FitchRatings

# FITCH RATES $400MM MASSACHUSETTS GO BONDS 'AA+'; OUTLOOK STABLE

Fitch Ratings-New York-25 July 2014: Fitch Ratings has assigned an 'AA+' rating to the following Commonwealth of Massachusetts general obligation (GO) bonds consolidated loan of 2014, series D (multi-modal bonds):

--$200 million subseries D-1 bonds;
--$200 million subseries D-2 bonds.

The bonds are scheduled to sell through negotiation on or about July 29, 2014. Each subseries has a final maturity of Sept. 1, 2043 and will be issued in the SIFMA mode, paying interest at a fixed spread to SIFMA. The bonds are expected to be remarketed or refunded prior to their mandatory tender dates (Sept. 1, 2016 and 2017, respectively); if they are not, the interest rate would re-set to 9% for as long as they remain outstanding.

Massachusetts has recently announced that it will be implementing a long-term asset/liability management strategy with the goal of more proactively managing interest rate exposure for the Commonwealth overall. Based on current conditions, this would involve issuance of approximately $3.6 billion in unhedged, floating-rate debt by the end of fiscal 2018, inclusive of the current sale. Fitch notes Massachusetts' high credit quality, strong management profile and demonstrated ability to manage a large capital borrowing program. Fitch expects the Commonwealth to closely manage the program and make adjustments as needed.

Fitch has also affirmed the following ratings:

--Approximately $19 billion of outstanding Commonwealth GO and Commonwealth guaranteed bonds at 'AA+'.

The Rating Outlook is Stable.

SECURITY

General obligations of the Commonwealth, to which its full faith and credit are pledged.

KEY RATING DRIVERS

STRONG AND WEALTHY ECONOMY: Massachusetts has a broad and diverse economy with the third-highest personal income per capita in the nation.

PRUDENT FINANCIAL MANAGEMENT: The Commonwealth has benefited from conservative budgeting and sound financial practices over time. A limitation on the use of capital gains-related tax revenue has reduced the volatility of economically sensitive revenues in the budget, and the Commonwealth has shown a commitment to reserve funding.

COMPARATIVELY HIGH LIABILITY BURDEN: Massachusetts' debt levels are high for a U.S. state government, and Fitch expects them to remain so. This is partially explained by the above-average role played by the Commonwealth in relation to local levels of government when compared to most other states. In addition, the Commonwealth is responsible for the pension benefits of not only Commonwealth employees but also teachers statewide, contributing to a combined burden of debt and pensions that is also well above the median for U.S. states rated by Fitch.

RATING SENSITIVITIES

The rating is sensitive to shifts in fundamental credit characteristics including the state's commitment to strong financial management practices.

CREDIT PROFILE

Massachusetts' 'AA+' GO rating reflects considerable economic resources and a record of prudent financial management. Credit strengths are tempered by a comparatively heavy debt burden that Fitch expects to remain high. The Stable Outlook reflects the expectation that the Commonwealth will continue to act as needed to ensure budget balance and maintain an adequate budgeted reserve position.

FINANCES AND MANAGEMENT

Massachusetts' financial position has stabilized in recent years, with solid revenue recovery following a period of steep decline in the recession. Fiscal 2013 benefitted from the acceleration of income into calendar 2012 that took place in anticipation of federal tax increases; revenues from income tax estimated payments were up 15.4% year-over-year and final returns 24.7%. Baseline overall tax revenue growth of 5.6% also reflected increases of 3.5% in personal income tax withholding receipts and 2.4% in sales tax revenue.

Fiscal 2014 revenues from personal income continued to be affected by the impact of the 2013 federal tax increases, with revenues from income tax estimated payments up 6.1% year-over-year but final returns down 7.7%. Nonetheless, solid growth of 5.4% in personal income withholding receipts, 5.9% in sales taxes and 9.3% in corporate tax revenues reflected the continued broad growth in the Commonwealth's economy. Baseline overall tax collections rose 4.9%. These results incorporated the retroactive repeal of a computer and software services tax that was included in the enacted budget (estimated impact of $161 million) and the reduction of the income tax rate to 5.2% from 5.25% effective Jan. 1, 2014 that was triggered by recent revenue growth (estimated impact of $65 million).

Fitch believes that the Commonwealth retains significant flexibility to address budget underperformance and has repeatedly demonstrated its commitment to doing so. Strong revenue results in fiscal 2011, which saw 9.1% year-over-year baseline tax revenue growth, allowed for an increase in the stabilization fund balance to $1.4 billion, up from $670 million at the end of fiscal 2010. Recovery continued in fiscal 2012, albeit at a more modest pace, with a 3.5% baseline increase in tax collections; the stabilization fund balance grew further to $1.65 billion. In fiscal 2013, scheduled draws were expected to lower reserve funding to $1.3 billion at year-end. However, the stabilization fund ended the year with a higher $1.56 billion balance. The Commonwealth estimates that the balance dropped to a still significant $1.26 billion at the end of fiscal 2014; the balance is budgeted to be reduced modestly in fiscal 2015, to $1.22 billion.

Massachusetts' demonstrated commitment to taking timely action to ensure budget balance in recent downturns while maintaining some level of reserves is important given the nature of the Commonwealth's revenue system, which quickly reflects changing economic conditions. For example, in the last downturn tax revenue forecasts were reduced significantly over the course of fiscal 2009, from $21.4 billion in the enacted budget to actual results of $18.3 billion, and the year ended down 13% (baseline) compared to fiscal 2008.

In addition to solid ongoing budget management, the Commonwealth has proactively taken steps to reduce the impact of volatile revenues on its budget and has developed a long-term fiscal policy framework focused on budget sustainability. The variability and unpredictability of capital gains-related tax revenue has been a key factor in volatility over time. In response, the fiscal 2011 enacted budget included a new mechanism for budgeting capital gains-related tax revenue that limits the amount of such revenue that can be included in the Commonwealth's budget to $1 billion (adjusted annually by a U.S. GDP growth-based formula starting in fiscal 2014), with excesses dedicated to reserve funding (90%) and retiree benefit obligations (10%). Capital gains revenues in fiscal 2014 are estimated to have been $1.069 billion, which upon certification would result in a $46 million set-aside above the statutory threshold for reserves and retiree benefit obligations.

A similar change requires one-time judgments and settlement payments in excess of $10 million to be deposited in the stabilization fund. The fund benefited from an unusually high $375 million of such revenue in fiscal 2012. The fiscal 2013 figure was $32 million. The fiscal 2015 budget modified the policy to establish a baseline above which such monies would be deposited in the stabilization fund, similar to the policy for capital gains, rather than the current requirement to deposit the whole amount; under the provision, the deposit would be $240 million in fiscal 2014 and an estimated $263 million in fiscal 2015.

## ECONOMY

Massachusetts has a fundamentally strong and wealthy economy. Institutions of higher education and health care are significant and lend stability, in addition to supporting development and innovation in other areas. At 128% of the U.S. average, personal income per capita is the third highest of the states.

The Commonwealth's economic performance in the recent recession was significantly better than the national experience, in contrast to 2002-2004 when Massachusetts experienced among the steepest employment drops in the country. Employment losses in 2009 were less severe than those of the U.S. (3.2% versus 4.3%), and Commonwealth employment rose 0.4% in 2010 while U.S. employment fell 0.7%. Employment continued to grow in 2011 (1.2%), 2012 (1.6%) and 2013 (1.4%) at a pace generally in line with the national trend. As of June 2014, Commonwealth employment grew 1.8% year-over-year, compared to 1.9% for the nation, and the unemployment rate measured 5.5%, compared to 6.3% for the U.S.

## DEBT AND OTHER LONG-TERM LIABILITIES

The Commonwealth's net tax-supported debt equals a comparatively high 9% of personal income, including sales tax obligations of the Massachusetts Bay Transportation Authority and the Massachusetts School Building Authority, as well as contract assistance commitments to the Massachusetts Department of Transportation. The comparatively high debt levels are partially explained by the Commonwealth's above-average role in relation to local levels of government when compared to most other states. GO debt continues to represent the majority of outstanding debt. Fitch expects debt levels to remain high for a U.S. state.

The Commonwealth is responsible for the pension benefits of not only Commonwealth employees but also teachers statewide. Massachusetts has undertaken some pension reforms and projects manageable growth in pension funding requirements going forward. A 2014 agreement accelerates the pension funding schedule by increasing annual contributions by 10% per year through fiscal 2017 and 7% in subsequent years. Full system funding is projected for fiscal 2036 based on current assumptions, although the statutory requirement remains fiscal 2040. The fiscal 2015 contribution is $1.8 billion.

On a combined basis, the burden of the Commonwealth's net tax-supported debt and the total unfunded liability of the state employees and teachers systems, adjusted for a 7% investment return assumption, equals 18.5%, well above the 6.1% median for U.S. states.

Contact:

Primary Analyst
Laura Porter
Managing Director
+1-212-908-0575
Fitch Ratings, Inc.
33 Whitehall Street
New York, NY 10004

Secondary Analyst
Douglas Offerman
Senior Director
+1-212-908-0889

Committee Chairperson
Marcy Block
Senior Director
+1-212-908-0239

Media Relations: Elizabeth Fogerty, New York, Tel: +1 (212) 908 0526, Email: elizabeth.fogerty@fitchratings.com.

Additional information is available at 'www.fitchratings.com'.

In addition to the sources of information identified in Fitch's report 'Tax-Supported Rating Criteria', this action was additionally informed by information from IHS Global Insight.

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. Local Government Tax-Supported Rating Criteria
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