



Fitch Rates West Virginia Excess Lottery Rev Bonds 'A+'

Fitch Ratings-New York-10 August 2017: Fitch Ratings has assigned an 'A+' rating to the following issuance of the state of West Virginia Economic Development Authority (EDA):

- \$22.935 million excess lottery revenue bonds, series 2017 A (tax-exempt);
- \$2.065 million excess lottery revenue bonds, series 2017 B (taxable).

The bonds are expected to be sold via negotiation on Aug. 17, 2017.

The Rating Outlook is Stable.

SECURITY

Excess lottery revenue bonds are secured by separate statutory allocations of net profits of the state excess lottery revenue fund; a special revenue fund of the state of West Virginia. Bonds hold successive lien positions against the pledged revenues. The EDA excess lottery revenue bonds currently offered are secured by a separate statutory allocation of \$3 million from the state excess lottery revenue fund.

KEY RATING DRIVERS

REVENUE DECLINES CONTINUE: As Fitch anticipated, excess lottery pledged revenue collections continued to decline through fiscal 2017, and were down 5%. Based on the lottery's projections, Fitch expects ongoing revenue losses, fueled by regional gaming competition and the state's weakened economy.

STRONG DEBT SERVICE COVERAGE: Well-managed lottery operations supported by conservative revenue forecasts have maintained strong debt service coverage despite ongoing revenue declines. Statutory limitations on leveraging and legislative action in 2014 to support the securities have also

served to maintain ample coverage. Estimated debt service coverage on excess lottery revenue bonds in fiscal 2017 was 5.3x; down from 5.6x the prior year. Fitch believes the structure can adequately absorb an additional decline in revenues expected to result from a moderate recession scenario while maintaining ample coverage.

DISCRETIONARY REVENUE STREAM: Excess lottery revenues are derived from discretionary spending; are exposed to current and future competition; and are sensitive to population, personal income, and employment trends.

RELATIONSHIP TO STATE RATING: The rating is capped by Fitch's evaluation of the state's general credit, which is not currently a limiting factor for the rating given the state's Issuer Default Rating (IDR) of 'AA'/Negative Outlook. Various covenants and statutory provisions protect bondholders; however, the flow of pledged revenue is not independent of state operations.

RATING SENSITIVITIES

PLEDGED REVENUE AND DEBT SERVICE COVERAGE: The rating is sensitive to Fitch's expectation of pledged excess lottery revenue performance, additional leveraging for capital projects, and continued solid coverage levels.

CREDIT PROFILE

The 'A+' rating considers the likelihood of continued revenue declines and the discretionary nature of excess lottery revenues, which are sensitive to population, personal income, and employment trends, as well as to existing and future competition. Offsetting these inherent uncertainties is the ample coverage of debt service by excess lottery revenues, the success of the lottery commission to-date in adapting to an increasingly competitive environment, and the resilience of the security under a moderate recession scenario.

Reflecting West Virginia's support for this security, the state enacted legislation in 2014 that expanded the revenue pledged to the repayment of the excess lottery revenue bonds. Lottery and excess lottery revenue, after respective payments of corresponding debt service, are available for payment

of one another's bonds on a subordinate basis.

The lottery operates a mix of six games, including: instant or scratch-off games (6.7% of fiscal 2017 lottery sales); online numbers games (8.7%); racetrack video lottery (48.4%); limited video lottery (32%); racetrack table games (3.6%); and casino gaming at the Greenbrier Resort (a modest 0.4% of fiscal 2017 lottery sales).

REVENUE DECLINES CONTINUE

With the addition and expansion of games, total lottery sales peaked at \$1.56 billion in fiscal 2007; gross sales have declined in most years since then due to the expansion of gaming in neighboring states, a weakened state economy, and the enactment of smoking bans at certain counties' gaming establishments. Lottery revenue has also been affected by a change in the demographic profile of participants, with younger partakers demonstrating a greater interest in social gaming offerings over traditional slot machines. Sales declined 5% in fiscal 2017 and a conservative 6.8% decline is projected by the lottery in fiscal 2018.

The excess lottery fund receives a share of net profits from racetrack table games, gaming at the Greenbrier resort and from a portion of net terminal income derived from racetrack video lottery and limited video lottery. Net excess lottery revenue was \$321.1 million in fiscal 2017, down from \$337.9 million in fiscal 2016.

The lottery's forecast of a continued decline in gross lottery revenues for fiscal 2018 results in a 7.3% projected decline in deposits to the excess lottery revenue fund. Fitch notes that the lottery chooses to forecast fairly conservatively, although Fitch likewise expects a reduction in revenues in fiscal 2018.

AMPLE DEBT SERVICE COVERAGE

The forecast decline in pledged revenues is expected to lower debt service coverage on excess lottery revenue bonds in fiscal 2018. Coverage in fiscal 2017 was also lower than the prior year. Fitch expects limited future borrowing as pledged revenues after paying debt service requirements are available to fund general state operations, which have been affected by weak

revenues. While the excess lottery revenue bonds occupy successive lien positions, actual transfers into the various debt service funds are all made on the same day, the 28th day of each month.

First revenues received into the excess lottery fund are applied to funding a senior citizen property tax credit (refundable credit), which is statutorily limited to \$10 million. The EDA and SBA excess lottery bonds are secured by separate statutory allocations of \$19 million each from the state excess lottery revenue fund. The WDA debt service transfer of \$6 million, a higher education policy commission transfer of \$15 million, and the \$3 million EDA parks transfer in support of the current offering, are on parity with the SBA transfer; all transfers are subsequent to the EDA excess lottery fund transfer. Coverage on statutorily permitted debt service in fiscal 2017 was 5.3x (5x when permitted debt service on the parks bonds is considered), down from 5.6x in fiscal 2016. The current borrowing has been factored into the lottery's forecasts for several years and limited future excess lottery borrowing is currently expected. Bondholders have no lien or other security interest in the projects funded by bond proceeds.

RESILIENCE OF PLEDGED REVENUE

Excess lottery revenues are derived from discretionary consumer spending; are exposed to current and future competition; and are sensitive to population, personal income, and employment trends. West Virginia's lottery and gaming market is expected to continue on its downward trajectory over the medium term, largely fueled by a weakened state economy which has been affected by structural changes in natural resource markets. Ongoing regional competition continues, with MGM's opening of a new casino in December 2016 at the National Harbor site in Maryland negatively affecting the Hollywood Charles Town property in West Virginia. The mid-Atlantic region has reached a gaming saturation point, in Fitch's view. The state projects excess lottery bond debt service coverage to decline to a still comfortable level of 4.6x in fiscal 2018.

Assuming full leveraging up to the current statutory limits, projected pledged excess lottery revenues stressed in a 1% national GDP decline scenario indicate a 6% decline in the revenue stream. Pledged revenues would continue to provide ample coverage of maximum allowed debt service in this

scenario. Ample cushion also remains when considering the longest consecutive period of historical revenue declines.

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U.S. Tax-Supported Rating Criteria — Effective April 18, 2016 to May 31, 2017 (pub. 18 Apr 2016) (<https://www.fitchratings.com/site/re/879478>)

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