New Issue: Moody's assigns Aa1 rating to $400 million of Massachusetts general obligation bonds

Global Credit Research - 21 Sep 2012

Commonwealth has $18.8 billion of general obligation debt outstanding

MASSACHUSETTS (COMMONWEALTH OF)
State Governments (including Puerto Rico and US Territories)
MA

Moody's Rating

ISSUE	RATING
General Obligation Bonds, Consolidated Loan of 2012, Series C	Aa1
Sale Amount $400,000,000	
Expected Sale Date 09/25/12	
Rating Description General Obligation	

Moody's Outlook

Opinion

NEW YORK, September 21, 2012 --Moody's Investors Service has assigned a Aa1 rating to the Commonwealth of Massachusetts' $400 million General Obligation Bonds, Consolidated Loan of 2012, Series C. Proceeds of the bonds, scheduled to sell on September 25, will be used to finance various capital projects.

SUMMARY RATING RATIONALE

The rating reflects the Commonwealth of Massachusetts' strong financial management practices and its demonstrated willingness to balance its budget when necessary through spending cuts, revenue increases and use of reserves; a large education and health care sector that generates high wages and that has helped to mitigate job losses in the current downturn; debt levels that are among the highest in the nation; and relatively low pension funding levels. The outlook is stable.

STRENGTHS

-- Strong financial management during economic downturns, particularly a willingness to promptly identify and close budget gaps through expenditure reductions, revenue increases and prudent use of reserves

-- Budget reserves that provide an adequate cushion to another downturn and the commonwealth's demonstrated commitment to rebuild them to stronger levels, including through a new statutory mechanism to replenish them going forward

-- High wealth and high levels of educational attainment and the presence of large, highly-rated higher education and health care institutions in the Boston area has lent a degree of economic stability and have mitigated some job losses during recessions

CHALLENGES

-- Managing expenditure pressures, especially from health care and social services, in a lower revenue environment and amid ongoing economic uncertainty

-- Debt ratios that are among the highest in the nation combined with relatively low pension funding ratios

-- Managing the challenges from federal downsizing during the next several years, which could have a heavy impact on the commonwealth's important healthcare sector

DETAILED CREDIT DISCUSSION

ECONOMY PERFORMS STRONGER THAN THE NATION BUT IS SLOWING

Through the downturn, Massachusetts' economy generally performed more strongly than the nation. It continues to outperform, but the pace is slowing. Based on jobs figures just released by the commonwealth, it's unemployment rate increased slightly in August to 6.3% (compared to 6.1% in the prior month), although that is still considerably better than the US average rate of 8.1%. Employment growth was better in Massachusetts than the national average for most of the downturn but in 2011 only increased by 0.6% compared to 1.2% for the US. For most of 2012 employment growth in Massachusetts has lagged the nation although in July it was about even. The commonwealth continues to be aided by its large education and health sector, which makes up more than 20% of employment. The state also has a large financial activities sector, with a significant mutual fund presence. While the important healthcare sector is partly behind Massachusetts's above-average employment and income performance, future federal downsizing could impact healthcare as well as government research and have a significant impact in Massachusetts. The state is characterized by high wealth and education levels but with slow population and job growth over the longer run. Per capita personal income in 2011 was $53,621, ranking second among the states.

COMMONWEALTH MAINTAINS HEALTHY FINANCIAL POSITION; FALL REVENUE COLLECTIONS WILL BE IMPORTANT BAROMETER

Massachusetts tax revenues increased by 2.9% in fiscal 2012, 0.5% greater than forecast. Total personal income taxes increased by 2.9%, sales taxes by 3.2% and corporate income taxes by 4.1%. The capital gains portion of the personal income tax decreased by 7.6%, an important measure in high wealth Massachusetts. The commonwealth estimates it ended the year with a budgetary basis ending balance of approximately $128 million. The budgeted fiscal 2013 revenue forecast reflects 4.5% growth compared to fiscal 2012. For the first two months of the year, neither of which are major ones for revenues, collections are essentially flat compared to the same period in the prior year. September, an important month for quarterly estimated income tax payments, will signal whether the full year forecast may need to be revised. The fiscal 2013 budget - which reflects 3.9% growth compared to fiscal 2012 - includes a draw on the Budget Stabilization Fund. In past years when revenue growth was strong enough, the commonwealth either reduced that or eliminated the withdrawal. Overall the commonwealth has reduced the amount of one time resources it uses in its budget, and the draw itself is only 1.0% of total budgeted funds.

HEAVY TAX-SUPPORTED DEBT LOAD; HIGH PENSION COSTS ALTHOUGH REFORMS WILL PROVIDE LONG-TERM BENEFITS

The commonwealth has a high debt burden, with $18.8 billion in outstanding general obligation bonds and nearly $32 billion in total net tax-supported debt. Debt levels have been driven upwards in part by the commonwealth's issuance of bonds to finance projects that in other states would be paid for at the local level. Based on Moody's 2012 state debt medians, the state's debt levels ranked second-highest among the 50 states on both a per-capita basis and as a percentage of personal income, respectively, and is the highest as a percentage of state gross domestic product. The commonwealth's debt per capita was $4,814, 9.4% of its personal income, and 8.4% of its gross domestic product.

A pension reform enacted by the state last year provides long-term benefits to the state. Based on an updated actuarial valuation released in September 2011, Massachusetts' pension funded ratio had improved to 71.1% as of January 1, 2011 from 67.5% in 2010. Among the changes, the pension reform measure extended the funding schedule from 2025 to 2040, which reduced the fiscal 2012 contribution from $2.2 billion to $1.4 billion (although that was still larger than then fiscal 2011 amount). The negative impact of pushing out the period to fully fund the retirement obligations was partially offset by increasing the retirement age for most state employees; eliminating early retirement subsidies; increasing the period for calculating retirement from an average of three years to five years; and eliminating double-dipping. The measure also prohibits the commonwealth from making less than the annual payment required by the new schedule if investment returns exceed expectations: greater-than-expected gains would be used to shorten the schedule. It further dedicates future tobacco settlement monies to the commonwealth's other post-employment benefits (OPEB) trust fund, starting in phases in fiscal 2013. The combined ratio of Massachusetts' pension and OPEB actuarially required contributions (ARC) to revenue is 16%, slightly higher than average. Left unchecked, those costs could limit the commonwealth's fiscal flexibility going forward, but the new plan should help to mitigate them.

CLOSELY MANAGED VARIABLE RATE DEBT AND SWAPS PORTFOLIO

Massachusetts has a total of $4.0 billion of floating rate debt outstanding, or 13% of its Moody's-calculated net tax supported debt. This includes: just more than $1 billion of variable rate demand bonds with unremarketed tenders supported by bank liquidity facilities; $994 million of SIFMA index ($266 million have maturities within the next twelve months); a $248 million direct loan; $401 million of auction rate bonds; $197 million of CPI index bonds; $845 million of LIBOR index bonds; and $289 million of variable rate bonds issued by the University of Massachusetts Building Authority and the Massachusetts Bay Transportation Authority that the commonwealth pledges its full faith and credit to pay if necessary. The commonwealth's variable rate and derivatives portfolio is closely managed and its liquidity facilities and swap agreements contain provisions favorable to the commonwealth and offset its relatively low available cash balances. Liquidity facilities contain a mix of three- and five-year term-out provisions that, considering the strength of Massachusetts' market access should provide ample time to refinance if necessary. Swap counterparties are well-diversified and do not reflect collateral posting requirements on the part of the commonwealth. In our analysis, the commonwealth's liquidity (reflecting current cash as well as amounts in the stabilization fund) is sufficient to handle unforeseen circumstances related to its variable rate debt and swaps.

OUTLOOK

The outlook for Massachusetts is stable, reflecting its good reserve levels and efforts to regain structural budget balance. The outlook also reflects our expectation that the commonwealth will continue to take proactive measures to close budget gaps if they emerge and continue its trend of strong financial management. Going forward, heavy reliance on one-time budget solutions, tighter cash margins, unexpectedly severe economic deterioration, or a large increase in tax-supported debt could be credit challenges.

WHAT COULD MAKE THE RATING GO UP

-- Continued rebuilding of reserves and establishment of stronger constraints on their use

-- Established trend of structural budget balance

-- Reduced debt ratios relative to Moody's 50-state median

WHAT COULD MAKE THE RATING GO DOWN

-- Protracted structural budget imbalance driven by deeper and/or prolonged economic downturn

-- Depletion of Budget Stabilization Fund to inadequate levels

-- Increased leveraging of the commonwealth's resources to pay debt service or further erosion in funding ratios

-- Narrowed cash flow that strains the commonwealth's liquidity

The principal methodology used in this rating was Moody's State Rating Methodology published in November 2004. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

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