Ohio (State of)

New Issue - Moody's Assigns Aa2 to Ohio's Administrative Building Fund Lease-Appropriation Bonds; Outlook Stable

Summary Rating Rationale
Moody’s Investors Service has assigned Aa2 ratings to the State of Ohio’s $70 million Capital Facilities Lease-Appropriation Bonds, Series 2017A (Administrative Building Fund Projects). The outlook on the bonds is stable.

The bonds have a long-term rating of Aa2, a notch below the state’s Aa1 general obligation (GO) rating, reflecting the need for biennial legislative appropriation of the lease payments backing the bonds. There are no bondholder remedies in the event of non-appropriation. The state’s Aa1 GO rating is supported by strong and proactive financial management, including timely responses to budget shortfalls and moderate, albeit below-average economic growth, and affordable debt, pension and other post-employment benefit (OPEB) liabilities.

Credit 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 state’s Budget Stabilization Fund

Exhibit 1
Ohio’s Year-Over-Year (YOY) Job Growth Slowed in Late 2016
YOY Non-Farm Job Growth

Credit Challenges
» Economy that remains vulnerable to manufacturing industry declines
» Potential revenue reductions from tax reform that threaten the state’s balanced financial operations
» Lack of certain best financial management practices

Rating Outlook
Ohio’s stable outlook is based on our expectation that its enacted budget and proactive financial management will support a satisfactory financial position for the current budget year, offsetting revenue losses from tax reforms. It also reflects our view that the state’s economy will remain stable, despite relatively weak demographic trends.

Factors that Could Lead to an Upgrade
» Sustained increase in reserves and fund balance position significantly above historic levels
» Economic performance that exceeds national averages over an extended period

Factors that Could Lead to a Downgrade
» 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

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on www.moodys.com for the most updated credit rating action information and rating history.
**Key Indicators**

**Exhibit 2**

<table>
<thead>
<tr>
<th>Description</th>
<th>FY 2011</th>
<th>FY 2012</th>
<th>FY 2013</th>
<th>FY 2014</th>
<th>FY 2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating Fund Revenues (000s)</td>
<td>22,853,269</td>
<td>23,799,656</td>
<td>25,077,473</td>
<td>24,320,752</td>
<td>25,554,301</td>
</tr>
<tr>
<td>Balances as % of Operating Fund Revenues</td>
<td>1.8%</td>
<td>5.3%</td>
<td>13.2%</td>
<td>14.9%</td>
<td>11.7%</td>
</tr>
<tr>
<td>Net Tax-Supported Debt (000s)</td>
<td>11,680,585</td>
<td>12,089,413</td>
<td>12,572,156</td>
<td>12,856,609</td>
<td>12,664,731</td>
</tr>
<tr>
<td>Net Tax-Supported Debt/Personal Income</td>
<td>2.8%</td>
<td>2.8%</td>
<td>2.7%</td>
<td>2.7%</td>
<td>2.6%</td>
</tr>
<tr>
<td>Net Tax-Supported Debt/Personal Income 50 State Median</td>
<td>2.8%</td>
<td>2.8%</td>
<td>2.6%</td>
<td>2.5%</td>
<td>2.3%</td>
</tr>
<tr>
<td>Debt/All Governmental Funds Revenue</td>
<td>23.4%</td>
<td>24.1%</td>
<td>24.1%</td>
<td>24.4%</td>
<td>22.6%</td>
</tr>
<tr>
<td>Debt/All Governmental Funds Revenue 50 State Median*</td>
<td>22.7%</td>
<td>23.8%</td>
<td>23.5%</td>
<td>23.0%</td>
<td>20.4%</td>
</tr>
<tr>
<td>Adjusted Net Pension Liability/All Govt Funds Revenue</td>
<td>19.6%</td>
<td>32.0%</td>
<td>33.0%</td>
<td>27.2%</td>
<td>24.3%</td>
</tr>
<tr>
<td>Adjusted Net Pension Liability/All Govt Funds Revenue 50 State Median</td>
<td>48.7%</td>
<td>63.9%</td>
<td>60.3%</td>
<td>59.2%</td>
<td>50.4%</td>
</tr>
<tr>
<td>Total Non-Farm Employment Change (CY)</td>
<td>1.3%</td>
<td>1.5%</td>
<td>1.8%</td>
<td>1.3%</td>
<td>1.5%</td>
</tr>
<tr>
<td>Per Capita Income as a % of US (CY)</td>
<td>91.4%</td>
<td>91.0%</td>
<td>91.5%</td>
<td>90.8%</td>
<td>90.6%</td>
</tr>
</tbody>
</table>

*All Governmental Funds Revenue excludes Federal revenues
Source: Ohio Comprehensive Annual Financial Reports; Moody's Investors Service

**Recent Developments**

Through February, Ohio's fiscal 2017 tax revenues are below estimate by $411.7 million (2.8% of revenues), due primarily to income tax collections that are $352.2 million (6.5%) lower than expected. Sales taxes, the state's second-largest revenue source, are $120 million (1.7%) below estimate. The state expects the final revenue shortfall to reach $592 million (2.7% of revenues) by year-end, and it plans to address the deficit primarily with expenditure savings and an increased use of General Revenue Fund balance. The state can also use up to $200 million from the Health and Human Services Fund that were transferred from the GRF earlier in the biennium to balance future funding shortfalls. However, the state has also allocated these reserves to fund aid to counties and transit authorities to transition them off the Medicaid sales tax (more below). The original fiscal 2017 budget carried forward $291 million of unencumbered, unobligated fund balance to support appropriations, and with the additional $77 million decrease, ending fund balance is projected to be $382 million (1.7% of state-source revenues). Budget-basis fund balances have steadily decreased from a peak of $1.1 billion (5.1%) in fiscal 2013 as the state phased in tax reform. However, during that period the state has continued to rebuild the Budget Stabilization Fund, which is now at $2 billion.

**Detailed Rating Considerations**

**Economy**

Ohio's employment growth slowed in the last few months of 2016 (see Exhibit 1). Through February 2017, Ohio's monthly non-farm employment growth declined to 0.8% year-over-year, down from 1.1% in September, and 2.3% in mid-2012. National job growth was more stable, at 1.6% through December, but has also slowed, from 1.9% earlier in 2016. Despite the slowdown, Ohio's seasonally adjusted nonfarm employment remains at its post-recession peak of 5.5 million. Ohio's February unemployment rate of 5.1%, is above the U.S. rate of 4.7%. The state's labor force growth has also been slow in 2016. The labor force declined slightly in December and January and YOY growth was 0.4% in February. The US labor force growth was 0.74% YOY through February. Job growth has been primarily in healthcare and education, and transportation and warehousing, and financial activities. Manufacturing, at 12.7% of total employment, saw 0.8% growth year-over-year through February. The strong dollar, lagging global economic growth and slowing auto demand will challenge the manufacturing sector's growth nationwide.

Despite some weakening, Ohio's rate of personal income growth remains near the US pace; it was 3.3% year-over-year through September, compared to 3.5% for the nation. Ohio's 2015 per-capita personal income ($43,566) has improved to 91% of the nation's, from 89% in 2008.

**Finances and Liquidity**

Governor John Kasich's proposed fiscal 2018-2019 biennial general revenue fund (GRF) budget incorporates somewhat optimistic revenue assumptions, continued tax reform, and restrained spending growth to achieve structural balance by the second year of the biennium, which ends June 30, 2019. The state's economic forecast assumes that state retail sales and food services growth, along
with personal income, wage and salary growth, will accelerate in 2018, driving annual baseline revenue growth slightly above 4% for personal income taxes and sales taxes. These assumptions are somewhat optimistic, given the lower-than-expected economic and revenue growth in fiscal 2016 and 2017 that resulted in two consecutive years of revenue gaps.

The budget proposes continued personal income tax reductions equivalent to a 17% rate reduction over two years, through consolidation of income tax brackets, a two-year phased rate cut, and increases in exemptions and credits for low-income taxpayers.

The $3.1 billion biennial revenue reduction would be mostly balanced with a proposed increase in the sales tax rate to 6.25% from 5.75%, expansion of the sales tax base, and increases in various other taxes such as tobacco and liquor taxes, and severance taxes. The estimated net GRF revenue loss is minimal at $51 million and $67.6 million in fiscal 2018 and 2019, respectively, however it is unclear whether the legislature will adopt all or a portion of these reform proposals.

Appropriations are projected to decline 5.6% to $33.1 billion in fiscal 2018, due to the reallocation of certain Medicaid expenditures outside the GRF, a topic discussed at greater length below. Fiscal 2019 appropriations are projected to grow 2.2%, to $33.8 billion. After growing almost 4% in fiscal 2017, GRF K-12 spending increases will be limited to 1.8% and 1.7% in fiscal 2018 and 2019, respectively, due to reductions in transportation cost-sharing and in guaranteed state aid for districts with enrollment declines of 5% or more. The proposed budget relies on $215 million of unencumbered, unobligated fund balance in fiscal 2018, resulting in a decline to $166 million (0.7% of own-source revenues), but will increase slightly to $189.4 million in fiscal 2019.

To balance the federally enforced elimination of the sales tax on Medicaid managed care organizations (MCO), the state has proposed implementing a new “Health Insuring Corporation” provider assessment on all MCOs. The state estimates that the managed care sales tax provided the GRF approximately $597 million, which will be more than offset by $615 million from the new assessment. The provider assessment revenue will be collected in a dedicated fund outside the GRF, and the state will shift an equivalent amount of Medicaid expenditures to the new fund, resulting in a net neutral impact on the GRF. The state also plans to make a one-time $207 million transfer in fiscal 2018 to counties and transit agencies to phase in the impact of the loss of the Medicaid MCO sales tax.

Although Ohio’s conservative budget management and economic growth have mostly absorbed the state’s tax reforms since 2012, revenue underperformance could challenge the state’s ability to maintain budget balance in the medium term. Continued mid-year budget gaps will increase the risk of using additional fund balances.

LIQUIDITY
The fiscal 2016 General Revenue Fund ending unencumbered, unobligated fund balance was $460 million (2.1% of state-source revenues), down from a high of $1.1 billion (5.1% of state-source revenues) in fiscal 2013. In fiscal 2016, the state made several designated transfers, including: $29.5 million to the Budget Stabilization Fund; $150 million to the Health and Human Services Fund; $100 million to the Public School Building Fund and $25 million to the Emergency Purposes/Contingency Fund.

Ohio has successfully prioritized and rebuilt its Budget Stabilization Fund (BSF) since the recession. The state raised the statutory target to 8.5% (from 5%) of total general revenue fund revenues (including federal revenues), followed by a $526.6 million deposit in early fiscal 2016, its fourth deposit into the BSF in the past five years. The current BSF balance of $2.0 billion is 9% of state-source general revenue fund revenues.

Fiscal 2016 audited results reflect available balances (assigned fund balance plus unassigned fund balance) at 13.8% of total operating fund revenues (excluding federal revenues), up from 11.7% the prior year (on a GAAP basis). The increase reflects lower-than-budgeted Medicaid and Education spending. The state maintains high flexibility with its assigned fund balances, which can be reallocated by the budget director. Fiscal 2016 unassigned fund balance was $864 million (3.4% of revenues), which nets the state’s $2 billion BSF and negative fund balances in other accounts of the General Fund.

Debt and Pensions
With net tax-supported debt of $12.7 billion, Ohio has maintained a moderate debt burden relative to other states. The state’s 2015 net tax-supported debt burden is slightly higher than the 50-state median of 2.5%, at 2.6% of personal income. Ohio ranks 24th among states based on net tax-supported debt as a percentage of personal income, down from 20th in 2005.
In April 2016, Ohio enacted a 2017-2018 capital biennium budget that provides a total of $2.62 billion in capital appropriations, with 83% funded by debt authorizations supported from the state general revenue fund. The budget authorizes $1.33 billion in GO debt and $591 million in lease appropriation debt.

In December 2014, the state, through its Department of Transportation, entered into a public-private partnership (PPP) to construct the Southern Ohio Veterans Memorial Highway (State Route 823), a four-lane limited access highway around the City of Portsmouth, Ohio. The Portsmouth Gateway Group, LLC’s $227.4 million senior Tax Exempt Private Activity Bonds, Series 2015 and its $208 million subordinate TIFIA loan were both assigned a Baa2 rating. Ohio’s termination payment as of June 30, 2015, for its PPP would be $30.9 million. Given the long-term, debt-like obligation of the state to make availability payments through the life of the concession agreement, we include this obligation in the state’s net tax supported debt.

DEBT STRUCTURE
Ohio has $466.8 million of variable-rate demand debt outstanding (or 4.1% of total debt), for which it maintains an internal liquidity program for tendered bonds that are not remarketed. The short-term rating on these bonds is VMIG 1, reflecting the state’s strong management of available liquid resources. As of November 2016, Ohio had $3.7 billion of same-day liquid assets available to support the bonds, on a discounted basis, and has access to an additional $1.9 billion of weekly liquidity (discounted). The state has never had a failed remarketing, but maintains clearly articulated process documents and has successfully implemented its liquidity support procedures.

The state treasury also supports the Ohio Municipal Assistance Program, providing back-up liquidity to qualified local governments that have issued bond anticipation notes. The program authorization is capped at $300 million, and there are currently $137.8 million of BANs outstanding.

DEBT-RELATED DERIVATIVES
The state is a party to five swap agreements with a combined notional principal of $364 million that hedge interest rate risk on its variable-rate obligations. Collateral posting requirements are pegged to rating levels starting at Aa3 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, 2016, the combined mark-to-market value of the swaps was negative $41 million.

PENSIONS AND OPEB
Ohio’s 2015 adjusted net pension liability (ANPL), our measure of the government’s pension burden, was 43% of own-source revenues, below the 50-state median of 85%. The three-year average ANPL as of 2015 is $14.4 billion, or 48% of revenue. The state participates in three pension systems, including the Ohio Public Employees Retirement System, the State Teachers Retirement System, and the Highway Patrol Retirement System. Moody’s ANPL reflects certain adjustments made to improve comparability of reported pension liabilities.

The state contributed $393 million to its pension systems in 2015. This amount is more than the contribution amount that would allow the state’s reported net pension liability to “tread water” – or remain stable from one year to the next, assuming investment return and other actuarial assumptions are met for the year. The tread water amount is determined by the actuarial cost of the year’s benefit accruals (“service cost”) plus interest on the net pension liability at the beginning of the year. The state’s contribution relative to the tread water benchmark implies a funding approach that will likely lead to declining net pension liabilities over time.

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 ($15 billion) pledged to cover liabilities. After the state enacted reforms in 2012, its OPEB liabilities dropped substantially. Its aggregate unfunded OPEB liability is $9.2 billion, with a 63% funded ratio, as of the most recent valuations. 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 combined debt service, pension, and OPEB contributions in fiscal 2015 were relatively low, at 6.7% of own-source governmental revenues. If the state pension contribution were equal to the “tread water” amount, these fixed costs would have been 6.5% of revenues.
Management and Governance
Ohio operates on a biennial budget. The state constitution has no revenue raising caps or mandated spending levels, providing 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’s statutory target is 8.5% of the prior year’s general revenue fund revenues (state and federal sources). 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. In addition, there is a statutory requirement to deposit surpluses in excess of 0.5% of general revenue fund revenues into the rainy day fund, which generally accelerates reserve restoration, although the legislature has diverted surpluses for other uses in past years.

Legal Security
The capital facilities lease appropriation bonds are secured by a lease agreement between the Ohio Department of Administrative Services, as lessee, and the Ohio Public Facilities Commission, as lessor. Debt service is payable from base rental payments. The lease stipulates that the obligation to make lease payments is absolute and unconditional, contingent only upon the appropriation of funds by the legislature, and not on whether the financed projects are in use. Debt service payment dates (October 1 and April 1) rely on appropriations enacted every other year and are far enough removed from the July 1 start of the state’s fiscal biennium to limit risk of non-appropriation due to late budget adoption.

Pursuant to the leases, the state agencies are required to include the lease payments in biennial budget request to the Office of Budget and Management. There are no debt service reserve funds associated with these bonds, and there are no bondholder remedies in case of default due to non-appropriation. In the event of non-appropriation, the lease will terminate. The importance of maintaining continued market access for subject-to-appropriation lease debt, in general, provides a strong incentive to continue making timely appropriations.

Use of Proceeds
Proceeds of the bonds will finance capital improvements for facilities occupied by various state agencies.

Obligor Profile
Ohio is the seventh-largest US state by population. Its gross domestic product per capita also ranks seventh among the states (in current dollars).

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.moodys.com for a copy of this methodology.

Ratings

Exhibit 3

<table>
<thead>
<tr>
<th>Issue</th>
<th>Rating</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capital Facilities Lease-Appropriation Bonds, Series 2017A (Administrative Building Fund Projects)</td>
<td>Aa2</td>
</tr>
<tr>
<td>Rating Type</td>
<td>Underlying LT</td>
</tr>
<tr>
<td>Sale Amount</td>
<td>$70,000,000</td>
</tr>
<tr>
<td>Expected Sale Date</td>
<td>04/04/2017</td>
</tr>
<tr>
<td>Rating Description</td>
<td>Lease Rental: Appropriation</td>
</tr>
</tbody>
</table>

Source: Moody’s Investors Service