# State of Delaware

| **Assigned** | **Rating** | **Outlook** |
|---|---|---|
| General Obligation Refunding Bonds, Series 2019A | AAA | Stable |
| **Affirmed** | **Rating** | **Outlook** |
| General Obligation Bonds | AAA | Stable |

**Methodology:**

**U.S. State General Obligation Rating Methodology**

**Analytical Contacts:**

Patricia McGuigan, Senior Director
(646) 731-3350
pmcguigan@kbra.com

Peter Scherer, Associate
(646) 731-2325
pscherer@kbra.com

Paul Kwiatkoski, Managing Director
(646) 731-2387
pkwiatkoski@kbra.com

**Rating Summary:** KBRA's rating is based on the State's very strong financial management policies and practices, that contribute to its favorable financial position and liquidity as well as a diverse economy anchored by financial services, chemicals and related industries, the healthcare sector and higher education.

The State serves as the legal domicile of over half of the publicly traded firms in the United States; and more than two thirds of the nation's Fortune 500 firms are incorporated in the State. The State's high gross state product (GSP) per capita and high percentage of GSP attributable to the finance and real estate sectors reflects the State's unique role as a center of corporate business development and a hub of the financial services industry. In KBRA's view, the State actively manages and protects its position as a leader in these areas through supporting the prompt resolution of disputes by the State's Court of Chancery and by updating its statutes to respond to changing business conditions. The State's economic base has shown growth relative to the region and the nation, as evidenced by its population growth since 2010 and favorable unemployment rates.

KBRA views the State's management structure and policies as providing a very strong framework for managing budgetary and financial operations. The State Constitution limits annual appropriations to 98% of estimated budgetary General Fund revenue and unencumbered cash balance, enhancing financial flexibility. Formal revenue and expenditure estimation is done under the Delaware Economic and Financial Advisory Council (DEFAC). In KBRA's view, the DEFAC process provides comprehensive and frequent revenue forecasts as well as consistent fiscal monitoring and long-term planning. The State has broad authority to take mid-year action to adjust disbursements, which KBRA views positively. Under the State Constitution, at fiscal year-end, excess unencumbered budgetary General Fund cash is transferred to the Budget Reserve Account. The account is not to exceed 5% of estimated budgetary General Fund receipts. Since inception in 1980, the State has not needed to draw on the Budget Reserve Account.

KBRA also views the financial position of the State as very strong based on its conservative budgeting policies, comprehensive and timely process of revenue estimation, high levels of financial reserves and strong liquidity position. In KBRA's view, the State is well focused on budgetary and cost controls. Budgetary General Fund revenue sources reflect the importance of the financial services and corporate activities industry, which relate to 45% of revenues. Historically, these revenues have shown some volatility, however, this is offset by the State's conservative financial management, revenue estimation process and ability to adjust disbursements. Over the last six years, the State has ended the fiscal year with a cash balance of over 10% and an unencumbered cash balance of over 5.5% of budgetary General Fund disbursements, which KBRA considers very strong.

KBRA views the State's tax-supported debt level as high, relative to population, personal income, and GSP. Delaware's high debt ratios reflect the centralized role of the State in financing schools and correctional facilities; projects generally funded by local governments in other states. KBRA views the State's debt structure favorably; all direct debt is fixed rate and is rapidly amortized. The funded ratio of the State's largest pension fund was a favorable 86.7% at June 2018. The State contributes essentially 100% of the actuarially recommended amount to fund its pensions. Debt service, pension contributions and OPEB costs are 8.7% of FY 2018 governmental expenditures, which KBRA considers to be low.

## Key Rating Strengths

- Very strong financial management policies and procedures. Comprehensive and timely process for revenue forecasting serves as a vehicle for consistent fiscal monitoring and long-term planning.
- High levels of financial reserves and strong liquidity position.
- Strong funded ratio of the State's pension funds.

## Key Rating Concerns

- Economic base is somewhat concentrated in corporate business activities and the financial services industry.
- State tax supported debt ratios are high compared to other states.

## Drivers for Rating Change

| | |
|---|---|
| • Not applicable given the AAA rating level. | + |
| • Significant sustained deterioration in the level of the State's general reserves.<br>• Significant increase in debt burden measures.<br>• Significant decline in pension funded ratios. | - |

| Rating Highlights | |
|---|---|
| General Fund Revenue Forecasts | 6x per year |
| Reserves as % of Disbursements, FY 2018 | |
| Budget Reserve Account | 5.0% |
| Budget Reserve & Unencumbered Cash | 13.7% |
| Net Tax-Supported Debt Service as a % Govt Expenditures | 2.4% |
| Pension Payment History | Full Payment |
| Population Growth Rate, 2010 to 2018 | |
| Delaware | 7.5% |
| U.S. | 5.8% |
| Unemployment Rate, Delaware v U.S. | DE Consistently Lower |

The Stable Outlook reflects the State's strong financial management framework, including the DEFAC revenue estimation process and conservative budgeting practices, which KBRA believes will continue to support the State's strong financial performance. The outlook also reflects KBRA's recognition of the State's ongoing efforts to maintain its leading role in corporate business development and the financial services industry.

To see KBRA's last full report on the state from February 5, 2019 click **here**.

| Rating Determinants (RD) | |
|---|---|
| 1. Management Structure, Budgeting Practices and Policies | AAA |
| 2. Debt and Additional Continuing Obligations | AA+ |
| 3. Financial Performance and Liquidity Position | AAA |
| 4. State Resource Base | AA+ |

# Recent Credit Updates

## Financial Performance Update

KBRA has reviewed the Delaware Economic and Financial Advisory Council June 2019 forecast of general fund operations, which estimates positive FY 2019 financial results. In addition, Delaware's June 2019 Monthly Financial Report indicates a further strengthening of cash position. The FY 2020 budget provides additional funding for education and includes education program initiatives, while budgeting to maintain the general fund's strong reserve position.

**FY 2020 Adopted Budget**

The FY 2020 Operating Budget totals $4.45 billion, which is a 4.2% increase in spending. The largest spending category is public education ($1.57 billion or 35% of appropriations). Public education also represents the largest spending increase with FY 2020 appropriations up 6.4% over the prior year's base budget. A portion of the education spending increase is for pay raises. The FY 2020 budgeted education spending also includes two new three-year initiatives, a $25 million weighted funding formula for low income and English learner students, and a $26 million program to bring parity to special needs children who are in the younger grades. The authorizing legislation requires that the initiatives be annually evaluated by an independent outside consultant. While Delaware ranks high in the nation for State support of education, the allocation of State funds to school districts is based primarily on enrollment. In January 2018 a still pending lawsuit alleges that the Delaware system of public schools fails to provide adequate educational opportunities for disadvantaged students.

On the revenue side of the budget, the independent Delaware Economic and Financial Advisory Council (DEFAC) is projecting 0.7% revenue growth for FY 2020. State revenues are derived from a diversity of sources with reliance on corporate and bank related tax receipts. The largest revenue source is PIT taxes, representing 34% of forecast revenue. PIT taxes are projected to increase 4.4% in FY 2020. DEFAC relies on a diverse range of information for its revenue forecasts including estimates from the US Bureau of Economic Analysis and IHS forecasts. FY 2020 forecasts include 2.1% growth in US real GDP, 1.2% growth in Delaware employment and 1.9% growth in Delaware's wages and salaries. Corporate income tax revenues are projected to decline approximately 21%, reflecting a newly deductible research and development credit as well as projected impacts from federal tax law changes. Abandoned property revenue, public utility taxes and lottery funds are also expected to modestly contract.

The State utilizes a budget smoothing mechanism to improve fiscal controls. Executive Order 21 signed in June 2018 establishes a Budget Stabilization Fund (BSF) from a portion of the unencumbered cash balance of the general fund. DEFAC is charged with calculating a benchmark index used for determining the deposit to the BSF. The FY 2020 BSF deposit is budgeted at $126.3 million, the budgetary reserve account is budgeted at $252.4 million and the projected FY 2020 year end unencumbered balance is $106.2 million. The projected sum (the BSF, budgetary reserve and unencumbered cash) is $484.8 million and represents 10% of FY 2020 expenditures, which KBRA views as strong.

**FY 2019 Estimates**

Estimates for FY 2019 operations indicate continued strong financial operations, with the year-end general fund unencumbered cash balance increasing to $369.0 million (from $334.1 million) and the Budget Reserve Account increasing to $240.4 million (from $231.6 million). DEFAC performs frequent forecasts throughout the year. The June 2019 DEFAC forecast estimates FY 2019 general fund revenue of $4.58 billion, which reflects growth of 4.4% over FY 2018 actual collections. The State's primary revenue sources experienced more robust growth, but were modestly offset by an estimated decline in net unclaimed property revenues. The largest revenue sources are PIT taxes (6.6% estimated growth) and franchise/LP/LLC taxes (5.8% estimated growth), which combined account for 60% of FY 2019 estimated revenues. Delaware does not levy a sales tax.

The June 2019 DEFAC forecast of General Fund operations indicates base budget expenditure of $4.27 billion which reflects growth of 4.0%. With additional one-time spending items, FY 2019 general fund expenditures are estimated at $4.41 billion (7.1% estimated growth). Additional one-time spending includes $189 million in general fund pay go capital financing and $49 million in one time spending for employee and retiree bonuses.

The net operating cash balance for month ending June 30, 2019 is $947.5 million, per the State Department of Finance monthly financial report, which reflects a $197.7 million increase from the beginning of the year. As required by the State Constitution, $240.4 million of the balance is dedicated to the Budget Reserve Account.

## Debt and Continuing Obligations Update

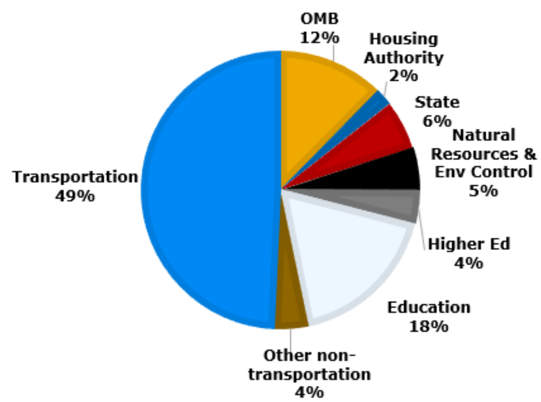
The General Obligation Refunding Bonds, Series 2019A are being issued for sizable net present value savings, with no change in debt structure.

The State's Fiscal 2020 Capital Budget totals $863 million and is one of the largest in state history. Almost half of the planned spending is for transportation projects to be funded with transportation trust funds (Figure 1). GO authorization of $230 is provided for in the capital budget, with approximately half of the GO bond funding for education, including higher ed.

On July 10, 2019, Governor Carney signed Executive Order 32 to convene a Retirement Benefit Study Commission to study the State's net OPEB liability to identify options to reduce the liability, taking into account the fairness in the distribution of cost between employees and retirees. Preliminary findings are expected on or before March 31, 2020. The State's governmental funds net OPEB liability was $7.2 billion at June 30, 2018.

**FIGURE 1**

**FY 2020 CAPITAL BUDGET PROJECTS**




*Source: State of Delaware, Senate Bill 180*

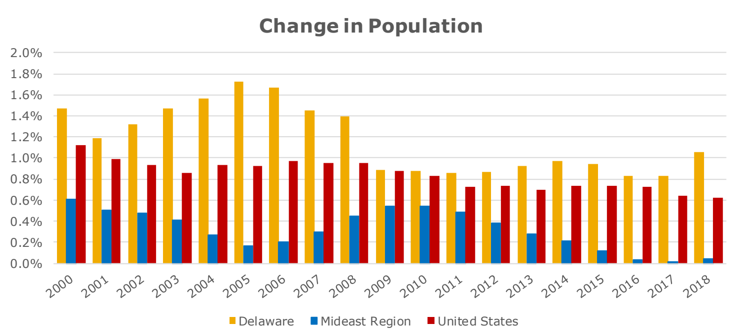
## Resource Base Update

KBRA continues to view Delaware's resource base as strong. Key strengths include a broad employment base with specialization in financial services as well as chemicals and advanced materials engineering, moderate per capita personal income levels at 96% of the U.S. average, good affordability relative to regional peers, and a business friendly judicial, tax, and regulatory environment that continues to attract businesses and residents to the State.

The State's financial services sector benefits from the State's modern and flexible chancery court system, whose extensive body of case law in corporate governance and history of prompt resolution of commercial and corporate disputes, together with the State's modern banking laws, fortify the State's role as a center for commercial banking, credit card banks, and other financial activities. The State's leadership in chemicals and advanced materials engineering reflects its history as the home of DuPont de Nemours, long a top employer in the State, and associated concentration of related higher education and private industry that has developed in the State over the company's 200 year history.

Delaware's population has grown faster than the region since the year 2000 (Figure 2). Employment growth has also outpaced the region since 2010, although more recent performance has lagged (Figure 3).

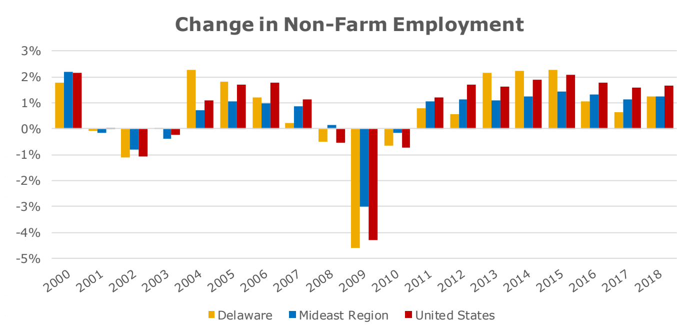
**FIGURE 2**




| | 2010 | 2018 | Δ 2010 to 2018 |
|---|---|---|---|
| Delaware | 899,595 | 967,171 | 7.5% |
| Mideast Region | 48,204,184 | 48,970,133 | 1.6% |
| United States | 309,326,085 | 327,167,434 | 5.8% |

*Source: U.S. Census Bureau*

**FIGURE 3**

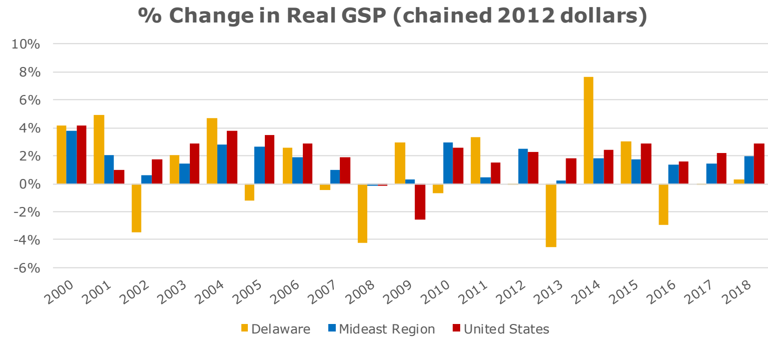



| *thousands* | 2010 | 2018 | Δ 2010 to 2018 |
|---|---|---|---|
| Delaware | 414 | 462 | 11.5% |
| Mideast Region | 21,662 | 23,852 | 10.1% |
| United States | 130,362 | 149,054 | 14.3% |

*Source: U.S. Bureau of Labor Statistics*

Slow employment growth since 2015 is tied in part to restructuring activities at DuPont, which spun off its performance chemicals business in 2015 (Chemours Company), finalized a merger with Dow Chemical in August 2017 (DowDuPont), and completed the spinoff of its material science business (heritage Dow) and agricultural/chemicals business (Corteva) in April and June of 2019, respectively. All but one of the restructured businesses (material sciences) will remain in the state, but the restructuring appears to have weighed on employment and economic output (Figures 3 and 4). Core areas of the State's economy such as finance, business services, and education continue to perform well, but the manufacturing and wholesale trade sectors have contracted over the last decade, partly reflecting headwinds from the restructurings. KBRA continues to monitor the State's economic performance with an eye toward understanding the long-term impact of the DuPont restructuring and its implications for growth going forward.

**FIGURE 4**




| *dollars in millions* | 2010 | 2018 | Δ 2010 to 2018 |
|---|---|---|---|
| Delaware | 60,016 | 63,855 | 6.4% |
| Mideast Region | 2,905,744 | 3,259,430 | 12.2% |
| United States | 15,598,753 | 18,566,442 | 19.0% |

*Source: U.S. Bureau of Labor Statistics*

## Conclusion

Based on the foregoing analysis, KBRA has assigned a long-term rating of AAA and Stable Outlook to the State of Delaware General Obligation Refunding Bonds, Series 2019A and affirmed the long-term rating of AAA and stable outlook on the State's outstanding general obligation debt.

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