

FITCH RATES \$358MM UNIVERSITY OF CONNECTICUT GO BONDS 'A+'; OUTLOOK STABLE

Fitch Ratings-New York-19 December 2016: Fitch Ratings-NY-19 December 2016: Fitch Ratings has assigned an 'A+' rating to approximately \$358 million in University of Connecticut (UConn) general obligation (GO) bonds, consisting of:

- \$322,245,000 GO bonds, 2017 series A;
- \$36,000,000 GO bonds, 2017 refunding series A.

The par amount of the refunding series is subject to change pending final sale.

The bonds are expected to sell via negotiated sale the week of Jan. 9, 2017.

The Rating Outlook is Stable.

SECURITY

The bonds are general obligations of the University of Connecticut, additionally secured by a pledge of and lien on a State of Connecticut debt service commitment for principal and interest, appropriated from the state's general fund without further legislative approval. The bonds are not general obligations of the state, and its full faith and credit are not pledged.

KEY RATING DRIVERS

UConn's GO bonds are rated one notch below the Issuer Default Rating (IDR) of the State of Connecticut based on the state's debt service commitment equal to principal and interest and appropriated without further legislative approval. Higher education is a constitutional state priority, and legal protections are strong.

The State of Connecticut's 'AA-' IDR Stable Outlook recognizes the state's broad economic resource base, the significant budget autonomy that is inherent in a state's powers, and a long-term liability burden that is elevated for a state but remains moderate in relation to resources. The state has experienced chronic economic and fiscal challenges during the current economic expansion and consequently, its scope of flexibility to address future cyclicity, in Fitch's view, has been reduced.

Despite repeated, and generally structural, responses to bring the current biennial budget into balance, it remains unclear whether the state has aligned its budget to potential future economic and revenue performance. The Stable Outlook at the 'AA-' rating level reflects Fitch's view that, despite its relatively high fixed cost burden and ongoing uncertainty, recent state corrective actions have primarily been structural in nature, and state managers continue to pursue fiscal management changes to improve the state's longer term prospects.

Economic Resource Base

Connecticut has a wealthy, mature and diverse economy anchored by a large finance sector and important manufacturing and education and health sectors. The last downturn in Connecticut was severe and the recovery has been very slow compared to previous economic cycles. Over the 2012 - 2015 period, employment in the state rose at roughly half of the pace enjoyed by the nation, and current employment remains below the prerecession peak. The state is the wealthiest in the U.S. as

measured by per capita personal income, although aggregate personal income gains have trailed the nation's and key finance and manufacturing sectors are experiencing only modest growth after the retrenchment of recent years.

Revenue Framework: 'aa' factor assessment

Tax revenues are diverse, although the largest tax revenue source, personal income tax (PIT), is subject to considerable cyclicity. Sales, corporate income, transportation and gaming taxes serve to further diversify the tax base. Baseline growth of taxes is likely limited given the state's mature economy and structural changes in key economic sectors. The state has unlimited legal ability to levy taxes.

Expenditure Framework: 'aa' factor assessment

As with most states, Connecticut's natural pace of spending growth is expected to be somewhat higher than that of revenues given the prominence of Medicaid; other social services, education, municipal aid and pension contributions add further to spending pressure. The state has consistently demonstrated the ability to cover its high fixed costs, including making full actuarial contributions.

Long-Term Liability Burden: 'a' factor assessment

The burden of debt and unfunded pension liabilities in relation to resources is elevated and among the highest for a state. Net tax-supported debt consists primarily of GO and transportation borrowings, with much of GO borrowing undertaken on behalf of local schools. Unfunded pensions are more significant, with high discount rates suggesting that future funded ratio erosion and higher contribution needs are possible, despite an otherwise very conservative amortization policy.

Operating Performance: 'aa' factor assessment

Frequent revenue reforecasting allows the state to identify revenue underperformance and quickly implement corrective actions. Gap-closing capacity remains strong but is less robust than during past expansions given that the state has been unable to quickly rebuild reserve balances and it already has implemented tax increases and spending cuts in the course of the current expansion. Further expenditure adjustments remain a source of additional flexibility, although high fixed costs limit the state's scope of action.

RATING SENSITIVITIES

RATING LINKED TO STATE CREDIT QUALITY: The rating on UConn's GO bonds is sensitive to changes in the state's IDR, to which it is linked.

MAINTAINING FISCAL RESILIENCE: The IDR is sensitive to the state's continued ability to manage comparatively weak economic recovery conditions and future economic and revenue downturns while maintaining an operating profile consistent with the current rating level. This is particularly important given that reserve balances are likely to remain low relative to history and potential budgetary needs. Evidence that through-the-cycle fiscal flexibility has deteriorated further could lead to a downgrade.

CREDIT PROFILE

The UConn GO bonds are issued by and carry the GO pledge of UConn, but their security and the 'A+' rating rest with the debt service commitment of the state. Principal and interest are paid annually from the state's general fund, appropriated and obligated for payment by the State Treasurer without requiring further legislative approval. Fitch rates the state's own GO bonds 'AA-' with a Stable Outlook, on par with the IDR. State general fund obligations, with the strength of continuing appropriations, are seen as slightly less well secured, and the UConn bonds fall within this category. The state's debt service commitment is separate from the operating appropriations

and allotments that the state makes available to the university, and UConn GO borrowing is integrated into the state's overall debt management.

Over the last two decades, the state has prioritized renewal and expansion of facilities at UConn, the state's flagship public university. The UConn GO bonds have been issued as part of the state's UConn 2000 program, first enacted in 1995 and since then extended through 2024. Under the most recent extension, the program's total estimated cost has risen to \$4.6 billion over the 1995-2024 period, of which \$4.3 billion will be UConn GO bonds benefitting from the state's debt service commitment. Of this amount, almost \$2.4 billion in debt service commitment bonds have been issued for university capital projects to date, with almost \$1.3 billion currently outstanding.

The latest extension, titled 'Next Generation Connecticut,' was authorized by the state in 2013 as part of an effort to expand UConn research facilities and faculty, particularly in science and technology. The majority of UConn 2000-funded projects have been at the main UConn campus in Storrs, with additional projects at smaller regional UConn campuses and the UConn Health Center in Farmington. Current proceeds will fund new construction at the Storrs campus, with additional proceeds for the UConn Health Center.

State of Connecticut

Connecticut has a diverse, mature and wealthy economic base, with a slowly growing population and an aging demographic profile. In contrast to past economic expansions, the state's performance in the current expansion has been unusually slow and uncertain. Employment gains through much of the recovery have been well below national averages and slower than past recoveries. The finance sector, with important banking and investment activity in the southwestern part of the state and insurance activity in Hartford, saw sizable employment losses through the recession and well into the recovery.

The state's large and sophisticated manufacturing sector has seen relatively flat employment since steep recessionary losses ended, although important defense-related manufacturing anchors the sector and may bring future gains. Tourism has grown in importance, but prospects for the state's gaming resorts are more uncertain given rising competition in neighboring states. The state's unemployment rate has historically run below the U.S. rate, but in more recent years has exceeded the nation's. Personal income per capita ranks highest among the states, at 141% of the national level, and aggregate personal income growth continues, albeit below national rates of growth.

Revenue Framework

Tax revenues for general fund needs are diverse, with PIT, corporate income and sales taxes serving as the primary tax sources. PIT receipts, particularly those derived from non-withholding, are particularly important but subject to volatility. The separate transportation fund receives a range of transportation-related receipts as well as resources from the general fund.

A mature economy and an older, more slowly-growing demographic profile result in a revenue profile that is likely to grow more slowly than national GDP over time.

The state has unlimited legal ability to raise tax revenues. Tax rate competitiveness is more of a factor in Connecticut than in some other states due to its relatively small size for a state and its proximity to neighboring states' urban employment centers. Transportation revenues, while dedicated for transportation needs, are statutorily, although not constitutionally restricted to transportation and have been subject in the past to frequent diversion for general needs.

Expenditure Framework

As with many smaller states, Connecticut's scope of spending is very broad, with the state responsible for delivering or funding numerous services at the local level. Formula funding for local schools and subsidies for higher education highlight the state's role in education, which extends as well to making teacher pension contributions and funding school capital. Municipal aid is also significant, although a sales tax-funded expansion included in the adopted fiscal 2015 budget was partly reversed given budgetary weakness. Medicaid and other social services are the largest spending commitments.

As with most states, spending growth is expected to be marginally above expected revenue growth without ongoing state action to control costs. This is largely driven by social service demands.

The state retains solid ability to cut spending despite several rounds of budgetary adjustment during the current and last biennia. Statute requires swift response in the event of forecast underperformance, either through rescissions, allotment cuts, or with legislative concurrence, depending on the size of the projected deficit. Fitch views Connecticut's fixed costs as being relatively high, well above the U.S. state median, driven by an above average burden of debt and unfunded pensions. Debt service includes support for GO bonds issued for school construction, as well as past deficit borrowing and conversion to GAAP budgeting. The state consistently makes full actuarial contributions toward paying down its unfunded pensions.

Long-Term Liability Burden

Connecticut's long-term liability burden for debt and pensions is elevated and amongst the highest for a U.S. state, although it remains a moderate burden on resources and the state continues to contribute full actuarial contributions to its pensions. Net tax-supported debt totaled \$22 billion as of July 2016, or 9.1% of 2015 personal income. Three-quarters of net tax-supported debt is GO, a large share of which has been issued for local school capital needs. GO borrowing includes \$2.3 billion in pension bonds issued to improve the funded ratio of the teachers retirement fund (TRF).

Both of the state's two major pension systems, covering state employees and teachers, have relatively low funded ratios driven by weak contribution practices in the past; both plans have now received full annual actuarial contributions for years, the TRF under a covenant linked to GO pension bonds. Connecticut has pursued reforms for both plans, and both maintain closed amortization schedules. The state is considering additional reforms to the state employees' plan lowering the investment return assumption and extending the amortization period to reduce the budgetary risk.

Operating Performance

Fitch views Connecticut as having strong gap-closing capacity, although somewhat diminished given its economic and revenue performance in recent biennia. Expenditure and revenue actions, particularly expenditure cuts, remain the state's primary sources of financial resilience given the relatively low balance of the budget reserve fund (BRF) and tax rate increases adopted in recent biennial budgets that make further increases more challenging. Financial resilience is supported by multiple revenue monitoring mechanisms, including consensus forecasting, and disciplined mechanisms to respond to identified budgetary weakness.

Draws on the BRF balance were used to close ending deficits of \$113 million in fiscal 2015 and \$170 million in fiscal 2016. These draws have left the BRF balance at \$236 million, or 1.3% of fiscal 2017 net revenues, below the \$519 million balance it held in fiscal 2014 and well under the nearly \$1.4 billion peak in fiscal 2009. Recent budgetary challenges have been driven by revenue underperformance, particularly in the non-withholding component of personal income

tax collections, although in both fiscal years the state took extensive administrative and legislative actions first to narrow the gaps before relying on reserves.

Revenue performance to date in fiscal 2017 has been below target, with the November consensus forecast showing weaker personal income and sales tax collections relative to expectations as of the May 2016 midterm budget revision for fiscal 2017. At present, the state's comptroller assumes a small deficit of \$69 million, compared to a \$23 million surplus assumed in the revised budget. A proposed biennial budget for the fiscal 2018-2019 biennium will be released early in 2017.

Along with relatively high fixed costs, the state continues to carry the burden of deficit notes issued during the last downturn, in contrast to past recoveries when surging tax receipts allowed past deficit notes to be repaid early and the BRF balance to be rebuilt. Despite this limitation and the challenges posed by its current slow recovery, the state's fiscal management has generally improved in recent biennia, with a greater reliance on structural solutions, continued full actuarial pension contributions and actions taken to correct a longstanding GAAP deficit.

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Date of Relevant Rating Committee: May 18, 2016

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

In addition to the sources of information identified in the 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)
<https://www.fitchratings.com/site/re/879478>

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