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Research Update:

Swiss Canton of Aargau Long-Term Rating Lowered To 'AA+' From 'AAA' On Weaker Financial Management; Outlook Stable

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Overview

- The Swiss Canton of Aargau retains, in our view, a structural deficit of about CHF150 million per year, although we expect this will be completely masked in 2018 and 2019 by nonrecurring revenue items and various current savings measures.
- The canton has so far not put in place a sufficient volume of budgetary measures that would sustainably close this gap from 2020, while taking other policy decisions that we believe could create future burdens. Together, we view this as a sign of weaker financial management.
- We are lowering our long-term rating on Aargau to 'AA+' from 'AAA', and affirming our 'A-1+' short-term rating.
- The outlook is stable.

Rating Action

On July 20, 2018, S&P Global Ratings lowered its long-term issuer credit rating on the Swiss Canton of Aargau to 'AA+' from 'AAA'. The outlook is stable. We also affirmed our 'A-1+' short-term issuer credit rating on the canton.

Outlook

Our stable outlook on Aargau reflects our view that, despite uncertainty about the form, timing, and extent of savings measures and structural reforms, the canton will not allow deficits to widen and its debt burden to rise materially above our current forecast. Furthermore, we assume a continuation of the canton's prudent liquidity management and no significant changes to the perceived level of contingent liabilities.

Downside scenario

We could consider a negative rating action on Aargau if, relative to the development of the general fiscal environment and external factors, the canton's administration relented in its focus on budgetary savings measures and structural reforms. A negative rating action could also result if the political debate, particularly ahead of the 2020 cantonal election, hampered management's ability to execute its agenda of fiscal stability to a greater extent than we currently assume. If this were sufficient to materially weaken budgetary performance and the expected debt burden trajectory, we would likely also revise downward our assessment of the canton's financial management. However, we currently view such a scenario as unlikely.

Upside scenario

A positive rating action on the canton could be the result of Aargau's parliament and administration finalizing expenditure reductions, revenue increases, and/or structural reforms that we deem to be of sufficient size and permanence to ensure a sustainable and robust return to surpluses after capital accounts also in 2020 and beyond. Such developments would, in our view, signal an improvement in the canton's financial management.

Rationale

We estimate that nonrecurring effects, next to ongoing savings measures, should result in small surpluses after capital accounts for the Canton of Aargau in 2018 and 2019. However, in our view, these mask an outstanding structural deficit of about Swiss franc (CHF)150 million ($152 million). The cantonal government and parliament have so far not passed measures that, in our view, would be sufficient to sustainably cover this underlying deficit from 2020.

We are furthermore concerned that actions taken due to current budgetary constraints might create future burdens. We consider the canton's response to the Swiss corporate tax reform plan SV 17 as the most relevant item in this respect, since it may reduce the attractiveness of the canton as a business location, in our view. Additionally, Aargau's hospitals are embarking on major refurbishment projects that they will finance by issuing debt independently in the capital markets, instead of relying on transfers from Aargau's budget, which we would view as providing a more transparent picture of the canton's consolidated debt position. Therefore, we now view Aargau's financial management as strong, rather than very strong as previously.

Despite a strong economic and institutional backdrop, management continues to face clear challenges

Our ratings on Aargau are firmly supported by the very strong regional economy and the extremely beneficial institutional framework for Swiss cantons.

With a GDP per capita of about CHF61,800 as of 2017 (about $62,700), Aargau ranks ahead of most international peers, although this amounts to only 78% of the Swiss average. Going forward, we expect GDP growth in the canton will broadly resemble that of Switzerland as a whole, implying a persistence of the current relatively high level, but also of the gap to the national average.

We consider a series of announced production plant closures/transfers and labor force reductions, such as those at the local facilities of GE, Roche, Rockwell, and Meyer Burger, in recent months as signs of the specific challenges faced by a canton like Aargau, where traditional industrial production is of above-average relevance (about 61% of GDP). We note, however, that unemployment in Aargau (2.9% as of March 2018) remains very low, and that new business formations continue to outnumber insolvencies.

With significantly rising payments received from the Swiss national fiscal equalization mechanism (NFA), Aargau increasingly benefits from the advanced institutional framework under which Swiss cantons operate. The relevant measurement, the canton's resource index (basically a measure of the canton's per capita tax base relative to all other Swiss cantons) fell to 83.8% (tentative value, formal validation by Swiss government still outstanding) for 2019 from 89.2% for 2015. While this increases receipts under the NFA to CHF408 million (almost 9% of adjusted operating revenues), the drop in index value also indicates that Aargau's economic strength and the average wealth of its inhabitants are falling further behind that of richer cantons. We estimate that the lack of affluent residents, for instance when compared with Zurich, is one of the root causes for the canton's structural fiscal constraints. With a reform of the NFA planned for 2020, Aargau stands to lose about CHF30 million-CHF60 million annually, depending on which of the currently discussed reform variants is implemented.

We continue to recognize that Aargau's financial management is acting prudently and undertaking very strong efforts to stabilize the cantonal budget. Nonetheless, despite surpluses realized in 2017 and forecast for 2018-2019 from various nonrecurring budget items as well as numerous savings initiatives, a structural deficit of about CHF150 million remains, as the canton freely admits. Final parliamentary agreement for structural revenue increases or expenditure cuts that can sustainably and comprehensively cover this deficit, also under less benign economic conditions, is still outstanding, despite a long ongoing political debate. Two attempts by the administration to get parliamentary approval for a hike in the cantonal tax multiplier as a key revenue-side measure were rejected by parliament in 2016 and 2017. With positive "one-offs" currently masking the structural deficit, 2020 being an election year in Aargau, and the conservative parties (SVP, CVP, FDP, together holding a majority in parliament) having voiced a preference for expenditure cuts over tax hikes, we see the canton's flexibility in financial management as being constrained by the political environment. Additionally, we are now more concerned than previously that short-term budgetary considerations (cantonal debt brake, political preference for savings over revenue increases, etc.) are increasingly tying the cantonal administration's hands and could lead to longer-term burdens. The canton's proposal for the local implementation of the Swiss tax reform project SV 17 and the high-volume capital-market borrowing plans of the two cantonal hospitals illustrate this risk, in our view.

Unlike its neighboring cantons, Aargau's financial management proposes only minimal cuts of 0.4 percentage points to its statutory corporate profit tax rates in response to the planned abolishment of preferential tax treatment for special status companies under SV 17. We understand limited budgetary leeway may be a key driver of this course of action, but believe this may weaken the canton's competitive position as a location for business going forward.

Similarly, the two cantonal hospitals (Aarau and Baden) are simultaneously embarking on refurbishment projects together totaling over CHF1 billion, all to be fully financed with commercial debt directly on their balance sheets despite limited earnings. This signals to us a somewhat less stringent approach to, and control over, subsidiary borrowing than so far assumed. Again, we believe budgetary considerations to have also played a role in the decision to rely on capital market rather than cantonal funds.

Overall, we lowered our rating on Aargau due to our perception that the canton's otherwise very prudent and capable financial management is acting under increasingly tighter constraints, which carries a greater risk of making suboptimal long-term decisions, in our view.

Borrowing by consolidated subsidiaries and forecast deficits drive up debt burden modestly

Aargau's budgetary flexibility is characterized by a comparatively high proportion of modifiable tax revenues relative to peers from other Germany-speaking countries outside of Switzerland; it can set the effective rates for about 50% of operating revenues. That said, the canton displays only a moderate volume of capital expenditures relative to total expenditures (only about 6%-7%), which leaves less room to lower spending.

An array of nonrecurring or temporary events characterized Aargau's 2017 budgetary performance, including a significantly higher-than-budgeted distribution from the Swiss National Bank (SNB), very strong revenues from withholding taxes collected and transferred by the Swiss Federation, high-than-usual inheritance taxes, lower-than-anticipated subsidies for health insurance premiums, and underutilization of the budget for capital expenditures. Aargau estimates that these events together amount to CHF120 million in volume. Consequently, Aargau managed to close 2017 with an operating surplus of 7% of operating revenues, and a surplus after capital accounts of almost 4% of total revenues, according to our cash-focused calculation methodology.

Going forward, we expect smaller surpluses after capital accounts of 1.2% and 1.5% to materialize in 2018 and 2019, respectively. This will be driven by the positive momentum from 2017 carrying over into 2018 (in particular, the continuation of strong withholding tax revenue receipts, and the SNB making a record profit distribution), and 2019 benefitting from an extraordinary inflow of CHF145 million for the (delayed) prolongation of the Klingnau hydropower plant concession.

However, further out into our forecast horizon, we predict that Aargau's underlying and so far not fully addressed structural deficit will become apparent, leading to deficits after capital accounts of 3.9% and 2.7%, respectively, for 2020 and 2021 (we exclude noncash items, particularly the release of accounting reserves). The conservative assumption that Aargau will not pass any tax multiplier increases for 2020 and 2021 constitutes a key modelling input for this forecast.

Our forecast that Aargau's tax-supported debt will rise to about 48% of consolidated operating revenues by 2021 reflects the inclusion of the Aarau cantonal hospital's expected new borrowings of CHF600 million. We are making a deliberate distinction between the cantonal hospitals in Baden (included only as a contingent liability) and Aarau (added to tax-supported debt) based on our perception of higher profitability and debt-carrying capacity at the Baden hospital. Overall, we continue to consider the canton's debt burden as low in an international comparison.

Under any scenario, Aargau's liquidity will remain excellent, in our view. Cash held (CHF267 million per year-end 2017), immediately available bank credit lines of CHF320 million, and more than CHF1 billion in counterparty credit lines for capital market borrowing operations compare with annual debt maturities of CHF335 million-CHF400 million over our 2018-2021 forecast horizon. This assumes CHF250 million of short-term debt to be continuously rolled over. The canton's proven access to bond-market financing is a further positive factor in our assessment of liquidity.

Our analysis continues to factor in a moderate volume of contingent liabilities. Aargauische Kantonalbank, owned 100% by the canton and equipped with a statutory cantonal guarantee, is the biggest component of this assessment. However, we regard the likelihood of the guarantee being called as low, due to the bank's strong own credit characteristics (we assess the bank's stand-alone credit profile at 'a+'). Planned borrowings of CHF450 million at the Baden cantonal hospital for refurbishments and new buildings, as well as Aargau's direct and indirect 28% stake in energy generation and trading group AXPO Holding AG are further prominent elements of our contingent liabilities assessment. However, for the latter, a plan to split into two separate companies, which might require additional capital, seems to have been shelved for now.

Key Statistics

Table 1

Canton of Aargau Key Statics

	--Fiscal year end Dec. 31--						
	2015	**2016**	**2017**	**2018bc**	**2019bc**	**2020bc**	**2021bc**
(Mil. CHF)							
Operating revenues	4,500	4,471	4,713	4,717	4,749	4,750	4,853
Operating expenditures	4,342	4,400	4,376	4,497	4,594	4,667	4,740

Table 1

Canton of Aargau Key Statics (cont.)							
	--Fiscal year end Dec. 31--						
	2015	**2016**	**2017**	**2018bc**	**2019bc**	**2020bc**	**2021bc**
(Mil. CHF)							
Operating balance	158	71	336	220	155	83	112
Operating balance (% of operating revenues)	3.5	1.6	7.1	4.7	3.3	1.7	2.3
Capital revenues	95	111	94	95	245	108	105
Capital expenditures	266	277	240	257	328	382	352
Balance after capital accounts	(13)	(95)	189	58	73	(191)	(134)
Balance after capital accounts (% of total revenues)	(0.3)	(2.1)	3.9	1.2	1.5	(3.9)	(2.7)
Debt repaid	690	415	670	390	335	400	400
Gross borrowings	680	500	620	332	262	591	534
Balance after borrowings	(23)	(10)	139	0	(0)	0	(0)
Modifiable revenues (% of operating revenues)	61.4	61.6	60.4	59.3	60.2	61.5	61.8
Capital expenditures (% of total expenditures)	5.8	5.9	5.2	5.4	6.7	7.6	6.9
Direct debt (outstanding at year-end)	1,590	1,675	1,625	1,567	1,494	1,685	1,819
Direct debt (% of operating revenues)	35.3	37.5	34.5	33.2	31.5	35.5	37.5
Tax-supported debt (outstanding at year-end)	1,744	1,884	1,881	1,928	1,960	2,257	2,496
Tax-supported debt (% of consolidated operating revenues)	35.7	38.8	36.9	37.8	38.2	43.9	47.6
Interest (% of operating revenues)	0.7	0.5	0.4	0.3	0.3	0.3	0.3
Local GDP per capita (single units)	61,689	61,497	61,762	62,972	64,087	65,266	66,506
National GDP per capita (single units)	78,507	78,268	78,811	80,407	82,209	83,822	85,472

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 francs.

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	Strong
Budgetary flexibility	Weak
Budgetary performance	Average
Liquidity	Exceptional
Debt burden	Low

Table 2

Canton of Aargau Ratings Score Snapshot (cont.)	
Key rating factors	
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 5, 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

- 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 - February 22, 2018
- International Public Finance Rating Trends: German, Austrian, And Swiss Local And Regional Governments - November 1, 2017
- Public Finance System Overview: Swiss Cantons- November 03, 2016
- Banking Industry Country Risk Assessment: Switzerland – November 06, 2017
- Full Analysis: Aargauische Kantonalbank – September 13, 2017
- Research Update: Swiss Canton Of Aargau Ratings Affirmed at 'AAA/A-1+'; Outlook Remains Negative – July 21, 2017
- Institutional Framework Assessments For Non-U.S. Local And Regional Governments - April 21, 2016
- Default, Transition, and Recovery: 2017 Annual International Public Finance Default Study And Rating Transitions – June 11, 2018

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

Downgraded; Rating Affirmed		
	To	From
Aargau (Canton of)		
Issuer Credit Rating	AA+/Stable/A-1+	AAA/Negative/A-1+
Downgraded		
Aargau (Canton of)		
Senior Unsecured	AA+	AAA

Additional Contact:
International Public Finance Ratings Europe; PublicFinanceEurope@spglobal.com

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.