

## CREDIT OPINION

16 July 2019

### Update

 Rate this Research

#### RATINGS

##### Mendoza, Province of

Domicile	Argentina
Long Term Rating	B2
Type	LT Issuer Rating - Fgn Curr
Outlook	Stable

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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## Province of Mendoza (Argentina)

Update following change in outlook to negative from stable

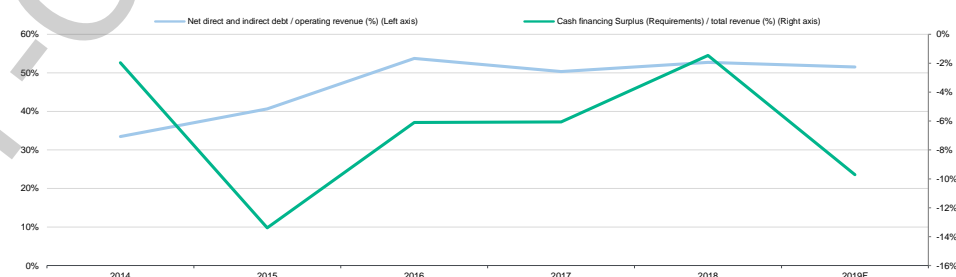
### Summary

The credit profile of the [Province of Mendoza \(B2 negative\)](#) reflects its strong economic fundamentals, offset by volatile operating and financial results. For 2019, we expect Mendoza to continue to post cash financing deficits of about 9.7% of its total revenue as a result of its ambitious infrastructure plan. Mendoza's credit profile incorporates its moderate debt levels and high exposure to foreign-currency debt. The province's net direct and indirect debt was equivalent to 52.7% of operating revenue as of 2018, and we expect it to be equivalent to around 51.6% of operating revenue by year-end 2019.

Like all Argentine regional and local governments (RLGs), the Province of Mendoza has significant macroeconomic and financial links with the [Government of Argentina \(B2 negative\)](#). In 2019-20, we expect RLGs to be hurt by the sovereign's economic performance, fiscal consolidation efforts and tight monetary policy. Furthermore, the current uncertainty regarding potential shifts in policy at a federal level could trigger market volatility, causing exchange rate pressures, pushing inflation higher and potentially affecting economic recovery prospects, all credit-negative factors for RLGs.

Exhibit 1

#### Trend of volatile cash financing results; debt expected to increase and deficits to persist



Source: Moody's Investors Service

### Credit strengths

» Strong economic base

### Credit challenges

- » Volatile operating and financial results
- » Moderate debt levels
- » Difficult operating environment

## Rating outlook

The negative outlook is in line with the negative outlook on Argentina's government bond rating and reflects the very close economic and financial links between the Argentine government and the sub-sovereigns.

## Factors that could lead to an upgrade

Given the negative outlook and the difficult operating environment, an upgrade of the issuer ratings is unlikely. However, the ratings could be upgraded if Argentina's bond rating is upgraded and if the province exhibits a sustained record of cash financing surpluses, leading to a decrease in its debt levels.

## Factors that could lead to a downgrade

A downgrade of Argentina's bond rating or a deterioration in the province's liquidity, hindering its ability to service its short-term debt payments in foreign currency, or both, could strain the province's ratings. In addition, if the province records a deterioration in its operating and financial results, leading to higher-than-expected debt levels, the ratings could be downgraded.

## Key indicators

Exhibit 2

### Province of Mendoza

Year ending December 31

	2014	2015	2016	2017	2018	2019F
Net direct and Indirect debt/operating revenue (%)	33.5	40.6	53.7	50.3	52.7	51.6
Cash Financing Surplus (Deficit) as % of total revenue	-2.0	-13.4	-6.1	-6.1	-1.5	-9.7
Interest expense as % of operating revenue (%)	2.6	2.9	6.5	6.1	7.3	7.7
Gross operating balance / operating revenue (%)	1.3	-6.9	-2.2	0.7	9.1	-2.1
Capital spending / Total expenditures (%)	5.7	7.5	5.5	8.2	11.6	8.1
Intergovernmental transfers / Operating revenue (%)	51.1	53.6	50.7	50.5	49.1	45.9
GDP per capita as % of national average	66.0	63.7	61.7	60.1	N/A	N/A

Source: Moody's Investors Service, Mendoza's financial statements

## Detailed credit considerations

On July 16, 2019, we affirmed Mendoza's B2 ratings (global scale, foreign and local currency) and revised the outlook to negative from stable. The decision to affirm the ratings reflects our view that Mendoza will keep its debt at moderate debt levels even amid a difficult operating environment. The negative outlook reflects the sovereign action, in which the outlook on Argentina's government bond rating was revised to negative from stable.

The credit profile of the Province of Mendoza, as expressed in its B2 negative ratings, reflects (1) a Baseline Credit Assessment (BCA) of b2, and (2) a low likelihood of extraordinary support from the Argentine government in the event of acute liquidity stress.

### Baseline Credit Assessment

#### Strong economic base

Mendoza benefits from a strong economy, which positions it as one of the most important provinces in Argentina. Mendoza's GDP per capita represents around 60% of the national average, and in the first quarter of 2019, the province's metropolitan areas showed an unemployment rate (10.6%) similar to the total national urban figure (10.1%). Mendoza's economy is diversified, with commerce and tourism representing 23% of the total GDP, followed by financial services (16%) and manufacturing (15%).

Moreover, Mendoza is the fourth-largest crude oil producing province in Argentina, which enables the province to receive hydrocarbon royalties, accounting for about 7% of its operating revenue in 2018. Royalties are paid in pesos at the US dollar selling exchange rate on the business day immediately before the date on which the payment is due. The royalties' revenue stream provides a natural hedge

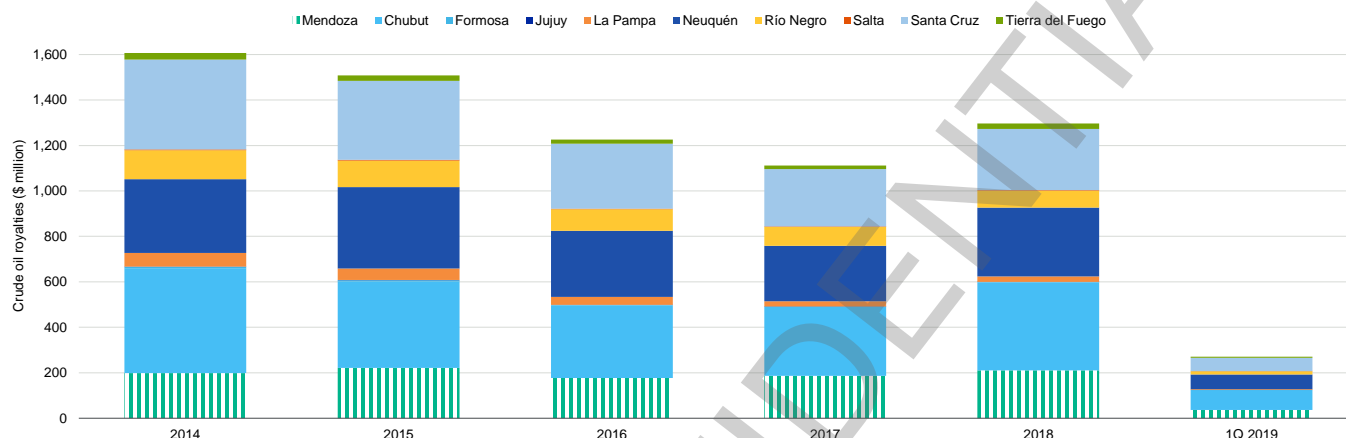
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to the province's US dollar-denominated debt, which is a substantial credit consideration in the current environment of significant currency depreciation.

Exhibit 3

### Mendoza is the fourth-largest crude oil producing province in Argentina

Annual crude oil royalties (in \$ millions)



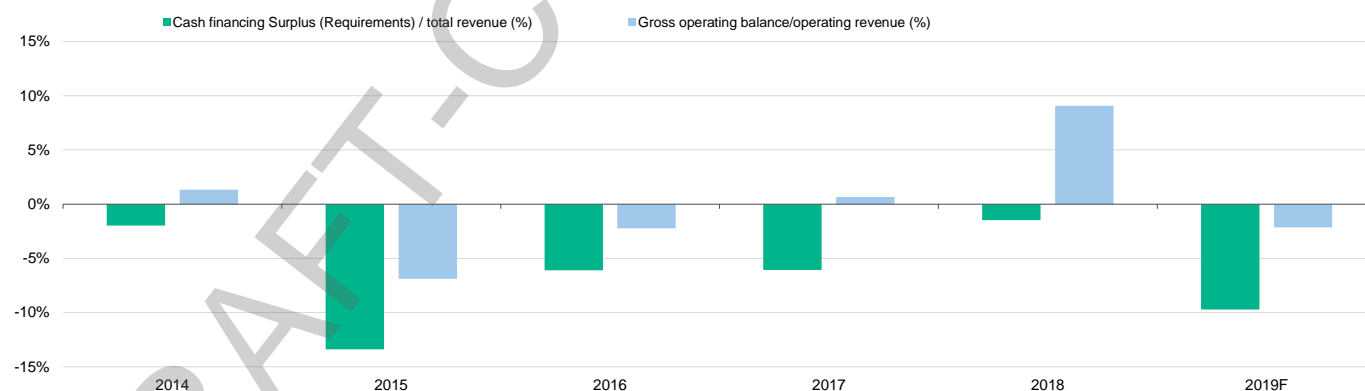
Source: Argentina's Energy Secretariat

### Volatile operating and financial results

The Province of Mendoza's fiscal performance has normally been characterized by its volatility because the province exhibited gross operating deficits in two out of the last five years. The average gross operating balance in 2014-18 was 0.4% of operating revenue; an operating deficit of up to 7% was registered in 2015, while a surplus of about 9% was registered in 2018. Cash financial results were also volatile, ranging from a deficit of 13.4% in 2015 to a deficit of 1.5% in 2018.

Exhibit 4

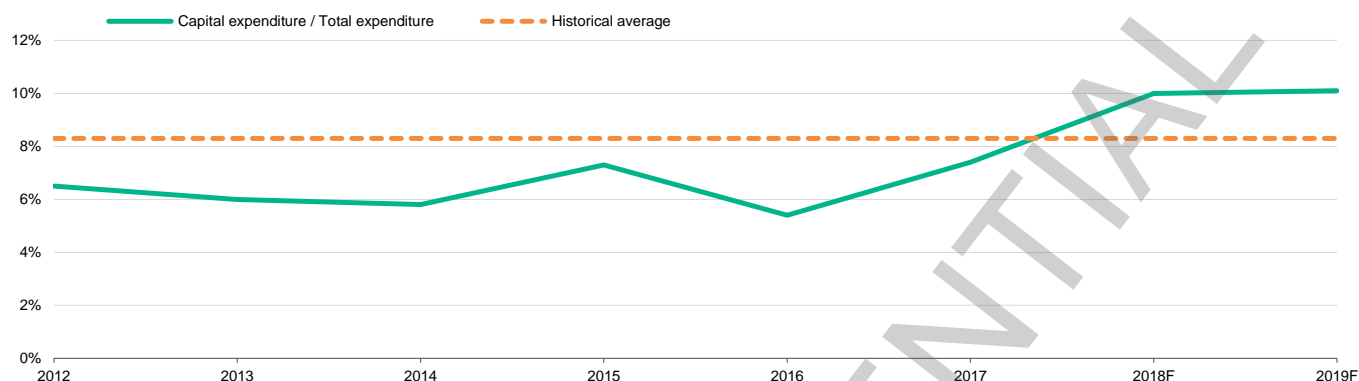
### Trend of operating surpluses and cash financial deficits will continue in 2019



Sources: Moody's Investors Service, Mendoza's financial statements

We expect Mendoza to continue registering operating deficits, reaching 2.1% in 2019, as a result of pressures mainly related to personnel and transfers to municipalities. Additionally, the province will continue to post cash financing deficits of about 9.7% of its total revenue in 2019 as a result of its ambitious infrastructure plan, well above the historical average.

Exhibit 5

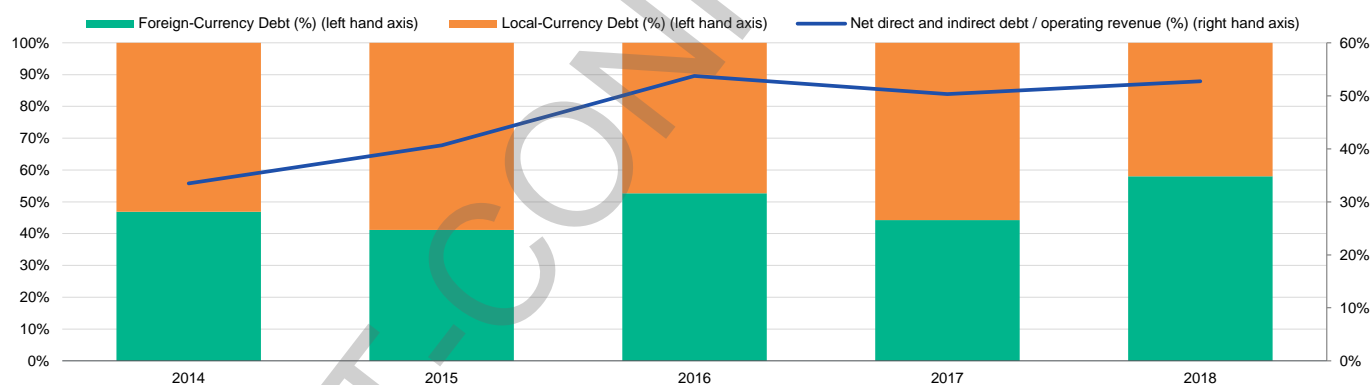
**Cash financial deficits will continue as the province develops an ambitious investment plan**

Source: Province of Mendoza

**Moderate debt levels and exposure to foreign currency**

Mendoza registered moderate debt levels, equal to 52% of its total revenue, as of year-end 2018. Mendoza holds a high share of unhedged debt in foreign currency; as of December 2018, 58% of the province's debt was denominated in foreign currency, compared with 44.2% as of year-end 2017 and 52.7% as of year-end 2016.

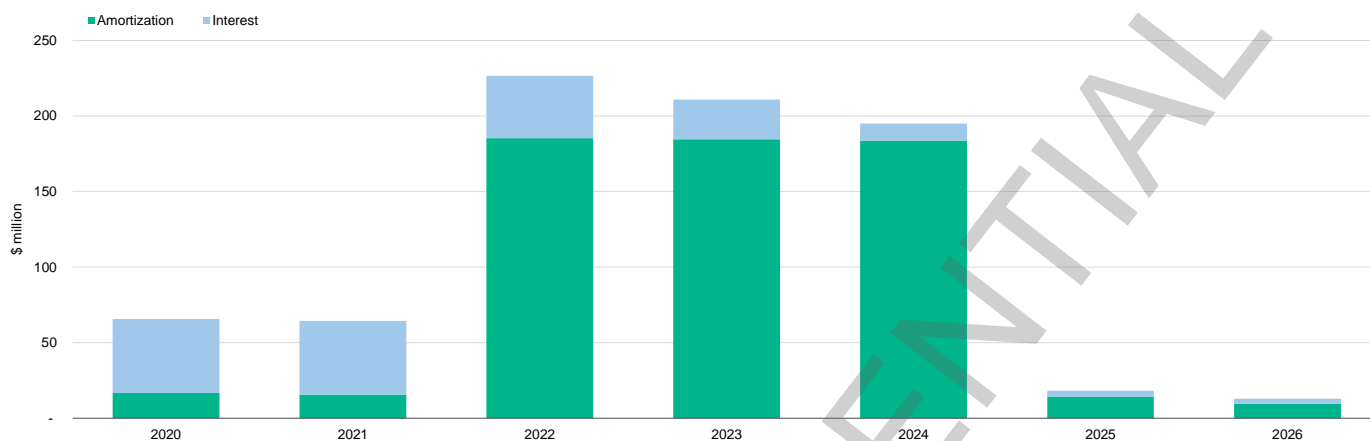
Exhibit 6

**Share of foreign- and local-currency debt and total debt to revenue**

Sources: Moody's Investors Service, Mendoza's financial statements

The negative credit implications of a higher debt burden are partially mitigated by the province's comfortable debt profile, because there will be no significant debt-service payments in foreign currency until 2022. For 2019, we estimate that debt service in foreign currency will represent about 2% of total revenue, which we consider manageable. Nevertheless, the expected material increase in debt limits the province's credit profile.

Exhibit 7

**Mendoza faces manageable debt-service payments in foreign currency for the next two years**

Source: Province of Mendoza

**Difficult operating environment**

Like the rest of the Argentine RLGs, the Province of Mendoza has strong links with the federal government. Argentina's economy shrank by 2.5% in 2018, after expanding by 2.9% in 2017, as multiple shocks led to a broad-based collapse in economic activity. We expect an economic contraction of 1.5% this year, because the recovery in the agricultural sector will be unable to completely offset persistent inflation, very tight financial conditions and austerity measures. We expect the negative real economic growth to have a significant impact on RLGs' revenue intake because both own-source revenue and automatic transfers from the federal government are highly correlated with economic performance.

Moreover, the combination of fiscal consolidation to achieve a primary balance in 2019 and a tighter monetary policy will strain the finances of provincial and local governments. We expect the federal government to decrease its discretionary transfers to provinces and transfer the responsibility of subsidies in public transportation, and electricity and water services for low-income consumers to provincial and municipal governments. At the same time, the deterioration in RLGs' own economic bases will persist as the federal government continues with its zero-growth target for the monetary base until year-end 2019. Nevertheless, despite the monetary restraint, we expect inflation to remain high at 35% in 2019, down from 48% in 2018, which will exert pressure on RLGs' current expenditure, mostly comprising wages and salaries.

Furthermore, the increased uncertainty regarding the continued fiscal consolidation needed to restore access to funding for the sovereign and the risk of policy shifts at a federal level, which could trigger strong market volatility and exchange rate pressures, may pose material systemic risks for RLGs.

**Extraordinary support assumptions**

We assess that there is a low likelihood of Mendoza receiving extraordinary support from the federal government, given that the federal government has not provided such support in the recent past.

## Rating methodology and scorecard factors

In the case of the Province of Mendoza, the BCA matrix generates an estimated BCA of b2, in line with the BCA of b2 assigned by the Rating Committee. The matrix-generated BCA of b2 reflects (1) an Idiosyncratic Risk score of 5 (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 B2, as reflected in the sovereign bond rating.

For details about our rating approach, please refer to the [Regional and Local Governments](#) rating methodology, published on January 16, 2018.

Exhibit 8

### Province of Mendoza - BCA Scorecard - 2018

#### [Regional and Local Governments](#)

Rating Factors						
Mendoza, Province of						
Baseline Credit Assessment	Score	Value	Sub-factor Weighting	Sub-factor Total	Factor Weighting	Total
Scorecard						
Factor 1: Economic Fundamentals						
Economic strength	9	60.3	70%	6.6	20%	1.32
Economic volatility	1		30%			
Factor 2: Institutional Framework						
Legislative background	5		50%	5	20%	1.00
Financial flexibility	5		50%			
Factor 3: Financial Performance and Debt Profile						
Gross operating balance / operating revenues (%)	3	5.1	12.5%	4	30%	1.20
Interest payments / operating revenues (%)	7	6.8	12.5%			
Liquidity	5		25%			
Net direct and indirect debt / operating revenues (%)	3	52.7	25%			
Short-term direct debt / total direct debt (%)	3	12.7	25%			
Factor 4: Governance and Management - MAX						
Risk controls and financial management	5			5	30%	1.50
Investment and debt management	5					
Transparency and disclosure	5					
Idiosyncratic Risk Assessment						5.02(5)
Systemic Risk Assessment						B2
Suggested BCA						b2

Source: Moody's Investors Service

## Ratings

Exhibit 9

Category	Moody's Rating
MENDOZA, PROVINCE OF	
Outlook	Stable
Issuer Rating	B2
Senior Unsecured	B2

Source: Moody's Investors Service

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