

CREDIT OPINION

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New Issue

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State of Connecticut

New Issue: Moody's Assigns Aa3 to State of Connecticut's \$500M GO Bonds, Ser. 2016B; outlook remains negative

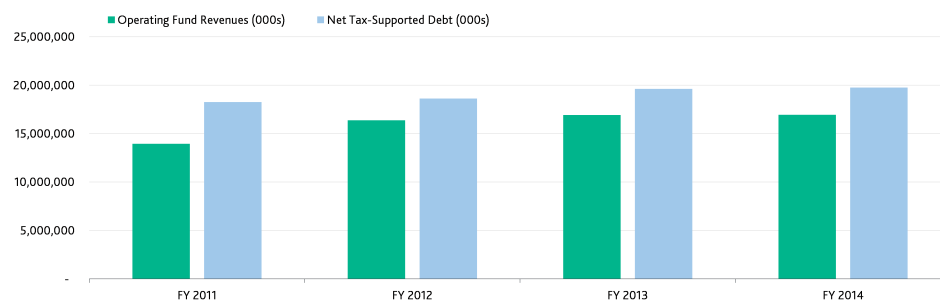
Summary Rating Rationale

Moody's Investors Service has assigned a Aa3 rating to State of Connecticut's \$500 million General Obligation Refunding Bonds (2016 Series B). The bonds are expected to price May 24.

The state's Aa3 rating reflects a large economy with high income levels, strong governance, and healthy liquidity, offset by high fixed costs relative to other states, as well as recent demographic changes, such as population loss.

Exhibit 1

Connecticut's Net Tax-Supported Debt has Increased



Source: Moody's Investors Service, CAFR

Credit Strengths

- » Legislated support for application of operating surpluses to the Budget Reserve Fund (BRF)
- » Wealthiest state in the nation with per capita personal income levels well above national levels
- » Strong governance with the ability to make mid-year budget adjustments

Credit Challenges

- » Fixed costs for debt, pension and other post-employment benefits (OPEB) relative to budget are among the highest in the nation

- » Vulnerability to financial market fluctuations due to effect on capital gains for very high wealth residents and employment in the financial services sector
- » General fund balance sheet will remain negative over near term and rainy day fund modest due to state's slower recovery from the recession

Rating Outlook

The negative outlook reflects the recent weakening demographics that have led to budgetary strain. While we expect the state to solve the budgetary gaps with recurring solutions, we believe that the weakening demographics will continue and place negative pressure on the state's economy and finances in the next few years, while the very high fixed costs reduce flexibility and present additional challenges.

Factors that Could Lead to an Upgrade

- » Achievement and maintenance of higher GAAP-basis combined available reserve levels
- » Established trend of structural budget balance
- » Evidence of sustained stronger economic performance
- » Reduced debt ratios relative to Moody's 50-state median and lower fixed annual costs
- » Significantly improved funding of pension and post-retirement liabilities

Factors that Could Lead to a Downgrade

- » Lack of improvement in available reserve levels
- » Reversion to significant one-time budget solutions, including deficit financings
- » Revenue weakness driven by delayed economic recovery
- » Cash flow strain stemming from reduced liquidity
- » Significant increase in fixed costs as percent of budget

Key Indicators

Exhibit 2

Connecticut	FY 2010	FY 2011	FY 2012	FY 2013	FY 2014
Operating Fund Revenues (000s)	12,856,987	13,935,599	16,378,765	16,909,327	16,934,668
Balances as % of Operating Fund Revenues	-11.5%	-12.5%	-6.4%	-7.2%	-1.2%
Net Tax-Supported Debt (000s)	18,467,835	18,247,554	18,615,067	19,623,311	20,272,617
Net Tax-Supported Debt/Personal Income	9.4%	9.1%	9.1%	9.2%	9.0%
Net Tax-Supported Debt/Personal Income 50 State Median	2.8%	2.8%	2.8%	2.6%	2.5%
Debt/All Governmental Funds Revenue	88.5%	83.2%	78.9%	80.1%	81.4%
Debt/All Governmental Funds Revenue 50 State Median*	23.4%	22.7%	24.3%	23.8%	23.0%
Adjusted Net Pension Liability/All Govt Funds Revenue	207.9%	189.7%	243.4%	236.0%	213.3%
Adjusted Net Pension Liability/All Govt Funds Revenue 50 State Median	57.1%	48.7%	63.9%	60.3%	59.2%
Total Non-Farm Employment Change (CY)	-1.1%	1.1%	0.9%	0.9%	0.7%
Per Capita Income as a % of US (CY)	142.4%	141.1%	141.7%	139.8%	140.9%

Source: Moody's Investors Service, state CAFR

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Recent Developments

On May 1, the Connecticut Office of Policy and Management reported that Connecticut's expected fiscal 2016 budget deficit projection had widened to \$259.1 million, a change of \$117.7 million from the amount reported on April 20. The majority of the shortfall is due to lower than anticipated personal income tax receipts in April. Connecticut's shortfall is small at only 1.4% of the general fund budget, but it is likely that the state will draw on its budget stabilization fund to close the gap.

On May 13, the amended fiscal 2017 budget passed the House and Senate, resulting in significant expenditure cuts of \$824.7 million to balance the 2017 budget. The amended budget did not include tax increases and also resulted in net cancellations of \$642.3 million in bond authorizations.

Detailed Rating Considerations

Economy

Connecticut's economic recovery continues to lag that of the nation. As of March 2016, the state's unemployment rate stood at 5.7% versus 5.0% for the nation. Through March 2016, Connecticut regained 76.7% of all jobs and 90.7% of all private sector jobs lost in the recession. From the peak in March 2008 to the low in February 2010, Connecticut lost 119,000 jobs, or 6.9% of its workforce. Real average earnings continue to improve as real median family income growth in 2014 surpassed the U.S. and Northeast averages for the first time in four years. The sectors with positive growth are education and health services, leisure and hospitality, transportation and utilities and professional and business services. The state's employment recovery is skewed towards lower-wage industries: The state's has experienced only 6.4% growth in average annual wages from fiscal 2011-2015 versus 16.9% in fiscal 2004-2008. However, the state will continue to contend with high energy costs and high tax burdens. Furthermore, there continue to be some economic headwinds. On January 13, General Electric Co. (GE, A1 stable) announced that it will move its corporate headquarters to Boston (Aaa stable) from Fairfield, CT (Aaa stable). According to Moody's Analytics, GE is the 20th-largest employer in Connecticut in terms of employees (4,300 with about 800 in the Fairfield headquarters). In addition, the state has had deteriorating demographics with two years of population loss since 2013.

Finances and Liquidity

In fiscal 2013, the state implemented a plan to begin addressing Connecticut's sizeable \$1.2 billion cumulative GAAP deficit. The state issued \$560 million of general obligation bonds, which generated \$598.5 million in proceeds (of the \$750 million total authorized by legislature) amortizing the bonds over 15 years and reducing the accumulated GAAP deficit to \$618.5 million. The remaining portion of the deficit will be amortized over 13 years starting in fiscal 2016, resulting in an annual payment of about \$47.5 million. These amounts will be "deemed appropriated", meaning no further legislative action is needed to make the payments.

The GAAP bond proceeds are not counted as General Fund revenues, and the proceeds cannot be used for any current or future budget appropriations. While the funding strategy enabled the state to begin addressing its longstanding sizeable GAAP deficit and injects discipline into the plan, the additional debt adds to the state's already high debt levels and fixed costs. Even with the plan, the unassigned General Fund balance will remain negative over the near term.

LIQUIDITY

Connecticut's liquidity remains healthy. The state did not have to borrow for cash flow purposes in calendar 2015 and does not anticipate cash flow borrowing in fiscal 2016. Cash balances averaged \$1.5 billion in fiscal 2015 and stood at \$1.8 billion, including bond proceeds, as of May 14, 2016.

Debt and Pensions

DEBT STRUCTURE

Connecticut is a frequent borrower and the state's debt per capita and debt-to-personal income ranked first and second, respectively, among the 50 states for Moody's 2015 debt medians. Net tax-supported debt equaled \$5,491 per capita and 9.0% of total state personal income, well above the 50-state median of \$1,054 in debt per capita and 2.6% for debt-to-personal income. These high debt ratios are partly due to substantial capital financing for K-12 school building construction that is carried out at the local level in many other states. However, with the \$2 billion POBs and the sale of \$560 million in GAAP Conversion bonds to address a portion of the state's sizeable cumulative GAAP deficit, on top of the state's normal sizeable annual debt issuances, Connecticut's debt ratios will

likely remain among the highest in the country. Connecticut adheres to a 20-year level principal repayment schedule for its general obligation debt, with a declining debt service schedule that provides some flexibility.

DEBT-RELATED DERIVATIVES

The state has \$1.7 billion in variable rate debt, most of which is indexed to either SIFMA or CPI, or approximately 11.2% of the state's total G.O. debt. Only \$55.6 million of the state's variable rate debt is swapped to fixed, based on 60% of LIBOR or a percentage point above CPI, after a \$280 million swap was terminated at par on March 1, 2015. As of March 31, 2016, the mark-to-market was minimal, at negative \$2.1 million against the state. In accordance with its swap guidelines, the state generally negotiates provisions that permit funding a required termination payment over a period of time to allow time for a refunding. Accordingly, the state would have 270 days to fund a termination payment for its general obligation swaps. The state has no plan to incorporate swaps into future GO bonds.

PENSIONS AND OPEB

Based on Connecticut's 2014 pension data, Connecticut's adjusted net pension liability (ANPL) was 213% of revenues, the second worst ratio in the 50-state median behind Illinois. Moody's adjusted net pension liability applies a bond index rate to determine the present value of plan liabilities, incorporates the market (rather than actuarial) value of plan assets and makes certain other changes to improve comparability of reported pension liabilities. Other pension ratios such as ANPL to personal income, GDP, and population are similarly very high for Connecticut. The state is currently funding 100% of the actuarial required contribution for both plans.

Connecticut also has a very high OPEB liability. As of the 2013 valuation, the liability stood at \$19.5 billion. The state is also responsible for the \$2.4 billion Teachers' OPEB liability. The OPEB trust fund contained \$229.6 million in net assets as of June 30, 2015.

Governance

The state has a constitutional balanced budget requirement, strong, binding consensus revenue process supported by nonpartisan and objective economic analysis that is conducted three times a year (January, April and November) or can be scheduled more frequently during times of revenue shortfalls or economic distress. There is a constitutional cap on spending, however, the Attorney General opined in November 2015 that it is not operative until the General Assembly adopts definitions. There is a statutory limit on debt payable from the general fund. The state is not subject to mandated initiatives or voter referenda. The Governor has limited executive authority to cut expenses by up to 5% of an individual appropriation, not to exceed 3% of any fund, without legislative approval, and if a deficit exceeds 1% of the general fund, there are requirements for a timely deficit mitigation plan to be developed. A super-majority is not required for tax increases or legislatively enacted budget adjustments. There is monthly budget reporting by both the Governor's budget office and the State Comptroller and budget adoption has been timely. The state does not conduct a debt affordability analysis, however, both the Governor's budget office and the Office of Fiscal Analysis prepare Fiscal Accountability reports that include multiple-year financial planning including projections of debt issuance, debt levels and debt cost. The state has frequently maintained a rainy day fund over the years, and there are statutory requirements that all budget surplus funds be deposited to the rainy day fund at year-end.

Legal Security

The bonds will be secured by the full faith and credit of the State of Connecticut.

Use of Proceeds

Bond proceeds will refund certain outstanding state GO bonds.

Obligor Profile

The State of Connecticut has a population of almost 3.6 million people. The state, located in the northeastern US, has a large and diverse economy with a gross state product of \$253 billion. It is the wealthiest state in the country with per capita income of 141% of the US average.

Methodology

The principal methodology used in this ratings was US States Rating Methodology published in April 2013. Please see the Ratings Methodologies page on www.moody.com for a copy of this methodology.

Ratings

Exhibit 3

CONNECTICUT (STATE OF)

<u>Issue</u>	<u>Rating</u>
General Obligation Refunding Bonds (2016 Series B)	Aa3
Rating Type	Underlying LT
Sale Amount	\$500,000,000
Expected Sale Date	05/24/2016
Rating Description	General Obligation

Source: Moody's Investors Service

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