30 April 2021

Sovereign and Public Sector

Free State of Bavaria Rating Report

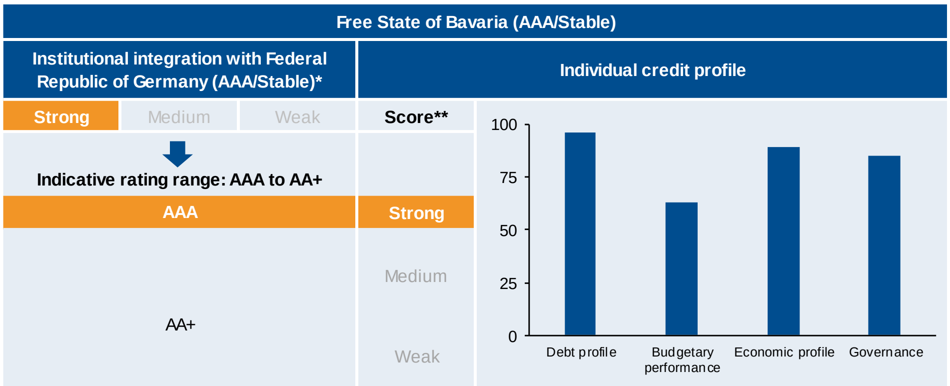
STABLE

AAA

Credit strengths	Credit weaknesses
• Wealthy economy • Strong budgetary performance • Low debt burden • Ample liquidity • Excellent capital market access • Highly integrated institutional framework	• Limited revenue flexibility • High pension liabilities • Sizeable, though largely low-risk, contingent liabilities

Rating rationale and Outlook: The AAA rating reflects the Free State of Bavaria's exceptionally strong individual credit profile, captured by a wealthy economy, strong budgetary performance, low debt burden, ample liquidity, and excellent capital market access. In addition, sizeable national discretionary support measures help compensate for the pressure on Bavaria's finances caused by the Covid-19 economic shock. The rating is also underpinned by a highly integrated institutional framework, characterised by a very strong revenue equalisation system together with the federal solidarity principle. Credit challenges relate to the limited revenue flexibility and high pension liabilities weighing on long-term expenditure flexibility, as well as sizeable, yet manageable, contingent liabilities. The Stable Outlook reflects our assessment that the risks Bavaria faces remain well balanced.

Figure 1: Scope's rating approach on the Free State of Bavaria



N.B. *Across countries/government layers (German Länder) **Across national peers (German Länder). From 1 (weakest) to 100 (strongest).

Source: Scope Ratings GmbH

Positive rating-change drivers	Negative rating-change drivers
• Not applicable	• Downgrade of Germany's sovereign rating, necessitating a rating review • Changes in the framework, resulting in weaker individual credit profile

Ratings & Outlook

Foreign currency

Long-term issuer rating	AAA/Stable
Senior unsecured debt	AAA/Stable
Short-term issuer rating	S-1+/Stable

Local currency

Long-term issuer rating	AAA/Stable
Senior unsecured debt	AAA/Stable
Short-term issuer rating	S-1+/Stable

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Bloomberg: RESP SCOP

Institutional framework

Integrated framework results in strong alignment of creditworthiness

The Free State of Bavaria, like all Germany's Länder, benefits from a mature, highly predictable and integrated institutional framework. The key elements are: i) a strongly interconnected revenue equalisation mechanism enshrined in the German constitution; ii) wide-ranging participation – and veto-rights – by the Länder in national legislation; iii) equal entitlement of the Länder regarding negotiations on federal reforms; and iv) a solidarity principle that ensures extraordinary system support in situations of budgetary emergency.

We view the federal system under which the German Länder[1] operate to be the strongest integrated system among European sub-sovereigns. We assess the system as 'high' for: i) institutionalised support; ii) fiscal interlinkage; and iii) political coherence, both among the Länder as well as between the Länder and the Federal Republic of Germany (AAA/Stable). Consequently, our assessment results in an indicative downward rating distance of a maximum one notch between the German sovereign and the rating of the individual Land (see **Figure 2)**.

Figure 2: Framework assessment

Institutional framework assessment: German Länder					
Category	Weight		Assessment: Integration	Assessment: Score	Weighted score
Institutionalised support	25%	Transfer & bailout regime	Full	100	25
	15%	Borrowing limits	Full	100	15
	10%	Funding support	Full	100	10
Fiscal interlinkage	20%	Tax authority	Full	100	20
	15%	Fiscal equalisation	Full	100	15
Political coherence	10%	Distribution of powers	Full	100	10
	5%	Common policymaking	Full	100	5
		Integration with the sovereign		Σ	100

Integration score	0-10	10-20	20-30	30-40	40-50	50-60	60-70	70-80	80-90	90-100
Indicative notch range	0-10	0-9	0-8	0-7	0-6	0-5	0-4	0-3	0-2	0-1

Source: Scope Ratings GmbH

Institutionalised support

Länder have been granted additional financial support from the federal government in five instances: Bremen (1992, 2006), Saarland (1992, 2005) and Berlin (2002). The court approves claims on the grounds of the 'Bundestreueprinzip', under which the Länder and the Bund are required to provide each other with mutual support in the event of a budgetary emergency. Berlin's claim in October 2006 was denied, with the court arguing that the city-state was not in an extreme budgetary situation. However, the judges noted that federal emergency support remains possible as ultima ratio if the budget and/or debt situation is assessed as extreme compared to that of other Länder.

Also, we consider the interpretation of the 'Bundestreueprinzip' to be an implicit bail-out rule, as it requires the provision of federal support in times of budgetary stress. We therefore define the degree of integration as high.

Debt brake since 2020 disabled to counteract Covid-19 effects

Regarding borrowing limits, Länder[2] must comply with a 'debt brake' since 2020, under which they cannot run structural financing deficits unless hit by a severe economic downturn or a natural disaster. The debt brake also caps the structural annual deficit of the central government at 0.35% of GDP. The German parliament used the emergency clause of the debt brake for 2020 and 2021 in response to the Covid-19 crisis.

[1] We use 'state' and the colloquial German terms interchangeably to refer to German federal states, individually as 'Land' and collectively as 'Länder'.
[2] The debt brake is a legal framework that prohibits structural deficits from 2020 onwards; article 109 (3) of the Basic Law stipulates that the Länder may incur deficits in a case of a recession or a natural disaster provided they pass respective legislation at the Land level.

Separately, the Free State of Bavaria invoked the safeguard clause of its debt brake for 2020 and 2021 to implement support measures and credit authorisations to mitigate the budgetary impact of Covid-19. The federal government has assumed the role as a primary shock absorber through deficit spending of EUR 390bn to date (or 12% of 2020 GDP), which has absorbed a large part of the costs for the economy caused by ongoing pandemic restrictions as well as for direct healthcare spending.

The finances of the Länder and their compliance with debt limits are monitored by the Stability Council, which was established in 2010 as a joint body of the German Federation and the Länder. The Stability Council monitors restructuring programmes and compliance with budgetary targets as defined in fiscal consolidation agreements between the Bund and the Länder. The Council comprises the finance ministers of each Land and the federal ministers of finance and economic affairs.

The Stability Council and the debt brake are important pillars for integrated financial relations between central and regional German governments, which leads us to assess integration between the two levels of government as high.

The Länder have autonomous funding combined with equal risk-weights

We view the level of funding support as high between the Länder and the federal government based on their history of stand-alone capital market issuance combined with aligned risk weights to the sovereign.[3]

Fiscal interlinkage

Shared tax authority with the Bund on high-revenue taxes

The Länder and the federal government share the tax authority, deciding together on rates and revenue distribution on high-revenue common taxes (income and VAT). The latest reform on federal financial relations (in 2017) took effect in 2020 and has resulted in a higher distributed share of VAT revenues to the Länder. The VAT distribution will also fully compensate for the different taxing powers, thereby replacing the former two-step process of horizontal equalisation payments between the Länder. Alongside common taxes, the central government and the Länder have separate tax authority on other less-revenue-generating taxes.

We assess the tax authority as highly integrated, based on the high share of common taxes and the clear separation of tax authority on less-revenue-generating taxes.

Bavaria is the largest contributor to the federal financial equalisation system

The German system is shaped by a financial equalisation system that strongly aligns different fiscal capacities among the regions. Bavaria was the largest net contributor to the system in 2019 (EUR 6.8bn[4]), with most other Länder being net beneficiaries (12 out of 16) to prevent political and economic division. The reformed equalisation system took effect in 2020, with distribution occurring via VAT. The net effect should be positive for all Länder as contributions from the federal government are greater under the new system. As a result, we maintain our assessment that the fiscal equalisation system contributes materially to high integration.

Political coherence

Federal reforms further strengthen the high level of political coherence

In 2017, the German government and the Länder agreed to reshape financial relations in the federal system, generally binding from 2020. In return for higher payments from the equalisation system, the regions have assigned limited executive and legislative rights to the central government in formerly autonomous policy areas, including physical and digital infrastructure and the higher-education system. In conformity with earlier federal reforms ('Föderalismusreformen II'), we observe that the higher the share of common

[3] Regulatory treatment of a sub-sovereign exposure in comparison with respective sovereign exposure for banks, which, in the European context, is defined under the European Banking Authority's Capital Requirements Regulation (CRR).
[4] Free State of Bavaria, final accounts 2019.

national legislation ('konkurrierende Gesetzgebung'), the more integrated the German federal system becomes.

The high share of common national legislation and the increasing political and financial involvement of the central government in regional policy areas lead us to assess the degree of common policymaking as high. This has been highlighted during the Covid-19 crisis, with major measures coordinated by the prime ministers of the Länder together with Chancellor Angela Merkel.

Special role of Bavaria with regional party

In addition, Bavaria has a unique role in the national political landscape. It is the only federal Land with a separate party: the Christian Social Union, or the CSU. The CSU has been in power since 1957 under different coalitions but usually as a one-party government and has always appointed the Land's prime minister. The party also has a long-standing agreement with the Christian Democrats (CDU) to co-operate in federal and regional elections. While the CDU does not compete with the CSU in Bavaria, the two parties form a common parliamentary party on the national level. The CSU's ability to represent Bavarian interests at the national level increases Bavaria's influence on national policy-making relative to the other Länder.

Individual credit profile

Bavaria is the second most populous German state with about 13m residents (16% of the German total) and has the country's second largest regional economy (18% of the total). The state's main responsibilities include healthcare and education, which are financed predominantly via shared taxes, transfers and other income.

Bavaria has one of the strongest individual credit profiles among peers

We assess Bavaria's individual credit profile as 'exceptionally strong' in view of the state's ability to maintain balanced budgets and cover debt repayments, even under adverse conditions. This reflects Bavaria's: i) low debt, ample liquidity, and excellent capital market access; ii) strong budgetary performance and above-average expenditure flexibility along with average revenue flexibility compared to other German Länder; iii) wealthy and highly competitive economy; and iv) the high quality of governance at the regional level. Credit challenges relate to limited revenue flexibility and high pension liabilities weighing on long-term expenditure flexibility, as well as sizeable, yet manageable, contingent liabilities. In addition, the Covid-19 crisis will lead to higher debt levels and temporary budgetary deterioration due to revenue losses and additional expenditure, especially in 2020, but the state's budgetary reserves and prudent financial management should compensate for the shock over the medium term.

Debt burden and liquidity profile

High own cash reserves

The Free State of Bavaria benefits from ample liquidity, which has supported the continuous reduction of the already low debt burden coming into the Covid-19 crisis. Bavaria holds sizeable cash holdings vis-à-vis national peers, stemming from its sound budgetary and financial management. Bavaria's ample cash holdings will comfortably cover debt service through to 2022. Moreover, the 2019 increase in cash reserves took place alongside an increase of postponed credit authorisations[5].

Solid cash flow profile and conservative liquidity planning

Bavaria benefits from highly predictable cash flows and prudent budgetary assumptions for liquidity planning. The state's cash flows, especially inflows, are prone to seasonal variations driven by the tax calendar. Similar to other Länder (excluding city-Länder), Bavaria's cash reserves tend to increase over the year, with peaks in mid-July and mid-October followed by significant outflows at the end of October and November. Moreover, the Land accumulates the Bavarian municipalities' shares in taxes before distributing

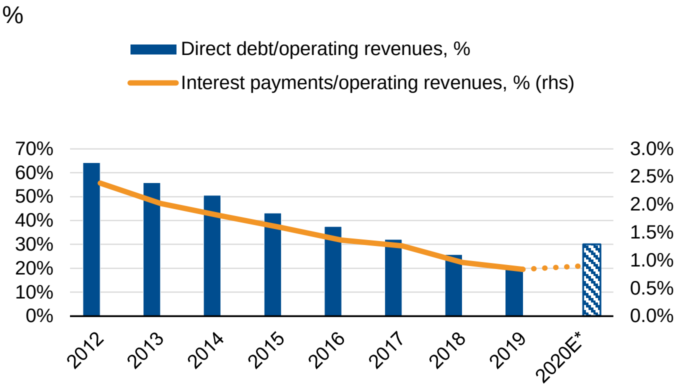
[5] In view of Bavaria's high own cash holdings combined with the low interest rate environment, a major instrument for reducing cash holdings is the postponement of credit authorisations. This means that authorisations to accept debt for the repayment of due loans are unused and due loans are settled using existing cash holdings.

them to the municipalities every quarter. These factors partly explain the state's excess liquidity during the year.

Excellent access to external liquidity

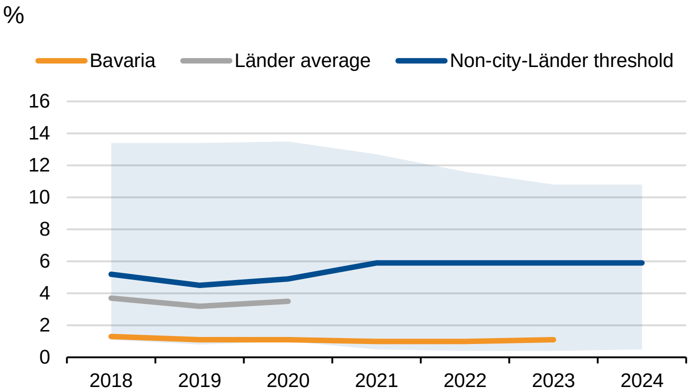
Bavaria has excellent access to external funding, which strengthens its resilience to shocks. External liquidity, if required, is available at short notice via credit facilities from various major financial institutions. German Länder lend excess liquidity to each other via commercial cash transactions, generating another source of liquidity. Combined with Bavaria's own sizeable reserves, this makes the risk of a liquidity shortfall negligible.

Figure 3: Debt and interest burden



* For 2020 with data from the Federal Statistical Office. Source: Bayerisches Staatsministerium der Finanzen und für Heimat, Federal Statistical Office, Scope Ratings GmbH

Figure 4: Interest-to-adjusted-tax ratio



Source: German Stability Council, Scope Ratings GmbH

Low debt burden and continuous debt reduction

Bavaria benefits from a low debt burden in a national and international context and has repaid all maturing debt without recourse to credit authorisations in recent years (reflecting its high cash holdings). Bavaria's direct debt amounted to EUR 13bn at the end of 2019. As a share of operating revenues reduced significantly between 2012 and 2019, from 64% to 20% (see **Figure 3**). In line with previous years, Bavaria's debt reduction in 2019 was via settling due loans using cash and postponing around EUR 14bn of unused credit authorisations to future budgets.

Low interest-payment burden

The reduction of debt has led to a fall in Bavaria's interest payments relative to operating revenues, to 0.8% in 2019 from 2.4% in 2012, further bolstering its fiscal position. Based on recent stability council assessments, Bavaria will continue to outperform most German Länder in terms of fiscal indicators. This view is also supported by Bavaria's very low interest-to-adjusted-tax ratio (see **Figure 4**) vis-à-vis national peers.

The Covid-19 crisis will lead to an increase in the debt burden, overall level to remain modest

In response to the Covid-19 crisis and as is the case for the German sovereign and other Länder, Bavaria passed legislation to invoke the safeguard clause of its debt brake and adopted budgetary measures that allow for up to EUR 20bn of new debt issuances in 2020 and up to EUR 11.6bn in 2021 via credit authorisations. Unused credit authorisations in 2020 and 2021 can be transferred under certain conditions to subsequent years, supporting the Land's financing flexibility. The funds will be collected under a dedicated account in the Land's core budget created to address the Covid-19 crisis. We expect that the overall take-up will be significantly lower, however, and that the volume of the 2020 authorisation of EUR 20bn should be sufficient to cover funding needs for 2020 and 2021. Scope estimates that Bavaria's direct debt effectively increased by about EUR 4.9bn in 2020, leaving significant headroom. While this will increase Bavaria's direct debt by about 10pps of operating revenues in 2020 (see **Figure 3**), Scope expects that the debt burden relative to operating revenues will peak in 2021.

Debt service to rise modestly and reduce expenditure flexibility to some degree

Under the debt brake rule, credit authorisations under the emergency clause come with a pre-defined redemption plan. Bavaria will amortise annual instalments of 5% of the total amount incurred under the 2020 credit authorisation from 2024 to 2044, and from 2025 to 2045 for debt incurred under the 2021 credit authorisation. A full utilisation of the 2020 credit authorisations of EUR 20bn would lead to additional debt service costs of EUR 1bn somewhat reducing expenditure flexibility. Thanks to favourable financing rates, we expect the interest-payment burden at below 1% of operating revenue from 2024.

Sound debt management

As for all German Länder, we assess Bavaria's access to capital markets as excellent. This was evident during the Covid-19 crisis, when all Länder maintained their excellent access, demonstrating investor confidence in the German framework. In response to the Covid-19 crisis, Bavaria re-entered the bond markets for the first time since end-2014, issuing EUR 7.2bn in 2020 at near-zero coupons. Bavaria also employs a conservative debt-management strategy with no foreign currency exposure and limited interest rate risks. Going forward, in view of the low interest rate environment, Bavaria's debt management strategy foresees i) the issuance of fixed-rate debt only; and ii) the exclusion of new derivatives to minimise risks and maintain low administrative costs in debt management.

Contractual guarantees exhibit low and declining risks

Outstanding contractual guarantees issued by Bavaria have increased to around EUR 8.5bn in 2019, up from about EUR 5bn in 2018, due to guarantees issued for a major infrastructure project. Another increase is expected in 2020 due to the guarantees provided to Bavaria's regional development bank to facilitate lending to businesses hit by the Covid-19 crisis, with a maximum envelope of EUR 12bn, as well as guarantees of a maximum EUR 26bn for the newly created 'BayernFonds', which was set up to issue guarantees itself or inject capital into mid-sized Bavarian companies. Guarantees in 2019 primarily were towards housing (EUR 3bn) and individual authorisations (EUR 5.5bn). Improved property values make it less likely that the Free State of Bavaria will have to honour the guarantees related to real estate transactions. In addition, guarantees for debt incurred by social housing associations are not relevant to the budget, in our opinion, because of the associations' stable rent income.

Materialisation of contingent liabilities in the financial sector unlikely

Challenges relate to Bavaria's sizeable implicit contingent liabilities arising from its 75% shareholding in the BayernLB bank (total assets of EUR 256bn in 2020). As a positive development, financial risk from the state's exposure was reduced in 2017[6] after BayernLB repaid its state aid in full. Moreover, the repayment of Bavaria's capital contribution in 2017 led to an early conclusion of the related EU proceedings. The bank's balance sheet is strong with i) a solid capital base, reflected by a CET1 capital ratio of 15.9% at YE 2020, well in excess of the regulatory requirement (minimum 9.5% for 2020); and ii) a low NPL ratio of 0.6% at end-2020, resulting in low risk provisions.

Solid management of major holdings

Bavaria's strong management of its major shareholdings is reflected in good overall financial results, indicating a low risk of materialisation of related contingent liabilities. The combined debt of entities in which Bavaria holds a majority share (excluding financial institutions) remained stable in 2019, at around EUR 1.9bn, as did the share of debt regarding participations with a negative annual result, which remained at around 3%.

The Covid-19 crisis will adversely affect the profitability of several of the Land's holdings, especially in 2020, with the Land providing support via loans or capital injections. Among the worst-hit entities are Munich Airport, Nuremberg Airport and exhibition centres.

[6] In 2008/09, Bavaria injected EUR 10bn of capital into the bank and issued EUR 4.8bn in guarantees for Bayern LB's structured finance portfolio. Under the EU state-aid proceedings, the European Commission scheduled a repayment of EUR 4.96bn until 31 December 2019 at the latest. With the repayment of EUR 1bn as of 30 June 2017, BayernLB has fully met the repayment obligation. The guarantees for the structured credit portfolio were terminated in 2014.

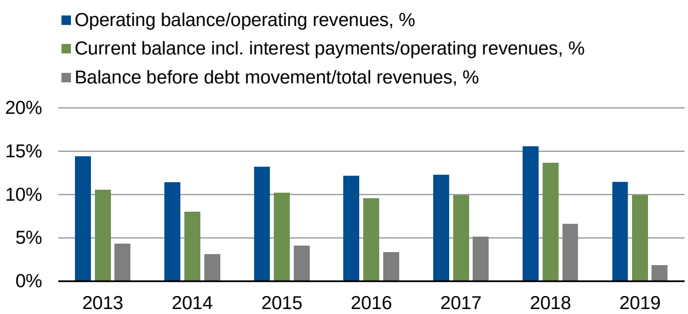
Budgetary performance and flexibility

Strong budgetary performance and flexibility

Bavaria benefits from strong budgetary performance, with high operating surpluses averaging 12.9% of operating revenues in 2015-19 and significant surpluses before debt movement averaging 4.2% of total revenues (see **Figure 5**). This performance is underpinned by the strong growth in tax revenue, continuous cost control and conservative budgetary management, which have helped towards a substantial reduction in debt and a build-up of cash reserves.

Figure 5: Budgetary performance

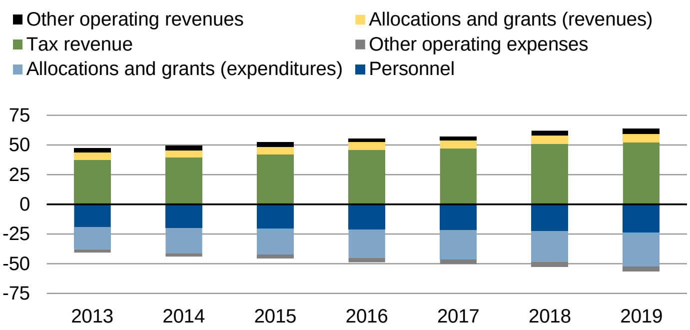
%



Source: Bayerisches Staatsministerium der Finanzen und für Heimat, Scope Ratings GmbH

Figure 6: Components of operating balance

EUR bn



Source: Bayerisches Staatsministerium der Finanzen und für Heimat, Scope Ratings GmbH

Operating revenue is driven by strong national growth

Bavaria's operating revenue is dominated by taxes (see **Figure 6**). As most taxes are subject to revenue equalisation, Bavaria mainly receives shared taxes (largely personal income taxes, VAT and corporate taxes), thereby limiting revenue flexibility. These revenues are initially collected by Bavarian tax offices but are later redistributed at national level in accordance with revenue-sharing agreements and additional transfer mechanisms. This weakens the link between the state's tax revenues and its economic performance.

Above-average expenditure flexibility vis-à-vis peers

The Free State of Bavaria enjoys a high share of investments (12% of total expenditure in 2019) and low administrative costs (6.4% of expenditure in 2019). The state also has a track record of fiscal consolidation and implementing cost-cutting during economic downturns to offset budgetary shocks, which will also be relevant after the Covid-19 shock. However, the expenditure structure is rigid: Bavaria's largest budgetary items relate to transfers and grants for ongoing purposes (at 44% of expenditure in 2019) as well as key allocations to municipalities. Around 37% is dedicated to personnel costs (around 60% of which is spent on education, science, research and culture, and 20% on security and legal protection), which reflects the Free State's extensive investments in education, science and high security standards.

Bavaria's 2020 and 2021 budgets will be heavily impacted by the Covid-19 crisis

After years of budgetary surpluses and net debt reduction, results in 2020 and 2021 will be driven by the Covid-19 pandemic; due to the higher uncertainty and to increase operational flexibility, Bavaria passed a budget for 2021 instead of the usual two years.

Scope expects Bavaria's financial results to worsen from a surplus of around EUR 1.2bn in 2019, or 2% of total revenues, to deficits of around 8% for 2020 and 4% in 2021. In our view, the adverse budgetary effects should be counterbalanced, and the budget should return to balance in the medium term, due to Bavaria's: i) conservative budget management; ii) track record of a commitment to fiscal consolidation; iii) possibility to adjust budgets in view of the high investment levels; and iv) economic and demographic outperformance vis-à-vis national peers.

The crisis will lead to lower-than-budgeted tax revenues, by around EUR 3.5bn in 2020 and EUR 3.7bn in 2021[7], and structural annual revenue shortfalls of around 5% of pre-crisis budgeted tax revenue going forward. The pre-crisis level of tax revenue should be reached in 2022. On the expenditure side, Bavaria has taken measures to mitigate the Covid-19 shock, on top of the measures decided on the federal level, some of which are channelled via the state's budget.

We estimate additional pandemic-related expenditure of around EUR 9bn in total in 2020 and 2021, or around 14% of 2019 total revenue, mainly relating to investment to increase healthcare capacity and procure medical equipment, fiscal support to households and municipalities, and funds directed towards transfers, loan guarantees and capital injections to small and medium-sized businesses. The Free State has also approved the Hightech Agenda Plus investment programme with EUR 900m for 2021 and 2022 for research and development and to stimulate the economy.

Pension payments weigh on long-term budgetary flexibility

Pension expenditure will take up an increasingly larger share of Bavaria's budget, with the number of eligible pensioners set to rise to 185,000 in 2040 (by 29% vs 2019), weighing on the state's long-term expenditure flexibility. According to Bavaria's report on future pension expenditure, which includes an alternative assumption on adjustments of the pensions by 2.5%-3.5% p.a., the share of pension expenditure will rise steadily from 9.1% in 2018 to peak between i) 11.1% in 2027 and reach 9.4% in 2050 (with a moderate growth rate of 2.5% p.a.), ii) 11.7% during 2033-2036 (with a growth rate of 3% p.a.) and iii) 12.6% during 2037-2042 (with a historically unlikely growth rate of 3.5% p.a.).

To ease the rising pressure from pension obligations, Bavaria plans to co-finance pension payments via: i) savings through implemented increases in the retirement age and managing compensation levels; ii) continuous debt reduction, thereby generating some fiscal room; and iii): withdrawals from its pension fund. The capital stock of the pension fund was EUR 3.2bn at the end of 2019. In addition to annual fund inflows of EUR 110m until 2030, Bavaria contributes pension allowances (EUR 19.9m in 2019). Overall, the combined measures, including anticipated savings, will result in a moderate share of pension expenditure with a peak below 10-12% - thus, broadly in line with today's levels.

Record-high investment levels over the medium term and planned return to balanced budgets in 2022

Bavaria's financial plan for 2020-24 is based on keeping investments at a record-high level (from around 12% of total expenditure in 2020 to 14% in 2024) and a return to balance in 2022, which will entail significant consolidation efforts via an economic recovery from 2021 and some expenditure adjustments.

Spending will take a particular focus on demographic developments and greenhouse gas reduction. Programmes include i) the technology initiatives Hightech Agenda Bayern, to which EUR 2bn is allocated until the end of the legislative period in 2023, and Hightech Agenda Plus, a supplement to the former in response to the Covid-19 crisis to give additional growth stimulus of EUR 900m for 2021 and 2022; and ii) a Bavarian climate protection offensive that includes higher outlays for research and development on environmental and climate protection at around EUR 231m in the 2019/20 budget.

Economy and social profile

Key economic region in Germany

Bavaria has a favourable socio-economic profile underpinned by a large, wealthy, well-diversified and highly competitive economy, resulting in a high regional growth potential and strong ability to generate its own revenues for the long term. With GDP of around EUR 633bn in 2019, Bavaria is one of the key economic regions in Germany, contributing

[7] Based on November 2020 tax projections and excluding the effects of the new equalisation scheme among German Länder, given that previous transfers are now budgeted as deductions from VAT revenues.

18% of national GDP. The state is also one of the wealthiest regions in Europe, with a GDP per capita at 17% above the German average and 40% above the euro area average.

Robust economic growth and highly competitive economy

Pre-crisis, economic expansion was strong but slowing in 2019, with an average real GDP growth of 2.5% in 2010-19, outperforming the German average of 2% (**Figure 7**).

Severe impact in 2020 and a strong rebound in 2021 expected

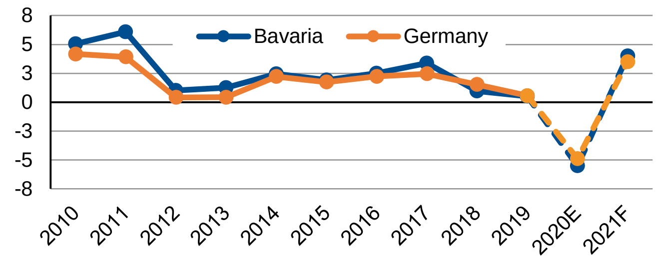
Following real growth of 0.5% in 2019, Bavaria's real GDP in 2020 declined by 5.5% due to the Covid-19 shock, slightly more than the German average of 4.9%. In early 2020, Bavaria's export-oriented industry was hard-hit by the global shutdown of activity, with exports declining by 11% in 2020 YoY. However, the exports sector has recovered and continues to perform better than the services sector, as highlighted by a 9-point expansion of the Bavarian ifo business climate index in March 2021. A continuing economic expansion, especially in major trading partners such as the US and China, should facilitate the recovery, which Scope estimates at around 4% in 2021.

Lowest unemployment in Germany despite Covid-19 effect

Bavaria enjoys favourable labour market characteristics, even though the Covid-19 shock has led to an increase in unemployment to 3.9% in March 2021 versus 2.8% in December 2019. This only moderate rise also reflects the federal government's large discretionary support, e.g. in the form of a national furlough scheme, now extended until the end of 2021 and grants to hard-hit businesses, as well as stimulus measures. Bavaria has the lowest unemployment rate among the German Länder (see **Figure 8**).

Figure 7: Real GDP growth

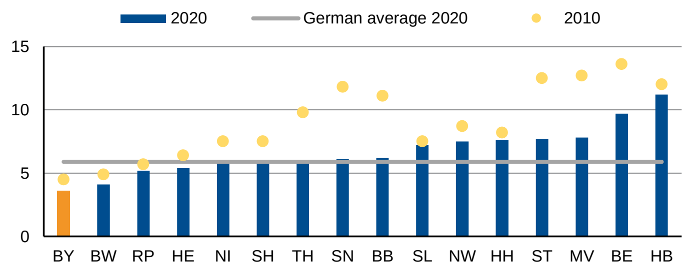
% yoy



Source: Federal Statistical Office, Scope Ratings GmbH

Figure 8: Unemployment ratio

% of total labour force, average



Source: Federal Statistical Office, Scope Ratings GmbH

Favourable demographic profile vis-à-vis other Länder

Bavaria enjoys positive demographics vis-à-vis other Länder, which are supporting the Free State's long-term tax revenue potential. Bavaria's Statistical Office projects an increase in the total population by 3% until 2039. The Free State records a high ratio of the population aged 16-65 years in 2019 (66%). Ageing will lead to an increase in the proportion of people aged 65 years and over against those aged 20-64, from 34% to 48% in 2039.

Quality of governance

Stable political environment

We assess Bavaria's quality of governance and decision-making flexibility as strong. This is supported by the state's i) track record of nominal debt reduction; ii) regular fulfilment of policy objectives defined in strategic plans; and iii) ability to weather economic downturns by cutting costs to compensate for adverse budgetary developments.

Governing coalition of CSU/Free Voters

After losing their electoral majority in 2018, the CSU reached a coalition agreement with the smaller, conservative Free Voters party to govern Bavaria. The CSU won 37.2% in the regional election, its lowest result since 1950. Under the coalition deal, the CSU's Markus Söder will remain the region's president, while the Free Voters will take over three ministries: economy, environment and culture.

Stable policy environment with a clear strategic focus; pandemic will delay debt reduction significantly

The fiscal objective of continuously reducing Bavaria's debt is legally enshrined in article 18, paragraph 1, sentence 2 of the BayHO. According to the coalition agreement, strategic priorities for the administrative term of Bavaria (2018-23) include: i) balanced budgets without recourse to new debt; ii) compliance with the debt brake mechanism from 2020; iii) a strong commitment to become debt-free in the long run; iv) a continued build-up of reserves. Bavaria has reacted with a sizeable support package to support businesses and providing direct healthcare spending through the pandemic. We don't expect that the state will make use of the full envelope of credit authorisations, but nevertheless, the crisis will delay the debt reduction plans of the administration materially.

Methodology

The methodology used for this Credit Rating and/or Outlook (Rating Methodology: Sub-Sovereigns, 18 May 2020) is available on https://www.scoperatings.com/#!methodology/list.

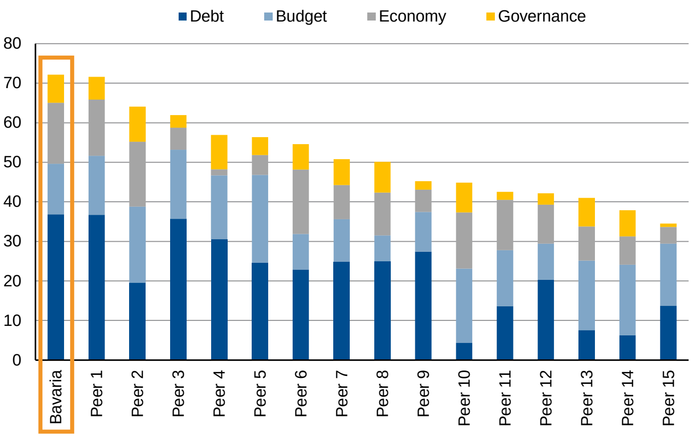
Scope Ratings GmbH and Scope Ratings UK Limited apply the same methodologies/models and key rating assumptions for their credit rating services, while Scope Hamburg GmbH's methodologies/models and key rating assumptions are different from those of Scope Ratings GmbH and Scope Ratings UK Limited.

Information on the meaning of each rating category, including definitions of default and recoveries can be viewed in the "Rating Definitions - Credit Ratings and Ancillary Services" published on https://www.scoperatings.com/#!governance-and-policies/rating-scale. Historical default rates of the entities rated by Scope Ratings can be viewed in the rating performance report on https://www.scoperatings.com/#governance-and-policies/regulatory-ESMA. Please also refer to the central platform (CEREP) of the European Securities and Markets Authority (ESMA): http://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml. A comprehensive clarification of Scope's definitions of default and rating notations can be found at https://www.scoperatings.com/#governance-and-policies/rating-scale. Guidance and information on how Environmental, Social or Governance factors (ESG factor) are incorporated into the rating can be found in the respective sections of the methodologies or guidance documents provided on https://www.scoperatings.com/#!methodology/list.

The Outlook indicates the most likely direction of the Credit Ratings if the Credit Ratings were to change within the next 12 to 18 months.

Appendix I: CVS/QS results and mapping table

Figure 9: CVS results, Free State of Bavaria



Source: Scope Ratings GmbH

Figure 10: QS results Free State of Bavaria

Individual credit profile - qualitative assessment (QS)					
Category	Weight	Qualitative Scorecard	Risk: *Low*	Risk: *Medium*	Risk: *High*
Debt burden and liquidity profile	*40%*	Debt profile			
		Contingent liabilities			
		Funding and liquidity			
Budget performance and flexibility	*30%*	Budget management			
		Expenditure flexibility			
		Revenue flexibility			
Economy and social profile	*20%*	Growth & diversification			
		Labour & demographics			
Governance	*10%*	Recent events & policy risk			
		Transparency & accountability			

Source: Scope Ratings GmbH

Rating mapping table

Indicative rating: notch adjustment – *downwards* – from sovereign rating

Indicative sub-sovereign rating			**Individual credit profile:** Strong ≥ 75	Strong ≥ 65	Medium ≥ 55	Medium ≥ 45	Medium ≥ 35	Weak ≥ 25	Weak < 25
			Indicative maximum notch adjustment from sovereign rating:						
Institutional framework: Integration with sovereign	Full	**0 - 1**	0	0	0	-1	-1	-1	-1
	Full	0 - 2	-1	-1	-1	-1	-1	-2	-2
	Full	0 - 3	-1	-1	-1	-2	-2	-2	-3
	Medium	0 - 4	-1	-1	-2	-2	-3	-3	-4
	Medium	0 - 5	-1	-2	-2	-3	-3	-4	-5
	Medium	0 - 6	-2	-2	-3	-3	-4	-5	-6
	Medium	0 - 7	-2	-2	-3	-4	-5	-5	-7
	Low	0 - 8	-2	-3	-4	-4	-5	-6	-8
	Low	0 - 9	-2	-3	-4	-5	-6	-7	-9
	Low	0 - 10	-3	-4	-5	-6	-7	-8	-10

Issuer
Free State of Bavaria
Country
Germany
Sovereign rating
AAA
Indicative rating adjustment
0
Additional considerations
-
Final rating
AAA

Appendix II: Statistical table

	2013	2014	2015	2016	2017	2018	2019
Financial performance	EUR m, unless noted otherwise						
Operating revenue	47,323	49,593	52,440	55,355	57,178	61,979	63,817
Operating revenue growth, %	*8.3*	*4.8*	*5.7*	*5.6*	*3.3*	*8.4*	*3.0*
Tax revenues	37,623	39,709	42,143	45,900	47,097	51,134	52,329
Allocations and grants	6,250	5,868	6,267	6,477	7,015	6,822	7,039
Other operating revenue	3,449	4,016	4,029	2,978	3,065	4,022	4,449
Current revenue	47,395	49,672	52,514	55,419	57,253	62,041	63,887
Active interests	73	79	74	63	76	62	70
Operating expenditure	40,495	43,924	45,498	48,622	50,143	52,346	56,499
Operating expenditure growth, %	*7.0*	*8.5*	*3.6*	*6.9*	*3.1*	*4.4*	*7.9*
Personnel	19,028	19,804	20,283	20,984	21,861	22,592	23,677
Allocations and grants	18,639	21,162	21,944	23,838	24,499	25,862	28,709
Other operating expenditure	2,829	2,958	3,271	3,800	3,783	3,892	4,113
Current expenditure	41,450	44,816	46,332	49,374	50,864	52,942	57,034
Interest payments	955	892	834	753	721	597	535
Operating balance	6,827	5,669	6,941	6,734	7,035	9,633	7,318
Current balance	5,945	4,856	6,181	6,044	6,390	9,098	6,853
Capital revenue	1,545	2,139	1,534	1,570	2,663	1,773	2,071
Capital expenditure	5,358	5,375	5,518	5,683	5,956	6,647	7,684
Capital balance	-3,813	-3,236	-3,984	-4,113	-3,293	-4,874	-5,613
Total revenue	48,941	51,811	54,047	56,989	59,917	63,814	65,958
Total expenditure	46,808	50,191	51,850	55,058	56,820	59,589	64,718
Balance before debt movement	2,132	1,620	2,197	1,931	3,096	4,225	1,240
Financial ratios							
Balance before debt movement/total revenue, %	4.4	3.1	4.1	3.4	5.2	6.6	1.9
Operating balance/operating revenue, %	14.4	11.4	13.2	12.2	12.3	15.5	11.5
Interest payments/operating revenue, %	2.0	1.8	1.6	1.4	1.3	1.0	0.8
Transfers/operating revenue, %	13.2	11.8	12.0	11.7	12.3	11.0	11.0
Personnel expenditure/operating expenditure, %	47.0	45.1	44.6	43.2	43.6	43.2	41.9
Capital expenditure/total expenditure, %	11.4	10.7	10.6	10.3	10.5	11.2	11.9
Debt							
Budget debt	20,565	20,025	19,525	19,525	19,525	19,525	19,525
thereof, direct debt	16,413	15,100	13,876	13,106	10,958	8,985	6,883
thereof, postponed credit authorisations	4,152	4,925	5,648	6,419	8,567	10,540	12,642
Stabilisation fund	10,000	10,000	10,000	9,450	8,950	7,450	7,400
thereof, direct debt	10,000	10,000	8,752	7,622	7,412	6,942	6,064
thereof, postponed credit authorisations	0	0	1,248	1,828	1,538	508	1,337
Postponed credit authorisations	4,152	4,925	6,896	8,247	10,105	11,048	13,978
Total direct debt	26,413	25,100	22,628	20,728	18,370	15,927	12,947
Overall risk	30,565	30,025	29,525	28,975	28,475	26,975	26,925
Debt ratios							
Total direct debt/operating revenue, %	55.8	50.6	43.2	37.4	32.1	25.7	20.3
Overall risk/operating revenue, %	64.6	60.5	56.3	52.3	49.8	43.5	42.2
Interest payments/total debt, %	3.6	3.6	3.7	3.6	3.9	3.7	4.1
Economy							
GDP at market prices	511,943	534,066	555,460	577,861	601,847	616,674	632,897
Share of German GDP, %	*18.2*	*18.2*	*18.3*	*18.4*	*18.5*	*18.4*	*18.4*
GDP per capita (EUR)	40,754	42,226	43,506	44,840	46,425	47,302	48,323
% of German GDP per capita	*116.9*	*116.8*	*117.3*	*117.8*	*118.3*	*117.3*	*116.8*
Population ('000s)	12,562	12,648	12,768	12,887	12,964	13,077	13,125
Real GDP growth, %	1.3	2.4	1.9	2.5	3.4	1.0	0.5
Unemployment rate (% of labour force)	3.8	3.8	3.6	3.5	3.2	2.9	2.8

Source: Bayerisches Staatsministerium der Finanzen und für Heimat, German Ministry of Finance, Federal Statistical Office, Scope Ratings GmbH

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