FITCH RATES OHIO TREASURER OF STATE $110MM BONDS 'AA'; OUTLOOK STABLE

Fitch Ratings-New York-19 February 2015: Fitch Ratings has assigned an 'AA' rating to the following state of Ohio (Treasurer of State) capital facilities lease-appropriation bonds:

--$50 million series 2015A (Mental Health Facilities Improvement Fund Projects);
--$20 million series 2015B (Juvenile Correctional Building Fund Projects);
--$40 million series 2015A (Parks and Recreation Improvement Fund Projects).

The bonds are expected to be sold via negotiation on or about Feb. 25, 2015.

The Rating Outlook is Stable.

SECURITY

The bonds are special obligations of the state, payable from payments under lease agreements between the Ohio Public Facilities Commission (OPFC) and the departments of mental health and developmental disabilities, youth services and natural resources. The lease agreements are subject to biennial appropriation from the state's general revenue fund (GRF).

KEY RATING DRIVERS

APPROPRIATION MECHANISM: The rating on the bonds backed by Ohio's lease appropriation, one notch below the state's general obligation (GO) rating, reflects the state's general credit standing, sound lease structure, and constitutional authorization for these types of bonds.

BROAD ECONOMY WITH LARGE MANUFACTURING SECTOR: The state's economy is broad and diverse, although manufacturing remains a disproportionally large sector. The state's economy is expanding but at a slower pace than immediately following the recession. The unemployment rate is under the national average.

MODERATE LIABILITY BURDEN: The state's debt burden is moderate and rapidly amortized. Debt is typically conservatively managed and primarily consists of GOs. On a combined basis, outstanding debt and pension obligations are a manageable and well below-average burden on the state.

DEMONSTRATED ABILITY TO MANAGE BUDGET CHALLENGES: The state generally has a careful approach to financial operations and has consistently managed to achieve budgetary balance, inclusive of surplus operating results in fiscal 2013, which provided for full funding of the state's budget stabilization fund (BSF).

RATING SENSITIVITIES

STATE GO CREDIT QUALITY: The rating is sensitive to changes in the state's 'AA+' GO rating to which it is linked.

CREDIT PROFILE

The bonds currently offered are secured by rental payments that are appropriated biennially under separate lease agreements between the OPFC and various state departments, as noted above.. The debt is authorized by the state's constitution and secured by the state's pledge of legislative appropriation, with the lease renewable biennially until the bonds are repaid.

The treasurer of state is required to submit an estimate of the debt service requirements to each department as well as the director of budget and management prior to the start of each fiscal year. Debt service must be included in the budget of the departments. The trustee does not have the ability to take possession of or operate the leased projects. The current offering will finance various capital projects.

LINK TO GO RATING

The state's 'AA+' GO rating, to which the current ratings are linked, is based on its careful financial management, ongoing record of maintaining fiscal balance, and a moderate, rapidly amortizing debt burden. Debt is supported by an economy that is slowly adding jobs lost in the recession.

The recession had a widespread impact on the Ohio economy, accelerating a longstanding slump in manufacturing and weighing on the slowly growing service sector. While there has been steady year-over-year job growth since July 2010, the state has yet to fully recover the jobs lost during the recession. Job growth has lagged the U.S., most recently recording 1.1% year-over-year growth in December 2014 versus the U.S. rate of 2.2%.

DEMONSTRATED ABILITY TO MANAGE BUDGET CHALLENGES

Fiscal management practices in Ohio are sound and the state has consistently maintained budgetary balance, including during the recession. The state's fiscal position has substantially improved since the downturn, when the state employed one-time measures for fiscal relief, including depleting the BSF. The state quickly began rebuilding the BSF in fiscal 2011, reaching the statutory target of 5% of GRF revenues by the end of the fiscal 2012-2013 biennium.

TAX POLICY CHANGES MANAGEABLE TO DATE

In recent biennia the state has pursued wide-ranging tax policy changes shifting the source of GRF tax receipts and lowering overall receipts relative to baseline. In the fiscal 2014-2015 biennium budget, tax policy changes have been manageable, aided by favorable fiscal trends and a sizable ending balance from fiscal 2013 helping to cover originally forecast structural imbalances in the following biennium. Although the governor's fiscal 2016-2017 budget proposal makes considerable structural progress compared to the enacted fiscal 2014-2015 budget and the fully rebuilt BSF provides an important source of flexibility, Fitch notes that structural challenges could reemerge if recent favorable fiscal trends shift.

The enacted budget for the 2014-2015 biennium included several tax rate changes offset in part by applying the remaining fiscal 2013 fund balance. Rate changes included lowering personal income tax (PIT) rates by 10% over three tax years beginning in 2013, increasing the sales tax rate by 0.25%, to 5.75%, as an offset, and reducing income taxes on small business owners, among other provisions. The PIT rate reductions and tax modifications for small business owners were forecast to result in a sizable amount of foregone revenue over the biennium and were only partly offset by the sales tax rate increase, some PIT index and exemption freezes, and other tax reform measures. As of its mid-biennium review, the state accelerated the final 1% PIT rate reduction into tax year 2014 and made other adjustments to revenues.

The executive budget for the 2016-2017 biennium proposes further wide-ranging tax policy changes. PIT rates would be lowered further across all brackets, with additional income tax reductions for certain small businesses. These reductions would be partially offset with a 0.5% sales tax rate increase, to 6.25%, expanding the sales tax base to certain services, and other targeted increases affecting commercial activity, oil and gas, and tobacco products; the overall impact would modestly lower revenues relative to the baseline. The tax policy changes are currently under consideration by the legislature.

FISCAL 2014 ENDED STRONGLY

Although the fiscal 2014-2015 biennium enacted budget anticipated a sizeable operating deficit in fiscal 2014, leading to some concern over the future ability to achieve balance, actual performance was better than anticipated primarily due to lower Medicaid spending. Tax revenues were just above forecast but 4.2% lower as compared to fiscal 2013, given tax policy changes noted above.

Fiscal 2014 PIT revenues were $215 million (2.7%) above estimate, although this represented a $1.4 billion (15.2%) reduction compared to fiscal 2013. In addition to tax policy changes, the PIT trend was affected by timing differences between the two fiscal years and the accelerating of income by taxpayers into fiscal 2013 in response to federal tax law changes. The reduced income taxes were partially offset by sales tax revenues that were just below estimate but rose $721 million (8.5%) year-over-year, likewise due to tax policy changes. The year ended with the fiscal 2014 budget essentially balanced, significantly better than forecast at the start of the year.

FISCAL 2015 OUTLOOK SOLID

Fiscal 2015 performance likewise has been solid, with the state lifting its expectations for the ending GRF balance accordingly. Higher than forecast revenues and lower than forecast state spending, particularly on Medicaid, is driving the improved outlook. As of the governor's executive budget for fiscal 2016-2017, the state is forecasting a fiscal 2015 GRF ending fund balance of $970.4 million, well above the $631.6 million assumed at mid-biennium. The governor proposes transferring $612.7 million of the projected balance to specific uses, including $374 million to the BSF to fully prefund the fiscal 2017 forecast BSF maximum, two fiscal years early. Including the planned fiscal 2015 transfers, the BSF balance would rise to $1.85 billion (5.9% of fiscal 2015 estimated GRF revenue).

FISCAL 2016-2017 BIENNIUM UNDER CONSIDERATION

The governor's executive budget for the fiscal 2016-2017 biennium, released on Feb. 2, includes a range of proposed tax policy changes noted earlier. The tax law changes would trim an estimated net $367 million from baseline revenues in fiscal 2016 and $444 million in fiscal 2017. Including these changes, GRF tax revenues are forecast to grow 5.3% in fiscal 2016, to $22.3 billion, and another 4.1% in fiscal 2017, to $23.3 billion. Overall GRF revenues (excluding transfers in) grow faster, at 13.1% in fiscal 2016 and 4.7% in fiscal 2017, driven by federal revenues for Medicaid expansion being shifted into the GRF as of fiscal 2016. The executive budget proposes continued reforms to Medicaid for cost-containment and other savings; state spending on Medicaid rises 4.4% in fiscal 2016 and 6.1% in fiscal 2017. The proposal forecasts a GRF ending balance of $190 million in fiscal 2016 (0.5% of GRF revenues) and $213 million in fiscal 2017 (0.6% of GRF revenues).

CONSERVATIVE DEBT MANAGEMENT

The state's debt management is generally conservative. Debt amortization is rapid, with all debt fully retired in 20 years and 78% of GRF-backed debt amortized in 10 years. Total tax-supported debt of $11.1 billion is equivalent to a manageable 2.3% of 2013 personal income. Debt ratios are expected to approximate current averages as GRF principal continues to roll off and personal income grows.

Funding for Ohio's five pension systems declined significantly with recessionary market losses; the largest system, PERS, declined from a strong 96% funded ratio as of Dec. 31, 2007 to 77.4% as of Dec. 31, 2011. Reform measures enacted in September 2012 have contributed to the improved financial sustainability of PERS and the state's other major systems. The most recent PERS valuation, from Dec. 31, 2013, showed the benefit of the reform measures as the reported funded ratio increased to 82.4%. Using Fitch's more conservative 7% discount rate assumption, PERS would have an estimated 72.9% funded ratio.

On a combined basis, the burden of the state's net tax-supported debt and the adjusted unfunded pension (UAAL) obligations attributable to the state (including about 45% of the unfunded liability of the state division of PERS, the state highway patrol system and a small share of the teachers retirement system) was approximately 3.3% of personal income in 2014, well below the median of 6.1% for U.S. states.

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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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Tax-Supported Rating Criteria
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=686015
U.S. State Government Tax-Supported Rating Criteria
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=686033