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Research Update:

# German State of Hesse Ratings Affirmed At 'AA+/A-1+' On Very Strong Finances; Outlook Stable

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**Research Update:**

# German State of Hesse Ratings Affirmed At 'AA+/A-1+' On Very Strong Finances; Outlook Stable

## Overview

- We expect Hesse's government to maintain its strong commitment to budget consolidation and to report surpluses after capital accounts, allowing for continuous debt reduction.
- We are affirming our 'AA+/A-1+' ratings on Hesse.
- The outlook is stable.

## Rating Action

On Aug. 31, 2018, S&P Global Ratings affirmed its 'AA+/A-1+' long- and short-term issuer credit ratings on the German state of Hesse. The outlook is stable.

At the same time, we affirmed our issue rating on Hesse's senior unsecured debt at 'AA+'.

## Outlook

The stable outlook reflects our expectation that Hesse will continue posting robust financial performances with surpluses after capital accounts, and continuously decrease its debt levels through 2021 after it increased them for the municipal support program (Hessenkasse). We further expect that Hesse will continue to have very favorable access to external liquidity for long- and short-term financing.

### Downside Scenario

We might consider lowering the rating if Hesse's financial position were to materially deteriorate, for example, through slippage in budget management. Substantial weakening of the state's excellent access to external liquidity could also weigh on the rating.

### Upside Scenario

We could raise the rating if Hesse considerably reduces its debt levels and substantially increases its internal liquidity buffers or obtains access to substantial committed credit lines, none of which is currently the case.

## Rationale

We expect Hesse to continue posting surpluses after capital accounts, helped by robust tax revenue growth and strict cost controls. The latter demonstrates the state government's increased commitment to budget consolidation. Hesse is one of the German states with very high tax revenue capacity, which has translated into a substantially improved budgetary performance. This was also helped by strict cost containment and adherence to the balanced budget principle, which the state has already achieved, before the set deadline of 2020. Hesse has not only outperformed its budgets in the past two years, but in our base case will continue to do so, reflected by surpluses after capital accounts.

These surpluses will allow Hesse to make net debt repayments, replenish the pension fund, and provide for cyclical and general budget challenges. They further allow the state to pursue additional political goals, such as reducing municipal indebtedness, increasing municipal investment subsidization (Hessenkasse), or raising public services (security, education, and tax administration) whileremaining within the limitations of the balanced budget requirement.

Hesse is continuously replenishing its pension fund, but the unfunded part remains a burden in comparison with provisions. Liquidity is adequate compared with that of other German states, primarily based on favorable access to external liquidity. But internal cash reserves are very low or have access restrictions, as is the case for collateral deposits. Hesse views cash holdings in the current interest-rate environment as not being economical.

### Very good management and a favorable economic environment are fostering improvements

We consider the state's financial management as very strong and proactive in improving transparency. Its budgeting and planning is reliable and forward-looking, provisioning for possible risks, for example due to pending federal government decisions. Hesse's financial management has been committed to a continuous consolidation path over recent years. In 2016, this finally resulted in surpluses after capital accounts, which have continued. This strict adherence to achieving or even exceeding the balanced budget requirement before the set deadline in 2020 confirmed our view of the state's very high level of political and managerial strength.

Hesse, like all German states, is bound by both the federal and its own constitution to refrain from or halt net new borrowing by 2020 (Schuldenbremse), except in certain legally defined cases. Despite having executed net debt repayments in 2016 and 2017, Hesse has now budgeted for further net debt repayments in 2019 (€100 million) and thereafter (€200 million annually), although it also expects to make debt repayments in 2018 that are beyond budget.

Moreover, in addition to its budgeted annual contributions to the pension fund, Hesse's government decided to further replenish the pension fund with cash, depending on annual financial headroom and noncash provisions for cyclical and general budget reserves, which we consider reflects the prudence of its financial management.

Financial headroom has also been used to expand and improve public services for security (police, judiciary), education (teachers), and tax administration, which had become a political goal that the state can now afford to deliver on.

Hesse is the frontrunner on accrual accounting among German states. It publishes annual reports containing balance sheet, financial performance, and cash flow statements according to German commercial generally accepted accounting principles. Based on the more robust information from its reporting, Hesse can better track future pressures, such as unfunded pension liabilities and long-term contracts linked to operating expenditures (e.g., rents and leases), and set corrective measures. Hesse applies high standards in its debt and liquidity management by actively managing its debt portfolio. The state partially fixed interest rates of future revolving maturities and extended the average duration of its debt portfolio substantially. These measures increase the predictability of future interest payments.

Hesse's economy is very strong and diversified, with expected GDP per capita at €46,800 (US$56,200) in 2018 and historically exceeding the German average by roughly 12%. In 2017, the state's economic expansion of GDP reached 2.2% (in real terms) which was at the German average. GDP growth oscillates around the German average, sometimes exceeding it and sometimes undershooting it, which depends on the development of its contributing sectors. Hessian exporters contribute 22% to the state's GDP and cover 5% of German exports, of which a major share is in pharmaceutical products. Exports grew by 4.4% in the first half of 2018. The improved economic environment can also be seen in employment increases of 1.2%, as well as in the lower unemployment rate at 5.0% on average in 2017.

The impact of Brexit on the financial industry in Frankfurt is hard to predict and quantify. Frankfurt is one of the favored European cities serving as the European headquarters of several international financial companies. While local financial institutions are reducing headcount, foreign financial institutions might hire those locals let go instead of relocating personnel from abroad. We are observing the Brexit negotiations closely, but we do not incorporate any possible outcomes into our analysis. We think it highly likely that a transition phase for the transfer of responsibilities to Frankfurt operations would be a realistic scenario.

We view the institutional framework in which German states operate as one of the most predictable and supportive in the world. Hesse is a major net contributor to the states' tax-equalization system, which facilitates almost equal per capita revenues for all German states. In 2017, it contributed €2.6 billion to equalization payments, representing 10.2% of its operating expenditures. A new equalization system has been agreed and will be implemented as of 2020. Due to higher federal government contributions, the net effect of this amendment should lead to higher revenues for Hesse of about €585 million in 2020. Hesse provisioned in its medium-term financial plan for the uncertain continuation of revenues from the reallocation of business tax, which roughly amount to €430 million annually, since a final solution is pending from the federal government. In our view, such provisioning seems prudent.

### Financial performance exceeded our forecasts, and allowed for net debt repayments, but contingent liabilities remained relatively unchanged

Hesse's government has for several years reported very solid budgetary performance, helped by tax revenue growth thanks to favorable economic development and cost control. Our new base case reflects marginally weaker budgetary surpluses compared with our previous base cases, based on some precautionary planning items as of 2020, such as the discontinuation of the special reallocation of business tax and slightly higher expenditures, possibly resulting from pending items the federal government still has not decided on.

For our forecast base-case years (2018-2021), we expect a continuation of robust financial results, with a slight dip in 2019. Operating surpluses should average 7.3% of operating revenues, and surpluses after capital accounts 2.3% of total revenues, having included the expansion of public services. Ongoing surpluses should allow the state to make net debt repayments and to replenish the pension fund (cash), as well as to increase cyclical and general provisions (non-cash). All these measures will be made under the premise of at least a balanced budget, except for net debt repayments, which are budgeted and planned as of 2019. Hesse currently expects that it could even achieve a further net debt repayment of at least €200 million in 2018.

Hesse's weak budgetary flexibility relies mainly on possible cuts to both operating and capital expenditures. Revenues offer less financial flexibility, as it has already raised the real estate transfer tax and does not plan asset sales, except for one real estate sale transaction in 2018, which should be closed soon.

Hesse's tax-supported debt is still very high in a global context, and in our base case we think it will reach 192% of consolidated total revenues in 2020. Our tax-supported debt figure includes direct debt, capitalized long-term rent obligations, and the committed debt for the municipal support program (Kommunaler Schutzschirm), as well as the new municipal support program (Hessenkasse) as of 2019, amounting to €2.4 billion and €5.7 billion, respectively, for 2018. Hesse will service the debt of both municipal support programs. The debt will reduce by annual amortizations over a maximum repayment period of 30 years. Net debt repayments and increasing operating revenues reduced Hesse's tax-supported debt to 183% of consolidated operating revenues in 2017. In our base case, we added €1.3 billion of regular short-term borrowing as an average outstanding amount, having reduced it from

€2.0 billion.

We view Hesse's contingent liabilities as moderate. Its largest contingent liability is its 8.1% stake in Landesbank Hessen-Thueringen Girozentrale (Helaba) (see "Credit FAQ Update: German Landesbanks' Unguaranteed Obligations; The Bottom-Up Approach," published July 19, 2005, on RatingsDirect). We believe that Hesse remains committed to Helaba, even in the absence of an explicit guarantee, due to its strategic importance for Hesse and Frankfurt as a banking center, and would support the bank beyond grandfathered guarantees if needed, although we currently view such a need as unlikely.

The Wirtschafts- und Infrastrukturbank Hessen (WIBank) also constitutes a contingent liability for Hesse. WIBank essentially acts as an arm of the state by promoting business, housing, and infrastructure within Hesse, and its liabilities benefit from a statutory guarantee and an explicit state guarantee. Hesse mandated WIBank as manager of its support programs. We regard WIBank's promotional business as low risk. Other contingent liabilities, including from litigation, are low, and should not burden the state's finances significantly, in our view.

We view Hesse's liquidity as adequate, while the debt-service coverage ratio is very low at only 6%. Our calculation includes very low cash levels (before debt service and borrowing) according to the state's liquidity planning, some term deposits, and no access to committed credit lines. Cash inflow and outflow for the next 12 months average about €1 billion (excluding debt service and borrowings). Hesse adheres to a zero cash reserve policy, and since 2017 to a negative cash policy, arranging short-term borrowing for liquidity management purposes and refinancing long-term debt in capital markets.

Collateral deposits, currently roughly €3.2 billion, are now financed by Hesse's own sources, but are restricted and therefore not accessible for debt-servicing. The state therefore relies heavily on functioning money and capital markets. Its access to short-term borrowing from federal funds and intraday access to Bundesbank funds cushions Hesse's liquidity, besides access to liquidity of money market participants. Including debt service, Hesse's cash position is turning negative.

Hesse has, in our view, strong access to external liquidity. We observe that German states enjoy overall an excellent credit standing, and capital markets view them as an asset class of their own. The states have access to deep and liquid capital markets at all times and to well-established reliable liquidity sources from other levels of government. We also reflect this view in our placement of Germany's banking sector in group '2' under our Banking Industry Country Risk Assessment methodology (on a 1-10 scale, group '1' denotes the lowest risk banking systems; see "Banking Industry Country Risk Assessment: Germany," published Oct. 11, 2017).

We consider it likely that Hesse would benefit from extraordinary financial support from the federal government or other German states in a stress situation. The federal or other states' treasuries could quickly invest in Hesse without the need for additional legislation, and such lending would be qualified as a cash investment on the lenders' side and not qualify as a state transfer, which we would define as extraordinary systemic support.

## Key Statistics

**Table 1**

**State of Hesse Selected Indicators**

| | --Fiscal year ended Dec. 31-- | | | | | | |
|---|---|---|---|---|---|---|---|
| **(Mil. €)** | **2015** | **2016** | **2017** | **2018bc** | **2019bc** | **2020bc** | **2021bc** |
| Operating revenues | 24,000 | 26,492 | 27,424 | 27,841 | 28,930 | 27,514 | 28,484 |
| Operating expenditures | 22,755 | 24,866 | 25,759 | 25,936 | 26,898 | 25,443 | 26,205 |
| Operating balance | 1,245 | 1,626 | 1,665 | 1,905 | 2,032 | 2,071 | 2,279 |
| Operating balance (% of operating revenues) | 5.2 | 6.1 | 6.1 | 6.8 | 7.0 | 7.5 | 8.0 |
| Capital revenues | 512 | 591 | 573 | 884 | 585 | 448 | 294 |
| Capital expenditures | 1,699 | 1,714 | 1,603 | 2,109 | 1,839 | 1,927 | 1,972 |
| Balance after capital accounts | 58 | 502 | 635 | 680 | 778 | 592 | 601 |
| Balance after capital accounts (% of total revenues) | 0.2 | 1.9 | 2.3 | 2.4 | 2.6 | 2.1 | 2.1 |
| Debt repaid | 5,119 | 5,591 | 5,953 | 5,405 | 4,502 | 5,423 | 6,039 |
| Gross borrowings | 5,453 | 5,363 | 5,730 | 4,645 | 3,641 | 4,717 | 5,316 |
| Balance after borrowings | 392 | 274 | 311 | (205) | (203) | (201) | (209) |
| Modifiable revenues (% of operating revenues) | 11.5 | 16.4 | 13.9 | 13.3 | 13.1 | 14.3 | 14.1 |
| Capital expenditures (% of total expenditures) | 6.9 | 6.4 | 5.9 | 7.5 | 6.4 | 7.0 | 7.0 |
| Direct debt (outstanding at year-end) | 44,960 | 47,502 | 47,821 | 46,859 | 46,065 | 45,424 | 44,775 |
| Direct debt (% of operating revenues) | 187.3 | 179.3 | 174.4 | 168.3 | 159.2 | 165.1 | 157.2 |
| Tax-supported debt (outstanding at year-end) | 47,463 | 50,040 | 50,267 | 54,892 | 53,804 | 52,827 | 51,841 |
| Tax-supported debt (% of consolidated operating revenues) | 197.8 | 188.9 | 183.3 | 197.2 | 186.0 | 192.0 | 182.0 |
| Interest (% of operating revenues) | 4.9 | 3.9 | 3.7 | 3.9 | 3.8 | 4.1 | 4.1 |
| Local GDP per capita (single units) | 42,428 | 43,496 | 44,944 | 46,796 | 48,528 | 50,110 | 51,673 |
| National GDP per capita (single units) | 37,485 | 38,260 | 39,545 | 41,015 | 42,490 | 43,894 | 45,258 |

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**

| State of Hesse Ratings Score Snapshot | |
|---|---|
| **Key rating factors** | |
| Institutional framework | Extremely predictable and supportive |
| Economy | Very strong |
| Financial management | Very strong |
| Budgetary flexibility | Weak |
| Budgetary performance | Very strong |
| Liquidity | Adequate |
| Debt burden | Very high |
| 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 - 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

- Default, Transition, and Recovery: 2017 International Public Finance Default Study And Rating Transitions – June 11, 2018
- Research Update: Germany 'AAA/A-1+' Ratings Affirmed; Outlook Stable – April 27, 2018
- Considerable Tax Inflows Will Curtail German, Swiss, And Austrian Local And Regional Government Borrowing In 2018 - February 22, 2018
- Banking Industry Country Risk Assessment: Germany - October 11, 2017

- Institutional Framework Assessments For Non-U.S. Local And Regional Governments - September 21, 2017
- Public Finance System Overview: German States - December 16, 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

Ratings Affirmed

| | |
|---|---|
| Hesse (State of) | |
| Issuer Credit Rating | AA+/Stable/A-1+ |
| Senior Unsecured | AA+ |
| Short-Term Debt | |
| Local Currency | A-1+ |

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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

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