FitchRatings

RATING ACTION COMMENTARY

Fitch Rates Delaware's $293 Million GO Bonds 'AAA'; Outlook Stable

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Fitch Ratings - New York - 02 Apr 2021: Fitch Ratings has assigned a 'AAA' rating to the following state of Delaware general obligation (GO) bonds:

--$293.18 million GO bonds, series 2021.

The bonds will fund the ongoing capital program and refund outstanding GO bonds for debt service savings. The bonds are scheduled to be sold by competitive bid on or about April 14, 2021.

Fitch has also affirmed the following State of Delaware ratings:

--Issuer Default Rating (IDR) at 'AAA';

--$2.2 billion in outstanding GO bonds at 'AAA'.

The Rating Outlook is Stable.

Feedback

SECURITY

The bonds are a general obligation, full faith and credit obligation of the state of Delaware.

ANALYTICAL CONCLUSION

Delaware's 'AAA' IDR and GO bond rating are based on strong financial operations that are supported by proactive management and institutionalized protections designed to ensure surplus operations. The state has considerable economic resources, which have grown through deliberate policies to maintain a climate attractive to banking and related entities; however, long-term revenue growth has been slow and is expected to only track inflation. Long-term liabilities are above the state median, reflecting, in part, debt issuance for purposes that are addressed at the local government level in most other states. Pensions are well funded.

ECONOMIC RESOURCE BASE

Delaware's economy is largely based on service-providing enterprises, including financial activities, professional and business services, and education and health organizations. After several years of relatively strong employment growth as the state emerged from the Great Recession, growth began to slow in 2016 and remained slightly below the pace of U.S. growth leading into the pandemic-related downturn. Per capita personal income is slightly below the national average, and rising at a slower pace than the national average.

On March 12, 2020, in efforts to mitigate coronavirus' spread, Governor Carney declared a state of emergency and subsequently closed all nonessential businesses in the state. As expected, economic activity and employment fell sharply, with employment declining 15% from its peak, equal to the U.S. rate of job loss. This despite the fact that Delaware kept many industries open, including manufacturing, most professional services and some retail. The state began a phased reopening of businesses in May 2020 and economic activity has picked up. Employment has rebounded 64.3% from the trough (as of February), ahead of the 57.6% U.S. rate. Even with the rebound in employment, Delaware's unemployment rate of 6.3% (as of February) is above the U.S. state median of 5.2%. However, the Fitch adjusted unemployment rate for Delaware of 7.3%, which adds back the declines in labor force since February 2020, approximates the U.S. states median of 7.2%. The gap between the official and Fitch-adjusted rates signals the depth of the labor market disruptions seen in Delaware and nationally.

KEY RATING DRIVERS

Revenue Framework: 'aa'

Financial operations are supported by a diverse array of revenue sources with the personal income tax (PIT) accounting for the largest share at approximately one-third. Delaware also leverages its status as the legal home to over half of all publicly-traded corporations in the U.S. and assesses taxes on limited partnerships, franchises and other business entities. This structure results in a revenue framework that is sensitive to national economic trends.

Expenditure Framework: 'aaa'

While carrying costs for debt and retiree benefits are above the U.S. states median, Delaware has demonstrated ample expenditure flexibility and the broad expense-cutting ability common to most U.S. states. Moreover, the state abides by its statutory restriction to budget 98% of expected revenue, providing a cushion for revenue variability. Education is a key cost driver as the state is highly involved with funding local education, including funding employer pension contributions for school district employees.

Long-Term Liability Burden: 'aa'

The state's long-term liabilities are a moderate burden on resources. Debt levels are above average for a U.S. state given the state's role in issuance for projects usually funded at the local level and have modestly ticked upward following years of decline. Pensions are well funded although other post-employment benefit (OPEB) obligations are sizable.

Operating Performance: 'aaa'

The state has exceptional financial resilience from strong financial management that has contributed to the maintenance of ample financial cushion through economic cycles. The relatively frequent monitoring of revenues and operating expenditures mitigates the effect of volatility in revenues and allows for rapid gap closing.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to a positive rating action/upgrade:

--Not applicable given the 'AAA' ratings.

Factors that could, individually or collectively, lead to a negative rating action/downgrade:

--A sustained slowing of revenue growth to below the level of inflation;

--An inability of the state to address its large unfunded OPEB liability could be considered an asymmetric risk that results in a lower long-term liability assessment;

--Failure to implement available policy measures that offset risks associated with a return to economic contraction consistent with Fitch's coronavirus downside scenario, resulting in an erosion of the state's superior gap-closing capacity;

--More severe economic weakness than envisioned in Fitch's coronavirus downside scenario, without evidence that available measures are adequate to counteract associated budgetary risks.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit [https://www.fitchratings.com/site/re/10111579].

Feedback

CURRENT DEVELOPMENTS

Delaware's fiscal 2020 revenue collections (year ended June 30) experienced weakness through this period of reduced economic activity, although revenue collections were not as deeply affected as had been anticipated at the start of the pandemic-related downturn. The Delaware Economic and Financial Advisory Council (DEFAC) lowered the general fund revenue forecast for fiscal 2020 by $325 million in May 2020, as compared with the December 2019 forecast, and by $195 million (4.2%) as compared with the original budget, and anticipated a yoy decline of 3.8%. Revenue performance was slightly better than anticipated, declining just 1.4% yoy. To offset the revenue decline and balance the budget, the state drew down general fund cash, controlled spending and increased reversions to the general fund. It did not draw on the rainy day fund (the budgetary reserve account [BRA]) in fiscal 2020.

Revenue collections in fiscal 2021 have been much stronger than anticipated when the budget was enacted in June 2020. In March 2021, DEFAC increased its revenue forecast for fiscal 2021 by $536 million (11.8%) as compared with the May 2020 forecast, based on a significant upward revision in personal income taxes, franchise taxes, corporate income taxes and gross receipts taxes. Personal income tax collections incorporate the receipt of deferred tax revenues in July 2020, as the state budgets on a cash basis, but are still expected to be 12% higher than budgeted. Although the state did not draw on the BRA in fiscal 2021, it did appropriate $63.2 million from a separate reserve, the budget stabilization account (BSA).

DEFAC is currently forecasting a small 2.9% decline in revenue for fiscal 2022, although as noted above, that takes into account the deferred personal income tax revenues received and accounted for in fiscal 2021 that are attributable to fiscal 2020. The unevenness in income tax collections across fiscal years obscures the overall growth in revenue with fiscal 2022 revenues forecast to be 7% higher than fiscal 2019 revenue. The governor's budget proposal for fiscal 2022 prudently appropriates 98% of anticipated revenue, maintains a fully funded rainy day fund, sets aside other reserves, and controls ongoing spending by allocating funds to non-recurring expenditures including for capital. The budget proposal would finance priorities including in education, higher education, water resources and economic development. It would provide a $500 pay increase to state employees as well as step increases for education and state employees. There is some tax relief incorporated in the proposal, in particular for low income residents who lost jobs during the pandemic. This is in the form of exempting unemployment benefits from state taxation in tax year 2020 and creating a refundable state earned income tax credit. The budget for fiscal 2022 is still under consideration by the Delaware legislature.

Under the American Rescue Plan Act (ARPA), Delaware's state and municipal governments expect to receive $1.36 billion in direct aid from the Coronavirus State and Local Fiscal Recovery Fund, of which the state's portion is $913 million. The state has not determined how it will utilize ARPA receipts and Fitch anticipates this will be a key topic for the legislature during the current session. The combination of direct aid and a significant amount of economic stimulus should have a positive near-term effect on state revenues. Fitch does not expect the stimulus aid to alter Delaware's long-term credit fundamentals, but should help bridge any near-term fiscal gaps.

REVENUE FRAMEWORK

General fund (GF) revenues are dependent on an unusual array of taxes related to business endeavors and financial institutions, linked to companies being legally domiciled in the state. Revenues include franchise and other fees levied on businesses and banks organized under state law as well as corporate income taxes and other fees. These combine to provide approximately one-third of general fund revenues. Abandoned property, which includes accounts and securities derived from the business domiciled in Delaware that revert to the state's general fund when left unclaimed for specific periods, typically accounts another 10% of GF revenues and is subject to significant volatility.

The state levies a personal income tax but not a general sales tax. The personal income tax provides about one-third of GF revenues and has recorded moderate growth over the past several years, offsetting more variable results in corporate-based taxes. Lottery revenues, which include gaming and account for just below 5% of revenues, have been pressured, reflecting growth and competition in nearby gaming venues outside the state.

Historical revenue growth, adjusted for the estimated effect of policy changes, has been near the rate of inflation over the past ten years. Fitch anticipates the long-term trend for revenue growth will remain in line with inflation and trail the pace of national economic growth given Fitch's view of growth prospects for Delaware's economy.

The state has no legal limitations on its ability to raise revenues through base broadenings, rate increases, or the assessment of new taxes or fees.

EXPENDITURE FRAMEWORK

As in most states, education and health and human services spending are Delaware's largest operating expenses. Education is the larger line item, as the state provides significant funding for local school districts and the public university and college system. The state's education commitment includes sharing the annual employer pension contribution for local school district employees with school districts. Health and human services spending is the second largest area of spending, with Medicaid being the primary driver.

Fitch expects that the pace of spending growth, absent policy actions, will be in line with to marginally above that of natural revenue growth, driven primarily by Medicaid, and require regular budget adjustments to ensure ongoing balance. The fiscal challenge of Medicaid is common to all U.S. states and the nature of the program as well as federal government rules limit the states' options in managing the pace of spending growth. Federal action to revise Medicaid's fundamental programmatic and financial structure appears does not appear to be a near-term priority of the current federal administration or congressional leadership. As with all federal programs, Medicaid remains subject to regulatory changes that could affect various aspects of the program. In other major areas of spending such as education, Delaware is able to more easily adjust the trajectory of growth.

Overall, Delaware retains ample ability to adjust expenditures to meet changing fiscal circumstances. While Medicaid remains a notable cost pressure, spending requirements for debt service and pension obligations are manageable and pensions are well-funded. The state's contributions to OPEB have approximated its contributions to the pension system in recent years, reflecting a large OPEB liability. Pension and OPEB contributions over the past several years have generally approximated the actuarially determined contribution.

LONG-TERM LIABILITY BURDEN

As a small state with a minimal number of local governments, Delaware's service functions are highly centralized, leading to above average long-term liabilities for a U.S. state. Per

Fitch's October 2020 State Liability Report, the state's total debt and adjusted net pension liabilities equaled 11.5% of 2019 personal income, a level of long-term liabilities that is well above the state median but still considered moderate.

Pension changes for the state employees' pension (SEP) system effective Jan. 1, 2012 aimed to bolster funding ratios through targeted benefit reductions and increased contributions by new employees. The net OPEB liability of over $7.3 billion equals 13% of 2019 state personal income. While Fitch views the OPEB liability as a more flexible obligation as compared with pensions and also more uncertain because of the complex assumptions used to calculate it, the magnitude of the liability given Delaware's already above-average long-term liabilities is a concern. As is the case with pension system contributions, the state pays school district OPEB, contributing to the high liability. The governor has formed a commission to study OPEB and identify options to address related liabilities, with recommendations expected to be taken up by the governor and general assembly in 2021 and 2022.

OPERATING PERFORMANCE

Delaware's ability to respond to cyclical downturns rests with its conservative budget practices, maintenance of reserves, and proactive approach to tracking and forecasting revenues and expenditures throughout the budget cycle. Financial operations are supported by conservative fiscal policies, including a constitutional provision that limits appropriations to 98% of anticipated revenues in the subsequent fiscal year, plus the unencumbered prior year budgetary general fund balance. In addition to the availability of unencumbered cash balances, the state maintains a fully funded budget reserve account at 5% of general fund revenue. The BRA may only be appropriated to fund an unexpected budgetary deficit and requires super-majority approval in both legislative bodies to access. The funding of additional reserves outside of the BRA and adherence to an appropriations benchmark that tempers spending growth provide additional financial resilience.

The Fitch Analytical Stress Test scenario analysis tool, which relates historical tax revenue volatility to GDP, indicates the volatility in Delaware's revenue structure relative to other states. Fitch believes the state's close tracking of both revenues and expenditures and frequent revenue forecast updates have historically allowed it to quickly respond to changing economic conditions. These practices have proven to be critical to sustaining financial balance and Fitch anticipates the state will take appropriate action to maintain balance should revenue expectations weaken.

Delaware exhibited strong budget management throughout the extended period of national economic expansion that followed the Great Recession. Its conservative budgeting practices helped it to rapidly rebuild its financial resilience after the Great Recession and to maintain strong balances and financial cushion on an ongoing basis. The state has maintained the BRA above the 5% target and sizable levels of unencumbered cash, although balances of the latter fluctuate with revenue performance and spending needs.

The state closely tracks revenue collections and expenditures during the year and forecasts are updated at least five times each fiscal year through comprehensive reviews by DEFAC. Frequent forecast updates have allowed the state to quickly respond to changing economic conditions, an important attribute as most of the state's revenues are economically sensitive with some baseline sluggishness that has required tax policy changes to fund rising expenditures. The state proactively reviews its tax policies and makes adjustments to ensure its budgets are balanced. These practices have proven to be critical to sustaining financial balance and support the state's strong operating performance.

In addition to the sources of information identified in Fitch's applicable criteria specified below, this action was informed by information from Lumesis.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

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

ESG CONSIDERATIONS

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This 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. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg

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APPLICABLE CRITERIA

U.S. Public Finance Tax-Supported Rating Criteria (pub. 27 Mar 2020) (including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

FAST States & Locals - Fitch Analytical Stress Test Model, v2.4.0 (1)

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ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

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