FitchRatings

Fitch Rates Delaware's $301MM GO Bonds 'AAA'; Outlook Stable

Fitch Ratings-New York-05 February 2016: Fitch Ratings has assigned an 'AAA' rating to $300.605 million state of Delaware general obligation (GO) bonds consisting of the following:

--$203.5 million GO bonds, series 2016A;
--$21.5 million GO bonds (AMT), series 2016B;
--$75.605 million GO series 2016 refunding bonds.

The par amount of the series 2016 refunding bonds is preliminary and subject to change based on market conditions. The bonds are expected to sell via competitive bid on March 1, 2016.

In addition, Fitch affirms the following rating:

--$2.1 billion outstanding GO bonds at 'AAA'.

The Rating Outlook is Stable.

SECURITY

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

KEY RATING DRIVERS

CONSERVATIVE FISCAL MANAGEMENT AND STRONG OVERSIGHT PROTECTIONS: Delaware's conservative fiscal management and longstanding constitutional protections are designed to ensure surplus operations. The budgetary reserve fund (BRF) was fully funded in fiscal 2015 at 5% of revenue. Additional cash balances strengthen the state's fiscal position. Finances of the state benefit from its position as the legal home of most U.S. corporations.

GENERALLY STABLE ECONOMIC BASE: Delaware's economy is based in large part on service-providing enterprises, including financial activities, professional and business services, and education and health organizations. Economic growth picked up momentum in 2014 after slower growth emerging from the recession, and unemployment rates equal the U.S. average.

SOUND PENSION FUNDING: The state employees' pension system maintains sound funded ratios and the state consistently funds its actuarially calculated contributions.

ABOVE-AVERAGE DEBT BURDEN: Although the state debt burden is above average, it reflects centralization of many local government functions and is mitigated by rapid amortization.

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 indicators.

CREDIT PROFILE
Delaware's 'AAA' GO bond rating is derived from its considerable economic and financial resources supported by proactive management and institutionalized protections designed to ensure surplus

operations. Above-average debt levels incorporate the state's issuance for purposes that are handled at the local government level in other states. Pensions are well funded.

CONTINUED ECONOMIC IMPROVEMENT

The state's economy, diversified through deliberate policies to maintain a climate attractive to banking and financial services, emerged from its slow growth coming out of the recession to more solid growth. Year-over-year (yoy) employment growth was 2.2% and 2.1% in 2013 and 2014, respectively, as compared to 1.7% and 1.9% for the nation. Growth in December 2015 has somewhat moderated, with the state recording a 1.6% yoy employment growth rate compared to 1.9% for the nation. The sectors exhibiting the most positive trends in December included professional and business services, financial activities, education and health services, and leisure and hospitality.

The state's forecast for employment growth in fiscal 2016 is 1.9%, which Fitch believes is reasonable based on experience to date and is just slightly ahead of the nation at 1.8%. Thereafter, the state forecasts a moderating of employment growth rates in fiscal years 2017 and 2018, to 1.5% and 1.1%, respectively. The forecast incorporated the expectation of workforce reductions at DuPont in the first quarter of 2016, from an employee base of 6,100, in advance of its expected merger with Dow Chemical, as well as the announced expansion of 1,800 jobs at J.P. Morgan to a total employee base of 9,300. While the loss of employment at DuPont is a negative for the state's economy, Fitch expects the loss to be softened by continued growth in other employers.

Historically, Delaware's per capita personal income (PCPI) has modestly surpassed that of the nation and that trend continued through 2014 with PCPI at 100.7% of the national average, ranking Delaware 20th among the states. On a yoy quarterly basis, the state's personal income growth through most of 2015 has approximated that of the mid-Atlantic region; yoy third-quarter personal income growth of 4.5% compared favorably to 4.3% for the region, just trailing the U.S. growth rate of 4.6%.

Employment remains concentrated in the banking and services industries; 10.4% of jobs in December 2015 were in financial activities (compared to 5.7% for the U.S.), but employment in business and professional services and education and health services now approximate national averages. Unemployment rates are typically well below the U.S. average at 5.7% in 2014 compared to the U.S. rate of 6.2% but have recently moved to approximate the U.S. average due to strong growth in the state's labor force, 3.4% yoy in December 2015 compared to 1.1% for the U.S.

WELL-MANAGED AND CONSERVATIVE FINANCIAL OPERATIONS

Delaware's financial operations are conservatively managed and ongoing monitoring of both revenues and expenditures by the independent Delaware Economic and Financial Advisory Council (DEFAC) ensures timely knowledge of operating trends; DEFAC reviews the revenue and expense forecast six times a year. Delaware's revenue mix reflects its position as legal home of most U.S. corporations, with various fees and taxes as well as abandoned property revenue all linked to companies being legally domiciled in the state. Abandoned property typically accounts for over 10% of general fund (GF) revenues with collections expected to account for 13.7% in fiscal 2016, an increase of 7.8% from fiscal 2015. This revenue stream is subject to considerable volatility, making annual forecasts challenging.

Strong financial results in fiscal 2015 were fueled by growth in personal income taxes (PIT; up 5.4% yoy) as well as growth in corporate income taxes (up 164.2% yoy) and net franchise and limited partnerships taxes (up 11.8% yoy). Overall, revenue increased 10.7% yoy from fiscal 2014. A modest increase of 1% in GF appropriations provided for a $122.5 million operating surplus for the fiscal year, increasing cash balances in the GF to $536.9 million or 13.6% of GF revenue for the year. The budget reserve fund remained fully funded at $212.5 million, providing for a sound operating cushion when combined with operating cash balances.

The enacted budget for fiscal 2016 totals $3.9 billion, a 2.7% increase from expenditures in fiscal 2015.

The budget built on DEFAC's June 2015 revenue estimate of $3.87 billion, allowing for the statutory 98% of forecast revenue to be budgeted. DEFAC's update of the revenue forecast in December 2015 increased GF revenue sources to $4 billion; a 4.4% increase from the June forecast. DEFAC is estimating 4.4% growth in the PIT from fiscal 2015; a decline of 23.9% in the CIT following receipt of a sizable payment in fiscal 2015 related to a federal tax audit; and 7.8% growth in abandoned property revenue. DEFAC currently anticipates the year ending with an addition to cash reserves of $103.4 million and the cumulative cash balance is expected to equal $640.3 million (16% of GF revenue) prior to a portion rolling forward to fund subsequent year's expenditures. The budgetary reserve fund is expected to total $214.8 million.

At its December 2015 meeting, DEFAC updated its revenue forecast for fiscal 2017. DEFAC anticipates a modest decline in GF revenue sources in fiscal 2017 of 0.3%, incorporating solid 4.1% growth in the PIT and 2.5% growth in net franchise and limited partnership tax revenue, offset by a large 15.2% decline in abandoned property tax. The estimated decline in this revenue relates to the state's potential loss in ongoing litigation challenging the statistical model for estimating these obligations. The governor's proposed budget for fiscal 2017 builds on the revenue forecast and proposes a $13.8 million net increase in GF revenue to support $4.16 billion in expenditures, a 5.7% increase from fiscal 2016. The bulk of the increase falls in education expense, proposed to increase by 7% from fiscal 2016. The proposed budget plans for the use of $120.1 million in available cash balances to fund appropriations, reducing the cumulative cash balance to $520.2 million (13% of revenues) while fully funding reserves at $220.4 million. Fitch believes the level of expected financial cushion is satisfactory despite the planned use of its resources for operations. The legislature will consider the governor's proposal in the current legislative session.

ABOVE-AVERAGE DEBT BURDEN; SOLID PENSION FUNDING LEVELS
As a small state with a minimal number of local governments, Delaware's service functions are highly centralized, leading to an upper-moderate debt burden. Net tax-supported debt as of June 30, 2015 equals about $2.7 billion, or 6.5% of personal income, with about 33% of debt issued through the transportation authority. This ratio has slowly declined since 2008, reflecting steps taken by the state to control its bonding for capital. However, the ratio is well above the 2.4% median debt burden for U.S. states. Debt remains a moderate burden on state resources; debt service was approximately 5.8% of revenues in fiscal 2015 despite a rapid rate of amortization with about 70% of principal retired in 10 years.

The state employees' pension (SEP) system was overfunded until 2009 when investment losses resulted in a small unfunded liability. Pension reforms effective Jan. 1, 2012 aimed to bolster funding ratios through targeted benefit reductions and increased contributions by new employees. Under the new GASB pension standards, SEP reported a 92.7% ratio of pension assets to liabilities in fiscal 2015 with a net pension liability of almost $665.3 million. On a combined basis, the burden of the state's net tax-supported debt and unfunded actuarial accrued liability (UAAL) for pension obligations, adjusted by Fitch to reflect a 7% return assumption, equals 10.1% of 2014 personal income, above the 5.8% median for states. The state's UAAL for other post-employment benefits (OPEB) remains sizable at $6 billion, equal to 13.8% of state personal income.

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Fitch recently published an exposure draft of state and local government tax-supported criteria (Exposure Draft: U.S. Tax-Supported Rating Criteria, dated Sept. 10, 2015). The draft includes a number of proposed revisions to existing criteria. If applied in the proposed form, Fitch estimates the revised criteria would result in changes to less than 10% of existing tax-supported ratings. Fitch expects that final criteria will be approved and published by the end of the first quarter of 2016. Once approved, the criteria will be applied immediately to any new issue and surveillance rating review. Fitch anticipates the criteria to be applied to all ratings that fall under the criteria within a 12-month period from the final approval date.

Applicable Criteria
Exposure Draft: U.S. Tax-Supported Rating Criteria (pub. 10 Sep 2015)
(https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=869942)
Tax-Supported Rating Criteria (pub. 14 Aug 2012)
(https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=686015)
U.S. State Government Tax-Supported Rating Criteria (pub. 14 Aug 2012)
(https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=686033)

Additional Disclosures
Dodd-Frank Rating Information Disclosure Form
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