FitchRatings

Fitch Rates Georgia's $1.4B General Obligations 'AAA'; Outlook Stable

Fitch Ratings-New York-09 June 2017: Fitch Ratings has assigned a 'AAA' rating to the following state of Georgia bonds:

--$788,640,000 general obligation (GO) bonds 2017A;
--$273,450,000 GO bonds 2017B (federally taxable);
--$352,450,000 GO refunding bonds 2017C.

The bonds will sell via competitive bid, on or about June 20, 2017.

Fitch has also affirmed the Long-Term Issuer Default Rating (IDR) of the state of Georgia and the ratings on outstanding GO and state guaranteed revenue bonds at 'AAA', and the ratings on the following appropriation-backed bonds issued by the Development Authority of Clayton County (DACC) that are linked to the state's IDR:

--DACC revenue bonds (TUFF Archives LLC-Secretary of State of Georgia Project), series 2012 at 'AA+';
--DACC revenue bonds (DACC Public Purpose Corporation II Project), series 2007 (issued on behalf of the Department of Natural Resources) at 'AA'.

The Rating Outlook is Stable.

SECURITY
The GO bonds are general obligations of the state of Georgia, secured by a pledge of the state's full faith and credit.

The DACC revenue bonds are secured by rental payments of TUFF Archives LLC and DACC Public Purpose Corporation II, respectively, which are derived from lease payments from the state, subject to annual appropriation.

KEY RATING DRIVERS

Georgia's 'AAA' IDR reflects the state's conservative debt management, proven willingness and ability to support fiscal balance and a broad-based and growing economy. The state proactively addressed weakened revenues during the great recession through steep spending cuts and draws from its rainy-day fund (the revenue shortfall reserve [RSR]). Since then, Georgia has maintained a conservative approach to fiscal management, by limiting spending growth and making progress in rebuilding the RSR balance. The state's long-term liability burden is low.

Additional Risk Feature
Exposure of bondholders to expense variability for the DACC Public Purpose Corporation II revenue bonds, primarily to building operations and maintenance costs, presents an additional risk feature warranting a two-notch distinction from the state's IDR.

Economic Resource Base
Georgia's economic profile is similar to that of the nation. Job losses during the Great Recession were particularly steep, but the state's recovery has outpaced national trends.

Georgia's demographic profile is somewhat mixed, with above-average population growth and a median age below the nation's, alongside relatively weaker wealth indicators. Overall, these factors should support further solid economic growth. Atlanta serves as a national corporate and transportation hub, historically anchoring the state's economy. Expansion in the previously challenged manufacturing industry is among the key drivers of improvement outside the Atlanta metro area.

Revenue Framework: 'aaa' factor assessment
Georgia's revenues, primarily income and sales taxes, will continue to reflect the depth and breadth of the economy, and its solid growth potential. The state has complete control over its revenues, with an essentially unlimited legal ability to raise operating revenues as needed. A recent constitutional amendment limiting the personal income tax rate does not constrain Fitch's assessment since full flexibility remains for other revenue sources.

Expenditure Framework: 'aaa' factor assessment
The state maintains ample expenditure flexibility with a low burden of carrying costs and the broad expense-cutting ability common to most U.S. states. Also as with most states, Medicaid remains a key expense driver, but one that Fitch expects to remain manageable.

Long-Term Liability Burden: 'aaa' factor assessment
Georgia's long-term liability burden is low, and overall debt management is conservative. While the state issues bonds regularly for capital needs, amortization of principal is rapid. Additionally, Georgia fully funds its actuarially determined employer contributions (ADECs, formerly ARC) for pensions, keeping the unfunded liability very low.

Operating Performance: 'aaa' factor assessment
The state is well-positioned to deal with economic downturns, with exceptionally strong gap-closing capacity due to its broad control over revenues and spending and rebuilt reserves. Georgia has a track record of restoring financial flexibility during economic expansions, which is important given the state's above average revenue volatility.

RATING SENSITIVITIES
SOLID FINANCIAL MANAGEMENT: The rating is sensitive to shifts in Georgia's fundamental credit characteristics including its history of timely action to address budgetary challenges and proactive measures to ensure fiscal flexibility.

IDR LINKAGE: The ratings on the DACC revenues bonds are sensitive to changes in the state's IDR of 'AAA'/Stable Outlook, to which they are linked.

EXPENSE VOLATILITY: For the DACC Public Purpose Corporation II bonds, recurring increases in O&M beyond the 6% annual rental increase permitted under the rental agreement, or an ongoing material increase in the variable interest expense beyond that level, could trigger a negative rating action.

CREDIT PROFILE

After a sharp recessionary downturn, the state's diverse economy has accelerated with employment growth outpacing national trends. Recovery in the manufacturing sector has been particularly important to this upturn. In the past, low value-added manufacturing had been a primary economic driver in the areas outside Atlanta. Those industries declined in the years leading up to the recession, which exacerbated the economic losses. However, since 2011, the sector has been growing with key gains coming in the automotive industry.

Revenue Framework

Georgia's personal income tax (PIT) and sales and use tax together account for approximately three-fourths of the state's general fund receipts. The PIT alone makes up nearly half of total receipts. Both revenue sources are fairly economically sensitive and respond quickly to shifts in the state's economic trajectory.

Fitch anticipates revenue growth will remain slightly positive and in line with the historical trend over the past decade, given the state's solid economic growth prospects. Robust revenue growth in years of economic gains is offset by sharp declines when Georgia's economy contracts.

Georgia voters recently enacted a constitutional cap on its income tax rate at the current level, but no such limit exists for the sales tax or other state revenue sources. While the PIT is the state's most significant revenue stream, Fitch does not view the constitutional cap as a limiting factor in the revenue framework assessment. For all other taxes and fees Georgia has no legal limitations on its independent ability to raise revenues through base broadenings, rate increases, or the assessment of new taxes or fees.

Expenditure Framework

As in most states, education and health and human services spending are Georgia's largest operating expenses. Education is the larger line item, as the state provides significant funding for local school districts and the public university and college system. Health and human services spending is the second largest area of spending, with Medicaid being the primary driver.

Spending growth absent policy actions will likely be in line with, to marginally above revenue growth, driven primarily by Medicaid, requiring regular budget management to ensure ongoing balance. The fiscal challenge of Medicaid is common to all U.S. states and the nature of the program as well as federal government rules limit the states' options in managing the pace of spending growth. In other major areas of spending such as education, Georgia is able to more easily adjust the trajectory of growth and did so both during and after the recession.

Federal action to revise Medicaid's programmatic and financial structure remains a possibility given recent House passage of the American Health Care Act and the president's proposed fiscal 2018 budget. Both include a basic restructuring of federal Medicaid funding to a capped amount. Whether a change in Medicaid funding has consequences for Fitch's assessment of the state's credit quality would depend on management's fiscal response to those changes. Responses that create long-term structural deficits or increased liability burdens could negatively affect both the expenditure framework assessment and the state's IDR.

Georgia retains ample expenditure flexibility. While Medicaid costs are somewhat beyond the state's ability to materially change given federal requirements for the program, the state's carrying costs are likely to remain manageable as a percentage of total spending, given carefully managed debt issuance and assuming that the pensions achieve their investment return targets. Like most states, Georgia's operating budget goes largely towards funding of services rather than direct service delivery allowing the state to shift costs to lower levels of government in times of fiscal stress.

Long-Term Liability Burden
Most of the state's modest tax-supported debt burden is in the form of GO or guaranteed revenue bonds and amortization of principal is rapid, with approximately 70% maturing within 10 years. Other outstanding obligations include federal grant anticipation revenue (GARVEE) bonds, capital leases, multi-year leases entered into by the State Properties Commission, and a small amount of notes and loans. Georgia's major pension systems covering both state employees and teachers have benefitted from consistent full funding of the ARC/ADEC. As of the June 30, 2016 valuation and under the new GASB 67 reporting standard, system-wide ratios of assets to liabilities

for the state employees and teachers' plans were reported at 72.3% and 76.1%, respectively. Using Fitch's more conservative 6% discount rate assumption, the state employees and teachers' plans are funded at 69% and 62.9%, respectively, as of June 30, 2016.

As reported in Fitch's November 2016 state pensions update, Georgia's net tax-supported debt and Fitch-adjusted unfunded pension liability attributable to the state totaled a low 4.4% of 2015 personal income. This was below the median of 5.1% for U.S. states. Using a more conservative 6% return assumption for pensions, instead of the 7.5% rate assumed under the state's accounting valuation, would raise the burden of long-term liabilities to a still-low 5.5% of 2016 personal income.

Operating Performance

Georgia's exceptionally strong gap-closing ability during cyclical downturns derives primarily from its superior budget flexibility. Conservative fiscal practices and a somewhat volatile, but still diverse and expanding, economy offer a strong platform for the state to gradually restore fiscal flexibility once utilized. Georgia typically responds to budgetary stress with spending restraint and use of budgetary reserves. During the Great Recession, the state's primary reserve fund (the RSR) went from a peak of $1.5 billion in fiscal 2007 to $104 million in 2009.

After a budget is enacted, the governor has significant statutory authority to administer the budget and scale back spending as needed, allowing the state to be responsive to changing conditions. The state made regular use of this tool during the last recession and continued these policies several years into the recovery. The governor has regularly ordered most agencies to reduce spending below enacted budget levels shortly after the start of fiscal years as a precautionary measure. The tactic has contributed to regular operating surpluses and rebuilding of reserves.

As revenues recover in economic expansions, Georgia works toward re-establishing reserves, primarily in its RSR, and gradually restoring prior-year cuts. Statutory requirements to transfer all end of year surpluses to the RSR (until its statutory cap, currently 15%, led the state to build a sizable balance leading into the last recession of slightly more than 8% of net revenues. And after drawing down the RSR significantly during the Great Recession, the state has steadily contributed to it during the expansion. At the end of fiscal 2016, the balance of $2 billion (net of an annual mid-year appropriation for K-12 education) was equivalent to 9.1% of net revenues.

Georgia has been slower to restore spending cuts, which were most prominently made in education spending. It was not until fiscal 2015 that annual state appropriations for education reached the pre-recession peak, while continued enrollment growth since the recession implied continued spending pressure. Increases in fiscal 2017 and in the enacted budget for fiscal 2018 make more progress towards fully restoring prior cuts. The slow restoration reflects Georgia's historically conservative fiscal practices. Fitch notes the state has consistently met its actuarial pension funding commitments and generally avoided non-recurring budget balancing measures since pulling out of the recession.

Current Developments
Georgia's revenue performance in fiscal year 2017 through May 2017 (as reported by the state's Department of Revenue [DOR]) has been strong and ahead of the enacted budget forecast reflecting overall economic growth as well as structural and procedural changes. PIT revenues were up 5.4% for the year with robust gains in withholding (5.9%) offsetting modestly weaker performance in non-withholding (3.3%). Sales and use tax revenues to the general fund were up 4.4% for the year. Total receipts collected by DOR were up 4.7%. The amended fiscal year 2017 (AFY) budget relies on 3% growth in revenues, indicating the state is likely to end with another surplus which will enable additional RSR contributions.

For fiscal 2018, the enacted budget continues the trend of applying revenue growth to support program expansion and restoration of prior year cuts. The budget forecasts general fund revenue growth of 3.5% from fiscal 2017 which Fitch considers reasonable given recent trends. Education funding was modestly increased with an additional $156 million for the Quality Basic Education program (the state's basic school grant) versus the amended fiscal 2017 budget, for growth of 1.6%.

Transportation funding continues to increase due to House Bill 170 (HB 170) enacted several years ago, which helps address the growing state's infrastructure demands. The bill, which altered the state's tax structure for transportation by restructuring motor fuel excise taxes and implementing new fees, was effective July 1, 2015. The state's appropriation for transportation expenditures increased by $163 million in fiscal 2018 vs the enacted fiscal 2017 budged, reflecting estimated growth in revenues from HB 170.

For additional information on the DACC revenue bonds please see "Fitch Rates $19MM Dev Auth of Clayton County Rev Bonds 'AA'; Outlook Stable" (dated Oct. 24, 2016) and "Fitch Rates Georgia's $1.4 Billion General Obligations 'AAA'; Outlook Stable" (dated June 3, 2016).

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Applicable Criteria
U.S. Public Finance Tax-Supported Rating Criteria (pub. 31 May 2017)
(https://www.fitchratings.com/site/re/898466)

Additional Disclosures
Dodd-Frank Rating Information Disclosure Form
(https://www.fitchratings.com/site/dodd-frank-disclosure/1024963)
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