FITCH RATES DELAWARE'S $360MM GO BONDS 'AAA'; OUTLOOK STABLE

Fitch Ratings-New York-22 November 2017: Fitch Ratings has assigned a 'AAA' rating to the following state of Delaware general obligation (GO) bonds:

--$234.2 million GO bonds, series 2017A;
--$15.8 million GO bonds, series 2017B (AMT);
--$110.585 million GO refunding bonds, series 2017C.

The bonds are scheduled to be sold via negotiation the week of Nov. 27, 2017.

In addition, Fitch has affirmed the following ratings for Delaware:

--Issuer Default Rating (IDR) at 'AAA';
--Approximately $2 billion GO bonds at 'AAA'.

The Rating Outlook is Stable.

SECURITY
General obligation, full faith and credit of the state of Delaware.

ANALYTICAL CONCLUSION

Delaware's 'AAA' IDR and GO bond rating is derived from its considerable economic resources, which have grown through deliberate policies to maintain a climate attractive to banking and related entities, and strong financial operations that are supported by proactive management and institutionalized protections designed to ensure surplus operations. Above-average debt levels incorporate state issuance for purposes that are addressed at the local government level in other states while 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. Employment growth slowed in 2016 following several years of more robust growth following the Great Recession, a trend that continues in 2017. Both population and labor force growth remain strong and while per capita personal income is below the national average, recent quarterly growth in total personal income has been solid and above the U.S. Unemployment rates remain well below the U.S. average.

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 almost one-third. Much of the balance of revenue sources reflect Delaware's leverage of its status as the legal home to over half of all publicly traded corporations in the U.S. and includes taxes on limited partnerships, franchises, and other business entities. This structure results in a revenue framework that is highly influenced by, and subject to, national economic trends.

Expenditure Framework: 'aaa'
While carrying costs are above the U.S. state average, Delaware has demonstrated ample expenditure flexibility and the broad expense-cutting ability common to most U.S. states. Moreover, the state is statutorily restricted to budgeting 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 an equal share of employer pension contributions for school district employees.

Long-Term Liability Burden: 'aaa'
On a combined basis, the burden of the state's net tax-supported debt and unfunded pension obligations exceeds the median for U.S. states but remains a low 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 and institutionalized protections are designed to ensure surplus operations. Strong management of financial operations results in the maintenance of ample financial cushion even through economic downturns. The ongoing monitoring of revenues and operating expenditures offsets volatility in its revenue sources and provides for rapid gap closing.

RATING SENSITIVITIES
The rating is sensitive to shifts in the state's fundamental credit characteristics including continuation of the state's conservative budgeting practices and strong economic foundation.

CREDIT PROFILE

Revenue Framework
General fund (GF) revenues are derived from an array of sources, with a considerable concentration in those related to business endeavors and financial institutions, all linked to companies being legally domiciled in the state. Including abandoned property revenue, this concentration represents just over 40% of GF revenues. Abandoned property, which includes accounts and securities and typically accounts for over 10% of GF revenues, is subject to significant volatility, making the six-times-per-year revenue forecasts by the independent Delaware Economic and Financial Advisory Council (DEFAC) challenging. DEFAC reviews support the state's maintenance of fiscal balance by providing objective assessments on the state's economy, revenues, and expenditures.

The state's revenue mix includes the PIT, which accounts for the largest share of GF revenues at 33%. The PIT has recorded moderate growth since 2013, offsetting more variable results in corporate-based taxes such as the corporate income tax (CIT) and bank franchise taxes. Lottery revenues, which include gaming and account for over 5% of revenues, have been pressured, reflecting growth and competition in nearby gaming venues outside the state.

The state enacted a number of adjustments to its revenue framework while developing the fiscal 2018 budget to help close an estimated $350 million (8% of expenditures) budget gap. Tax policy changes included rate adjustments to its corporate franchise tax, realty transfer tax, and tobacco and alcohol taxes. The state also changed the method employed to apportion net taxable income for multi-state corporations for taxation purposes. These modifications followed changes to the CIT in the 2016 legislative session to support economic development initiatives.

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. Absent these changes, Delaware's baseline revenue growth has been comparatively slow and is expected to remain so.

Based on the current outlook for economic growth and inclusive of the 2017 tax measures, the September 2017 DEFAC meeting forecast solid revenue growth in fiscal 2018, moderating to a more subdued 1.2% growth rate in fiscal 2019. The forecast for these fiscal years was increased from the earlier June forecast to incorporate both the tax policy changes as well as a modest, additional $95 million to reflect stronger anticipated receipts for the PIT, abandoned property, lottery, and business taxes over the two-year period.

Lottery revenues, which include revenues from video gaming and casino tables, have stabilized after consecutive years of declines as competing venues came on line, and recent forecasts indicate continued stabilization. The state believes that the new MGM National Harbor casino that opened in Maryland in December 2016 largely siphoned customers from other Maryland casinos rather than further impacting Delaware venues.

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 an annual employer pension contribution for local school district employees that is shared with school districts. Health and human services spending is the second largest area of spending, with Medicaid being the primary driver.

Fitch expects that spending growth, absent policy actions, will be ahead 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. In other major areas of spending such as education, Delaware is able to more easily adjust the trajectory of growth.

Federal action to revise Medicaid's programmatic and financial structure, including a basic restructuring of federal Medicaid funding to a capped amount, remains a possibility. Whether a change in Medicaid funding has consequences for Fitch's assessment of a state's credit quality would depend on the state's fiscal response to those changes. Responses that create long-term structural deficits or increased liability burdens could negatively affect both the expenditure framework assessment and the IDR.

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 exceeded its contributions to the pension system in recent years, reflecting a large unfunded OPEB liability relative to the stronger pension funded ratio. Pension 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 an above average debt burden for a U.S. state. Net tax-supported debt as of June 30, 2017 was equal to almost $2.6 billion, or 5.7% of personal income, with one-third

of net debt issued by the transportation authority. Dictates of a statutory three-part test limits debt issuance; however, the ratio is well above the median debt burden for U.S. states and additional debt issued on the small base is expected to sustain the ratio over the medium term.

Pension reforms 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. Adjusting for a 6% return assumption for pensions, Fitch calculates the state's debt plus unfunded pension liability burden at 10% of 2016 personal income, well above the median for states but a low burden on resources. Fitch views the OPEB liability as a more flexible obligation and one in which the state can make changes to reduce the liability, easing concern over the state's sizable unfunded actuarially accrued liability in fiscal 2017, which at almost $8.3 billion, equals a high 18% of state personal income.

Operating Performance
Delaware's ability to respond to cyclical downturns rests with its superior budget flexibility. The state's economic performance through the Great Recession closely matched the experience of the nation as a whole, with a sharp revenue decline in fiscal 2009. To achieve budgetary balance, the state applied almost the entirety of its unencumbered cash balance ($180 million) in fiscal 2009 and reduced expenditures by a comparable amount but did not appropriate from its budget reserve account (BRA), which remained fully funded at 5% of GF revenue.

Financial operations are supported by conservative fiscal policies, including a constitutional provision that limits appropriations to 98% of anticipated revenues in the forthcoming fiscal year, plus the unencumbered prior year budgetary GF balance. The state closely tracks revenue collections and expenditures during the year and forecasts are updated six times each fiscal year through comprehensive reviews by DEFAC. 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.

Delaware has continued to demonstrate ample financial flexibility, with conservative budgeting practices helping it to maintain strong balances and financial cushion. The state has maintained the BRA at the 5% target although unencumbered cash balances have fluctuated due to inconsistency in key revenue sources, particularly sources tied to corporations and businesses. The BRA was over-funded at 5.5% of revenues in fiscal 2017 and a similarly sized balance is anticipated in fiscal 2018. The unencumbered cash balance declined in fiscal 2017 to $75 million from $172 million in fiscal 2016 as final revenues were just below expectations and expenditures were slightly higher.

Combined, the unencumbered cash balance and the BRA equaled a still strong 7.4% of fiscal 2017 revenues at year-end. The state expects this ratio to increase to 9.2% in fiscal 2018 as its cash balances are restored from expected positive results inclusive of the 2% budgetary cushion required in the enacted $4.2 billion General Fund budget. Absent unanticipated actions, Fitch expects the balances to remain stable into fiscal 2019 as DEFAC currently anticipates balanced operations in that year.

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Applicable Criteria
U.S. Public Finance Tax-Supported Rating Criteria (pub. 31 May 2017)
https://www.fitchratings.com/site/re/898466

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