FitchRatings

Fitch Rates Delaware's $340MM GO Bonds 'AAA'; Outlook Stable Ratings Endorsement Policy

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Fitch Ratings-New York-11 February 2013: Fitch Ratings assigns an 'AAA' rating to $340.01 million of the following general obligation (GO) bonds of the State of Delaware:

--$115.01 million GO bonds, series 2013A;
--$225 million GO bonds, series 2013B.

The series 2013A bonds are expected to sell via negotiation the week of Feb. 19, 2013 and the series 2013B bonds are expected to sell via competitive bid on Feb. 21, 2013.

In addition, Fitch affirms the following ratings:

--$1.7 billion in 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: Delaware's conservative fiscal management and longstanding constitutional protections designed to ensure surplus operations result in the maintenance of solid fund and cash balances and budgetary reserve funds.

STRONG PENSION FUNDING: The state employees' pension system maintains strong funded ratios and the state consistently funds its actuarially calculated annual required contributions.

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.

GENERALLY STABLE ECONOMIC BASE: Delaware has considerable economic and financial resources although economic rebound from the recession has been fairly slow. Finances of the state benefit from its position as legal home of most U.S. corporations.

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 handled at the local government level in other states. Pensions are well funded.

SLOW ECONOMIC IMPROVEMENT

The state's economy, diversified through deliberate policies that created a climate attractive to banking and related business services, and pharmaceuticals, has been slow to emerge from the recession, reflected in year-over-year (y-o-y) employment growth that has trailed the nation, although Fitch believes the economy remains stable. The state's current economic forecast anticipates more robust economic growth, beginning in 2013 with 1.5% annualized growth compared to 1.4% for the U.S., and continuing through the near term economic forecast, through 2015.

Historically, Delaware's per capita personal income (PCPI) has surpassed that of the nation, but recent personal income performance has lagged the U.S., with 2011 PCPI just trailing the U.S. at 99.7% of the national average, ranking Delaware 21st amongst the states. On a y-o-y quarterly basis, the state's personal income growth in 2012 has been uneven; y-o-y third quarter personal income growth of 3% compared favorably to 2.3% for the region while remaining below the 3.2% for the U.S. Growth of 2.1% in the second quarter growth lagged both the region and the U.S.; 2.2% and 3%, respectively.

The uneven PCPI performance incorporates the slow employment growth in the state following the recession. Y-o-y employment growth in December 2012 was 0.6% compared to 1.4% for the U.S. and annual growth averages have trailed the U.S.; 0.8% growth in 2011 and the state's forecast of 0.2% growth in 2012 compare to the nation's 1% in 2011 and the state estimate of 1.4% for the U.S. in 2012.

Employment remains concentrated in the banking and services industries; 10.5% of jobs in December 2012 were in financial activities (compared to 5.9% for the US) 13.1% were in business and professional services (compared to 12.9% for the U.S.), and 16.6% were in education and health services (compared to 15.1% for the U.S.) Unemployment levels are typically well below the U.S. average; 6.9% in December 2012 compared to the U.S. rate of 7.8%; an improved rate from one year prior but still well above rates in the mid-3% range prior to the recession.

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. The state proactively addressed expected revenue shortfalls in fiscal years 2009 and 2010, and a return to more robust revenue growth in FY 2011 reflected economic stabilization in the state. The state was able to close the anticipated budgetary gaps without using its budget reserve fund, which remained fully funded at $186 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.

Following healthy 9% budgetary revenue growth in FY 2011, general fund revenues in FY 2012 were initially 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. Multiple revisions to DEFAC's revenue forecast, incorporating negative revisions to corporate income, estate, and bank franchise taxes, as well as the state lottery, resulted in about $170 million (4.9%) lower revenue for FY 2012 as compared to FY 2011. When combined with 9.8% growth in general fund appropriations, general fund operations produced a $233 million operating deficit for the fiscal year. The state drew on excess cash balances in the general fund to fund the deficit but the budget reserve fund remained fully funded. The unrestricted general fund balance was a notable 34% of general fund revenue on a GAAP basis in FY 2012.

The forecast for personal income tax (PIT) revenue, which grew 4.5% between fiscal years 2011 and 2012 (incorporating a rate reduction in the top rate from 6.95% to 6.75%) was revised to a total 6.3% growth for FY 2013 at DEFAC's December 2012 meeting, incorporating continued improvement in economic conditions and maintenance of the current PIT rate. The December 2012 forecast also included almost 86% growth in corporate income taxes in FY 2013 and over 77% growth in abandoned property revenue offset by expected declines from FY 2012 in franchise taxes (1.2%), lottery (11.6%), and gross receipts tax (2.5%). Overall, DEFAC estimates revenues in FY 2013, which ends on June 30, will show 11.2% growth from FY 2012. The state does not have a sales tax.

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 revenues with collections expected to be a high 15% in fiscal 2013; this variable revenue stream was 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. The state has capped the use of these funds in the budget for the current fiscal year, with amounts received over $566 million to the General Fund to be dedicated to other state expenditures, including OPEB expense.

The governor's proposed budget for FY 2014 totals $3,712 million; a 3.4% increase from anticipated expenditures in FY 2013. The budget proposal builds on DEFAC's December 2012 revenue estimate for FY 2014 and allows for the statutory 98% of forecast revenue to be budgeted. The current revenue forecast also incorporates the scheduled sunset of a number of tax increases (PIT, gross receipts tax, estate tax, corporate franchise tax) that were implemented during the recession. The governor has proposed rolling back the rates on the PIT and the gross receipts tax, but to levels above the scheduled sunset rate; the estate and corporate franchise taxes are proposed to stay at current levels. The legislature is expected to review the governor's proposal in the current legislative session.

ABOVE AVERAGE DEBT BURDEN WITH STRONG 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, 2012, equals about $2.7 billion, or 7.3% of personal income, with about 41% 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 increasing over the past decade and it is well above the average debt burden for U.S. states. Debt is still a moderate burden on state resources; debt service was approximately 4% of revenues in FY 2012 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. 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 state also implemented changes to retirees' prescription drug plans for significant annual cost savings to the state. While the reported funded ratio declined to 91.5% as of June 30, 2012, from 94% as of June 30, 2011, the state anticipates modest improvement in future funding ratios from recently 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, 2012 declines to a still solid 86.7%. The state has targeted improving its OPEB funding; assets in the state's irrevocable trust currently provide a 2.8% funding ratio.

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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. 14, 2012);
--'U.S. State Government Tax-Supported Rating Criteria' (Aug. 14, 2012).

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