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CREDIT OPINION
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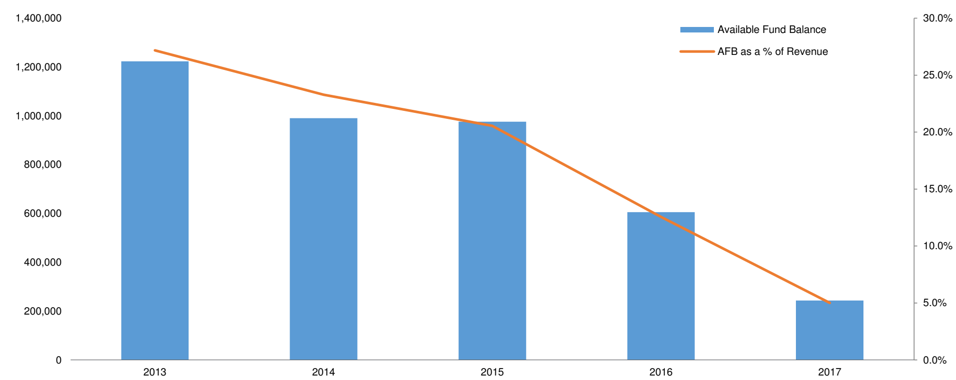
Delaware (State of)

Update to credit analysis

Summary

Delaware's (Aaa Stable) credit profile benefits from strong financial management practices, enforced by a well-established practice of revenue monitoring and forecasting, and a long history of maintaining budgetary reserves. Despite declines in GAAP-basis available fund balances during the last two fiscal years, Delaware's conservative approach will likely lead to rebuilding of these balances in coming years. Moreover, the state benefits from a steady economic base that we expect to gain momentum in the months ahead, reflecting the state's strength in the finance industry.

Exhibit 1
Fiscal 2017 GAAP-basis General Fund reserves declined, reflecting drop in unassigned fund balance.



Includes unassigned General Fund balance and Budget Reserve Account Balance.
Source: Delaware comprehensive annual financial reports

Credit strengths

» Financial management policies that include frequent revenue forecast updates and conservative budgeting

» Maintenance of financial reserves and liquidity

Credit challenges

» Large debt burden and high fixed costs relative to peer Aaa-rated states

» High economic concentration in financial services

Rating outlook

Delaware's stable outlook is supported by prudent structural governance features (including frequent revenue forecast revisions) that will keep the state in a strong position relative to peers through future economic cycles.

Factors that could lead to a downgrade

» Depletion of financial reserves

» Greater loss of output or employment than peer states during a national economic contraction

» Weakened financial management practices

Key indicators

Exhibit 2

Delaware	FY 2012	FY 2013	FY 2014	FY 2015	FY 2016
Operating Fund Revenues (000s)	4,223,865	4,538,384	4,255,647	4,749,041	4,816,998
Balances as % of Operating Fund Revenues	22.8%	22.6%	18.5%	16.1%	8.1%
Net Tax-Supported Debt (000s)	2,325,311	2,300,239	2,280,579	2,256,218	2,421,656
Net Tax-Supported Debt/Personal Income	6.2%	5.7%	5.5%	5.2%	5.4%
Net Tax-Supported Debt/Personal Income 50 State Median	2.8%	2.6%	2.5%	2.5%	2.5%
Debt/Own-Source Governmental Funds Revenue	37.9%	36.1%	48.2%	44.0%	46.9%
Debt/Own-Source Governmental Funds Revenue Median	37.4%	36.1%	35.8%	34.4%	32.7%
ANPL/Own-Source Govt Funds Revenue	87.5%	68.7%	79.8%	68.4%	59.8%
ANPL/Own-Source Govt Funds Revenue Median	94.2%	87.6%	81.8%	83.0%	82.2%
Total Non-Farm Employment Change (CY)	0.6%	2.1%	2.2%	2.3%	1.1%
Per Capita Income as a % of US (CY)	98.4%	98.5%	97.6%	99.0%	98.2%

Source: Moody's Investors Service

Profile

Delaware is the sixth-smallest state, based on its 2017 population of 961,939, according to the most recent estimates from the US Census Bureau. The state's gross domestic product, currently about $74 billion, ranks 41st among states. Delaware's personal income per capita in 2016 was $47,869, or 97% of the national level.

Detailed credit considerations

Economy

Delaware's economy is less diverse than the vast majority of other states, based on the Moody's Analytics index of state industrial diversity. Delaware's 0.62 score on the 0 to 1 index scale compares with a median score of 0.74. States with higher scores have employment bases in industries that more closely align with the nation as a whole. Delaware's lower ranking reflects high concentration of employment in some industries, primarily financial services.

Like many other US states, Delaware suffered a long-running decline in manufacturing employment that culminated with the restructuring, in 2009, of the US auto industry. Delaware's total jobs in the manufacturing sector declined 30% in the past 15 years, mostly during the 2002-to-2010 period. This period also coincided with a decrease in the state's relative wealth. Personal income per capita sank to 98.4% of the nation's in 2012 from 119% of the nation's in 2002. However, growth since the 2008-2009 recession has created new service-sector jobs in Delaware and stabilized the state's manufacturing sector. Total nonfarm payrolls as of the end of last year had increased 10% from the post-recession trough (in 2010, on an annual average basis) and by 3.8% from the pre-recession peak reached in 2007.

Now, the state's economy is poised for faster growth in view of economic conditions that favor employers in the consumer credit industry. Financial services are a larger part of Delaware's economy than any other state. The financial sector produced almost $33 billion, or 46%, of Delaware's $71.5 billion total gross domestic product in 2016. This is more than double the 20% national share.

Finances and Liquidity

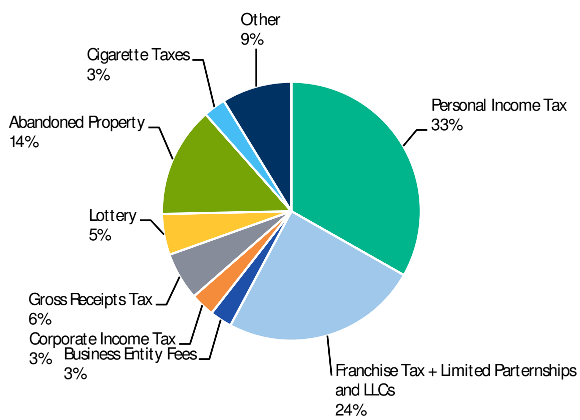
Delaware's expenditures have tended to grow more rapidly than revenues in recent years. In fiscal 2017, for example, general fund disbursements (on a budgetary basis) increased 4.9%, compared with revenue growth of 1.7%. For the current fiscal year, 2018, the state faced a gap of $385 million, or about 9% of revenue, resulting from slowing revenue growth combined with unexpectedly large healthcare and education funding requirements. The state closed the gap using a mix of spending reductions and tax increases.

Largely as a result of the tax increases, the state expects revenues to grow 5.6% in fiscal 2018. The fiscal 2018 budget keeps spending at prior-year levels. Delaware projects that its revenues will grow 1.8% in fiscal 2019 and by about 2.2% in fiscal year 2020. These modest growth forecasts should help lead to structural balance.

Delaware's tax revenue system relies on the state's role as the preferred legal home for publicly traded companies. About half of all US publicly traded firms and more than two-thirds of the Fortune 500 are organized under Delaware law. The state derives about a quarter of its revenue from franchise taxes levied on these corporations, as shown in the exhibit below. Abandoned property revenue, which is also related to the state's position as a preferred legal domicile for corporations, accounts for 13% of revenue. Bank franchise taxes and other corporate levies account for another 5% of the state's receipts.

Exhibit 3

Much of Delaware's revenue is derived from the state's role as a preferred corporate domicile
Fiscal 2017 general fund revenues, millions



Source: State of Delaware (unaudited)

Delaware since 1980 has maintained a Budget Reserve Account, a constitutionally mandated rainy day fund that holds cash and is managed by the state's Cash Management Policy Board. The account can have as much as 5% of the state General Fund's estimated budgetary revenue. The current balance is $231.6 million. Drawing these funds requires approval by legislative super-majorities (three-fifths of the members of each chamber). By observing a limit on appropriations, Delaware creates a second buffer against revenue underperformance. The state can only appropriate 98% of estimated general fund revenue. The current year's $4.1 billion appropriation is within this limit, which can be waived based on super-majority approval, although the state has generally adhered to this practice even in times of fiscal pressure. Together with the Budget Reserve Account, the appropriation cap creates an effective 7% budgetary reserve.

On a GAAP basis, Delaware's available balances including financial reserves and unassigned General Fund balances have declined in recent years. In the state's 2017 comprehensive annual financial report (CAFR), the state unassigned General Fund balance plunged to $11.4 million – down from $390 million in 2016 and $763 million in 2015. These declines, which are depicted in Exhibit 1, partly reflect the state's accounting treatment for reimbursements related to unclaimed property (or escheat). The liability for escheat refunds increased by about $188 million in fiscal 2017. Delaware makes greater budgetary use than other states of assets derived from abandoned property, which generated $554 million (unaudited), or 14% of total general fund revenue in fiscal 2017.

Delaware's competitive advantage as legal domicile

Delaware plays a unique role in corporate America as legal domicile for two-thirds of Fortune 500 companies and more than half of all publicly traded firms in the US. In recent years, Delaware has expanded its dominant position in this field. Delaware's corporate laws are modern and have broad acceptance in the US. The state's Court of Chancery has a well-developed body of jurisprudence in corporate law. As of October 2017, there were 1.3 million businesses registered in the state. Delaware's long-standing position as preferred domicile enhances its economic and revenue stability.

LIQUIDITY

Delaware has very strong liquidity. As of September 2017, Delaware had total available liquid resources of $1.6 billion, or 39% of expected fiscal 2018 general fund revenues. Delaware has not had to issue bond- or revenue-anticipation notes in more than 40 years because of its strong liquidity.

Debt and Pension

DEBT STRUCTURE

Delaware's debt burden is high relative to other states due to its funding of capital projects on behalf of school districts. Delaware's $2.5 billion in net tax-supported debt was 5.4% of personal income, which ranked sixth-highest among states in our most recent (dated May 2017) debt medians study, and was more than twice the 50-state median of 2.5%. The state has high fixed costs compared to other Aaa-rated states.

Delaware has no outstanding variable-rate debt. The state's practice of relying on fixed-rate debt limits its vulnerability to rising interest rates and also to the potential liquidity risks that certain types of variable rate debt entail.

Delaware's general obligation debt is paid out relatively rapidly, with 70% of outstanding debt scheduled to be repaid in 10 years. All of the state's general obligation debt is scheduled to mature in 20 or fewer years. This increases short-term funding pressure, while enhancing long-term fiscal flexibility.

The amount of debt Delaware can issue is limited by a three-part statutory test. New debt authorized in any year must be less than 5% of general fund revenue. Debt service, including bonds secured by transportation revenues, must be less than 15% of general fund and transportation revenue. The maximum annual debt service on general obligation debt must be less than the state's cash balances.

DEBT-RELATED DERIVATIVES

Delaware is not party to any debt-related derivatives.

PENSIONS AND OPEB

Delaware has an average pension liability relative to its revenues for a state. Its $3.4 billion adjusted net pension liability as of fiscal 2016 was 60% of revenue, well below the 50-state median of 82%. The state regularly makes the actuarially determined contribution, which was $187 million in fiscal 2017, or 5% of the budget. Delaware contributed 112% of its tread-water contribution. The tread-water contribution is the amount that would cover interest on the beginning-of-the-year net pension liability, plus employer service cost accruals during the year.

The state has determined that its liability for other post-employment benefits (OPEB) was $8.6 billion as of June 30, 2017. Like most states, Delaware has not significantly funded this liability. It has provided $355 million, or 4% of the liability. The state estimates that its OPEB actuarially determined annual required contribution for fiscal 2018 is $543 million, of which the state only expects to cover $237 million, or less than half.

The state retains significant flexibility in addressing OPEB costs. In 2011 and 2013, Delaware enacted laws that shifted some of the burden to employees and the federal government, respectively.

Governance

The Aaa rating assigned to Delaware's general obligation bonds is based in large part on legal provisions that will encourage the state to maintain a strong financial profile over a long period. A panel of 31 gubernatorial appointees, known as the Delaware Economic and Financial Advisory Council (DEFAC), provides the state's revenue estimates. This panel, which includes officials from the public and private sector, meets six times a year and issues revenue and expenditure forecasts used by both the executive and legislative branches of government during the budget process. The state's requirements for consensus forecasts, well-managed expenditure growth, and a limit on appropriations support long-term prospects for financial strength. Delaware's otherwise strong management profile is tempered by a constitutional requirement that tax increases be approved by a three-fifths legislative majority, which reduces the state's financial flexibility.

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