State of Delaware

Issuer: State of Delaware		
Assigned	**Rating**	**Outlook**
General Obligation Refunding Bonds, Series 2020B	AAA	Stable
Affirmed	**Rating**	**Outlook**
General Obligation Bonds	AAA	Stable

Methodology:
U.S. State General Obligation Rating Methodology

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

As a result of the economic impacts of the COVID-19 pandemic, the state is projecting a FY 2020 YOY revenue decline of -3.8%. Expenditure savings from constrained spending and Medicaid savings are partial mitigants, although a modest use of reserves is forecast. The State closed FY 2019 with financial reserves at historic highs. State leaders are currently addressing the FY 2021 proposed budget, as a reduced FY 2021 revenue forecast lowers the appropriation limit. The current offering is expected to achieve approximately $17 million in savings in FY 2021. Under the federal CARES Act, the State received $927 million of Coronavirus Relief Funds, which can only be used for COVID-19 related expenditures. The State is considering using a portion of the funds for the State Unemployment Insurance Trust (UIT) Fund.

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 sector 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 performed well relative to the region and the nation, as evidenced by its population growth and unemployment rates. Like the nation, the State's unemployment rate spiked in April, reaching 14.8%. Low wage sectors have been hardest hit by employment losses.

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's budgetary and cost controls are well focused. 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. The State has prudently accumulated General Fund reserves, with the FY 2019 Budget Reserve Account and unencumbered cash balance equal to a strong 14.1% of budgetary basis General Fund disbursements.

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 85.4% at June 2019. The State contributes essentially 100% of the actuarially recommended amount to fund its pensions. Debt service, pension contributions and OPEB costs are 9.3% of FY 2019 governmental expenditures, which KBRA considers to be low.

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.

For a more detailed analysis of the State of Delaware's general obligation bond rating, please refer to KBRA's **report** published January 10, 2020.

Key Credit Considerations

KBRA continues to monitor the direct and indirect impacts of the COVID 19 virus. Please refer to KBRA ongoing research on the topic **here** for more information.

The rating was assigned because of the following key credit considerations:

Credit Positives

- 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.
- Low fixed costs; and a favorable funded ratio for the State's primary pension fund.

Credit Challenges

- 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.

Rating Sensitivities

• Not applicable given the AAA rating level.	+
• Should General Fund spending demands substantially outpace revenue growth, with a resultant material structural imbalance, this could contribute to downward rating pressure. Ongoing financial operating balance with strategic use of reserves is a hallmark for the current rating level. • The State has achieved ample reserves to help weather the next economic downturn. Prudent use of reserves is anticipated, but a sustained deterioration in reserve levels would be a credit negative. • The State actively monitors its level of debt issuance, and debt burden is expected to remain at the current level. A significant increase in debt could crowd out other spending needs and diminish borrowing capacity. • The State maintains well funded pensions. A deterioration in funded levels would raise long term liabilities for the State, decrease future operating flexibility and put downward pressure on the rating.	-

ESG Considerations

When relevant to credit, ESG factors are incorporated into the credit analysis in the same manner as all other credit-relevant factors. Among the ESG factors that have impact on this rating analysis are:

- Discussion in RD 1: Management Structure, Budgeting Practices and Policies, considers several Governance Factors. The state's management structure, transparency, policies and practices contribute to strong governance. Delaware's financial monitoring, budgetary control, long-term planning, and commitment to pension funding, are additional strengths pertaining to governance.
- Discussion in RD 3: Service Area and Economy reflects Social Factors. KBRA has examined the following areas for this credit: trends in population, education, income, poverty levels, employment, unemployment, GSP and the economic impacts of COVID-19.

More information on ESG Considerations for the Public Finance sector can be found **here**.

Rating Highlights	
General Fund Revenue Forecasts	6x Per Year
Reserves as a % of Disbursements, FY 2019	
Budget Reserve Account	8.6%
Budget Reserve & Unencumbered Cash	14.1%
Net Tax-Supported Debt Service as a % of Govt Expenditures[1]	3.2%
Pension Payment History	Full Payment
Population Growth 2010 to 2019	
Delaware	8.2%
U.S.	6.1%
Unemployment Rate, April 2020	
Delaware	14.8%
U.S.	14.4%

[1]FY 2019, before school district reimbursement.

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+

Financial Performance Update

The Delaware Economic and Financial Advisory Council (DEFAC) released its May budgetary General Fund and Transportation Fund expenditure forecasts for the current fiscal year. In addition, on January 30, 2020, the Governor released his Fiscal 2021 Recommended Operating Budget, Supplemental One-time Appropriation and Bond and Capital Improvements Act for the State of Delaware.

Current Year Projected Budgetary Performance

The State is projecting to close FY 2020 with the Budget Stabilization Fund ($126.3 million) and Budget Reserve Account ($252.4 million) intact, and undesignated reserves of $39.1 million.

The independent DEFAC prepares forecasts six times a year. The practice of frequent fiscal monitoring and reporting is hallmark of a highly rated issuer.

The May 2020 release shows projected FY 2020 general fund revenues of $4,415.5 million, which while an improvement from the March forecast, reflects a YOY decline of -3.8%. The largest contributors to the FY 2020 YOY revenue decline are personal income taxes (-5.7%), lottery receipts (-24.4%) and corporate income taxes (-34.4%). State revenues are derived from a diversity of sources with reliance on corporate and bank related tax receipts. Delaware does not levy a sales tax.

DEFAC relies on a diverse range of information for its revenue forecasts including estimates from the US Bureau of Economic Analysis and IHS forecasts. Forecasts reflect the following key assumptions:

Figure 1

	FY 2019 Actual	FY 2020	FY 2021	FY 2022
DE Employment	1.1%	-3.6%	-11.2%	11.0%
DE Wages & Salary	4.0%	-1.5%	-6.8%	4.2%
US Real GDP	2.6%	-1.6%	-3.9%	6.7%

Source: DEFAC Background Detail, May 2020

In response to the economic impacts of the pandemic, the state has constrained its FY 2020 spending and projected expenditures are under budget. In addition to savings from State actions, Medicaid savings of $31 million are projected. While Medicaid enrollment has increased, savings is enabled by decreased medical utilization and a temporary increase in the federal reimbursement rate (the CARES Act increases federal reimbursement by 6.2% for January to June).

While projected expenditures exceed projected revenues, the state has ample unassigned funds to absorb the gap. At the close of FY 2019 reserves were a historic high, the total of the budget reserve and unassigned cash balance was $618 million, which represents a strong 14.1% of FY 2019 general fund expenses.

Outlook for FY 2021

The Governor's FY 2021 Recommended Operating Budget operating expenditures of $4,629.5 million and reflects investment in three priority areas: clean water ($50 million), Wilmington education initiatives ($50 million) and economic development ($70 million). The budget also includes $34.7 million to support a 2% state workforce salary increase. At the time of the proposal, the base operating budget reflected a 4% increase in spending. Education spending (excluding higher ed) accounts for 35.8% of the base budget. With adjustments (largely pay-go capital spending), proposed expenditures reflected 7.5% growth.

Under state law, budgeted expenses cannot be budgeted at more than 98% of projected revenue. With DEFAC's May forecast, the estimated FY 2021 appropriation limit is now $4,472.0 million, which is $491 million lower than the proposed budget. State leaders will also need to consider the pandemic's impact on FY 2021 Medicaid costs. As elevated unemployment continues and the enhanced unemployment insurance rolls off in July, Medicaid enrollment will continue to trend up. Further, utilization will increase as stay at home orders are lifted. Among the budgetary considerations for FY 2021, is a reduction in pay-go spending. The General Assembly (GA) must take final action on the budget by June 30th.

Coronavirus Relief Fund

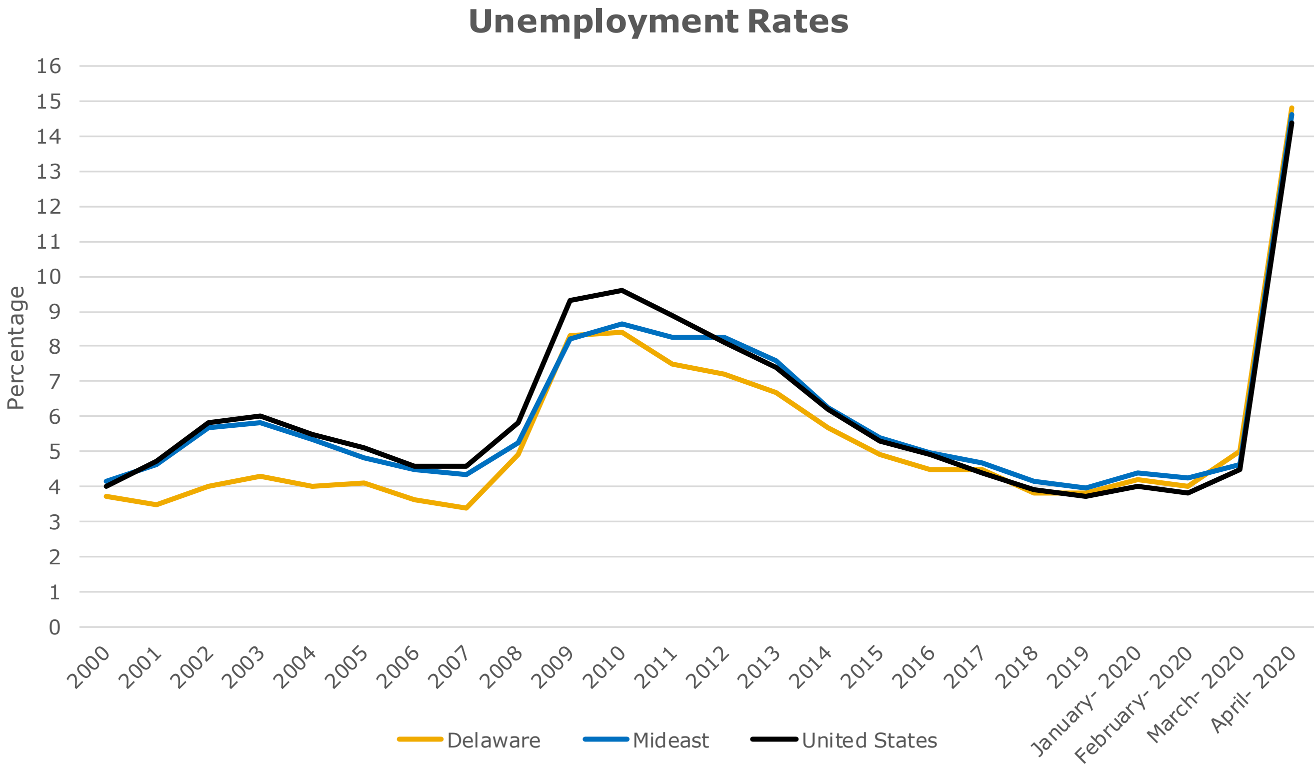
Under the federal CARES Act, the State has received $927 million from the Coronavirus Relief Fund (CRF), and the New Castle County has received an additional $323 million. The CRF allocation can only be used for COVID-19 related expenditures from January 2020 to December 2020. The funds cannot be used to replenish revenue shortfalls. The State is considering using a portion of the funds for the State Unemployment Insurance Trust (UIT) Fund, a permitted use under U.S. Treasury guidance. The UIT Fund receives revenues from payroll taxes. By using CRF money for the UIT Fund, the State payroll tax rate can be kept lower thereby helping to foster economic recovery.

State Resource Base Update

KBRA continues to view the State's resource base as strong. Per capita gross state product (GSP) ranked 9th among the States in 2019 and the economy benefits from the State's position as the legal domicile of more than two-thirds of the nation's Fortune 500 companies, which is an important factor in the State's role as a center for corporate business development and as a hub of the financial service industry.

Headwinds tied to the COVID-19 crisis however are likely to weigh significantly on the State in the near to medium term. According to the Bureau of Labor Statistics, April 2020 unemployment spiked to 14.8% in April from 5.0% in March.

Figure 2



	Delaware	Mideast	United States
April- 2020	14.8	14.6	14.4
Great Recession Peak	8.4	8.6	9.6
Point Δ Since Great Recession Peak	+6.4	+6.0	+4.8

Source: U.S Bureau of Labor Statistics

Note: Delaware's seasonally adjusted April 2020 unemployment rate was 14.3%.

Similar to the nation as a whole, employment losses in Delaware have been focused in the leisure, hospitality, food services, and retail sectors, with these sectors accounting for approximately 64.9% of continuing unemployment claims as of mid-May compared to 17.8% of non-agricultural employment as of the third quarter of 2019 according to the Bureau of Labor Statistics and Delaware Department of Labor. Average weekly wages across these sectors was about $500 in 2019 compared to the all industry average of $1,125. Many of the highest paid sectors in the State including wholesale trade, finance & insurance, professional & technical services, together 24.8% of employment, have fared better account for just 8.4% of claims.

Continuing weekly unemployment claims in Delaware ranged from 5,000 to 7,000 in 2020 through March 14th but have subsequently increased to more than 51,000 as of the week ended May 16th. While the duration and severity of COVID-related disruption remains to be seen, a pronounced recessionary environment appears increasingly likely in the near term both in Delaware and nationally.