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PUBLIC SECTOR EUROPE

CREDIT OPINION
1 July 2019

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RATINGS

Ticino, Republic and Canton of

Domicile	Switzerland
Long Term Rating	Aa2
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.

Contacts

Elise Savoye, CFA +33.1.5330.1079
VP-Senior Analyst
elise.savoye@moodys.com

Dina Dexheimer +49.69.70730.807
Associate Analyst
dina.dexheimer@moodys.com

Massimo Visconti +39.02.9148.1124
VP-Sr Credit Officer/Manager
massimo.visconti@moodys.com

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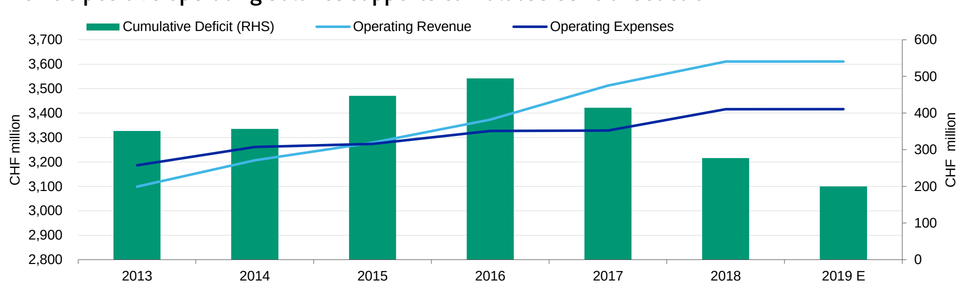
Republic and Canton of Ticino (Switzerland)

Update following affirmation of Aa2 ratings

Summary

The credit profile of the Republic and Canton of Ticino (Ticino, Aa2 stable) is underpinned by (1) the canton's improving positive gross operating balance (GOB) because of a high degree of budgetary and financial flexibility and strong stance to maintain long-term financial equilibrium; (2) its sound financial and debt management, which supports Ticino's strong liquidity and deleveraging; and (3) a strong and diversified economy. Ticino faces the following credit challenges: (1) a high debt exposure, although declining, which is expected to stabilise and potentially decline over 2019-20; and (2) the sizeable exposure to contingent liabilities, particularly in the form of deficiency guarantees issued to the canton's fully owned bank, Banca dello Stato del Canton Ticino (Banca Stato). The credit profile also reflects a moderate likelihood of support from the Government of Switzerland (Aaa stable) if the canton were to face acute liquidity stress.

Exhibit 1
Ticino's positive operating balance supports cumulated deficit reduction



Source: Issuer, Moody's Public Sector Europe

Credit strengths

» Improving performance supported by a constitutional requirement on financial equilibrium

» A very high degree of budgetary and financial flexibility, combined with sound debt management

» A strong and diversified economy

Credit challenges

» High debt levels, although declining

» Sizeable exposure to contingent liabilities

Rating outlook

The stable rating outlook reflects our expectation that the Republic and Canton of Ticino will maintain financial equilibrium and absorb accumulated deficit. The canton's prudent and flexible budgetary management further supports the stable outlook.

Factors that could lead to an upgrade

A combination of the following could have positive rating implications: (1) a positive GOB, amounting to and stabilising at a double-digit percentage of operating revenue; and (2) a sustained deleveraging.

Factors that could lead to a downgrade

Negative pressure could be exerted on the rating by one or a combination of the following: (1) a materially higher-than-expected net direct and indirect debt (NDID) to revenue ratio; and (2) significant financial pressure arising from contingent liabilities.

Key indicators

Exhibit 2
Republic and Canton of Ticino
Year ending 31 December

	2013	2014	2015	2016	2017	2018
Net direct and indirect debt as % of operating revenue	92.4	93.7	100.4	96.1	87.1	81.1
Accrual financing surplus (requirement) as % of total revenue	-11.6	-7.9	-5.9	-3.5	-1.4	-2.6
Gross operating balance as % of operating revenue	-2.8	-1.7	0.1	1.4	5.2	5.4
Interest payments as % of operating revenue	1.3	1.1	1.1	1.0	0.7	0.6
Intergovernmental transfers as a % of operating revenue	29.5	29.1	29.0	29.0	29.2	29.1
Capital spending as a % of total expenditure	10.6	9.1	8.9	7.9	9.6	11.0
GDP per capita as a % of national average	102.4	104.9	104.9	104.9	104.9	104.9

Sources: Issuer, Moody's Public Sector Europe

Detailed credit considerations

On 28 June 2019, we affirmed Ticino's Aa2 ratings with a stable outlook, reflecting the canton's improving financial performance and gradual deleveraging supported by its strong stance towards financial equilibrium and its high degree of budgetary and financial flexibility. The ratings also factor in Ticino's high leverage and sizeable exposure to contingent liabilities.

The credit profile of the Republic and Canton of Ticino, as expressed in its Aa2 stable rating, combines (1) a Baseline Credit Assessment (BCA) of aa2, and (2) a moderate likelihood of extraordinary support from the Swiss Confederation in the event the canton faces acute liquidity stress.

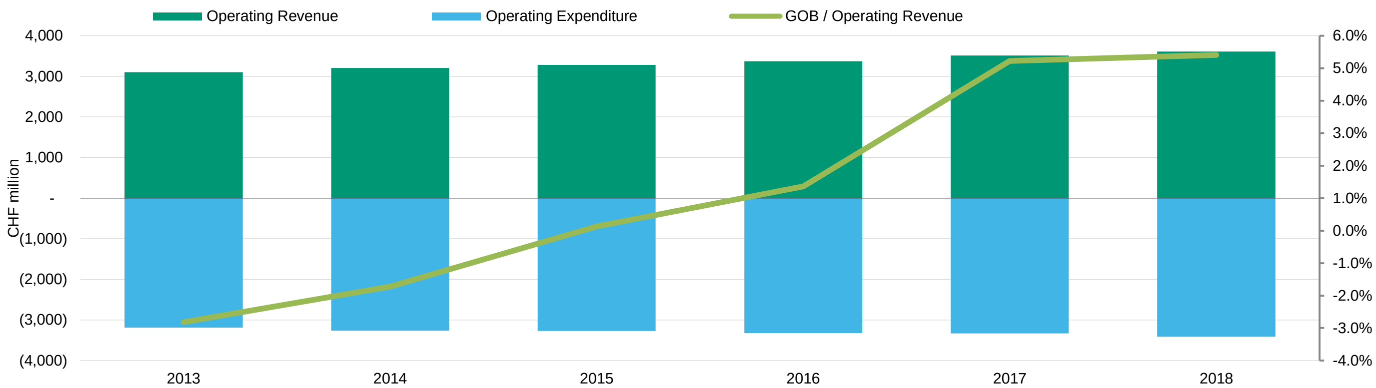
Baseline Credit Assessment

Improving financial performance supported by a constitutional requirement on financial equilibrium

Ticino's constitutional law requires it to maintain a long-term operating financial equilibrium, a credit positive. The cantonal government has put in place a financial plan focused on spending reductions, which allowed Ticino to reach financial equilibrium.

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on www.moodys.com for the most updated credit rating action information and rating history.

Exhibit 3
GOB is improving because of revenue growth



Source: Issuer, Moody's Public Sector Europe

Ticino started executing a spending review designed to reach a financial surplus, which was achieved in 2017 after years of deficits, one year ahead of its target. In 2018, Ticino reported a positive operating balance of 5.4% of operating revenue. This was because of a 3.8% structural growth in its tax revenue and some one-off items like extraordinary dividends from the National Swiss Bank of CHF56.2 million compared with a projected regular annual dividend of CHF28.2 million.

Ticino's spending review is designed to achieve savings of CHF 156 million in 2019. We foresee persistently high, although manageable, future demand for healthcare and social services, reflecting Ticino's ageing population. However, we consider Ticino's plan credible and expect revenue growth to exceed expenditure growth, contributing to continued positive GOB over the next two years. The trend of generating positive GOB demonstrates Ticino's strong stance towards achieving and maintaining financial equilibrium. As Ticino posts positive results, cumulated deficit will likely be null by year-end 2019.

A very high degree of budgetary and financial flexibility, combined with sound debt management
Ticino's very low tax rates provide it a significant financial buffer. The canton, like its peers, has unlimited autonomy in setting tax rates and exerts full control over its costs, which gives it a high degree of fiscal flexibility. Ticino also has good access to capital markets, including the short-term money market.

Tax receipts account for 63.6% of the canton's revenue, followed by intergovernmental transfers (29.1%) and other revenue (7.3%). Under the Swiss fiscal system, the federal government, the cantons and the municipalities all levy separate personal income taxes and corporate taxes. Ticino has complete freedom to set the rate for cantonal personal income tax and corporate tax, which account for the highest proportion of total tax payments.

General purpose grants account for 55.9% of Ticino's intergovernmental transfers. Ticino also benefits from a robust inter-cantonal revenue equalisation system, which ensures a stable annual GOB. Budgetary flexibility is more limited on the expenditure side because of costs associated with the canton's ageing population.

Ticino takes a proactive approach to treasury and debt management. Treasury budgets are carefully planned in advance through the fiscal year. As of 2018, the canton had access to CHF3.5 billion of uncommitted credit lines with 30 banks and supranational organisations. The credit lines are renewable and have a maturity of between one week and 12 months. As of year-end 2018, the canton had used CHF410 million of short-term debt.

Cash on hand stood at an adequate 6% of operating revenue in 2018, which was in line with that of its peers. However, we do not consider the cash position as a challenge because of easy borrowing fostered by Switzerland's current negative interest rates.

A strong and diversified economy
Ticino is a medium-sized canton, with a population of about 353,700 and a relatively diversified service-based economy. Per capita GDP is slightly above the national average (106% as per the last reported figure in 2016), but significantly above the EU28 average (285%). The canton's unemployment rate was 3% in 2018, lower than the Swiss average of 2.6%. Located in the southern part of

Switzerland, Ticino shares its border with the Region of Lombardy (Italy) (Baa2 stable), the wealthiest region of Italy. Ticino's workforce includes about 64,000 skilled cross-border workers, a number that has increased over the last few years. Cantonal GDP is mainly driven by the service industry (76%), followed by manufacturing (22%). Trade, banking and real estate account for the bulk of Ticino's economic activity, although banking industry growth has slowed since the financial crisis. About 76% of Ticino's workforce is employed in the service industry, where trade, banking and tourism are the dominant sectors. The districts of the City of Lugano (Aa3 stable) and Mendrisio are key international hubs for import and export businesses, a strong source of potential growth. Ticino has particular strengths in raw material trading and fashion industry logistics, which help attract skilled workers. As a consequence of the economic dynamism, Ticino's operating revenue increased by 16.5% in 2013-18 although its tax rates remained unchanged.

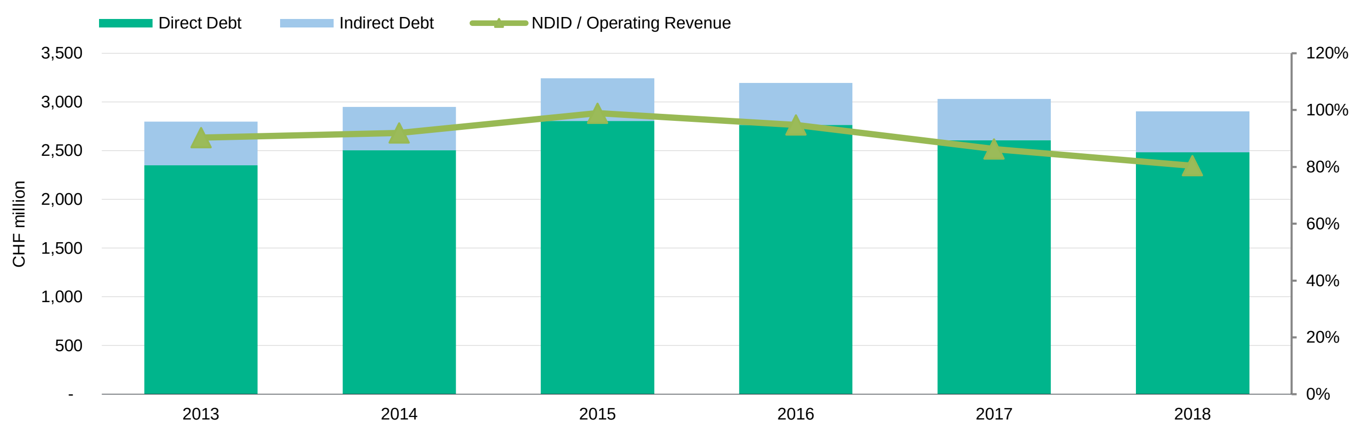
High debt levels, although declining

In 2018, Ticino's NDID amounted to CHF2.9 billion, or 81.1% of realised operating revenue, which is higher than that of its national and international peers but is on a downward trend. This level of debt is manageable, considering the current low interest rates (Ticino pays on average 1.2%) and the canton's significant financial flexibility. We expect NDID as a percentage of operating revenue to decrease gradually over the next few years, down from 81.1% as of year-end 2018 as a consequence of improving operating surplus and deleveraging following the reduction in cantonal cumulated deficit.

As of year-end 2018, long-term direct debt accounted for 71% of Ticino's NDID, followed by short-term (14%) and indirect debt (15%). Indirect debt consists of a financial liability to the cantonal pension fund of CHF454 million with a fixed amortising schedule aimed at funding up to 85% of the canton's pension obligations by 2051. Its pension liabilities are currently 66% funded.

Exhibit 4

Net direct and indirect debt (NDID) is declining steadily



Sources: Issuer, Moody's Public Sector Europe

Sizeable exposure to contingent liabilities

Ticino owns 100% of Banca Stato and provides a full deficiency guarantee on the bank's deposits (2.7x cantonal revenue). Banca Stato is an autonomous institution under public law, which aims to promote Ticino's economic development through mortgage lending and asset management. Its activities cover all the operations of a universal bank. Although the bank's risk appetite is low, we see some risk from M&A activity. Should the balance sheet of the bank expand, the value of cantonal guarantees will grow proportionally, a credit negative. However, the potential threat posed by Banca Stato is moderate because of its low-risk business profile, and the canton is further protected by its good access to the capital markets.

Ticino's exposure to contingent liabilities is also derived from its fully owned electricity wholesaler Azienda Elettrica Ticinese (AET). AET's institutional mandate is to guarantee the procurement of electricity for the canton at competitive prices. AET's leverage is currently low compared with that of Ticino, but should the debt of AET increase, Ticino's exposure to its subsidiary will increase, a credit negative. However, we believe that risks posed by this contingent liability are low and manageable by Ticino.

Insituto di Previdenza del Cantone di Ticino (IPCT) is a public company aiming at serving the future pensions of Ticino's employees. Ticino guarantees the future payments of IPCT to its beneficiaries. Back in 2013, Ticino decided to register a CHF454.5 million liability (*debito di risanamento*) to meet the 85% legal minimal coverage by year-end 2051, an amount that amortises every year based on a fixed amortisation scheduled (interest and principal). This amount is already recorded in Ticino's indirect debt. Ticino's exposure to the remaining unfunded part of its pension fund corresponds to a little less than 17% of its operating revenue. Given Ticino's capacity to change the pension levels retroactively with a law, we believe the canton would not have to effectively disburse this amount if it does not have the financial capacity to do so.

Extraordinary support considerations

We believe Ticino has a moderate likelihood of extraordinary support from the Swiss Confederation, reflecting our assessment of the risk to the Swiss Confederation's reputation if the canton were to default. This reflects Swiss cantons' ample autonomy, and the strongly decentralised relationship between the cantons and the Swiss Confederation.

Rating methodology and scorecard factors

The assigned BCA of aa2 is close to the scorecard-indicated BCA of aa1. The one-notch differential reflects a number of factors that the scorecard does not capture. These include the potential pressure that might arise from the canton's contingent liabilities.

The matrix-generated BCA of aa1 reflects (1) an Idiosyncratic Risk score of 2 (presented below) on a 1-9 scale, where 1 is the strongest relative credit quality and 9 the weakest; and (2) a Systemic Risk score of Aaa, as reflected in the sovereign bond rating (Aaa stable).

For details about our rating approach, please refer to Rating Methodology: Regional and Local Governments, published on 16 January 2018.

Exhibit 5

Republic and Canton of Ticino

Regional and Local Governments

Baseline Credit Assessment	Score	Value	Sub-factor Weighting	Sub- factor Total	Factor Weighting	Total
Scorecard						
Factor 1: Economic Fundamentals						
Economic strength	5	104.86	70%	3.80	20%	0.76
Economic volatility	1		30%			
Factor 2: Institutional Framework						
Legislative background	1		50%	1.00	20%	0.20
Financial flexibility	1		50%			
Factor 3: Financial Performance and Debt Profile						
Gross operating balance / operating revenue (%)	5	4.78	12.5%	3.00	30%	0.90
Interest payments / operating revenue (%)	1	0.70	12.5%			
Liquidity	1		25%			
Net direct and indirect debt / operating revenue (%)	5	81.12	25%			
Short-term direct debt / total direct debt (%)	3	16.50	25%			
Factor 4: Governance and Management - MAX						
Risk controls and financial management	1			1.00	30%	0.30
Investment and debt management	1					
Transparency and disclosure	1					
Idiosyncratic Risk Assessment						2.16(2)
Systemic Risk Assessment						Aaa
Suggested BCA						aa1

Source: Issuer, Moody's Public Sector Europe

Ratings

Exhibit 6

Category	Moody's Rating
TICINO, REPUBLIC AND CANTON OF	
Outlook	Stable
Issuer Rating	Aa2
Senior Unsecured -Dom Curr	Aa2

Source: Moody's Investors Service

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