Fitch Rates Delaware's $325MM GO Bonds 'AAA'; Outlook Stable

Ratings Endorsement Policy
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Fitch Ratings-New York-08 October 2014: Fitch Ratings assigns an 'AAA' rating to $325 million series 2014 state of Delaware general obligation (GO) bonds consisting of the following:

--$100 million GO bonds, series 2014B;
--$225 million GO bonds, series 2014C.

The par amount of the series 2014B bonds is preliminary and subject to change based on market conditions. The bonds are expected to sell via negotiation the week of Oct. 20, 2014.

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 2014 at 5% of revenue. Finances of the state benefit from its position as legal home of most U.S. corporations.

CASH BALANCES DECLINED IN 2014: Despite the state's strong fiscal management, cash balances declined substantially in fiscal 2014 due to unexpected corporation income tax revenue loss but remained solid. The state has budgeted for an increase in its cash balances in fiscal 2015.

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, although unemployment rates have recently inched above the U.S. average. The increase in the unemployment rate appears to be partly attributable to growth in the labor force as employment has also shown solid year over year (yoy) growth.

SOUND PENSION FUNDING: The state employees' pension system maintains sound funded ratios and the state consistently funds its actuarially calculated annual required 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, has emerged from its slow growth coming out of the recession to more recent solid growth. Yoy employment growth trailed the nation in calendar years (CYs) 2011 and 2012 (0.9% and 0.3%, respectively, compared to 1.2% and 1.7%, for the U.S.) but exceeded the nation in 2013 at 1.9% yoy growth compared to 1.7% for the nation. Growth through August 2014 has been very positive, with the state recording a 2.7% yoy employment growth rate compared to 1.8% for the nation. The sectors exhibiting the most positive trends in August included professional and business services (up 7.5%), financial activities (up 2.2%), and construction (up 8.9%).

The state is currently forecasting growth above the national average for CY 2014 (2.2% compared to 1.7% for the nation), which Fitch believes is reasonable based on experience to date. The state believes this momentum will carry into CY 2015, with 2.2% employment growth expected that year compared to 1.9% for the nation. Thereafter, the state forecasts a moderating of employment growth rates in CYs 2016 and 2017, at 1.5% and 1.4%, respectively, compared to forecast national growth rates of 1.7% in those years.

Historically, Delaware's per capita personal income (PCPI) has modestly surpassed that of the nation and that trend continued through 2013 with PCPI at 101.2% of the national average, ranking Delaware 23rd amongst the states. On a yoy quarterly basis, the state's personal income growth in the first half of 2014 has approximated that of the mid-Atlantic region; yoy second-quarter personal income growth of 3.6% compared favorably to 3.5% for the region while recording below the 4.1% for the U.S.

Employment remains concentrated in the banking and services industries; 10.3% of jobs in August 2014 were in financial activities (compared to 5.8% for the U.S.), but employment in business and professional services and education and health services are now more approximate to national averages. Unemployment rates are typically well below the U.S. average, 6.7% in CY 2013 compared to the U.S. rate of 7.4% but have recently moved to exceeding the U.S. average even as they continue to move downward (6.5% in August 2014 compared to 6.1% for the nation).

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 14% in fiscal 2015, an increase of 16.7% from fiscal 2014. This revenue stream is subject to considerable volatility, making annual forecasts of this revenue source challenging.

Strong financial results in fiscal 2013 were fueled by growth in personal income taxes (up 9.4% yoy) that included the push forward of personal income into CY 2012 due to uncertainty over federal tax legislation, as well as growth in corporate income taxes (up 57.8% yoy) and in abandoned property revenue (up 77.3% yoy). Overall, revenue increased 11% yoy from FY 2012. A modest increase of 1.8% in GF appropriations provided for a $71.3 million operating surplus for the fiscal year, increasing cash balances in the GF to $635.9 million or just over 17% of GF revenue for the year. On a GAAP basis, the unrestricted GF balance was a considerable 32.7% of GF revenue for FY 2013.

The enacted $3.8 billion GF budget for FY 2014 incorporated 4.2% growth in public education expense and 5.6% growth in the state's Medicaid program. As a budget balancing measure, the state included several changes and/or extensions to state taxes that were otherwise scheduled to sunset, including maintaining a 4% gross receipts tax rate, reducing the top PIT rate to 6.6% from the prior 6.75% rate but above the 5.95% roll-back rate, and maintaining the statewide estate tax and the corporate franchise tax at the then current maximum levy of $180,000. Total GF revenues in support of the budget were expected to grow by a modest 0.3%, and DEFAC forecast a $187.2 million use of cash balances to fund operations, bringing the cumulative cash balance to $448.7 million (12% of GF revenue).

The revenue forecast was updated several times by DEFAC over the course of the fiscal year with final revenues coming in 4.5% ($168 million) lower than the original revenue expectation on which the 2014 budget was based. The largest deviation from forecast was in corporate income taxes; off from forecast by almost 50% ($101 million), due to a sizable $73.5 million refund paid to a taxpayer as well as a delay in the receipt of tax revenue from a completed IRS audit, now expected to be collected in fiscal 2015. Personal income taxes (PIT), which account for almost a third of GF revenues, came in 1.3% above forecast. As only modest expenditure reductions were put into place to compensate for the revenue loss, the year ended with a $221.5 million use of cash balances to fund operations, reducing the cumulative cash balance to $414.4 million (11.6% of GF revenue). The BRF remained fully funded at $201.7 million, providing for a sound operating cushion when combined with available cash balances.

The enacted budget for FY 2015 totals $3.8 billion, a 1% increase from expenditures in FY 2014. The budget proposal builds on DEFAC's June 2014 revenue estimate for FY 2015 of $3,945 million and allows for the statutory 98% of forecast revenue to be budgeted. Budgetary expenditure growth is expected to be supported by 3.2% growth in the PIT, 2.4% growth in gross receipts taxes, and sizable 113% growth in corporate income taxes, which incorporates the receipt of the delayed audit revenue as well as a 42% expected decline in refund payments from FY 2014. Abandoned property revenue is expected to increase by 16.7% from FY 2014. DEFAC currently anticipates the year ending with an addition to cash reserves of almost $114 million and the cumulative cash balance is expected to equal $528.3 million (13% of GF revenue). The budgetary reserve fund is expected to equal $212.5 million.

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, 2014 equals about $2.8 billion, or 6.6% of personal income, with about 33% of debt issued through the transportation authority. This ratio has remained fairly stable since at least 2008, reflecting steps taken by the state to control its bonding for capital. However, the ratio is well above the 2.6% median debt burden for U.S. states. Debt remains a moderate burden on state resources; debt service was approximately 5.7% of revenues in FY 2013 despite a rapid rate of amortization with about 70% of principal retired in 10 years.

The state employees' pension system was overfunded until 2009 when investment losses resulted in the development of a small unfunded liability. Pension reforms effective Jan. 1, 2012 aimed to bolster funding ratios through targeted reductions in new employee benefits and increased contributions by new employees. The reported funded ratio was 91.1% as of June 30, 2013 and the state anticipates the ratio to improve in future years due to recent healthy investment returns. Using Fitch's more conservative 7% discount rate assumption (as compared to the state's 7.5% assumption), funding as of June 30, 2013 declines to a still solid 86.3%.

On a combined basis, the state's net tax-supported debt and adjusted, unfunded pension obligations attributable to the state, as adjusted for a 7% return, totals 10.4% of 2013 personal income, well above the 6.1% median for all U.S. states. Despite a recent change to retirees' prescription drug plans that resulted in significant annual cost savings to the state, the state's liability for other post-employment benefits (OPEB) remains sizable at $5.77 billion; equal to 13.8% of state personal income.

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In addition to the sources of information identified in Fitch's Tax-Supported Rating Criteria, this action was additionally informed by information from IHS Global Insight.

Applicable Criteria and Related Research:
--'Tax-Supported Rating Criteria' (Aug. 14, 2012);
--'U.S. State Government Tax-Supported Rating Criteria' (Aug. 14, 2012).

Applicable Criteria and Related Research:
Tax-Supported Rating Criteria

U.S. Local Government Tax-Supported Rating Criteria

Additional Disclosure
Solicitation Status