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CREDIT OPINION
7 September 2018

Update

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RATINGS

Abruzzo, Region of

Domicile	Italy
Long Term Rating	Baa3 , Possible Downgrade
Type	LT Issuer Rating
Outlook	Rating(s) Under Review

Please see the ratings section at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

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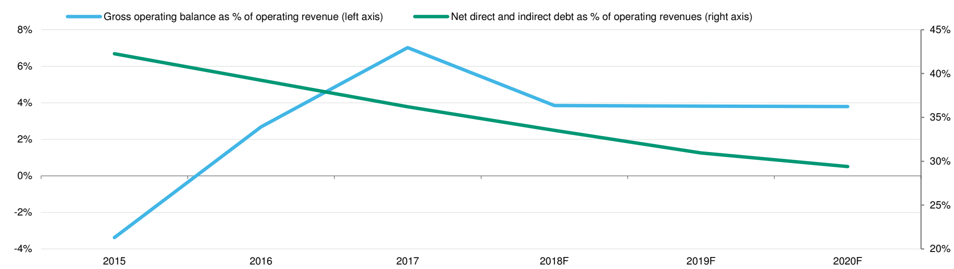
Region of Abruzzo (Italy)

Update to credit analysis

Summary

The credit profile of the Region of Abruzzo (Abruzzo, Baa3 RUR-) reflects the region's satisfactory budgetary performance, which benefits from balanced healthcare accounts and the regional administration's consolidation efforts in recent years. The credit profile also reflects the moderate debt burden and high degree of fiscal rigidity affecting the regional budget, both of which are expected to ease in the future. The region's liquidity is adequate, although its cash reserves are almost entirely earmarked. Abruzzo's credit profile also benefits from strong extraordinary support from the Government of Italy (Baa2 RUR-).

Exhibit 1
Debt likely to continue to decline, along with a stabilising operating margin



F = Forecast.
Sources: Issuer, Moody's Investors Service

Credit strengths

» Satisfactory budgetary performance

» Balanced healthcare accounts

» Adequate liquidity

Credit challenges

» Narrow economic base

» Moderately high, but declining, debt levels

» Lingering off-balance-sheet financial risks

Rating outlook

The review for possible downgrade reflects close institutional, economic and financial links between Italian regional and local governments (RLGs) and the central government.

Factors that could lead to a downgrade

We would consider downgrading the rating of Abruzzo in case of a downgrade of Italy's sovereign rating, a material deterioration in the funding framework of Italian RLGs, and/or any sharp deterioration in the issuer's debt or liquidity metrics during the review period.

Factors that could lead to the confirmation of the rating

We would consider a confirmation of Abruzzo's rating in case of a confirmation of Italy's sovereign rating, and/or no material changes in the funding framework of Italian RLGs during the review period.

Key indicators

Exhibit 2
Region of Abruzzo
Year ending December 31

Region of Abruzzo

	2015PC	2016PC	2017PC	2018F	2019F	2020F
Net direct and indirect debt as % of operating revenues	42.3	39.2	36.4	33.8	31.3	29.7
Cash financing surplus (requirement) as % of total revenue	-5.6	8.6	5.9	-	-	-
Gross operating balance as % of operating revenue	-3.4	2.7	7.0	3.9	3.8	3.8
Interest payments as % of operating revenue	2.2	1.9	1.8	1.9	1.8	1.7
Intergovernmental transfers as a % of operating revenues	69.5	70.0	70.2	71.3	71.4	71.4
Capital spending as a % of total expenditures	6.0	7.5	6.6	11.9	14.4	2.1
GDP per capita as a % of national average	86.5	86.0	86.0	-	-	-

PC = Pre-closing, F = Forecast.
Sources: Issuer, Moody's Investors Service

Detailed credit considerations

On 29 May 2018, we placed the Region of Abruzzo on review for possible downgrade, following a corresponding action on Italy's government bond rating on 25 May. This placement reflects the close institutional, economic and financial links between Italian RLGs and the central government.

The credit profile of Abruzzo, as expressed in its Baa3 RUR- rating, combines (1) a Baseline Credit Assessment (BCA) of ba1, and (2) a strong likelihood of extraordinary support from the central government if the region were to face acute liquidity stress.

Baseline Credit Assessment

Satisfactory budgetary performance

Abruzzo recorded volatile operating results in recent years, reflecting state-induced revenue dynamics and a rigid cost structure dominated by healthcare. In 2017, the region achieved a slight operating surplus of 7%, compared with a 3.4% deficit in 2015. This improvement underlines the administration's efforts towards fiscal consolidation and the latest efficiencies registered in the healthcare balance.

Furthermore, the full amortisation of healthcare-related structured transactions issued in 2005-07 enabled Abruzzo to regain €42 million in 2015 and €21 million 2016. This creates additional room in the regional budget in the near future, with the help of balanced healthcare accounts and continued control on operating expenditure. Historically, the management of other key regional responsibilities, such as local transportation, has not exerted significant pressure on the regional budget and has had a modest impact on the region's debt and operating expenditure.

Following the introduction of new accounting principles ex *Decreto Legislativo 118/2011*, the Court of Accounts rejected Abruzzo's 2013 statement of accounts because of the miscalculation of the region's budgetary deficit. Since then, only 2013's accounts have been audited, with the 2014-17 accounts still carrying a pre-closing, unaudited status. The financial performance of Abruzzo should remain unaffected by this audit review.

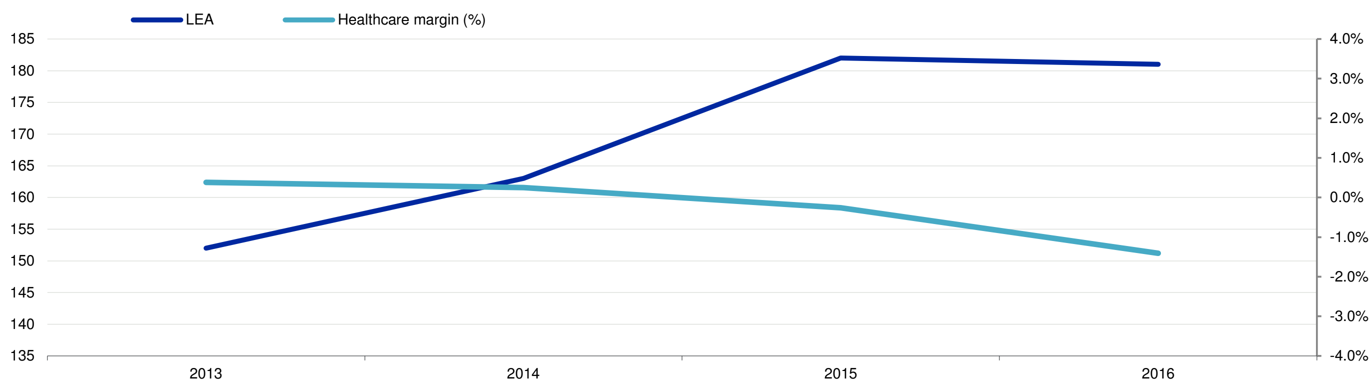
Balanced healthcare accounts

In 2017, the healthcare sector represented a high 87% of the regional budget. The region is keeping healthcare expenses under tight control. While we positively note the region's success in curbing operating deficits and cleaning up the budgets of its healthcare entities, this sector will continue to strain the regional budget. The cost rationalisation imposed by the national government will likely force all regions to further trim their expenditure.

The regional administration has been effective in improving fiscal discipline and transparency in the healthcare sector. Abruzzo's Livelli Essenziali di Assistenza (LEAs), the national healthcare scoring system, were exceptionally high in 2015 (last available data) at 182 points, the highest in the region's history. The sector margin, however, became slightly negative in 2015 and it is currently following a downward trend. This is mainly due to temporary planned increases in the expenses - bringing the services up to satisfactory quality levels. If this trend reverts going forward, there is a high likelihood that the region will exit the government-imposed healthcare recovery plan in the medium term.

Exhibit 3

The quality of the healthcare service improved significantly while healthcare margin became negative in 2015



LEA: Livelli Essenziali di Assitenza, indicator of the quality of healthcare service
Margin restated after the central government's review "Tavolo di monitoraggio".
Sources: Region of Abruzzo, Moody's Investors Service

Adequate liquidity

Historically, Abruzzo's monthly cash balance has adequately covered its ordinary expenditure, including its debt-service costs. In 2017, Abruzzo's cash balance amounted to €369 million, equivalent to 36% of the region's direct debt, or 6.6x of its debt repayment for that year.

However, as is the case for many Italian RLGs, the region's cash is almost entirely earmarked for specific purposes, including debt service, leaving little buffer for extraordinary expenditure that may arise. The region has some exposure to off-balance-sheet financial risks associated with its swaps, the materialisation of which may trigger some liquidity stress.

Narrow economic base

With around 1.3 million inhabitants, Abruzzo accounts for 2.2% of Italy's population. The regional economy accounts for around 1.9% of the country's GDP, with GDP per capita around 14% lower than the national average. The region has a relatively mature demographic profile, which exerts long-term pressure on the region's healthcare system.

Abruzzo presents a well-diversified economy, with revenue stemming mostly from the industrial and manufacturing sectors. However, Abruzzo's economy has traditionally underperformed the Italian average. The region's unemployment rate increased slightly to 12.6% in 2016 from 12.1% in 2015 (national average 11.5%). A strong hearthquake hit the region in 2009, causing severe damages to L'Aquila, one of Abruzzo's main cities, and its surroundings. Reconstruction work will continue to help the GDP recovery as many construction sites related to EU-sponsored projects were opened. Regional revenue has thus far remained relatively stable, while reconstruction works are financed through state and EU funds, thus easing pressure on the regional budget.

Moderate, although declining, debt levels

Abruzzo's net direct and indirect debt as a percentage of operating revenue was 36% in 2017. This degree of leverage is moderate compared with that of its peers, which register a median of 65%. This ratio is, however, higher than that of its peers rated at and above the sovereign level, which register medians of 14% and 18%, respectively. We forecast a deleveraging process, which will lead to a ratio of 29% in 2020. The region's direct debt stock amounted to €1 billion or 31% of its operating revenue in 2017.

In 2013, Abruzzo borrowed €174 million from Italy's Ministry of Finance to refinance the healthcare-related commercial debt accumulated as of year-end 2012. Government debt bears low interest rates and will be repaid over 30 years starting from 2022, until when it is obliged to pay interests only. This is thanks to a special treatment from the central government following the 2016 earthquake. We do not envisage any new debt for capital spending in the near future.

Abruzzo's debt consists of 80% of variable interest rate debt, which reaches 0% when calculated after swaps. However, as of December 2017, the mark-to-market value of the interest swaps registered an out of the market value. The average maturity of the direct debt is around 15 years. All debt is amortising, with the exception of two bullet bonds that are hedged through amortising swaps. We expect a stable trend of regular direct debt repayments, which we expect to be around €50 million for each of the next three years.

Financial risks (off balance sheet) linger, but appear manageable

The region's debt stock and our debt ratios include €60 million indirect debt as of 2017 arising from loans incurred by local governments with Cassa Depositi e Prestiti (Baa2 RUR-) and which are serviced by the region.

The financial debt of non-self-supporting companies attributable to the region's indirect debt amounted to around €35 million in 2017. It represents 3% of the region's net direct and indirect debt. Another 12% is attributable to securitisation contracts in which the Region entered, that we register as indirect debt, amounting to €140 million in 2017. The region is reviewing the balance sheets of companies owned by the regional government. Abruzzo does not expect any significant additional debt stemming from this ongoing review.

Extraordinary support considerations

We consider a strong likelihood of extraordinary support from the central government. While recognising the central government's promotion of greater accountability for Italian regions, we also believe that the provision of sensitive and co-shared responsibilities, such as healthcare — together with the region's presence in the capital markets — presents strong incentives for the central government to consider bailing out Abruzzo in the event of need.

Rating methodology and scorecard factors

The assigned BCA of ba1 is in line with the scorecard-indicated BCA. The matrix-generated BCA of ba1 reflects (1) an Idiosyncratic Risk score of 4 (presented below) on a 1-9 scale, where 1 represents the strongest relative credit quality and 9 the weakest; and (2) a Systemic Risk score of Baa2, as reflected in the sovereign bond rating for Italy.

For details about our rating approach, please refer to Rating Methodology: Regional and Local Governments, 16 January 2018.

Exhibit 4

Region of Abruzzo

Baseline Credit Assessment	Score	Value	Sub-factor Weighting	Sub- factor Total	Factor Weighting	Total
Scorecard						
Factor 1: Economic Fundamentals				5.20	20%	1.04
Economic strength		86.11	70%			
Economic volatility	1		30%			
Factor 2: Institutional Framework				5.00	20%	1.00
Legislative background	5		50%			
Financial flexibility	5		50%			
Factor 3: Financial Performance and Debt Profile				2.27	30%	0.68
Gross operating balance / operating revenues (%)		4.30	12.5%			
Interest payments / operating revenues (%)		1.90	12.5%			
Liquidity	1		25%			
Net direct and indirect debt / operating revenues (%)		36.42	25%			
Short-term direct debt / total direct debt (%)		5.44	25%			
Factor 4: Governance and Management - MAX				5.00	30%	1.50
Risk controls and financial management	5					
Investment and debt management	5					
Transparency and disclosure	5					
Idiosyncratic Risk Assessment						4.22 (4)
Systemic Risk Assessment						Baa2
Suggested BCA						ba1

Sources: Issuer, Moody's Investors Service

Ratings

Exhibit 5

Category	Moody's Rating
ABRUZZO, REGION OF	
Outlook	Rating(s) Under Review
Issuer Rating	Baa3[1]
Senior Unsecured -Dom Curr	Baa3[1]

[1] Placed under review for possible downgrade on 29 May 2018.
Source: Moody's Investors Service

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