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Research Update:

Swiss Canton Of Aargau Ratings Affirmed at 'AAA/A-1+'; Outlook Remains Negative

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Research Update:

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Overview

- The Swiss Canton of Aargau is likely to face more years of lower than initially forecast tax receipts and increasing costs.
- Our base case assumes that the canton will respond to these challenges with a sufficiently sized program of savings measures and structural reforms, including a potential increase in the cantonal tax multiplier.
- Accordingly, we are affirming our 'AAA/A-1+' long- and short-term ratings on Aargau.
- The negative outlook reflects the risk that the canton could delay or not fully implement the envisaged savings and reform measures, causing us to lower our assessment of the canton's financial management and leading to marginally weaker budgetary performance.

Rating Action

On July 21, 2017, S&P Global Ratings affirmed its 'AAA/A-1+' long- and short-term issuer credit ratings on the Canton of Aargau. The outlook remains negative.

Outlook

The negative outlook reflects the risk that, relative to forecast unfavorable developments regarding tax revenue and expenditures, the execution of various savings measures could be insufficient to prevent a further drop in the canton's already slightly negative balance after capital accounts.

Downside Scenario

We could consider a negative rating action if there is a delayed or only partial implementation of savings measures, possibly in conjunction with a weaker development of exogenous factors, in particular tax collections and hospital costs . This would weigh on the canton's budgetary performance and could lead us to revise downward our assessment of the canton's financial management over the next 12 months.

Upside Scenario

We could revise the outlook on Aargau back to stable if we came to the conclusion that a sufficient volume of savings measures and structural reforms will actually be implemented to sustainably prevent further structural deterioration of budgetary results. This would require strong political (including parliamentary) and managerial commitment to consolidation measures and their timely implementation, as well as improved visibility of their effectiveness regarding stabilizing the budget.

Rationale

Our base-case scenario assumes that the canton will take more forceful steps to offset various anticipated negative exogenous effects on the budget with an array of savings measures, as well as deeper structural reforms. As a result, we expect that budgetary performance will be confined to moderate deficits after capital accounts, the cantonal debt ratio will not rise rapidly, and liquidity will not come under any pressure. Failure to act decisively would, however, widen deficits somewhat, increase debt, and could weigh on our assessment of the canton's financial management.

Despite a strong economic backdrop, budgetary challenges require a determined response

With real GDP per capita of about Swiss francs (CHF) 61,000 (equivalent to about U.S. $62,500), a growing population, and sufficient sectoral diversification, the Canton of Aargau operates in what we consider to be a very strong economic environment. We estimate regional real GDP growth for 2017 at 2.0%, exceeding our expectation of 1.6% for the Swiss Confederation as a whole.

Under the very supportive institutional framework, Aargau, like all Swiss cantons, can set effective rates for personal income and corporate profit taxes in order to finance its significant responsibilities (e.g. for police, education, health, and social care). However, with its resource potential at 87% of the Swiss average, the canton is also a recipient of significant funds from the national fiscal equalization scheme. Aargau stands to receive CHF259 million in 2017, rising to CHF336 million in 2018, under the scheme.

Despite this positive backdrop, Aargau has experienced three years (2014 to 2016) where the fiscal outcome fell short of the target for the respective period. To date, the canton has reacted by putting together short-term savings programs that were then implemented to varying degrees.

However, with 2016 budgetary results confirming a fairly significant drop in tax receipts, continued higher costs (e.g. for cantonal hospitals), and no automatic or immediate budgetary improvements, the newly-elected finance director has commissioned a more strategic review. This comprehensive 10-year plan aims to identify the amount of savings required to restore budgetary balance and propose concrete measures to be employed in pursuit of this goal. The new "roadmap" includes various expenditure cuts that fall under the discretion of the canton's executive, a series of measures requiring approval from the regional parliament (including an increase of the cantonal tax multiplier by 5% from 2019 onward), and additional fiscal revenues (most importantly a so far unbudgeted CHF145 million for the prolongation of the Klingnau hydropower plant concession and the temporary redirection of proceeds currently still earmarked for retiring past special-purpose financings).

Under our base-case scenario, we assess the canton's financial (and political) management as very strong and, in particular, able to identify and implement suitable strategies to counteract the threat of any larger structural imbalances.

Accordingly, our base case assumes a timely and near full execution of the various savings and structural reform measures outlined.

On the contrary, if there were any significant delays to or omissions from the consolidation strategy, we could reassess our view of the canton's financial management. In particular, we regard the proposal to increase the cantonal tax multiplier as a litmus test of the administration's political strength and ability to manage revenues versus expenditures, even under adverse conditions. While we do not expect the proposed 5 percentage point increase to be fully granted by the legislators (a 1 percentage point increase of the multiplier was rejected as recently as December 2016), we could interpret a significant shortfall--if not compensated by alternative savings measures--as a sign that the administration's control over the canton's fiscal strategy is weaker than our base case assumes.

Savings measures should contain deficits, keeping debt low

Regarding budgetary performance and flexibility, we forecast that Aargau will continue to display average results.

Under our base-case scenario, future budget execution over the forecast horizon will be affected by lower-than-budgeted tax revenues and concession fees (a reduction of CHF50 million to CHF80 million per year versus the canton's published 2017-2020 budget/financial planning), as well as rising hospital costs (an increase of CHF30 million to CHF 40 million per year). This will be mitigated by better-than-budgeted fiscal equalization receipts (about CHF60 million to CHF70 million per year versus the budget), gains from increasing the tax multiplier by an assumed 3 percentage points from 2019 onward (about CHF55 million per year), and the expected Klingnau concession prolongation payment.

We assume that the canton's various countermeasures should partially reverse any detrimental developments. Accordingly, we forecast results to fall short of the current budget/medium-term financial plan by no more than about CHF70 million per year. The receipt of CHF145 million for extending the Klingnau hydropower plant concession in 2018 is a pivotal "bridging item" in this context, buying the canton time until more structural measures can be implemented and bear fruit. Overall, our base case implies that the cantonal operating balance will--excluding the Klingnau-related one-off revenues--display surpluses of 3%-4% over the forecast horizon. The balance after capital accounts is likely to reflect a deficit of 0.5%-3.0% during this time, in our view.

As a possible downside scenario, various negative developments such as tax revenue shortfalls and cost increases could occur with greater magnitude, while additional revenues and savings measures could be delayed and reduced. We also assume a tax multiplier increase of only 1%. Consequently, we forecast Aargau's operating balance, under our downside scenario, to weaken toward 0.3%-2.0% of operating revenues (excluding Klingnau), while deficits after capital accounts should widen to beyond the 5% threshold of total revenues in 2020.

As a result of the expected budgetary performance, we forecast the ratio of tax supported debt to consolidated operating revenues to rise moderately to 40% by 2020 from its 2016 year-end value of 39%, and to 48% under our alternative downside case scenario. We regard these values as still low compared to peers.

We view the canton's liquidity as exceptional, reflecting not only CHF225 million of cash held as of May 2017 (reduced to avoid negative interest rates), but primarily more than CHF1 billion in counterparty credit lines. These compare to projected annual debt maturities of CHF385 million-CHF670 million per year over the forecast horizon, assuming that CHF300 million of short-term debt is continuously rolled over.

As reflected by the canton's public bond issuances, the most recent being two tranches totaling CHF250 million in February 2017, the canton continues to enjoy strong access to external liquidity via the capital markets.

Our analysis factors in a moderate volume of contingent liabilities. We attribute these primarily to Aargauische Kantonalbank, 100% owned by the canton and equipped with a statutory cantonal guarantee for its liabilities. We regard the likelihood of the guarantee being called as low, due to its own strong credit characteristics.

Our analysis also factors in the situation at AXPO Holding AG, where the canton directly and indirectly holds a 28% stake in the energy generation and trading group. After write-downs due to extremely low energy price levels, a split into two separate companies could require a capital injection. However, we understand that no direct participation of the cantonal budget is currently planned.

Key Statistics

Table 1

Canton of Aargau Key Statistics

	--Fiscal year end Dec. 31--						
(Mil. CHF)	**2014**	**2015**	**2016**	**2017bc**	**2018bc**	**2019bc**	**2020bc**
Operating revenues	4,303	4,500	4,471	4,574	4,803	4,811	4,854
Operating expenditures	4,271	4,342	4,400	4,431	4,542	4,622	4,691
Operating balance	32	158	71	143	261	188	164
Operating balance (% of operating revenues)	0.7	3.5	1.6	3.1	5.4	3.9	3.4
Capital revenues	61	95	111	98	125	105	105
Capital expenditures	215	266	277	265	346	380	410
Balance after capital accounts	(122)	(13)	(95)	(24)	40	(86)	(141)
Balance after capital accounts (% of total revenues)	(2.8)	(0.3)	(2.1)	(0.5)	0.8	(1.8)	(2.8)
Debt repaid	365	690	415	670	410	385	450
Gross borrowings	493	680	500	650	370	475	600
Balance after borrowings	6	(23)	(10)	(44)	0	4	9

Table 1

Canton of Aargau Key Statistics (cont.)

	--Fiscal year end Dec. 31--						
(Mil. CHF)	**2014**	**2015**	**2016**	**2017bc**	**2018bc**	**2019bc**	**2020bc**
Modifiable revenues (% of operating revenues)	65.0	61.4	61.6	61.1	62.1	60.7	61.5
Capital expenditures (% of total expenditures)	4.8	5.8	5.9	5.7	7.1	7.6	8.0
Direct debt (outstanding at year-end)	1,600	1,590	1,675	1,655	1,615	1,705	1,855
Direct debt (% of operating revenues)	37.2	35.3	37.5	36.2	33.6	35.4	38.2
Tax-supported debt (outstanding at year-end)	1,751	1,744	1,884	1,864	1,824	1,914	2,064
Tax-supported debt (% of consolidated operating revenues)	37.4	35.7	38.8	37.6	35.1	36.8	39.4
Interest (% of operating revenues)	0.9	0.7	0.5	0.4	0.3	0.3	0.3
Local GDP per capita (single units)	61,959	61,488	61,329	61,917	63,348	64,678	66,159
National GDP per capita (single units)	78,148	77,526	77,248	77,829	79,084	80,596	82,323

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. Base case reflects S&P Global Ratings' expectations of the most likely scenario. Downside case represents some but not all aspects of S&P Global Ratings' scenarios that could be consistent with a downgrade. Upside case represents some but not all aspects of S&P Global Ratings' scenarios that could be consistent with an upgrade.

Ratings Score Snapshot

Table 2

Canton of Aargau Ratings Score Snapshot

Key Rating Factors	
Institutional Framework	Extremely predictable and supportive
Economy	Very strong
Financial Management	Very strong
Budgetary Flexibility	Average
Budgetary Performance	Average
Liquidity	Exceptional
Debt Burden	Low
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, July 6, 2017. Interactive version available at http://www.spratings.com/sri

Related Criteria And Research

Related Criteria

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

Related Research

- Research Update: Switzerland Ratings Affirmed At 'AAA/A-1+'; Outlook Stable - May 19, 2017
- Refinancing Needs Continue To Dominate German, Swiss, And Austrian Local And Regional Government Borrowing In 2017 - February 23, 2017
- Default, Transition, and Recovery: 2016 Annual Non-U.S. Local And Regional Government Default Study And Rating Transitions - May 08, 2017
- Public Finance System Overview: Swiss Cantons- November 03, 2016
- Banking Industry Country Risk Assessment: Switzerland - September 02, 2016
- Aargauische Kantonalbank – September 29, 2016
- Research Update: Swiss Canton Of Aargau Outlook Revised To Negative; Ratings Affirmed At 'AAA/A-1+' – July 22, 2016
- Institutional Framework Assessments For Non-U.S. Local AndRegional Governments - April 21, 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

	Rating	
	To	From
Aargau (Canton of)		
Issuer Credit Rating		
Foreign and Local Currency	AAA/Negative/A-1+	AAA/Negative/A-1+
Senior Unsecured		
Local Currency	AAA	AAA

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.globalcreditportal.com and at spcapitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public Web site 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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