

CREDIT OPINION

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New Issue

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Contacts

Marcia Van Wagner 212-553-2952
 VP-Sr Credit Officer
 marcia.vanwagner@moody's.com

Nicholas Samuels 212-553-7121
 VP-Sr Credit Officer
 nicholas.samuels@moody's.com

Connecticut (State of)

New Issue - Moody's Assigns Aa3 to UConn GO bonds supported by State of Connecticut; outlook negative

Summary Rating Rationale

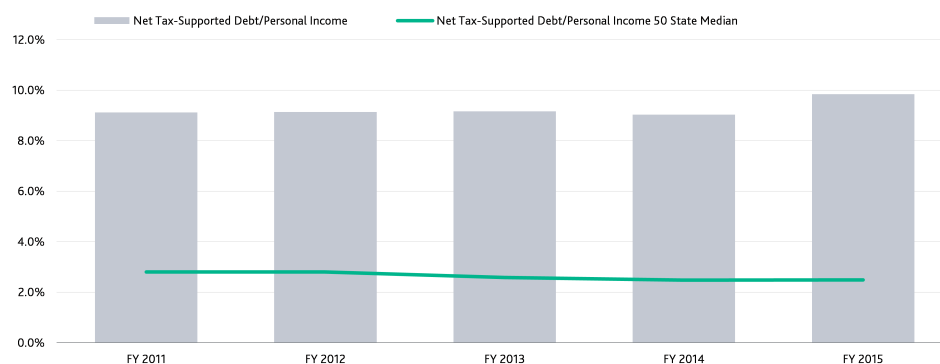
Moody's Investors Service has assigned a Aa3 rating to the [University of Connecticut's](#) approximately \$320 million General Obligation Bonds (2017 Series A) and approximately \$40 million 2017 Refunding Series A. The bonds are expected to price on January 11.

The Aa3 rating is derived from the strong legal security provided by the [State of Connecticut's](#) (Aa3 negative) commitment to pay debt service through the UConn 2000 program; pursuant to that commitment amounts sufficient to pay debt service are deemed appropriated from the general fund without need for any additional legislative action. Because of the lack of appropriation risk and the state's strong commitment to pay debt service, we rate the bonds at the same level as the state's general obligation bonds. Additional security is provided by the university's full faith and credit pledge of assured revenues, defined as tuition, fees, and other resources for repayment of the bonds.

Exhibit 1

Connecticut Net Tax-Supported Debt Far Exceeds State Median

High debt stems from borrowing for local governments



Source: Connecticut audited financial statements; Moody's Investors Service

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

Connecticut's outlook is negative, which reflects a lagging economy and weakening demographics that have led to budgetary strain as fixed costs have risen. While we expect the state to solve the budgetary gaps with recurring solutions, we believe that economic trends will place negative pressure on the state's finances in the next few years, while the very high fixed costs reduce flexibility.

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

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Key Indicators

Exhibit 2

Connecticut	FY 2011	FY 2012	FY 2013	FY 2014	FY 2015
Operating Fund Revenues (000s)	13,935,599	16,378,765	16,909,327	16,880,411	17,187,461
Balances as % of Operating Fund Revenues	-12.5%	-6.4%	-7.2%	-1.2%	-2.3%
Net Tax-Supported Debt (000s)	18,247,554	18,615,067	19,623,311	20,272,617	22,103,517
Net Tax-Supported Debt/Personal Income	9.1%	9.1%	9.2%	9.0%	9.8%
Net Tax-Supported Debt/Personal Income 50 State Median	2.8%	2.8%	2.6%	2.5%	2.5%
Debt/All Governmental Funds Revenue	83.2%	78.9%	80.1%	81.4%	84.5%
Debt/All Governmental Funds Revenue 50 State Median*	22.5%	23.8%	23.5%	23.0%	20.4%
Adjusted Net Pension Liability/All Govt Funds Revenue	189.7%	243.4%	236.0%	213.3%	202.3%
Adjusted Net Pension Liability/All Govt Funds Revenue 50 State Median	48.7%	63.9%	60.3%	59.2%	50.4%
Total Non-Farm Employment Change (CY)	1.1%	0.9%	0.9%	0.7%	0.7%
Per Capita Income as a % of US (CY)	150.4%	146.9%	144.2%	143.7%	142.8%

Source: Moody's Investors Service; Connecticut state audited financial reports

Recent Developments

Recent developments are incorporated in the detailed rating considerations below.

Detailed Rating Considerations

Economy: High Income State Lags US Recovery

Connecticut is a wealthy state, with per capita personal income exceeding 142.8% of the US. However, the state's economy continues to lag that of the nation. While the state's unemployment rate as of October is only slightly elevated compared to the nation, at 5.1% versus 4.9% nationwide, the state's job count is still less than the peak prior to the recession. Job gains have been concentrated in education and health services, leisure and hospitality, transportation and utilities and professional and business services and have yielded slower wage growth than in the past: the state has experienced only 7.2% growth in average annual wages from calendar year 2011-2015 versus 14.5% in calendar 2004-2008.

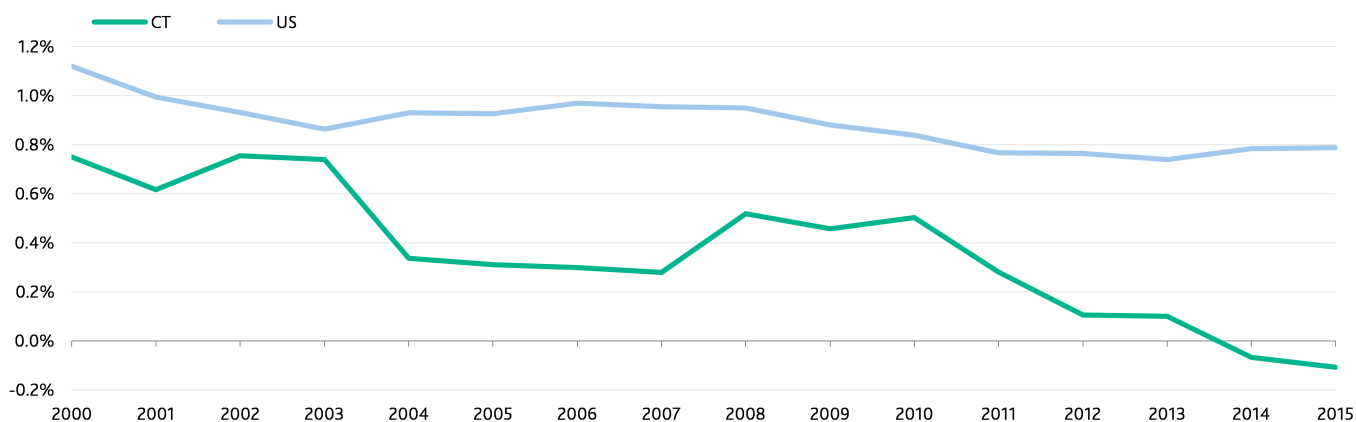
Economic headwinds include lackluster performance in the state's high-paid financial activities sector. While the US has recovered nearly all the financial activities jobs lost in the recession, Connecticut continued to lose finance jobs into 2014 and has since recovered only about one quarter of those lost. To compound the sluggish recovery, job growth has been concentrated in low-wage sectors such as retail and service jobs.

The state's demographics show a negative trend, with two years of population loss since 2013 contributing to an underperforming housing market and lagging labor force growth.

Exhibit 3

Negative Population Trends Reflect and Contribute to Weak Recovery

CT and US annual population growth



Source: Source: Moody's Analytics; US Bureau of Labor Statistics

Finances and Liquidity: State Struggles to Close Gaps

The executive's Office of Policy and Management (OPM) and the General Assembly's Office of Fiscal Analysis (OFA) released a new consensus revenue forecast on November 10, followed by fiscal accountability reports authored by each body. The revenue forecast resulted in a reduction in personal income tax (PIT) revenues of almost \$67 million compared to the enacted budget and also reflected underperforming sales taxes. With higher expenditures, the new forecast resulted in a \$90 million swing in the projected operating results from a \$22 million surplus to a nearly \$68 million deficit according to OPM's forecast, despite the state's receipt of \$80 million more than originally expected from a legal settlement with the [Royal Bank of Scotland N.V.](#) (A3 positive).

According to the forecast, revenue will grow at a slow 1.2% annual average pace through 2020, based on average nominal US GDP growth of about 4.25%. The OFA projects that fixed costs (including debt service, OPEB contributions, pension contributions and entitlements such as Medicaid) will grow \$900 million in fiscal 2018 and would require \$1.2 billion in cuts in other spending to achieve budget balance. The revenue forecast is reasonable based on the state's recent performance but is subject to the risk of a national recession during the forecast period.

The state ended fiscal 2016 with a deficit of \$170 million, which is the state's second consecutive operating deficit. The deficit will be closed with a draw on the state's rainy day fund, resulting in a balance in that fund of \$235 million. The year-end position was an improvement from earlier deficit projections that were as high as \$316 million. There were two rounds of gap-closing programs during the year totaling more than \$500 million in actions.

The state passed an amended fiscal 2017 budget in May. The revised budget resulted in significant expenditure cuts of \$847.2 million to balance the 2017 budget. The revision also canceled a net \$642.3 million in bond authorizations. OPM has requested that agencies factor in a 10% reduction in their fiscal 2018 budget requests to help close a projected \$1.2 billion gap. The governor will release the mid-year budget adjustment and proposed budget for fiscal 2018 in February.

CLOSING GAAP DEFICIT INCREASES DEBT BURDEN

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 or fiscal 2016 and does not expect to do so in fiscal 2017. Cash balances averaged \$2 billion in fiscal 2016 and the state projects an average balance of \$1.8 billion in fiscal 2017.

Debt and Pensions: Large Liabilities Create High Fixed Costs

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 9.8% of total state personal income, well above the 50-state median of \$1,054 in debt per capita and 2.5% 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 \$1.754 billion in variable rate debt, most of which is indexed to either SIFMA or CPI, or approximately 11% of the state's total GO debt. Only \$40 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. The swap counterparties are [JP Morgan Chase Bank, N.A.](#) (Aa2(cr)/P-1(cr)) and Morgan Stanley Capital Services Inc. As of September 30, 2016, the mark-to-market was minimal, at negative \$1.7 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

Connecticut's adjusted net pension liability (ANPL), our measure of the government's pension burden, is significantly above the 50-state median. As of the state's 2015 financial statements, ANPL was 288% of own-source governmental revenue, and 202% of total governmental revenue, the second highest among the states. The state participates in 3 pension systems, of which the most significant are the State Employees Retirement System (SERS) and the Teachers Retirement System (TRS). Connecticut is among the handful of states that take responsibility for directly funding teacher pensions. Moody's ANPL reflects certain adjustments made to improve comparability of reported pension liabilities.

The state contributes the full amount of its actuarially determined contribution, about \$2.2 billion in fiscal 2015. It is required via bond indenture to pay the full required contribution to the Teachers plan and by collective bargaining to do the same for the State Employees. Even so, its 2015 contributions would not have prevented its net pension liability (NPL) from growing even if investment returns all the actuarial assumptions associated with the plan had come to fruition, as the contributions were about 92% of our "tread water" benchmark, which is the payment covering the year's newly accrued service costs and interest on the NPL. The assumed rate of investment return on the TRS fund assets, which also is used to discount the liabilities, was reduced to 8% from 8.5% starting with the 2016 valuation, leading to a significant increase in the contribution for fiscal 2018. The state also recently reached an [agreement](#) with labor representatives to change its approach to funding SERS to a level dollar payment, to lower the investment rate of return assumption to 6.9% from 8%, and to extend amortization of most of the plan's unfunded liabilities to 2046 from 2032. The net impacts of these changes on the budget will not be known until the SERS 2016 valuation is published later this month, but the press release announcing the agreement indicated that the state is expecting it to yield annual budgetary savings.

Connecticut also has a very high OPEB liability. As of the 2015 valuation, the liability stood at \$18.9 billion. The state is responsible for the \$2.99 billion Teachers' OPEB liability as of the recently-released June 30 2016 valuation, a 23% increase in UAAL since the 2014 valuation. The OPEB trust fund contained \$229.6 million in net assets as of June 30, 2015.

The state's combined debt service, pension, and OPEB contributions in fiscal 2015 were nearly 30% of own-source governmental revenues, among the highest of the states. The high fixed costs are partly attributable to the state's absorption of certain costs covered by local governments in most other states. High fixed costs reduce the share of discretionary spending and the state's budgetary flexibility.

Governance: State Profile Features Strong Practices

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 supermajority 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 UConn 2000 program is an arrangement between the University of Connecticut and the State of Connecticut pursuant to state statute and a master indenture dated November 1, 1995. The current offering of bonds is secured by a pledge of and lien upon the state debt service commitment, which is defined by the UConn 2000 Act as the state's commitment to pay an amount sufficient to make full and timely debt service. Payments are deemed appropriated from the state's general fund and do not require annual legislative action. The act directs the state treasurer to deposit payments into the debt service fund held by the trustee of the bonds. Although the legislature may exercise its power to change the statute, we view the state to have made a long-term commitment to continue to service the bonds as a priority item of its general fund.

The bonds are general obligations of the University of Connecticut, further secured by and payable from amounts of the state debt service commitment appropriated out of the state general fund and obligated to be paid by the state treasurer. The bonds are payable from all of the university's assured revenues, which are defined in the master indenture to include tuition, fees, legally available gifts and grants, annual state appropriations for operating expenses, and the state debt service commitment. While assured revenues are legally pledged, the university expects to rely on the receipts of the pledged state debt service commitment and does not plan to budget other revenues for bond repayment.

Pursuant to the terms of the indenture for the bonds, the university covenants that so long as the bonds are outstanding it will establish and increase its tuition, fees and charges in an amount sufficient to meet its debt service requirements. Nonetheless, the state debt service commitment will continue to provide the primary source of bondholder security. We believe that the university would have very limited ongoing ability to assume responsibility for payment on the general obligation bonds, given the magnitude of annual debt service relative to its existing revenue base.

Use of Proceeds

Proceeds of the new money issuance will be used for capital improvements to the university's facilities, part of the UConn 2000 Infrastructure Improvement Act. The refunding bond proceeds will be used to refund outstanding debt to provide net debt service savings.

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.

The University of Connecticut is the state's flagship university and part of the state's system of public higher education. The university is a body politic and instrumentality and agency of the State of Connecticut. The state's support for the university reflects the status as the flagship institution of the state system of higher education.

The university is able to borrow money in its own name on behalf of the state for certain capital improvements at the university. Since 1996, the state has authorized approximately \$4.3 billion of UCONN 2000 bonds (excluding refundings), of which about \$2.4 billion were issued and \$1.3 billion are currently outstanding. Bond authorization includes project funding and costs of issuance.

Methodology

The principal methodology used in this rating was Lease, Appropriation, Moral Obligation and Comparable Debt of US State and Local Governments published in July 2016. Please see the Rating Methodologies page on www.moody.com for a copy of this methodology.

Ratings

Exhibit 4

Connecticut (State of)

Issue	Rating
General Obligation Bonds, 2017 Refunding Series A	Aa3
Rating Type	Underlying LT
Sale Amount	\$40,000,000
Expected Sale Date	01/11/2017
Rating Description	Annual Appropriation Obligation (Non Lease)
General Obligation Bonds, 2017 Series A	Aa3
Rating Type	Underlying LT
Sale Amount	\$320,000,000
Expected Sale Date	01/11/2017
Rating Description	Annual Appropriation Obligation (Non Lease)

Source: Moody's Investors Service

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Contacts

Marcia Van Wagner 212-553-2952
VP-Sr Credit Officer
marcia.vanwagner@moodys.com

CLIENT SERVICES

Americas	1-212-553-1653
Asia Pacific	852-3551-3077
Japan	81-3-5408-4100
EMEA	44-20-7772-5454