

Research Update:

Argentine Province of Mendoza 'CCC-' Ratings Affirmed, Outlook Remains Negative

May 23, 2023

Overview

- Accumulated cash in 2021 and 2022 and continued commitment to prudent fiscal measures to curb spending should enable the Argentine province of Mendoza to cover its debt service payments in 2023-2025.
- However, we cap our long-term ratings on Argentine provinces at the same level as the 'CCC-' transfer and convertibility (T&C) assessment on Argentina, which reflects potential restrictions on accessing foreign exchange (FX).
- Therefore, we affirmed our 'CCC-' long-term issuer credit and issue-level ratings on the province of Mendoza.
- The negative outlook on Argentine local and regional governments (LRGs), including on Mendoza, reflect the increasing vulnerabilities in macroeconomic conditions, including provinces' potentially narrower access to foreign currency to meet obligations.

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Rating Action

On May 23, 2023, S&P Global Ratings affirmed its 'CCC-' global scale issuer credit and issue-level ratings on the province of Mendoza. The outlook remains negative.

Outlook

Similar to other local governments in Argentina, the negative outlook on our rating on Mendoza reflects potential further deterioration of overall credit conditions, given Argentina's challenging economic dynamics including its worsened external liquidity, which has raised pressure on the FX market. Nevertheless, Argentine provinces in general have been improving their finances in recent months. However, they depend on the availability of foreign currency to service their debt. The central bank's international reserves have fallen in the first quarter of 2023, and we expect them to come under greater pressure as the ongoing severe drought hits agricultural exports, weakening foreign-currency inflows and further limiting the ability of nonsovereign entities to convert or transfer money for timely debt service.

Downside scenario

We could lower the long-term ratings on Mendoza if the central government further tightens access to FX, which could impair the province's ability to service foreign-currency debt in the next six to 12 months. In addition, we would likely consider a debt exchange or restructuring as distressed and tantamount to default at such a low rating level.

Upside scenario

We could raise the ratings in the next 12 months if we see improvement in conditions for LRGs' access to foreign currency to service debt. A track record of the sovereign's successful execution under the IMF's Extended Fund Facility, coupled with clarity on how policy will ease financing challenges and provide a road map to address Argentina's major structural macroeconomic imbalances, would be positive for Mendoza and Argentine LRGs in general.

Rationale

Our stand-alone credit profile (SACP) on Mendoza of 'b-' reflects our view that cash accumulated during 2021 and 2022, along with commitment to fiscal-containment measures, should allow the province to cover its debt service payments in 2023-2025. Mendoza's international bond started amortizing this year and total debt service (including principal and interest) in U.S. dollars will total \$130 million annually in 2023-2025, which includes about \$25 million from multilateral lending institutions. We believe that overall debt service, which also includes loans from Banco Nacion and the national government, and local bonds for minor amounts, should be manageable for the province.

However, risks will stem from uncertainty in the province's capacity to access sufficient foreign currency to bulk up needed sums to service debt in U.S. dollars, as well as potential macroeconomic instability that could strain Mendoza's fiscal flows and cash position. This is reflected in our T&C assessment and the sovereign rating cap on the ratings on Mendoza.

Fiscal performance boosted cash levels recently, but pressures are likely to emerge

We expect Mendoza to post operating surpluses averaging 11.8% of operating revenue during 2023-2025, along with balanced results after capex, as the province mostly relies on its own financial resources to fund infrastructure spending. Fiscal results improved substantially in 2021 and 2022 mostly thanks to high inflation that pushed up revenues rapidly, while spending remained under control. Therefore, despite the recovery in capex and a policy to lower tax rates, Mendoza accumulated cash in the past two years.

Our forecast assumes increases in Mendoza's own-source revenue and transfers from the national government (accounting for 57% of the province's total revenue) to be broadly in line with nominal GDP growth. We incorporate potential pressures on operating spending, particularly payroll (50% of the government's outlays) amid high inflation and given that public-sector employee salaries haven't recovered in real terms since the wage freeze in 2020. We believe that high inflation can lead to volatility in fiscal performance, especially if salary negotiations become more frequent. We also believe that Mendoza's budgetary flexibility is limited due to a relatively rigid operating spending structure, while increases in taxes are unlikely.

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The province has been receiving capital transfers from the national government since October 2019 for a large hydroelectric dam project, Portezuelo del Viento, which currently total about \$650 million (from a total \$1 billion in committed transfers). There's uncertainty over whether the project will move forward--in which case Mendoza would solicit using funds for other hydro or energy projects. Given that the project's construction is financed through an account separate from the provincial budget, we exclude these transfers from our fiscal estimates and only consider any spending for the project that's additional to these transfers.

We assume international debt markets will remain closed to Argentine LRGs, and Mendoza will cover funding needs with pre-approved loans from multilateral lending agencies, as well as with loans from the national government. The province generally can issue short-term notes (Letras) for a total of 2.5% of budgeted revenue, although it doesn't plan to do so because it doesn't currently have short-term liquidity needs. Any Letras that Mendoza issues must mature before the election in September 2023.

Given limited access to credit markets, building cash buffers and maintaining their value in real terms is a key challenge for Argentine provinces. Improved fiscal performance allowed Mendoza to accumulate cash. Based on our estimates, Mendoza's free and available cash should cover debt repayment for the next 12 months. Nevertheless, this could change, especially if volatility in the exchange rate is higher than we expect. At the same time, Mendoza generally has high debt owed to suppliers at the end of the year that can pressure its cash position, although these obligations are generally lowered and compensated by the first-quarter revenue collection.

The province's debt stock dropped to 36% of operating revenue in 2022 from 60% in 2020. About 75% of debt is denominated in U.S. dollars, which underscores the potential currency risk. We expect debt burden to diminish in coming years and interest payments to below 5% of operating revenue, largely because financing conditions remain tight. The province's debt service has increased in 2023 as the 2029 international bond began to amortize.

Low institutional predictability and subdued economic growth limit Mendoza's financial planning

Our economic outlook for Mendoza is bleak, in line with that for the sovereign. The Argentine economy will likely contract in 2023 given significant imbalances in the run up to the election and the severe drought, and we expect growth will be below the average of peers of similar levels of development, with a trend of 2% in 2024-2025. Meanwhile, inflation is still likely to stay close to 100% year-over-year in 2023, and will continue to pressure the country's already weak socioeconomic indicators. Sluggish economic growth and exchange-rate depreciation resulted in Mendoza's GDP per capita at \$8,700 in 2023, below the estimated national GDP per capita of \$14,125.

The provincial administration has a track record of curbing spending and reducing the fiscal gap, while it has maintained commitment to lower the tax burden. More recently, the province has been discussing changes in the local Fiscal Responsibility Law, which include improvements in an anticyclical fund, currently not in use, but if approved it would hold at least one month's worth of payroll and to be used during periods of lower operating revenue. Our base-case scenario assumes the continuity in policies following the gubernatorial and legislative elections in the province in September 2023.

Amid the increasingly strained financial conditions, including a very limited access to external funding, the administration decided to prioritize operating and capital spending over timely payment of its international bond in 2020, which was restructured.

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Finally, we assess the institutional framework for Argentina's LRGs 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. This jeopardizes the LRGs' financial planning and consequently their credit quality.

Key Statistics

Table 1

Selected indicators

	2020	2021	2022	2023bc	2024bc	2025bc
(MIL. ARP)						
Operating revenues	163,446	255,466	478,709	914,028	1,630,503	2,690,809
Operating expenditures	158,614	224,035	397,855	783,352	1,451,746	2,414,411
Operating balance	4,832	31,431	80,855	130,676	178,758	276,398
Operating balance (% of operating revenues)	3.0	12.3	16.9	14.3	11.0	10.3
Capital revenues	827	1,487	1,003	1,985	3,670	6,055
Capital expenditures	6,238	19,012	53,514	105,400	175,000	275,000
Balance after capital accounts	(579)	13,906	28,343	27,261	7,427	7,453
Balance after capital accounts (% of total revenues)	(0.4)	5.4	5.9	3.0	0.5	0.3
Debt repaid	4,113	7,336	15,116	49,766	71,970	110,684
Gross borrowings	7,327	8,939	7,354	14,880	41,850	69,750
Balance after borrowings	2,635	15,509	20,582	(7,625)	(22,692)	(33,481)
Direct debt (outstanding at year-end)	98,087	118,375	173,744	246,639	347,344	435,975
Direct debt (% of operating revenues)	60.0	46.3	36.3	27.0	21.3	16.2
Tax-supported debt (outstanding at year-end)	98,087	118,375	173,744	246,639	347,344	435,975
Tax-supported debt (% of consolidated operating revenues)	60.0	46.3	36.3	27.0	21.3	16.2
Interest (% of operating revenues)	4.9	3.6	4.5	3.1	2.3	1.7
Local GDP per capita (USD)	5,287	6,566	8,495	8,793	N.A.	N.A.
National GDP per capita (USD)	8,496	10,579	13,652	14,125	N.A.	N.A.

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.

Ratings Score Snapshot

Table 2

Rating score snapshot--Province of Mendoza

Key rating factors	Scores
Institutional framework	6
Economy	5
Financial management	5
Budgetary performance	3
Liquidity	4
Debt burden	2
Stand-alone credit profile	b-
Issuer credit rating	CCC-

Key Sovereign Statistics

- Argentina Long-Term Foreign Currency Rating Lowered To 'CCC-' On Heightened Vulnerability; Outlook Negative , March 29, 2023
- Sovereign Risk Indicators, April 10, 2023. An interactive version is available at <http://www.spratratings.com/sri>

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- Criteria | Governments | International Public Finance: Methodology For Rating Local And Regional Governments Outside Of The U.S., July 15, 2019
- Criteria | Governments | International Public Finance: Methodology: Rating Non-U.S. Local And Regional Governments Higher Than The Sovereign, Dec. 15, 2014
- General Criteria: Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions, Nov. 19, 2013
- 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

- Argentine Local And Regional Governments Downgraded To 'CCC-' On Lower Transfer And Convertibility Assessment, March 30, 2023
- Province of Mendoza's Stand-Alone Credit Profile Revised Up To 'b-' On Improved Liquidity, 'CCC+' Ratings Affirmed, June 8, 2022

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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

Mendoza (Province of)

Issuer Credit Rating CCC-/Negative/--

Mendoza (Province of)

Senior Unsecured CCC-

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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