

FITCH RATES DELAWARE'S \$275MM GO BONDS 'AAA'; OUTLOOK STABLE

Fitch Ratings-New York-21 October 2011: Fitch Ratings assigns an 'AAA' rating to the following general obligation (GO) bonds of the State of Delaware:

- \$50 million GO bonds, series 2011A;
- \$225 million GO bonds, series 2011B.

In addition, Fitch affirms the following ratings:

- \$1.6 billion in outstanding GO bonds at 'AAA'.

The Rating Outlook is stable.

The bonds are expected to sell via negotiation the week of Oct. 31.

SECURITY

General obligation, full faith and credit of the State of Delaware

KEY RATING DRIVERS

--**CONSIDERABLE ECONOMIC RESOURCES:** The state's considerable economic resources remain solid despite some slippage in employment and wealth indicators. Finances of the state benefit from its position as legal home of most U.S. corporations.

--**CONSERVATIVE FISCAL MANAGEMENT:** Conservative fiscal management and longstanding constitutional protections designed to ensure surplus operations result in the maintenance of fund and cash balances and budgetary reserve funds.

--**STRONG PENSION FUNDING:** The state employees' pension system maintains strong funded ratios and the state is taking steps to increase funding of its other post-employment benefits (OPEB) liability.

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

CREDIT PROFILE

Delaware's premier credit standing centers on its considerable economic and financial resources, supported by institutionalized protections designed to ensure surplus operations. The state's economy, diversified through deliberate policies that created a climate attractive to banking and related business services, and pharmaceuticals, continues to be hampered by the lingering effects of the recession, reflected in year-over-year (y-o-y) employment losses and slow overall economic growth. This sluggish economic growth, and expectations for reduced growth nationwide, transferred to a recent reduction in the state's revenue forecast for fiscal (FY) 2012, opening a gap in the current year's budget that the state plans to address through carryover cash balances from FY 2011.

Historically, Delaware's per capita personal income (PCPI) has surpassed that of the national average, but recent personal income performance has lagged the U.S., with 2010 PCPI just trailing the U.S. at 99% of the national average, ranking Delaware 21st amongst the states. On a y-o-y quarterly basis, the state's growth in 2011 has been more positive; y-o-y second quarter personal income growth of 5.5% compared favorably to 4.1% for the U.S. Employment remains concentrated in the banking and related services fields; 10.3% of jobs in August 2011 were in financial activities (compared to 6% for the US) and 13% were in business and professional

services (equal to U.S.) Manufacturing's presence was a modest 6.3% compared to a national average of 9.8% of employment.

Unemployment levels are typically well below the U.S. average; 8.1% in August 2011 compared to the U.S. rate of 9.1%; although, like the nation, the rate remains relatively high due to the anemic pace of economic growth. Employment growth, which had slowed as compared to the U.S. beginning in 2006, began to decline midway through 2008 and declined .5% in 2008 compared to a .4% drop for the U.S. Generally, job losses since 2008 in Delaware have been equivalent to national averages although recent data suggest that they have yet to abate while the nation is showing modest growth; August y-o-y employment loss of .7% compared to 1% growth for the U.S. The state's September forecast projects a slow recovery in employment with .9% employment growth in FY 2012 matched with a projected .9% national average and 1.8% growth forecast for FY 2013.

Delaware has demonstrated the willingness to cut spending and raise taxes as needed to preserve budget balance. The state addressed expected revenue shortfalls in fiscal years 2009 and 2010 by instituting a statewide hiring freeze, implementing state agency budget reductions, increasing corporate franchise, personal income and cigarette taxes, using federal stimulus funds, and deauthorizing cash-funded capital projects. The state was able to close the budgetary gaps without using its budget reserve fund, which remained fully funded at \$186.4 million (5%) of prior year appropriations. The unreserved general fund balance remained sizable at 24.4% of revenues in FY 2010 on a GAAP basis.

Revenues improved in FY 2011 with total revenues 7% higher than estimated at the beginning of the fiscal year; a 9.2% increase from FY 2010. The unencumbered cash balance is estimated to have increased from \$165.8 million in FY 2010 to \$307.7 million in FY 2011 and the state ended fiscal year 2011 with its budget reserve fund intact. The reserve has not been used since inception in 1980.

Following the robust revenue growth in FY 2011, revenues in FY 2012 were expected to grow at a 2.3% rate, allowing for personal income, bank franchise, public utility, and gross receipts tax cuts, various fund allocations, and a 2% state employee salary increase to be effective Jan. 1, 2012. The Delaware Economic and Financial Advisory Council (DEFAC) in its most recent forecast, from September 2011, notably lowered the general fund revenue estimate for fiscal 2012 (by \$234 million) from June 2011, reflecting the impact of \$26 million in legislated tax cuts included in the adopted FY 2012 budget, \$43 million in reduced revenue expectations, and \$165 million in allocated funds to various state economic development, higher education, and housing initiatives in the FY 2012 budget. Personal income tax (PIT) revenue is forecast to grow at a 4.6% rate in FY 2012, down from 6.3% forecast in June, but this includes a rate reduction in the top rate from 6.95% to 6.75%, accounting for over a third of the reduced forecast; the balance of the reduction comes from downwardly revised economic growth expectations. The state does not have a sales tax.

Lottery revenues (8.1% of FY 2011 general fund revenues) have been negatively affected by the start of video lottery operations in Pennsylvania and slot operations in Maryland. The planned opening of casinos in both Pennsylvania and Maryland are expected to reduce this revenue source still further, contributing to a revised FY 2012 revenue forecast of 7% lost from this revenue source y-o-y.

DEFAC reviews the revenue forecast at least six times per year and Fitch expects that any further adjustments will be followed by responsive action by the state.

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 10% to 12% of general fund revenues though collections were a high 15% in fiscal 2010; this variable revenue stream has been negatively affected by the downturn in financial markets but the state's decision to shorten the dormancy period on held securities has resulted in an increase in these collections.

Operations in FY 2012 are expected to benefit from \$82.7 million in federal stimulus funds that had not been utilized in FY 2011, including \$55.3 million of enhanced federal matching funds for

Medicaid (FMAP) and \$27.4 million in education jobs funding. The enacted general fund operating budget of \$3.5 billion, not inclusive of continuing appropriations or encumbrances, is an increase of 6% from FY 2011 and includes increased spending for Medicaid (\$205 million) due to a forecast large increase in caseloads (\$150 million or 32%) as well as the expiration of federal stimulus funds (\$55 million). The state believes there is some potential for the caseload estimate to be reduced during the course of the fiscal year.

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, 2011, equals about \$2.7 billion, or 7.8% of personal income, with about 45% of debt issued through the transportation authority. This ratio remains below the double-digit levels experienced in the state's very weak fiscal period of the mid-1970s, reflecting steps taken by the state to reduce its bonding for capital. However, the ratio has been steadily increasing over the past decade and it is well above the average debt burden for U.S. states but still a moderate burden on state resources; debt service was approximately 4% of revenues in FY 2011 and a rapid rate of amortization is noted as well.

The state employees' pension system was overfunded until 2009 when investment losses resulted in the development of a small unfunded liability. The funded ratio was a strong 96% as of June 30, 2010, moderated to a still solid 86.4% using Fitch's more conservative 7% discount rate assumption.

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Additional information is available at 'www.fitchratings.com'. The ratings above were solicited by, or on behalf of, the issuer, and therefore, Fitch has been compensated for the provision of the ratings.

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. 15, 2011);
--'U.S. State Government Tax-Supported Rating Criteria' (Aug. 15, 2011);
--'Enhancing the Analysis of U.S. State and Local Government Pension Obligations' (Feb. 17, 2011).

Applicable Criteria and Related Research:

Tax-Supported Rating Criteria

http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=648898

U.S. State Government Tax-Supported Rating Criteria

http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=648897

Enhancing the Analysis of U.S. State and Local Government Pension Obligations

http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=604785

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