

Research Update:

Province Of Mendoza 'SD' Credit And 'CC' Debt Ratings Affirmed, New International Bond Rated 'CCC+'

October 29, 2020

Overview

- On Oct. 5, 2020, the Argentine province of Mendoza completed the exchange of its international bond.
- The province is planning to restructure its local-law debt, which we would likely consider as a distressed exchange given Mendoza's very weak fiscal performance and liquidity.
- We're assigning a 'CCC+' issue-level rating to the province's new 2029 international bond. We're also affirming our issuer credit rating (ICR) at 'SD', and our rating on its 2021 local bond at 'CC', given that in our view, a default or distressed debt exchange on the local debt is a virtual certainty.
- We don't assign an outlook to 'SD' ratings, and we would most likely assign a 'CCC+' post-default ICR to the province following the resolution of its local-law debt restructuring.

Rating Action

On Oct. 29, 2020, S&P Global Ratings affirmed its global scale ICR on the province of Mendoza at 'SD'. We also took the following rating actions:

- We assigned an issue-level rating of 'CCC+' to the province's new 2029 international bond.
- We withdrew our issue-level rating on the 2024 international bond, included in the restructuring.
- We affirmed the issue-level rating on the 2021 local bond at 'CC'.

PRIMARY CREDIT ANALYST

Patricio E Vimberg
Buenos Aires
(54) 114-891-2132
patricio.vimberg
@spglobal.com

SECONDARY CONTACTS

Manuel Orozco

Sao Paulo
(55) 11-3039-4819
manuel.orozco
@spglobal.com

Constanza M Perez Aquino

Buenos Aires
(54) 114-891-2167
constanza.perez.aquino
@spglobal.com

Outlook

We don't assign outlooks to 'SD' ratings because they express a condition and not a forward-looking opinion of default probability.

Downside scenario

We will lower the issue-level rating on the 2021 local bond to 'D' from 'CC' once Mendoza reaches an exchange agreement with local-law bondholders, in line with our methodologies. Given its stressed fiscal performance and weak liquidity, we would likely consider the exchange as distressed and tantamount to default. We could also lower the rating on this bond to 'D' if the province misses a debt service payment.

Upside scenario

We will raise our ratings on the province, most likely to 'CCC+', following the completion of its local-law debt restructuring in the next six months, given that a sharply lower debt service stemming from the broad debt exchange would decrease short-term default risk.

Rationale

On Oct. 5, 2020, Mendoza was the first province to complete an exchange of its foreign law debt, out of the 12 Argentine provinces currently looking to do so. Mendoza now aims to exchange its local-law debt. This second exchange will be performed from a distressed fiscal position and would potentially include losses to bondholders with respect to the original promise. As a result, we would likely consider the exchange as tantamount to default.

We lowered our ICR on Mendoza to 'SD' on June 19, 2020, because it missed an interest payment on its 2024 international bond beyond the grace period. The 'SD' rating signals that the province is still undergoing a broad debt restructuring process, which will be completed after its domestic debt exchange.

Once all Mendoza's debt is restructured, we will likely assign a post-default ICR of 'CCC+', because short-term default risk would significantly diminish due to lower debt service obligations. The debt exchange would provide medium-term fiscal and liquidity relief. However, the severe recession in 2020, exacerbated by COVID-19 and lockdown measures, along with a weak economic recovery during the next two years, will continue to weigh on the province's creditworthiness. Post-default ratings will also incorporate the risk of the sovereign transferring further fiscal stress to the provinces, given the underlying volatile and unpredictable institutional framework. As a result, the ICR on Mendoza would be capped at the sovereign credit rating and its transfer and convertibility assessment, both currently at 'CCC+'.

Debt exchange to provide medium-term relief, but unable to compensate for the severe economic recession

Following the sovereign, Mendoza was the first province to successfully restructure its foreign-law debt, achieving a 95% acceptance rate on the exchange proposal, and eliminating holdout risk. The new \$590 million bond extends the maturity to 2029 from 2024, has a step-up average coupon

rate of 5% (previously 8.375%), and smoothens its debt service profile with 13 semi-annual capital installments (previously three). As a result, Mendoza's international debt service payments in 2021-2024 will decrease to \$280 million from more than \$600 million prior to the exchange.

Nonetheless, fiscal challenges will remain significant. The medium-term relief from the debt exchange won't be enough to compensate for the fiscal damage stemming from the severe recession, exacerbated by COVID-19 and lockdown measures, while economic rebound during 2021-2022 will likely be sluggish. The pandemic has ratcheted up pressure on the province's already weak finances, leading to a sharp fall in tax collection as the economy came to a halt and demands increased to raise spending to contain the spread of the virus.

Our base-case scenario assumes that Mendoza will post an operating deficit of 6% of operating revenue in 2020, and only gradually narrow in the next two years, as the economy will recover slowly. In order to partly contain fiscal slippage, the province has frozen public-sector wages, and is paying the mid-year portion of the 13th salary payment in monthly installments. However, we expect the province to continue to face substantial budgetary constraints given its expenditure rigidity, as the provincial payroll accounts for more than 50% of operating expenditures, and demand for public-servant salary rises will likely resume in the next two years.

On the other hand, we expect the province to make progress in its infrastructure projects as part of the economic recovery, mainly related to the hydroelectric dam, Portezuelo del Viento. Timely execution would be contingent on the federal government transferring the resources already committed to the project. We expect the province to post moderate deficits after capex, of about 4.8% of total revenues, during 2020-2022.

Cash-flow shortfalls will continue pressuring the province's liquidity. Based on our calculations, Mendoza's estimated free cash reserves will be much lower than its debt service payments in the next 12 months, despite the sharp reduction in debt service stemming from the exchange. We expect Mendoza to rely on short-term 'Letras' and delay payments to suppliers to cover its financing needs in coming years, because we consider the province's access to external liquidity will remain limited, as a reputational consequence of the distressed exchanges.

Nevertheless, the broad debt restructuring and foreign exchange dynamics of the official rate will help stabilize the province's debt stock and lower its interest burden. Beyond its market debt, the province has also refinanced its debt with federal government-owned bank Banco Nación, and other federal government loans. We expect provincial debt to remain at about 55% of operating revenue in 2020, and gradually decline in 2021-2022, while interest payments to drop to about 3.2% of operating revenues in 2020-2022 from 7.4% in 2019. However, 65% of Mendoza's debt is in dollars, and exposed to Argentina's inflation, given that 13% of debt is tied to inflation-linked instruments.

Support from the federal government could be delayed given its own severe fiscal strains

We expect the effect of the COVID-19 pandemic and lockdown measures to exacerbate the province's already weak economic performance. The virus outbreak and the relatively high ICU occupancy rates are likely to delay the economic recovery. Moreover, Argentina's outstanding macroeconomic challenges and weak global demand are likely to result in a subdued economic performance in the medium term. We expect Argentina's GDP to contract 12% this year, and expand 4.1% in 2021-2022.

We consider that the provincial administration's debt, liquidity, and budgetary policies have weakened over the past years. Lack of consensus in the local legislature has led to delays in

passing budgets, and inability to implement borrowing approvals, potentially increasing roll-over risk. Furthermore, the ongoing broad debt restructuring and default highlight a weak payment culture.

Finally, we believe that, amid eroding macroeconomic conditions, the sovereign could delay fiscal support measures to subnational governments, especially given Argentina's history of major policy swings. We assess the institutional framework for Argentina's local and regional governments as very volatile and underfunded, reflecting our perception of the sovereign's very weak institutional predictability and volatile intergovernmental system that has been subject to various modifications to fiscal regulations, and lack of consistency over the years, which jeopardize the LRGs' financial planning, and consequently, their credit quality.

Key Statistics

Table 1

Selected Indicators

	2017	2018	2019	2020bc	2021bc	2022bc
(Mil. ARP)						
Operating revenues	65,728	91,149	130,833	162,739	239,375	342,474
Operating expenditures	65,755	82,881	129,857	173,069	245,954	345,605
Operating balance	(27)	8,268	976	(10,330)	(6,580)	(3,130)
Operating balance (% of operating revenues)	(0.0)	9.1	0.7	(6.3)	(2.7)	(0.9)
Capital revenues	1,343	1,291	1,558	5,676	7,766	8,449
Capital expenditures	5,129	10,065	13,845	6,230	8,723	12,081
Balance after capital accounts	(3,812)	(506)	(11,312)	(10,885)	(7,536)	(6,762)
Balance after capital accounts (% of total revenues)	(5.7)	(0.5)	(8.5)	(6.5)	(3.0)	(1.9)
Debt repaid	3,895	3,629	1,930	5,054	10,636	10,614
Gross borrowings	7,720	6,658	6,266	3,618	14,243	20,000
Balance after borrowings	13	2,522	(6,976)	(12,321)	(3,929)	2,624
Direct debt (outstanding at year-end)	33,067	48,062	73,073	90,020	112,690	127,955
Direct debt (% of operating revenues)	50.3	52.7	55.9	55.3	47.1	37.4
Tax-supported debt (outstanding at year-end)	33,067	48,062	73,073	90,020	112,690	127,955
Tax-supported debt (% of consolidated operating revenues)	50.3	52.7	55.9	55.3	47.1	37.4
Interest (% of operating revenues)	6.1	7.3	7.4	4.4	2.9	2.2
Local GDP per capita (USD)	8,800	7,235	6,353	5,242	NA	NA
National GDP per capita (USD)	14,611	11,706	10,068	8,316	8,708	10,288

Table 1

Selected Indicators (cont.)

	2017	2018	2019	2020bc	2021bc	2022bc
<p>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. N/A--Not applicable. N.A.--Not available. N.M.--Not meaningful.</p>						

Ratings Score Snapshot

Table 2

Province of Mendoza Snapshot

Key rating factors	Scores
Institutional framework	6
Economy	5
Financial management	5
Budgetary performance	5
Liquidity	5
Debt burden	3
Stand-alone credit profile	sd
Issuer credit rating	SD

S&P Global Ratings bases its ratings on non-U.S. local and regional governments (LRGs) on the six main rating factors in this table. In the "Methodology For Rating Local And Regional Governments Outside Of The U.S.," published on July 15, 2019, we explain the steps we follow to derive the global scale foreign currency rating on each LRG. The institutional framework is assessed on a six-point scale: 1 is the strongest and 6 the weakest score. Our assessments of economy, financial management, budgetary performance, liquidity, and debt burden are on a five-point scale, with 1 being the strongest score and 5 the weakest.

Key Sovereign Statistics

- Sovereign Risk Indicators, Oct 12, 2020. An interactive version is available at <http://www.spratings.com/sri>

Related Criteria

- Criteria | Governments | International Public Finance: Methodology For Rating Local And Regional Governments Outside Of The U.S., July 15, 2019
- General Criteria: Criteria For Assigning 'CCC+', 'CCC', 'CCC-', And 'CC' Ratings, Oct. 1, 2012

- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- Challenges And Opportunities Await Argentine Provinces After Their Debt Restructuring, Oct. 26, 2020
- Argentina Faces Challenges And Opportunities After Its Restructuring, Sept. 18, 2020
- Argentina Upgraded To 'CCC+' From 'SD' On Settlement Of Restructuring Of Foreign And Local Law Debt; Outlook Stable, Sept. 7, 2020
- Province of Mendoza Downgraded To 'SD' From 'CC' On Missed Interest Payment On Its 2024 Bond, June 19, 2020
- Province of Mendoza Downgraded To 'CC' From 'CCC-' On Virtual Certainty Of Default; Outlook Negative, June 2, 2020
- Province of Mendoza Downgraded To 'CCC-' From 'B-' On Severe Liquidity Pressures, Outlook Remains Negative, April 27, 2020

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

New Rating

Mendoza (Province of)

Senior Unsecured CCC+

Not Rated Action

	To	From
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Mendoza (Province of)

Senior Unsecured NR D

Ratings Affirmed

Mendoza (Province of)

Issuer Credit Rating SD/--/--

Mendoza (Province of)

Senior Unsecured CC

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.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.

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