MOODY'S
INVESTORS SERVICE

New Issue: Moody's assigns Aa2 ratings to $110M Ohio Capital Facilities Lease Appropriation Bonds, Series 2015; outlook stable

Global Credit Research - 17 Feb 2015

State currently has $1.6B of appropriation-backed debt outstanding

OHIO (STATE OF)
State Governments (including Puerto Rico and US Territories)
OH

Moody's Rating

ISSUE		RATING
Capital Facilities Lease-Appropriation Bonds, Series 2015A (Mental Health Facilities Improvement Fund Projects)		Aa2
Sale Amount	$50,000,000	
Expected Sale Date	02/24/15	
Rating Description	Lease Rental: Appropriation	
Capital Facilities Lease-Appropriation Bonds, Series 2015A (Parks and Recreation Improvement Fund Projects)		Aa2
Sale Amount	$40,000,000	
Expected Sale Date	02/24/15	
Rating Description	Lease Rental: Appropriation	
Capital Facilities Lease-Appropriation Bonds, Series 2015B (Juvenile Correctional Building Fund Projects)		Aa2
Sale Amount	$20,000,000	
Expected Sale Date	02/24/15	
Rating Description	Lease Rental: Appropriation	

Moody's Outlook STA

NEW YORK, February 17, 2015 --Moody's Investors Service has assigned Aa2 ratings to Ohio's planned issuance of $110 million Capital Facilities Lease-Appropriation Bonds Series 2015, issued in the three series listed above. The bonds are scheduled to price the week of February 23rd.

SUMMARY RATING RATIONALE

The Aa2 ratings, a notch below the state's Aa1 general obligation (GO) rating, reflect the need for biennial legislative appropriation of lease payments backing the bonds. There are no bondholder remedies in the event of non-appropriation. However, roughly a fifth of the state's net tax-supported debt is subject to appropriation, and the importance of maintaining access to the capital markets provides strong incentive for future legislatures to make the required appropriations.

The state's Aa1 GO rating is supported by strong and proactive financial management, including timely response to budget shortfalls and moderate, affordable debt, pension and other post-employment benefit (OPEB) liabilities. Recent revenue growth has helped improve the state's financial position, mitigating exposure to an economy that that will lag the nation.

OUTLOOK

The stable outlook for Ohio is based on our expectation that reasonable budget assumptions and proactive financial management will support a satisfactory financial position for the current budget year. It also reflects our view that the state's economy will remain stable, despite relatively weak demographic trends.

WHAT COULD MAKE THE RATING GO UP

- Sustained increase in reserves and fund balance position meaningfully above historic levels

- Economic performance that exceeds national averages over an extended period

WHAT COULD MAKE THE RATING GO DOWN

- Evidence of financial deterioration, including a return to budgetary structural imbalance

- Weakening of GAAP-basis general fund balances and liquidity position below current expectations

- Persistent economic weakness, reflected in below-average employment, personal income or demographic trends

STRENGTHS

- Conservative fiscal management including sound budgeting and proactive responses to budgetary shortfalls

- High levels of internal liquidity including available balances outside the general revenue fund

- Relatively moderate long-term liabilities that are affordable compared to the state's budget

- Statutory requirement to deposit surplus year-end revenues in the Budget Stabilization Fund

CHALLENGES

- Economy that remains vulnerable to manufacturing industry exposure

- Potential revenue reductions from tax reform that could threaten the state's balanced financial operations

- Lack of certain best financial management practices

RECENT DEVELOPMENTS

The governor's proposed FY 2016-2017 biennial budget increases general revenue fund appropriations 12.5% and 4.8%, respectively, over the next two fiscal years and proposes continued income tax rate reductions and other tax reforms. Cost growth is concentrated in key spending areas of Primary and Secondary Education (6.1% and 4.5% increases in each year) and Medicaid (21.4% and 6.2%). The substantial increase in fiscal 2016 Medicaid spending is largely driven by an accounting shift that will move certain expenditures, and the associated Federal funding, into the general revenue fund.

DETAILED RATING RATIONALE

ECONOMY: STATE ECONOMY REMAINS STABLE OVERALL, DESPITE SLOWER JOB GROWTH

After a strong initial post-recession recovery, Ohio's job growth has been below the national average. Through December 2014, Ohio's non-farm employment grew only 1.2% on an annualized basis, down from approximately 2.3% in mid-2012, and below the nation's 2.3% level. Nonfarm jobs remain 124,000 short of the 2006 peak, and, at 5.3 million in December 2014, Ohio's employment has fallen back to 1996 levels. The state's unemployment rate has been below the US rate since February 2014 and was 4.8% in December (preliminary), compared to 5.7% for the US. The state's personal income growth has been at or above the nation's since mid-2011. Ohio's 2013 per-capita personal income ($41,049) improved slightly relative to the US, to 92%, from 90% in 2008.

Overall, manufacturing, healthcare and professional services have been key components of Ohio's stabilized economy. According to Moody's Analytics, Ohio's recovery will lag the nation due to weaker demographics, but the state's economy has strengthened in 2014 and will continue to through early 2015, due to strong car and aerospace manufacturing, high healthcare demand, and growing professional services such as consulting and computer design in Cincinnati (Aa2, negative) and Cleveland (A1, stable).

FINANCES AND LIQUIDITY: ADDITIONAL TAX REFORM PROPOSED IN GOVERNOR'S FY16-FY17

BUDGET; STATE WILL USE RESERVES

The governor's proposed FY 2016-2017 biennial budget continues income tax rate cuts in calendar 2015 and 2016 of 15% and 8%, respectively. Together with income tax rate reductions in the past two fiscal years, this would bring the top marginal tax rate down to 4.106% by 2016 from 5.925% in 2013. This reduction will be partially offset by increasing the sales tax rate and broadening the base to include certain services, and increasing the severance, commercial activity and cigarette tax rates. The net impact of these reforms will reduce general revenue fund revenues by an estimated $366.7 million and $443.5 million in fiscal 2016 and 2017, respectively. However, tax receipts, post-reform, are budgeted to increase 5.3% and 4.1% in the two fiscal years due to assumed base revenue growth of 5.1% and 4.5% in fiscal 2016 and 2017, and an increased allocation of certain taxes to the general revenue fund. Through January, fiscal 2015 tax receipts have grown 2.4% over the prior year, however the state projects tax receipt growth will accelerate to 5.3% by the end of the fiscal year.

These proposed tax reforms closely follow tax cuts implemented in the current biennial budget and the spring 2014 mid-biennial review. The combined net revenue decrease of tax reforms adopted to date for fiscal 2014 and 2015 is a significant $2.4 billion, or 6% of combined tax receipts.

The state plans to use accumulated fund balances to partially balance and phase-in the tax reforms. The fiscal 2015 General Revenue Fund ending fund balance is projected to decline to $970 million (4.5% of state-source revenues), from a recent high of $2.3 billion (11% of state-source revenues) in fiscal 2013. However, this outperforms earlier projections for fiscal 2015 of $632 million (3% of revenues). The governor has proposed using a portion of these cash balances for various items, including pre-funding the Budget Stabilization Fund to meet the fiscal 2017 cap ($374 million) and supporting student loan debt reduction ($120 million). The resulting fiscal 2015 unobligated fund balance would be $357.7 million (1.7% of revenues), $200 million of which would phase-in the tax reform in fiscal 2016. Fiscal 2016 and 2017 unobligated fund balance is projected to decline to $190 million and $213 million, respectively.

While solid financial performance has supported slower-than-expected fund balance declines, we view these tax reform budgets as vulnerable to slower-than-expected baseline revenue growth, particularly in light of recent fluctuations in Ohio's job growth trends.

SOUND BUDGET MANAGEMENT STABILIZES FINANCIAL PERFORMANCE THROUGH PERIOD OF ECONOMIC RECOVERY AND TAX REFORM

Ohio's conservative budget management and continued economic growth have led to favorable financial performance, allowing for gradual absorption of tax reform impacts. The state's recent budgetary cash balance levels exceeded expectations, reaching $1.7 billion (8.4% of state-source revenues) in fiscal 2014, compared to an original projection of $726 million. Despite the fiscal 2014 tax reform and fiscal cliff impact, income taxes exceeded budget by 2.7% ($215 million). The state budgeted a 17% decline in fiscal 2014 income taxes, which included the impact of an 8.5% income tax reduction, various other reforms and a 1% decline caused by taxpayer reaction to the fiscal cliff. Total fiscal 2014 tax receipts exceeded budget by 0.9% ($175.5 million). In addition, actual fiscal 2014 disbursements were 3.4% ($1.1 billion) below budget. Results through January 2015 continue this trend: tax receipts were 1.8% above budget and disbursements were 1.6% below budget.

Liquidity

RESERVES REPLENISHED THROUGH SOLID FINANCIAL PERFORMANCE AND FISCAL 2013 JOBS OHIO PAYMENT

The state made a $996 million deposit - its third consecutive deposit - into the Budget Stabilization Fund (BSF) early in fiscal 2014. At $1.48 billion (5.06% of fiscal 2014 general revenue fund revenues), the BSF has reached its statutory maximum for the first time since fiscal 2000. The statutory requirement to deposit surpluses in excess of 0.5% of general revenue fund revenues into the Budget Stabilization Fund generally accelerates reserve restoration, although the legislature has diverted surpluses to other uses in past years.

The state's financial position continues to improve on a GAAP basis. Fiscal 2014 audited results reflect an increase in available general fund balance (unassigned fund balance, including the BSF, plus assigned fund balance) to $3.6 billion (14.8% of state-source GRF revenues) from $3.3 billion (13.2% of state-source revenues) in fiscal 2013. As discussed above, we expect these balances to decline during the next two years as the state implements tax reform.

The long-term lease of the state liquor enterprise to JobsOhio that provided for the $500 million GRF contribution terminates in January 2038. In addition to the up-front payment, the state will receive 75% of excess net profits above an agreed-upon threshold. In June 2014, the state Supreme Court dismissed litigation filed in April 2011 challenging the creation of JobsOhio, a non-profit corporation formed to lease the enterprise.

DEBT AND PENSIONS

Debt Structure

Ohio has maintained a moderate debt burden relative to other states. The state's debt burden is consistent with the 50-state median, at 2.7% of personal income, and has declined over time relative to other states. Ohio ranks 26th among states based on net tax-supported debt as a percentage of personal income, down from 20th in 2005. Ohio has about $553 million of variable-rate demand debt outstanding, for which the state has maintained an internal liquidity program for tendered bonds that are not remarketed. The ratings on these bonds are VMIG 1, reflecting the state's strong management of available liquid resources. Ohio had $3.0 billion of same-day liquid assets available to support the bonds as of January 2015, on a discounted basis, and has access to an additional $964 million of weekly liquidity (discounted).

Debt-Related Derivatives

The state is a party to five swap agreements with a combined notional principal of $433.66 million that hedge interest rate risk on its variable-rate obligations. Collateral posting requirements are pegged to rating levels starting at A3 and lower, and termination provisions are triggered if the state's rating falls below Baa3 (Moody's) or BBB- (S&P). Triggers at these low rating levels introduce minimal risk to the state. As of June 30, 2014, the combined mark-to-market value of the swaps was negative $49.9 million.

Pensions and OPEB

Ohio's pension liability and annual contributions remain affordable despite the growth in liability and declines in the reported funded ratio since 2008. After several consecutive years of declines in funded ratio, the reported funded ratio for the state's largest pension fund improved to 82% in 2013 from 77%. This reflects both improved investment returns and the impact of pension reform.

Based on the state's fiscal 2013 pension data, we have calculated that its adjusted net pension liability (ANPL) was 33% of revenues. The 50-state median ANPL to revenues is 60.3%, and Ohio ranks 41st in this ratio. Our adjustments to reported state pension data include the common 20-year amortization period, as well as an assumed 13-year duration of plan liabilities and a market-based discount rate to value the liabilities, rather than the long-term investment return used in reported figures. Our adjusted liability amounts include the three major state plans, the Ohio Public Employees Retirement System, the State Teachers Retirement System, and the Highway Patrol Retirement System.

In September 2012, Ohio approved pension reform legislation that ensures state plans comply with a 30-year amortization period, assuming level contributions at 14% of payroll. Benefits are not guaranteed by the state, and are not subject to collective bargaining. The reform took effect in January 2013 and reduces benefits in OPERS (members only) and STRS (members and retirees), and also increases contributions for STRS. The state estimates that the reform reduced the OPERS and STRS liabilities by $3.2 billion and $15.7 billion, respectively, although the state's share of the STRS liability is minimal.

Unlike most states, which fund other post-employment benefit (OPEB) obligations on a pay-as-you-go basis, Ohio's OPEB programs have substantial assets ($17.1 billion) pledged to cover liabilities. After the 2012 reforms, OPEB liabilities dropped substantially, and the state's aggregate funded ratio as of the most recent valuations is 65%. Pension and OPEB benefits are not guaranteed under state law, and contribution requirements and benefit levels can be changed for future and current employees. The state's pay-go portion in 2012 for OPEB was about $75 million, a minimal portion of its budget.

GOVERNANCE

Ohio operates on a biennial budget. The state constitution has no revenue raising caps or mandated spending levels, providing the state flexibility to increase revenues and cut expenditures when needed. The Governor also has the ability to reduce appropriations through executive orders. The state rainy day fund has a statutory maximum pegged at 5% of the prior year's general fund revenues. The state is also required to retain funding equal to 0.5% of fiscal year revenues in the general revenue fund that could be carried over to the following fiscal year.

KEY STATISTICS

Per capita income relative to U.S. average: (91.7%)

Industrial diversity (1=most diverse): (0.80)

Employment volatility (U.S.=100): (107)

Available balances as % of operating revenue (5-yr. avg.): (4.1%)

NTSD/total governmental revenue: (24.6%)

3-year avg. adjusted net pension liability/total governmental revenue: (27.6%)

OBLIGOR PROFILE

Ohio is the 7th largest state by population in the United States. Its gross domestic product per capita also ranks 7th among the states (in current dollars).

LEGAL SECURITY; BONDS ARE SECURED BY LEASE AGREEMENTS WITH OHIO PUBLIC FACILITIES COMMISSION

The capital facilities lease-appropriation bonds are secured by three lease agreements between the Ohio Public Facilities Commission (OPFC), as lessor, and state government units: Departments of Mental Health and Addiction Services and Developmental Disabilities, the Department of Youth Services, and the Department of Natural Resources. Appropriations for each department's lease obligations are provided separately. The OPFC is a state agency composed of six state officials: the governor, the attorney general, state auditor, the secretary of state, the treasurer, and the budget director. Although OPFC is the lessor, pursuant to the three lease agreements, the lessees (DMH and DDD, DYS and DNR) owe lease payments to the treasurer. The lease payments are assigned and remitted directly to the trustee at least two days prior to the debt service payment dates.

The lease agreements stipulate that the obligation to make rental payments is contingent only on the appropriation of funds by the legislature, and not on whether the financed projects are in use. Rental payments are not subject to termination, abatement or set-off, except in the event the legislature does not appropriate funds. Interest payment dates (October 1 and April 1 for DYS, August 1 and February 1 for DMH, DDD and DNR) are far enough removed from the July 1 start of the state's fiscal biennium to limit risk of an event of non-appropriation due to late budget adoption. There are no debt service reserve funds associated with these issues, and there are no bondholder remedies in the event of non-appropriation. The ratings are also supported by the treasurer's explicit authority under the enabling legislation to issue lease revenue obligations for capital facilities on behalf of state agencies. The importance of maintaining continued market access for subject-to-appropriation lease debt, in general, provides a strong incentive to continue making appropriations in a timely manner. About a fifth of Ohio's net tax-supported debt requires appropriation for payments.

USE OF PROCEEDS

The proceeds from the proposed sale would be used to finance capital costs of facilities leased to the Mental Health Departments and Developmental Disabilities, DNR, and the DYS, respectively and pay costs associated with the issuance of the sale.

RATING METHODOLOGY

The principal methodology used in this rating was The Fundamentals of Credit Analysis for Lease-Backed Municipal Obligations published in December 2011. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

REGULATORY DISCLOSURES

For ratings issued on a program, series or category/class of debt, this announcement provides certain regulatory disclosures in relation to each rating of a subsequently issued bond or note of the same series or category/class of debt or pursuant to a program for which the ratings are derived exclusively from existing ratings in accordance with Moody's rating practices. For ratings issued on a support provider, this announcement provides certain regulatory disclosures in relation to the rating action on the support provider and in relation to each particular rating action for securities that derive their credit ratings from the support provider's credit rating. For provisional ratings, this announcement provides certain regulatory disclosures in relation to the provisional rating assigned, and in relation to a definitive rating that may be assigned subsequent to the final issuance of the debt, in each case where the transaction structure and terms have not changed prior to the assignment of the definitive rating in a manner that would have affected the rating. For further information please see the ratings tab on the issuer/entity page for the respective issuer on www.moodys.com.

Regulatory disclosures contained in this press release apply to the credit rating and, if applicable, the related rating outlook or rating review.

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