

Research Update:

DRAFT: Region of Stockholm Outlook Revised To Positive On Strong Cash Flows And Debt Reduction; 'AA+/A-1+' Ratings Affirmed

March 26, 2024

Vendor headline: S&PGR Revises Stockholm Outlook To Positive; Afrms 'AA+' Rtgs

Overview

- We expect the Region of Stockholm's balances after capital accounts will trend toward surpluses due to a tax rate increase, reduced cost inflation, and continued central government support.
- At the same time, we expect the region's debt burden will decrease through 2026, owing to strong cash flows after investments and robust revenue growth.
- We have therefore revised our outlook on the Region of Stockholm to positive from stable and affirmed our 'AA+/A-1+' global scale and 'K-1' regional scale ratings.

Rating Action

On March 29, 2024, S&P Global Ratings revised the outlook on the Swedish Region of Stockholm to positive from stable. At the same time, we affirmed the 'AA+' long-term and 'A-1+' short-term global scale issuer credit ratings, and our 'K-1' short-term Nordic regional scale rating on the region.

Outlook

The positive outlook reflects a higher likelihood that Stockholm may improve its budgetary execution, including the possibility of posting surpluses after capital accounts. The strong cash flow generation should be driven partly by higher tax revenues, reduced cost inflation, and contributions to co-finance infrastructure investments. Consequently, we also expect the region's debt burden will continue to decrease through 2026.

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Upside scenario

We could raise the ratings on Stockholm in the next two years if there was a strong commitment to financial management and improvements in the budgetary process, leading to maintained structural surpluses after capital accounts. An upgrade could also come from a continued reduction in the region's debt burden.

Downside scenario

We could revise the outlook to stable if we see a reduced likelihood that the region's budgetary outcomes will structurally improve beyond our current expectations. This would likely reflect a lower commitment to cost control and increased capital expenditure, potentially resulting in sustained (albeit likely marginal) deficits. It would also imply reduced clarity regarding the continuation of the region's path toward debt reduction.

Rationale

We revised the outlook on the ratings on Stockholm to positive from stable because we believe there is a higher likelihood that the region will post surpluses after capital accounts. Strong operating cash flow generation combined with sizable infrastructure co-financing should also lead to a reduction in debt through 2026, both in nominal and relative terms.

An extremely supportive institutional framework and strong socioeconomic fundamentals continue to support the ratings

We consider the institutional framework in Sweden extremely predictable and supportive. In our view, the framework displays a high degree of stability, while the sector's revenue and expenditure management are based on a far-reaching equalization system and tax autonomy. Historically, central government has provided extensive support to the local and regional government (LRG) sector. This can be demonstrated by the additional grants distributed in response to the pandemic or--more recently--to cover rising pension costs (see "Swedish Municipalities And Regions Have Flexibility To Balance Costs," published Nov. 29, 2023, on RatingsDirect).

The region is governed by a minority coalition consisting of the Social Democrats, the Centre Party, and the Green Party. Together with the Left Party--which plays a supporting party role without formally being a part of the coalition--the ruling government holds a majority of seats in the regional parliament. Apart from a few management-related issues in the past, we regard the region's management as competent due to guiding principles including strict budget discipline and cost control. Prior to 2023, during which extraordinary pension costs burdened budgetary performance, the region had a long track record of posting positive balanced budget results. Furthermore, we believe that the financial management is committed to prudent and risk-minimizing financial policies, which underpin the strong liquidity position.

The region's economy is strong, supported by a well-diversified labor market and high incomes, signaling its importance as a national and regional growth center. At the same time, Stockholm benefits from Sweden's robust economic fundamentals, demonstrated by our estimate of GDP per capita at about \$57,600 in 2024.

Solid tax revenue growth, continued central government support, and reduced cost inflation will support performance metrics and lead to a reduction the region's debt burden

Although Stockholm reported a negative bottom-line result for 2023 in accrual terms, the cash-flow adjusted operating balance remained solid. The outcome was also stronger than expected in the budget, primarily because of stronger tax revenue growth than expected. Moreover, given the extraordinary circumstances surrounding the significantly higher pension costs, Local Government Act allows the region to report a negative accrual-based result according to the balanced budget framework. This is without having to restore the deficit in the subsequent three years or drawing on the accumulated equity reserves.

In 2024, pension expenditures will remain high. This is mainly due to high inflation in June 2023 leading to higher CPI-linked provisions and financial costs. That said, about 60% of the region's pension expenditures will not generate a cash outflow, meaning that the full effect is not reflected in our calculated performance metrics (see "Sweden's Local And Regional Governments Have Less Room To Maneuver Over The Next Year As Pension Costs Rise," published Sept. 14, 2023).

Due to the pension costs, we expect the region will post a negative accrual-based budget result in 2024, while the cash-based operating balance will remain relatively solid at about 8.6%. The operating result will also be boosted by the political decision to increase the tax rate by 30 basis points in 2024, which we estimate adds an additional Swedish krona (SEK)2.4 billion in tax revenue. Moreover, as part of its spring amending budget, central government has announced an additional SEK6 billion to be distributed to regions this year to support the health care sector, of which Stockholm is expected to receive about SEK1.27 billion.

In 2025-2026, we expect the region's pension costs will decrease notably, allowing the region to post accrual-based surpluses again. At the same time, we expect robust tax revenue growth and reduced cost inflation will support performance metrics through 2026. That said, we believe the health care sector will remain under pressure and the debate regarding the central government's role in providing additional grants will continue. Although there are different views on how much the sector needs, we expect central government will continue to distribute funds to support the sector, as reflected in our strong assessment on the Swedish institutional framework. Moreover, we also acknowledge that the region may face longer-term challenges in terms of revenue shortfall within public transportation, considering the uncertain demand for commuter travel. So far, commuter traffic has not returned to the level seen in 2019. Still, we expect the region will navigate these challenges and maintain strong operating balances through 2026.

We expect the region's investment needs will remain sizable, leading to high capital expenditure throughout the forecast period. The largest infrastructure project concerns the extension of the underground railway system, which will improve commuting options for residents in the greater Stockholm area. The capital expenditure for this project will be co-financed by central government and the municipalities the underground lines will traverse. Furthermore, cash inflow from the sale of a former hospital building will likely provide a temporary boost to capital revenue toward the end of the forecast period. As a result of strong cash flows from operations and sizable co-financing, we expect the region's balance after capital accounts will be positive on average between 2024 and 2026--although we expect deficits for 2024 and 2025. Despite upcoming challenges and uncertainties, we believe there is a higher likelihood that the region will manage to post surpluses on a more structural level.

In assessing the region's budgetary performance, we regard financial flexibility as below average. This is because, as with other Swedish health care regions, Stockholm employs a greater share of

high-income earners, leading to larger annual pension costs than the municipalities in relative terms. In our view, these pension payments crowd out other expenditures and require additional revenue to comply with the balanced budget requirement. The relatively higher burden on regions' income statements has become more evident recently since inflation started to surge, translating into notably higher pension cost growth.

We expect Stockholm's average cost of debt will remain elevated through 2026. At the same time, the cost of new funding will decrease in line with the expectation that the Swedish central bank--the Riksbank--will lower the policy rate. Given our expectation of a decrease in nominal debt burden, the region's interest expenditure should be manageable.

Our base case includes continued strong operating cash flows and high co-financing contributions for capital expenditure. We forecast the region's tax-supported debt will decrease to 35% of consolidated revenue in 2026, down from 43% in 2023. This trend also reflects gradually decreasing debt related to the public-private partnership project regarding the Nya Karolinska Solna hospital. Furthermore, since we assess Stockholm on a consolidated basis, our analysis incorporates the debt of the region's subsidiaries--including transport company AB Storstockholms Lokaltrafik--as well as financial leases. Furthermore, we consider the region's exposure to contingent liabilities as limited. This is measured as a share of consolidated revenues and we consider the risk of materialization as low.

We regard Stockholm's liquidity position as very strong, supported by ample liquidity sources, including cash holdings and committed facilities. We estimate the weighted debt-service coverage ratio at 167%. We expect the region will maintain its long-term debt maturity structure and strong liquidity position through 2026, although we expect a peak in debt repayments in 2025. Furthermore, the region has a strong track record of reliable access to external financing, including bonds, commercial paper, and funding from the European Investment Bank. Overall, we consider the region's liquidity management to be sophisticated, underpinned by prudent and risk-minimizing financial policies.

Key Statistics

Table 1

Region of Stockholm--Selected Indicators

(Mil. SEK)	--Year ended Dec. 31--					
	2021	2022	2023e	2024bc	2025bc	2026bc
Operating revenues	119,309	123,048	127,960	133,475	137,444	141,209
Operating expenditures	106,290	110,244	116,186	122,028	125,537	128,927
Operating balance	13,019	12,804	11,774	11,447	11,907	12,282
Operating balance (% of operating revenues)	10.9	10.4	9.2	8.6	8.7	8.7
Capital revenues	3,564	4,969	5,702	5,628	4,120	5,780
Capital expenditures	11,037	13,028	16,785	17,340	17,010	14,441
Balance after capital accounts	5,546	4,745	691	(265)	(983)	3,621
Balance after capital accounts (% of total revenues)	4.5	3.7	0.5	(0.2)	(0.7)	2.5
Debt repaid	9,800	5,503	6,406	4,964	7,526	6,117
Gross borrowings	7,638	520	4,857	4,066	8,009	1,996

Table 1

Region of Stockholm--Selected Indicators (cont.)

(Mil. SEK)	--Year ended Dec. 31--					
	2021	2022	2023e	2024bc	2025bc	2026bc
Balance after borrowings	2,450	(3,696)	1,397	(1,163)	(500)	(500)
Direct debt (outstanding at year-end)	59,961	54,558	52,606	51,220	51,175	46,482
Direct debt (% of operating revenues)	50.3	44.3	41.1	38.4	37.2	32.9
Tax-supported debt (outstanding at year-end)	61,760	56,497	54,698	53,521	53,706	49,266
Tax-supported debt (% of consolidated operating revenues)	51.8	45.9	42.7	40.1	39.1	34.9
Interest (% of operating revenues)	1.1	1.1	1.1	1.2	1.2	1.2
Local GDP per capita (single units)	N/A	N/A	N/A	N/A	N/A	N/A
National GDP per capita (single units)	528,606	572,067	596,359	607,603	625,921	643,526

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. SEK--Swedish krona. e--Estimate. 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

Region of Stockholm--Ratings Score Snapshot

Key rating factors

Institutional framework	1
Economy	1
Financial management	2
Budgetary performance	3
Liquidity	1
Debt burden	2
Stand-alone credit profile	aa+
Issuer credit rating	AA+

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, Dec. 11, 2023. An interactive version is available at <http://www.spratings.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
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- Institutional Framework Assessment: Swedish Municipalities And Regions Have Flexibility To Balance Costs, Nov. 29, 2023
- Sweden's Local And Regional Governments Have Less Room To Maneuver Over The Next Year As Pension Costs Rise, Sept. 14, 2023

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

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.spglobal.com/ratings for further information. A description of each of

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