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Research Update:

Canton of Basel-City Outlook Revised To Positive; 'AA+/A-1+' Ratings Affirmed

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Overview

- We believe that the management of the Swiss Canton of Basel-City is well-equipped to weather budgetary challenges stemming from the upcoming reform on corporate taxes, which, when implemented, might lead to revenue losses for Basel-City.
- Although the timing of implementation and exact effects on Basel-City are still to be decided, we believe the canton's stringent budgeting execution and meaningful flexibilities will help it sustain balanced accounts after capital expenditures at least until 2019.
- We are revising our outlook on Basel-City to positive from stable and affirming our 'AA+/A-1+' ratings on Basel-City.
- The positive outlook reflects our view that Basel-City's budgetary performance may exceed our base case, thanks to sound planning practices and the canton's high level of preparedness for the upcoming challenge.

Rating Action

On Nov. 10, 2017, S&P Global Ratings revised its outlook on the Swiss Canton of Basel-City to positive from stable and affirmed its 'AA+/A-1+' long- and short-term issuer credit ratings on the canton.

We also affirmed our 'AA+' issue ratings on Basel-City's senior unsecured debt.

Outlook

The positive outlook on Basel-City reflects our view of the canton's competent financial management and the likelihood that its management will be able to weather any budgetary repercussions of the upcoming nationwide tax reform without drawbacks to Basel-City's financial performance after 2020. The public discussion on the reform is currently ongoing, and consequently, the amounts of the potential revenue shortfalls resulting from the reform are unknown. We believe that the strong planning skills and apt budgeting execution of Basel-City's management speak to the likelihood that its management will implement measures to successfully cater for any adverse financial effects of the reform.

Upside Scenario

All other things remaining equal, we could raise our ratings on Basel-City if the management succeeds in creating budgetary headroom over the next two years to mitigate potential revenue losses. This would likely be an outperformance of our current base-case scenario and would further support our view of the canton's managerial strength and long-term financial planning.

Downside Scenario

We could revise the outlook back to stable if the canton's management does not adequately address the upcoming changes to the tax system. In addition, pressure on the ratings would build if its cantonal bank, Basler Kantonbank, were to call upon the canton for support. However, we currently view this scenario as unlikely.

Rationale

The rating on Basel-City reflects the extremely predictable and supportive institutional framework for Swiss cantons, its very strong local economy with outstandingly high GDP per capita and low unemployment rates, as well the canton's overall very sound financial situation. The rating also benefits from the canton's excellent liquidity situation. The canton's debt burden constrains the rating, as do its moderate but potentially sizable contingent liabilities related to Basler Kantonbank.

Delay of corporate tax reform grants management time to prepare

The canton of Basel-City is one of only six contributors to the Swiss equalization system, thanks to its very favorable economic and financial profile. In 2018, Basel-City will be obliged to pay Swiss franc (CHF) 124 million (about €107 million; equivalent to 3% of operating revenues) to the weaker cantons. The Swiss Confederation is currently preparing a nationwide corporate tax reform, which was originally scheduled to take effect by 2019. 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.

We understand that the reform process has slowed following a negative vote by the people in early 2017, and so the financial effects of an adapted reform attempt will not materialize before 2020. Currently the cantonal management expects yearly maximum shortfalls of tax revenues of about CHF140 million (3.4% of operating revenues), which, without compensating measures, would structurally deteriorate the canton's strong budgetary performance from 2020. We also note that the shortfalls are indicative only, and Basel-City's management might plan for various scenarios and take preventive actions to mitigate negative effects. In this regard, we see as positive Basel-City's competent management and we expect strict budget discipline to mitigate the adverse financial effects that could arise from the reform. Aside from stringent work to contain costs, we expect the canton to make use of its notable revenue flexibility to counter revenue shortfalls if the need arises.

In our view, Basel-City benefits from a very strong economy. The city is home to some of the most important corporations in the pharmaceutical and chemical sector globally. Accordingly, the canton's GDP per capita, which we estimate at about CHF170,000, is exceptionally high in an international comparison, making Basel-City one of the wealthiest regions in the world. Despite being heavily export dependent, the canton weathered the effects of the appreciation of the Swiss franc in 2015-2016, which indicates the low price-sensitivity of exports in our view.

Budgetary surpluses and excellent liquidity balance risks from moderate debt and contingent liabili-

ties

Basel-City has consistently outperformed its financial plans, especially with the help of higher-than-budgeted tax revenues. We note that a one-off transfer to the cantonal pension fund burdened the 2016 actual results, but the five-year average budgetary performance for Basel-City is stronger than for most Swiss peers, even when including this one-off item. We understand that the canton cushioned the effects from the change to the pension plan (to defined contributions from defined benefits) on active members and protect their acquired rights. We estimate that rising tax revenues will enable the canton to post positive results after capital accounts on average over 2017-2019, despite Basel-City's very ambitious investment plans for the upcoming years—with a peak of investments projected in 2017. The upcoming reform of the corporate tax taking effect from 2020 might lead to a structural deterioration, but should not alter the canton's overall sound budgetary performance.

We project Basel-City's stock of direct debt will hover around 90% of operating revenues through 2020. 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 Aargau, Vaud, and Zurich. The canton does not have any outstanding debt denominated in foreign currency. Basel-City is increasing the duration of its debt portfolio to benefit from the current low-interest environment.

Under the country's political framework, Swiss cantons enjoy a great amount of budgetary flexibility, which we assess as strong for Basel-City. The canton reports a comfortably high share of modifiable operating revenues of 83%, which also includes the modifiable municipal taxes. We estimate capital expenditures to make up 7%-9% of total expenditures in the upcoming years, reflecting the canton's current ambitious investment plan, which includes improvements to traffic infrastructure and educational facilities.

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. Moreover, our assessment of the canton's liquidity takes into account the strong access of all Swiss cantons to liquidity in the domestic market. In fact, the canton has reduced its own cash levels, due to the current low interest rate environment. Despite the reduction of liquid assets, however, we have not observed a deterioration in the canton's liquidity position. Basel-City has signed a CHF900 million credit line with its Basler Kantonalbank, which the canton uses multiple times 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 participations in dependent

companies, are minor relative to operating revenues. We therefore assess the canton's contingent liabilities as moderate overall.

Key Statistics

Table 1

(Mil. CHF)	—Fiscal year ending Dec. 31—					
	2014	2015	2016	2017bc	2018bc	2019bc
Operating revenues	3,985	4,209	4,266	4,086	4,129	4,188
Operating expenditures	3,620	3,558	3,991	3,659	3,714	3,833
Operating balance	365	651	275	427	415	355
Operating balance (% of operating revenues)	9.2	15.5	6.4	10.4	10.1	8.5
Capital revenues	39	38	19	75	15	12
Capital expenditures	354	433	393	446	357	312
Balance after capital accounts	50	257	-98	56	73	55
Balance after capital accounts (% of total revenues)	1.2	6.0	(2.3)	1.3	1.8	1.3
Debt repaid	1,001	1,408	1,392	300	803	400
Gross borrowings	1,239	879	1,981	316	780	401
Balance after borrowings	288	(272)	408	1	0	29
Modifiable revenues (% of operating revenues)	78.3	75.7	85.6	85.6	86.3	85.9
Capital expenditures (% of total expenditures)	8.9	10.8	9.0	10.9	8.8	7.5
Direct debt (outstanding at year-end)	3,797	3,268	3,926	3,755	3,732	3,731
Direct debt (% of operating revenues)	95.3	77.6	92.0	91.9	90.4	89.1
Tax-supported debt (outstanding at year-end)	3,797	3,268	3,926	3,755	3,732	3,731
Tax-supported debt (% of consolidated operating revenues)	95.3	77.6	92.0	91.9	90.4	89.1
Interest (% of operating revenues)	1.3	0.9	0.7	0.9	0.9	1.1
Local GDP per capita (CHF)	163,632	162,389	161,967	163,522	167,299	170,812
National GDP per capita (CHF)	78,872	78,507	78,268	78,541	79,717	81,154

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. CHF—Swiss franc.

Ratings Score Snapshot

Table 2

Canton of Basel-City Ratings Score Snapshot

Key rating factors

Institutional framework	Extremely predictable and supportive
Economy	Very strong
Financial management	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 rating.

Key Sovereign Statistics

- Sovereign Risk Indicators - October 13, 2017. An interactive version is also available at <http://www.spratings.com/sri>.

Related Criteria And Research

Related Criteria

- 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 - October 15, 2009
- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings - April 07, 2017

Related Research

- Sovereign Risk Indicators - October 13, 2017. An interactive version is also available at <http://www.spratings.com/sri>.
- Institutional Framework Assessments For Non-U.S. Local And Regional Governments - September 21, 2017
- Research Update: Switzerland Ratings Affirmed At 'AAA/A-1+' ; Outlook Stable - May 19, 2017
- Default, Transition, and Recovery: 2016 Annual Non-U.S. Local And Regional Government Default Study And Rating Transitions - May 08, 2017
- Refinancing Needs Continue To Dominate German, Swiss, And Austrian Local And Regional Government Borrowing In 2017 - February 23, 2017
- Public Finance System Overview: Swiss Cantons - November 03, 2016
- Banking Industry Country Risk Assessment: Switzerland - September 02, 2016

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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 agreed that all key rating factors were unchanged.

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

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

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.

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