



RATING ACTION COMMENTARY

Fitch Affirms the Province of Chubut's IDRs at 'CC'

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Fitch Ratings - São Paulo - 07 Nov 2023: Fitch Ratings has affirmed the Province of Chubut's (Chubut or the province) Long-Term Foreign- and Local-Currency Issuer Default Ratings (IDRs) at 'CC'. Chubut's standalone credit profile (SCP) is assessed at 'cc'. Chubut's senior secured step-up notes of USD650 million due in 2030 (Bocade) has also been affirmed at 'CC'.

Chubut's SCP of 'cc' reflects Fitch's expectations that actual debt service coverage ratio (ADSCR) will remain below 1x in the next 12 months-24 months in Fitch's scenario horizon. The province will face capital payments of USD100 million of its Bocade bonds in 2024, with the first quarterly installment of USD25 million in January 2024. The bonds count with pledged royalties' revenues as collateral. Chubut's rating considers the current context of macroeconomic vulnerability, history of high volatility in operating margins, and a high share of dollar denominated debt. Fitch relied on its rating definitions to position the province's SCP and ratings.

KEY RATING DRIVERS

Risk Profile: 'Vulnerable'

The assessment reflects Fitch's view that there is a very high risk of the issuer's ability to cover debt service with the operating balance weakening unexpectedly over the 2023-2025 scenario horizon due to lower revenue, higher expenditures or an unexpected rise in liabilities or debt-service requirements.

Revenue Robustness: 'Weaker'

Chubut's revenue structure highlights a moderate fiscal autonomy and reliance on cyclical oil and gas royalties and transfers from a 'CC' sovereign. The more balanced revenue

composition relative to Argentine peers is undermined by the dependency toward commodity sales, which is highly cyclical.

The assessment reflects the evolving nature of the national fiscal framework, dependence on a 'CC' sovereign counterparty risk for 43.4% (three year-average) of its total revenue, amid an adverse macroeconomic environment riddled with higher inflation. To date, as per law, federal co-participation transfers have never been interrupted to provinces. However, the government can make modifications (exemptions) that affect the co-participating resources. Recent changes (increase in the non-taxable minimum of income tax and exemption from VAT on the basic food basket) could lead to a strong slowdown in co-participation in the last quarter of 2023.

Chubut is heavily dependent on the oil sector, with royalties representing 25.3% of operating revenues on average in 2020-2022. The price per barrel is set by the central government with no clear pricing setting mechanism and might deviate from market prices. Royalties are linked to the official exchange rate. Own tax collection averaged at 23% of operating revenues in 2020-2022.

Revenue Adjustability: 'Weaker'

Chubut's ability to generate additional revenue in response to possible economic downturns is limited, like all Fitch-rated Argentine local and regional governments (LRGs). Fitch considers that local revenue adjustability is low and is challenged by the country's large and distortive tax burden. The negative macroeconomic environment further limits the province's ability to increase tax rates and expand tax bases to boost its local operating revenues. Structurally high inflation also constantly erodes real-term revenue growth and affects affordability. On its rating case, Fitch expects operating revenues to increase below the average inflation rate for 2023-2025.

Expenditure Sustainability: 'Weaker'

Argentine provinces have high expenditure responsibilities, including healthcare, education, security, social security, inter-urban transportation and other services. The country's fiscal regime is structurally imbalanced due to revenue-expenditure decentralization. This is further exacerbated by the nation's macroeconomic commitments with the IMF.

Chubut's operating balance has been quite volatile across the years, reflecting its dependency on oil royalties. On the expenditure front, high inflation has forced an

adjustment to the payroll bill and goods and services. Fitch estimates that Chubut accumulated a real drop of 8.8% in Opex in 2022 when compared to 2017. The containment of expenditures resulted in an improvement to the operating balance in 2021-2022. However, pressure to adjust payroll to past inflation remains and is likely to result in higher Opex growth going forward. Fitch expects a re-composition of expenditure above inflation levels for 2023, with an average operating margin of 4% for 2023-2025.

The province reports no significant delays towards suppliers and the payroll bill and pensions are being paid on a timely basis.

Expenditure Adjustability: 'Weaker'

For Argentine subnationals, infrastructure needs and expenditure responsibilities are deemed as high, with leeway or flexibility to cut expenses viewed as low. National capital expenditure (capex) is low and insufficient, translating capex burdens to LRGs.

Province of Chubut capex to total expenditure ratio averaged at 11.1% for 2018-2022. Staff cost in 2022 corresponded to 61.4% of total expenditures, translating into a high expenditure rigidity for the Province of Chubut. This further limits the ability of the province to perform expenditure cuts. Chubut reports one of the highest ratios of personal expenditures to total expenditures among Argentine provinces.

Liabilities & Liquidity Robustness: 'Weaker'

There is a weak national framework for debt and liquidity management and an underdeveloped local financial market, which led Argentine LRGs to issue debt in foreign currency, causing a structural reliance on external markets for financing. Chubut currently does not comply with the national fiscal framework (Ley de Responsabilidad Fiscal) and, therefore, cannot take new loans for infrastructure financing. Only refinancing transactions are allowed.

The Province of Chubut's direct debt totaled ARS163 billion at YE 2022. Approximately 68% of debt is denominated in foreign currency. Exposure to foreign exchange (FX) risk and capital controls are a significant fragility of Argentine LRGs.

There is significant maturity concentration in 2023-2028. The DDE of Chubut's senior secured bonds created some fiscal space for 2021-2022, but starting in 2023, capital repayments become more sizable. These bonds count with pledged royalty revenues as collateral.

The province has performed capital payments of USD84.4 million in 2023, including extraordinary amortizations of USD6.5 million, which were triggered by high coverage ratios as per the bond agreement. For 2024, Chubut should perform capital payments in the amount of USD100 million following Bocades' restructured debt amortization schedule.

Liabilities & Liquidity Flexibility: 'Weaker'

This KRF assessment considers that in Fitch's view, the Argentine national framework in place regarding liquidity support and funding available to subnationals is 'Weaker', as there are no formal emergency liquidity support mechanisms established. The current context of national capital controls is another risk captured in the liquidity flexibility assessment, as the imposition of exchange regulations could ultimately affect LRGs' ability to fulfil their financial obligations, especially considering the distressed sovereign counterpart of 'CC' and scarce foreign reserves.

Debt Sustainability: 'bb category'

The Province of Chubut's debt sustainability score deteriorated to 'bb' from 'a' in the previous annual review on the back of a significant depreciation of the real exchange rate and deteriorating operating margins. The primary metric of the debt sustainability assessment, the payback ratio, is projected at 14.3x for 2025 under Fitch's rating case, aligned with the 'bbb' category. The secondary metric, the ADSCR, is projected at 0.2x in 2025, aligned with the 'b' category. Fitch applies an override to the overall debt sustainability assessment given the significantly weaker coverage ratio. Fiscal debt burden is projected at 33.4% in 2025.

DERIVATION SUMMARY

The Province of Chubut's 'cc' SCP reflects rating definitions that consider the province's very high level of credit risk, given its pressured DSCR over the next 12 months-24 months. Chubut's risk profile is assessed as 'Vulnerable', while its debt sustainability is assessed at 'bb'. The rating is based on Fitch's rating definitions. Fitch classifies Chubut as a Type B LRG, as it covers debt service from cash flow on an annual basis.

The SCP also factors in national and international peer comparison, in particular Province of Neuquen (CC), Province of La Rioja (CC), and Kaduna State (B-/Stable). Fitch does not apply any asymmetric risk or ad-hoc support from the central government and assesses intergovernmental financing as neutral to the province's ratings.

Debt Ratings

Province of Chubut's USD650 million step-up senior secured notes due in 2030 (Bocade notes) are rated 'CC'. The bonds are rated at the same level as the province's IDRs.

These bonds count with pledged royalty revenues as collateral. Bocade's 2021-2023 coverage has been above the transaction's 1.35x requirement.

KEY ASSUMPTIONS

Risk Profile: 'Vulnerable'

Revenue Robustness: 'Weaker'

Revenue Adjustability: 'Weaker'

Expenditure Sustainability: 'Weaker'

Expenditure Adjustability: 'Weaker'

Liabilities and Liquidity Robustness: 'Weaker'

Liabilities and Liquidity Flexibility: 'Weaker'

Debt sustainability: 'bb'

Support (Budget Loans): 'N/A'

Support (Ad Hoc): 'N/A'

Asymmetric Risk: 'N/A'

Rating Cap (LT IDR): 'N/A'

Rating Cap (LT LC IDR) 'N/A'

Rating Floor: 'N/A'

Quantitative assumptions - Issuer Specific

Fitch's rating case is a "through-the-cycle" scenario, which incorporates a combination of revenue, cost and financial risk stresses. It is based on 2018-2022 figures and 2023-2025 projected ratios. The key assumptions for the scenario include:

Average operating revenue growth of 130.5% for 2023-2025, assuming growth below average inflation towards the medium-term to stress operating margins;

Opex average growth of 140.2% for 2023-2025, assuming growth above inflation towards the medium-term due to real term expenditure re-composition;

Average net capital balance of approximately negative ARS84.3 billion during 2023-2025, below the historical average in real terms, reflecting lower operating balances;

Cost of debt considers noncash debt movements due to currency depreciation with an average exchange rate of ARS343.56 per U.S. dollar for 2023, ARS898.88 per U.S. dollar for 2024 and ARS1963.82 per U.S. dollar for 2025.

Consumer price inflation (annual average percent change) of 125.3% for 2023, 157.5% for 2024 and 122% for 2025.

Quantitative assumptions - Sovereign Related

Figures as per Fitch's sovereign actual for [2022] and forecast for [2025], respectively (no weights and changes since the last review are included as none of these assumptions was material to the rating action):

Issuer Profile

The Province of Chubut is located in the Patagonian region of Argentina, where socioeconomic indicators tend to be better than the national average. The province is in a strategic geographic position and is the country's largest oil-producing province.

RATING SENSITIVITIES

Factors that Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade

Signs of deeper liquidity stress that could compromise debt repayment capacity in the short to medium term, including evidence of increased refinancing risk in its local and foreign currency debt; as well as any regulatory restrictions to access FX by LRG.

The Foreign Currency IDR would be downgraded if there are any indications of any credit event that reflects a near default situation.

Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade

Improved operating balances that strengthens the actual DSCR above 1.0x on a sustained basis under Fitch rating case projection horizon.

ESG CONSIDERATIONS

Chubut, Province of has an ESG Relevance Score of '4' for Rule of Law, Institutional & Regulatory Quality, Control of Corruption due to the negative impact the weak regulatory framework and national policies of the sovereign have over the province which has a negative impact on the credit profile, and is relevant to the rating[s] in conjunction with other factors.

Chubut, Province of has an ESG Relevance Score of '4' for Biodiversity and Natural Resource Management due to the province's significant economic and financial exposure to the hydrocarbon sector, which has a negative impact on the credit profile, and is relevant to the rating[s] in conjunction with other factors.

Chubut, Province of has an ESG Relevance Score of '4' for Creditor Rights. Chubut concluded its DDE in December 2020 and has complied to negotiated terms throughout 2021-2023. The DDE continues to weigh on its credit profile, and is relevant to the rating[s] in conjunction with other factors.

The highest level of ESG credit relevance is a score of '3', unless otherwise disclosed in this section. A score of '3' means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. Fitch's ESG Relevance Scores are not inputs in the rating process; they are an observation on the relevance and materiality of ESG factors in the rating decision. For more information on Fitch's ESG Relevance Scores, visit <https://www.fitchratings.com/topics/esg/products#esg-relevance-scores>.

DISCUSSION NOTE

There was an appropriate quorum at the committee and the members confirmed that they were free from recusal. It was agreed that the data was sufficiently robust relative to its materiality. During the committee no material issues were raised that were not in the original committee package. The main rating factors under the relevant criteria were

discussed by the committee members. The rating decision as discussed in this rating action commentary reflects the committee discussion.

References for Substantially Material Source Cited as Key Driver Rating

The principal sources of information used in the analysis are described in the Applicable Criteria.

RATING ACTIONS

ENTITY / DEBT ↕	RATING ↕	PRIOR ↕
Chubut, Province of	LT IDR CC Affirmed	CC
	LC LT IDR CC Affirmed	CC
senior secured	LT CC Affirmed	CC

[VIEW ADDITIONAL RATING DETAILS](#)

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APPLICABLE CRITERIA

[International Local and Regional Governments Rating Criteria \(pub. 03 Sep 2021\)](#)
(including rating assumption sensitivity)

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Chubut, Province of

EU Endorsed, UK Endorsed

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