

FITCH RATES DELAWARE'S \$225MM GO BONDS 'AAA'; OUTLOOK STABLE

Fitch Ratings-New York-10 February 2017: Fitch Ratings has assigned an 'AAA' rating to the \$225 million state of Delaware general obligation (GO) bonds, series 2017. The bonds are scheduled to be sold via negotiation the week of Feb. 13, 2017.

The Rating Outlook is Stable.

SECURITY

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

KEY RATING DRIVERS

Delaware's 'AAA' Issuer Default Rating (IDR) 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. Economic growth slowed in 2016 following several years of more robust growth earlier in the current expansion. Recent employment data shows continued declines in state manufacturing sector employment that were more than offset by solid growth in professional and business services, leisure and hospitality, and other service sectors. Unemployment rates remain well below the U.S. average.

Revenue Framework: 'aa' factor assessment

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' factor assessment

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' factor assessment

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 has declined in recent years through limited borrowing. 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, but are only a moderate burden on resources. Pensions are well-funded although other post-employment benefit (OPEB) obligations are sizable.

Operating Performance: 'aaa' factor assessment

The state has exceptional financial resilience and institutionalized protections are designed to ensure surplus operations. Strong management of its 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 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 also been pressured, reflecting growth and competition in nearby gaming venues outside the state.

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. Delaware's revenue growth absent tax policy changes has been comparatively slow and is expected to remain so. PIT and business tax trends are expected to remain stable over the next two to three years absent a significant pull-back in the economy, based on recent results and current forecasts for economic growth. At the DEFAC meeting in December 2016, annual revenue growth for fiscal 2017 was adjusted to 0.9%, as compared to 1.9% growth projected in June 2016, while growth of a modest 0.4% is projected for fiscal 2018.

Lottery revenues, which include revenues from video gaming and casino tables, had stabilized after consecutive years of declines as additional, but competing venues have also come on line and recent forecasts indicate some softening. The new MGM National Harbor casino opened in Maryland in December 2016, further saturating the mid-Atlantic gaming market. DEFAC currently projects a 2.8% decline in lottery revenue in fiscal 2017 and a 0.3% decline in fiscal 2018.

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 equal share of annual employer pension contributions for local school district employees. 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 appears likely, although the magnitude and timing of changes for state budgets remains unknown. Both the new Presidential administration and Congressional leadership support significant Medicaid policy shifts. As one of the largest parts of state budgets and by far the biggest source of federal funding to the states, federal decisions could have significant implications for states' ability to manage this key budget item.

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 other post-employment employee benefits (OPEB), however, has exceeded its contributions to the pension system in recent years, reflecting both a large unfunded OPEB liability relative to the stronger pension funded ratio. Based on the state's actual contributions for OPEB, debt service, and pensions, carrying costs accounted for a still manageable 8.6% of expenditures in fiscal 2016. Pension contributions over the past several years have generally approximated the actuarially determined contribution.

Long-Term Liability Burden

Per Fitch's 2016 State Pension Update report, the state's total net tax-supported debt and unfunded pension liabilities represented 7.4% of 2015 personal income, well above the 5.1% median for states.

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. Net tax-supported debt as of Dec. 31, 2016, is equal to about \$2.3 billion, or 5.2% of personal income, with almost one-third of debt issued through the transportation authority. The ratio has slowly declined since 2008, reflecting steps taken by the state to control its bonding for capital as well as the dictates of a statutory three-part test to limit debt issuance. However, the ratio is well above the 2.4% median debt burden for U.S. states.

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. For the year ended June 30, 2016, SEP reported an 84.1% ratio of pension assets to liabilities with a net pension liability of \$1.5 billion. 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 UAAL for OPEB, which at \$7.15 billion equals a very high 15.9% 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 largely 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. 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 5.4% of revenues in fiscal 2016 and a similarly sized balance is expected in fiscal 2017. Unencumbered cash balances bolster the state's financial flexibility; \$171.8 million was most recently recorded on June 30, 2016. The unencumbered balance is expected to decline substantially in fiscal 2017, to \$26.4 million, as revenue sources are currently anticipated to be 1.2% below expectations as of the enacted budget.

Recent Operating Performance

As mentioned above, DEFAC's December 2016 economic and revenue forecast projected GF revenues in fiscal 2017 that are 1.2% below its expectations at the time the budget was enacted. The state is expected to apply its unencumbered cash balance to close the revenue forecast change. If these expectations hold for the fiscal year, revenue growth from fiscal 2016 will be a modest 0.9%. DEFAC has projected negligible revenue growth for fiscal 2018 at 0.4%, absent any tax policy measures. Given the slowly growing revenues, reduced unencumbered cash balance for fiscal 2017, and expected growth in expenditures, the state is now projecting a \$350 million budget gap for fiscal 2018. The state relates that about \$150 million of the gap stems from new expenditure demands for education, largely related to enrollment increases and investments in early childhood education.

The outgoing governor proposed a fiscal 2018 budget that solved for the budget gap through a mixture of increasing revenue sources and expenditure reductions. The new governor, who took office on Jan. 17, is reviewing the budget proposal and considering a variety of actions to ensure budgetary balance. The governor expects to deliver a revised fiscal 2018 budget proposal for the legislature's consideration after DEFAC's next meeting in March, at which time the revenue forecast will be updated.

The BRA is expected to be maintained at the 5% of revenues statutory limit.

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Date of Relevant Rating Committee: June 10, 2016

Additional information is available at 'www.fitchratings.com'.

In addition to the sources of information identified in Fitch's applicable criteria specified below, this action was informed by information from Lumesis and InvestorTools.

Applicable Criteria

U.S. Tax-Supported Rating Criteria (pub. 18 Apr 2016)

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