of direct debt will hover around 90% of operating revenues through 2022. We view this ratio as moderate in an international comparison, but it exceeds the debt ratio of many of Basel-City's domestic, 'AAA' rated peers like Zurich and Vaud. In contrast to Vaud, Basel-City does not face pressures from pension obligations as the cantonal pension fund is fully funded. The canton does not have any outstanding debt denominated in foreign currency.

Basel-City has exceptional liquidity, in our view. Cash, liquid assets, and committed facilities cover more than 120% of debt service over the next 12 months. The canton has reduced its own cash levels, due to the current negative interest rate environment, but intends to keep a minimum liquidity level. To offset the low amount of liquid assets, Basel-City has signed a CHF900 million credit line with Basler Kantonalbank, which the canton may use during the year for daily cash management. Basel-City benefits from strong access to the deep, liquid Swiss capital market, as demonstrated by regular bond issues, even in times of heightened financial market volatility.

Basel-City's main contingent liability is Basler Kantonalbank, its cantonal bank, as the canton legally guarantees practically all of the bank's liabilities. In our opinion, Basel-City's creditworthiness could be harmed if

the bank called on the guarantee or had to rely on the canton for significant capital contributions. However, we currently view the likelihood of such a scenario as remote. The canton's other contingent liabilities, such as guarantees or stakes in dependent companies, are minor relative to operating revenues. We therefore assess the canton's contingent liabilities as moderate overall.

Key Statistics

Table 1

Basel-City (Canton of) Selected Indicators

(Mil. CHF)	--Year ending Dec. 31--						
	2015	**2016**	**2017**	**2018bc**	**2019bc**	**2020bc**	**2021bc**
Operating revenues	4,209	4,266	4,144	4,189	4,283	4,173	4,257
Operating expenditures	3,558	3,991	3,648	3,776	3,879	3,938	3,988
Operating balance	651	275	496	413	405	235	268
Operating balance (% of operating revenues)	15.5	6.4	12.0	9.8	9.4	5.6	6.3
Capital revenues	38	19	19	10	6	6	20
Capital expenditures	433	393	513	298	273	315	366
Balance after capital accounts	257	(98)	2	125	137	(74)	(78)
Balance after capital accounts (% of total revenues)	6.0	(2.3)	0.0	3.0	3.2	(1.8)	(1.8)
Debt repaid	1,408	1,392	300	803	400	600	250
Gross borrowings	879	1,981	200	740	293	674	328
Balance after borrowings	(272)	408	(184)	12	30	(0)	0
Modifiable revenues (% of operating revenues)	75.7	85.6	86.8	85.0	84.2	88.1	88.5
Capital expenditures (% of total expenditures)	10.8	9.0	12.3	7.3	6.6	7.4	8.4
Direct debt (outstanding at year-end)	3,268	3,926	3,772	3,709	3,602	3,676	3,754
Direct debt (% of operating revenues)	77.6	92.0	91.0	88.6	84.1	88.1	88.2
Tax-supported debt (outstanding at year-end)	3,268	3,926	3,772	3,709	3,602	3,676	3,754
Tax-supported debt (% of consolidated operating revenues)	77.6	92.0	91.0	88.6	84.1	88.1	88.2
Interest (% of operating revenues)	0.9	0.7	0.7	0.9	0.9	1.0	1.1
Local GDP per capita (CHF)	168,891	168,367	169,529	172,954	176,811	180,258	183,791
National GDP per capita (CHF)	78,569	78,436	78,803	81,353	83,151	84,974	86,827

The data and ratios above result in part from S&P Global Ratings' own calculations, drawing on national as well as international sources, reflecting S&P Global Ratings' independent view on the timeliness, coverage, accuracy, credibility, and usability of available information. The main sources are the financial statements and budgets, as provided by the issuer. bc--Base case reflects S&P Global Ratings' expectations of the most likely scenario.

Ratings Score Snapshot

Table 2

Ratings Score Snapshot	
Key Rating Factors	
Institutional framework	Extremely predictable and supportive
Economy	Very strong
Financial management	Very strong
Budgetary flexibility	Strong
Budgetary performance	Strong
Liquidity	Exceptional
Debt burden	Moderate
Contingent liabilities	Moderate

S&P Global Ratings bases its ratings on local and regional governments on the eight main rating factors listed in the table above. Section A of S&P Global Ratings' "Methodology For Rating Non-U.S. Local And Regional Governments," published on June 30, 2014, summarizes how the eight factors are combined to derive the foreign currency rating on the government.

Key Sovereign Statistics

- Sovereign Risk Indicators, Oct. 11, 2018. Interactive version available at http://www.spratings.com/sri

Related Criteria

- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings , April 7, 2017
- Criteria - Governments - International Public Finance: Methodology For Rating Non-U.S. Local And Regional Governments, June 30, 2014
- Criteria - Governments - International Public Finance: Methodology And Assumptions For Analyzing The Liquidity Of Non-U.S. Local And Regional Governments And Related Entities And For Rating Their Commercial Paper Programs, Oct. 15, 2009
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- International Public Finance Rating Trends: German, Austrian, And Swiss Local And Regional Governments, Oct. 22, 2018
- Will The Swiss Tax Reform Plan TP 17 Cost Some Cantons More Than Others? Aug. 29, 2018
- Default, Transition, and Recovery: 2017 Annual International Public Finance Default Study And Rating Transitions, June 11, 2018

- Research Update: Switzerland Ratings Affirmed At 'AAA/A-1+'; Outlook Stable, May 18, 2018
- Considerable Tax Inflows Will Curtail German, Swiss, And Austrian Local And Regional Government Borrowing In 2018, Feb. 22, 2018
- Banking Industry Country Risk Assessment: Switzerland, Nov. 6, 2017
- Institutional Framework Assessments For Non-U.S. Local And Regional Governments, Sept. 21, 2017
- Public Finance System Overview: Swiss Cantons, Nov. 3, 2016

In accordance with our relevant policies and procedures, the Rating Committee was composed of analysts that are qualified to vote in the committee, with sufficient experience to convey the appropriate level of knowledge and understanding of the methodology applicable (see 'Related Criteria And Research'). At the onset of the committee, the chair confirmed that the information provided to the Rating Committee by the primary analyst had been distributed in a timely manner and was sufficient for Committee members to make an informed decision. After the primary analyst gave opening remarks and explained the recommendation, the Committee discussed key rating factors and critical issues in accordance with the relevant criteria. Qualitative and quantitative risk factors were considered and discussed, looking at track-record and forecasts.

The committee's assessment of the key rating factors is reflected in the Ratings Score Snapshot above.

The chair ensured every voting member was given the opportunity to articulate his/her opinion. The chair or designee reviewed the draft report to ensure consistency with the Committee decision. The views and the decision of the rating committee are summarized in the above rationale and outlook. The weighting of all rating factors is described in the methodology used in this rating action (see 'Related Criteria And Research').

Ratings List

Upgraded; Ratings Affirmed

	To	From
Basel-City (Canton of)		
Issuer Credit Rating	AAA/Stable/A-1+	AA+/Positive/A-1+
Senior Unsecured	AAA	AA+

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Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.