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CREDIT OPINION
7 June 2019

Update

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RATINGS

Fukuoka Prefecture

Domicile	Japan
Long Term Rating	A1
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.

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Fukuoka Prefecture (Japan)

Update to credit analysis

Summary

Fukuoka Prefecture's A1 rating is at the same level as that of the Government of Japan (A1 stable), reflecting our view that the central government's rating and those of the regional and local governments (RLGs) in Japan should be the same, given their close links.

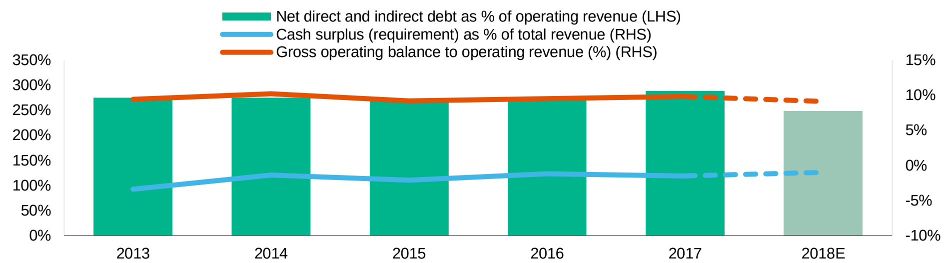
The considerable level of oversight and supervision exercised by the central government, as well as the well-developed equalization system of transfers through the local allocation tax (LAT) system, ensures that any credit issues at the RLG level are identified and addressed early. We also assess that there is a very high likelihood that the Japanese government would step in to provide immediate assistance in the event of an acute liquidity crisis.

Fukuoka Prefecture's rating also reflects its diversified regional economy and favorable operating margin and debt structure, but takes into account its higher debt levels.

Exhibit 1

Fukuoka Prefecture's debt level remains high with continued negative cash balance

Fukuoka Prefecture's operating margin, cash surplus (requirement) and debt ratio



Fiscal year starting in April and ending in March of the following year. Fiscal 2018 is our estimates.
Source: Moody's Investors Service

Credit strengths

» Strong institutional framework is supported by a close relationship with the central government.

» Fukuoka Prefecture enjoys a highly diversified regional economy as the center of the Kyushu region.

» Operating margin is maintained at a reasonable level.

Credit challenges

» The debt burden is high.

Rating outlook

The rating outlook is stable reflecting the outlook on Japan's sovereign rating.

Factors that could lead to an upgrade

An upgrade of Japan's sovereign rating would be the principal determinant of an upgrade of Fukuoka Prefecture's rating.

Factors that could lead to a downgrade

A downgrade of Japan's sovereign rating would be the principal determinant of a downgrade of Fukuoka Prefecture's rating. Furthermore, any policy changes that would materially weaken the highly centralized system or the level of oversight provided by the central government would trigger downward pressure on the rating.

Key indicators

Exhibit 2

Fukuoka Prefecture

Fukuoka Prefecture	FY2013	FY2014	FY2015	FY2016	FY2017[1]
Net Direct and Indirect Debt / Operating Revenue (%)	274.8	275.2	269.3	274.5	288.4
Interest Payments / Operating Revenue (%)	3.5	3.3	3.1	2.9	2.7
Gross Operating Balance / Operating Revenue (%)	9.4	10.2	9.2	9.5	9.8
Cash Financing Surplus (Requirement) / Total Revenue (%)	-3.4	-1.4	-2.1	-1.2	-1.5
Capital Spending / Total Expenditure (%)	17.2	16.3	15.2	15.1	15.6
Unemployment Rate (%)	5.0	4.5	4.1	3.5	3.4
Population ('000s)	5,107	5,108	5,112	5,116	5,117

[1] Fiscal 2017 started 1 April 2017 and ended 31 March 2018

Source: Moody's Investors Service

Detailed credit considerations

Fukuoka Prefecture's A1 rating combines (1) a Baseline Credit Assessment (BCA) for the entity of a2; and (2) a very high likelihood of extraordinary support from the national government in the event of acute liquidity stress.

Baseline Credit Assessment

Strong institutional framework is supported by a close relationship with the central government

RLGs in Japan benefit from a highly developed, predictable and stable institutional framework. This protective arrangement contributes notably to their credit strength through the central government's oversight of RLG performance and provision of fiscal transfers that reduce fiscal disparities.

Under the New Revival Law, passed in 2007, RLGs' fiscal operations are overseen by the central government, which uses various fiscal indicators. If an entity's indicators exceed defined thresholds, it is identified as either an “early-correcting entity” or a “revival entity” and must then carry out plans to improve its fiscal situation.

We believe that this law, which covers a wide range of RLG activities, reflects the central government's strong resolve to reduce the risk of a financial crisis at the local level and bolster the local sector's credit risk profile.

Japanese RLGs have limited revenue flexibility in own-source revenue. The country’s Local Tax Law determines the tax base available to RLGs and limits the range of permitted tax rates. For each major local tax, RLGs may apply the standard rate or a higher rate, up to a prescribed maximum.

Depending on the tax, the maximum rate is typically 10%-50% higher than the standard rate, although in some cases (for example, the inhabitants tax on individuals and property tax) there is no legal maximum. While an RLG may impose a tax not specified in the Local Tax Law, the Minister of Internal Affairs and Communications (MIC) must first approve it.

Because of insufficiency in the central government's tax revenue, which is used to fund LAT transfers, the central government has allocated issuance of specific amounts of rinzai-sai debt (MIC-approved operating debt) to the RLGs in place of LAT cash transfers. The larger RLGs, in particular, have been apportioned larger rinzai-sai amounts because of their greater ability to access capital markets than smaller RLGs.

The cost of rinzai-sai debt servicing is included in each RLG's future LAT. However, since the central government has seen large shortfalls in the sources that fund LAT, we are monitoring the sustainability of the LAT transfer model, including the debt-servicing costs for rinzai-sai.

Fukuoka Prefecture benefits from a diversified regional economy as the center of Kyushu

Fukuoka Prefecture's economy is the largest of the seven prefectures located on the island of Kyushu. The Prefecture represents about 40% of the region's GDP and more than one third of the region's total population, which was around 5.12 million as of March 2019. Fukuoka Prefecture is the only prefecture in Kyushu that has recorded consecutive population growth from 2011.

Fukuoka Prefecture's GDP amounted to about ¥19 trillion in fiscal 2015, with GDP per capita equaling around 90% of the national average based on our estimates. In addition to being lower than the national average, Fukuoka Prefecture's GDP per capita is also lower than that of export-oriented manufacturing centers, such as Shizuoka and Hiroshima Prefectures. We regard Fukuoka Prefecture's economic diversity as a strength, despite its lackluster GDP per capita.

Wages that are lower than the national average, together with a highly developed transportation network and supportive RLG policies, have attracted large manufacturers to the Kyushu region, where they have built production facilities. However, they continue to locate their headquarters outside the region, meaning that the local RLGs do not benefit from corporate tax revenue. Nevertheless, the presence of manufacturing facilities has attracted migrants to Fukuoka Prefecture, which results in its GDP per capita being lower than that of its peers.

Operating margin is stable

Fukuoka Prefecture's financial performance, measured by the gross operating balance to operating revenue (operating margin), has been stable around 10% over the past five years, supported by the growth in the tax revenue with better corporate profit. Although we expect the trend to stabilize, we estimate the Prefecture's operating margin to remain around 9%-10% over the next fiscal year with its operating spending under control.

The Prefecture has recorded a cash financing deficit for the past several years, although the deficit has moderated from improved operating balances. Nevertheless, its operating balance has been insufficient to cover its capital spending. We estimate that the Prefecture will continue to record cash financing deficits at least through the next fiscal year, because of additional disaster recovery expenses from the damages caused by heavy rains in 2018 and the subsequent preventive investments, estimated to cost around ¥60 billion in its fiscal 2018 revised budgets. The Prefecture has also budgeted preventive investments in fiscal 2019. As such, the Prefecture will be constrained to reduce its debt and its debt burden will remain high.

Fukuoka Prefecture renewed its five-year Fiscal Reform Plan 2017 that started in April 2017. The Prefecture aims to continue to streamline operations and generate about ¥109 billion of economies during the five years through cost reductions or securing revenue.

Debt burden is high

Fukuoka Prefecture's net direct and indirect debt to operating revenue as of the end of fiscal 2017 was 288.4%, deteriorating from the previous year because of the continued issuance of rinzai-sai debt. Japanese rated RLGs have higher debt burden compared with global RLGs. Among the RLGs we rate, Japanese prefectures have higher debt burden than the designated cities, typically around 250% or above because the prefectures have larger rinzai-sai debt. As of the end of fiscal 2017, Fukuoka Prefecture's net debt for all accounts amounted to almost ¥3.7 trillion, an increase of around 2% from the previous year.

According to its Fiscal Reform Plan 2017, the Prefecture plans to reduce debt issued to fund capital spending on a constant manner, in total by around ¥78 billion by fiscal 2021, about a 3.5% reduction in debt from fiscal 2016. However, disaster-related capital spending will lead to increase its debt, which will make it difficult to meet this target. Rinzai-sai debt issuance also limits its total debt reduction.

We include rinzai-sai debt when calculating the Prefecture's debt burden metric, even though we recognize that this debt resulted from the central government being unable to fund LAT with cash transfers, and not because the prefecture was fiscally irresponsible. The impact of this debt on the prefecture's BCA is mitigated by the fact that (1) the MIC treats rinzai-sai as debt to be subsidized through future LAT transfers; and (2) how much rinzai-sai debt each RLG issues is determined by a mechanical formula that tends to generate heavier debt levels for larger RLGs whose market access is deemed as excellent. These larger RLGs include Fukuoka Prefecture.

The level of rinzai-sai debt does not strictly reflect the actual fiscal imbalance of Fukuoka Prefecture. However, the other Japanese prefectures that we rate have made efforts to cut debt issuance to fund capital spending to minimize the increase in debt from rinzai-sai issuances. Although the inclusion of rinzai-sai debt results in Fukuoka Prefecture's debt burden metric being comparable with that of other prefectures, its total debt profile highlights its relatively weaker financial position than the others.

The long tenors of Fukuoka Prefecture's debt and its good market access mitigate the effects of its high debt burden. The Prefecture's debt comprises mostly long-term, fixed-rate bonds or bank borrowings. Fukuoka Prefecture benefits also from favorable capital market conditions, very low interest rates and the investors' appetite for debt with longer maturities.

Fukuoka Prefecture also funds itself from public resources, such as the central government and Japan Finance Organization for Municipalities, as well as regional banks, with which it has long-standing relationships.

Extraordinary support considerations

The very high likelihood of extraordinary support from the central government reflects our assessment of Japan's highly centralized system of RLGs, as well as Japan's unique history of risk socialization.

Output of the Baseline Credit Assessment Scorecard

In the case of Fukuoka Prefecture, the BCA matrix generates an estimated BCA of a3, close to the BCA of a2 assigned by the rating committee.

The matrix-generated BCA of a3 reflects (1) an Idiosyncratic Risk score of 3 on a 1 to 9 scale, where 1 represents the strongest relative credit quality and 9 the weakest; and (2) a Systemic Risk score of A1, as reflected in the sovereign bond rating (A1 stable).

Rating methodology and scorecard factors

Exhibit 3

Fukuoka Prefecture, fiscal 2017

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	7	87.90	70%	5.2	20%	1.04
Economic volatility	1		30%			
Factor 2: Institutional Framework						
Legislative background	1		50%	3	20%	0.60
Financial flexibility	5		50%			
Factor 3: Financial Performance and Debt Profile						
Gross operating balance / operating revenues (%)	3	9.63	12.5%	3.5	30%	1.05
Interest payments / operating revenues (%)	3	2.81	12.5%			
Liquidity	1		25%			
Net direct and indirect debt / operating revenues (%)	9	288.40	25%			
Short-term direct debt / total direct debt (%)	1	5.00	25%			
Factor 4: Governance and Management - MAX						
Risk controls and financial management	1			1	30%	0.30
Investment and debt management	1					
Transparency and disclosure	1					
Idiosyncratic Risk Assessment						**2.99(3)**
Systemic Risk Assessment						**A1**
Suggested BCA						**a3**

Source: Moody's Investors Service

Ratings

Exhibit 4

Category	Moody's Rating
FUKUOKA PREFECTURE	
Outlook	Stable
Issuer Rating	A1
Senior Unsecured -Dom Curr	A1

Source: Moody's Investors Service

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