



Fitch Rates Indiana Finance Authority's \$180MM State Appropriation Bonds 'AA+'; Outlook Stable

Fitch Ratings-New York-11 August 2017: Fitch Ratings has assigned an 'AA+' rating to Indiana Finance Authority's (IFA) \$180.25 million highway revenue refunding bonds series 2017A.

The Rating Outlook is Stable.

The bonds, which will refund certain outstanding highway revenue notes, are expected to sell via negotiation the week of Aug. 14.

In addition, Fitch has affirmed Indiana's 'AAA' Issuer Default Rating (IDR) and 'AA+' ratings on outstanding Indiana appropriation-backed debt issued by the Indiana Finance Authority (IFA), the Indiana State Office Building Commission, and the Indiana Transportation Finance Authority. Fitch has also affirmed at 'AA+' the rating on the IFA's TIFIA loan with the U.S. Department of Transportation (USDOT) for the East End Crossing Project.

The IFA was established in 2005. The state's debt structure formerly was diffuse with state appropriation-backed debt issued through several commissions and authorities. The IFA is the successor agency to the former agencies.

The Rating Outlook is Stable.

SECURITY

The bonds are limited obligations of the IFA, paid from biennial state legislative appropriations made to the Department of Transportation and then to IFA.

KEY RATING DRIVERS

The 'AA+' rating on the series 2017A bonds and other appropriation-backed debt, one notch below the state's 'AAA' IDR, is based on debt service paid from lease payments, subject to legislative appropriation.

Indiana's 'AAA' IDR reflects the state's low long-term liability burden and strong operating profile including a commitment to ongoing structural budget balance and rapid restoration of fiscal flexibility in times of economic expansion. Cyclical declines can be sharp for the state, with an above-average susceptibility of state revenues to weakness during recessions. However, strong reserves and prudent budget management have helped to maintain fiscal balance.

Economic Resource Base

Despite ongoing diversification, Indiana's economy remains highly dependent on manufacturing, which makes up about one-fifth of employment and earnings in the state, approximately double the national levels. As a result, the state is prone to large economic swings in conjunction with national business cycles and is also likely to see slower overall growth than the nation. The state's seasonally adjusted monthly non-farm payroll employment declined 8.6% from its pre-recession peak to recessionary trough, versus a 6.3% decline for the nation. Despite this concentration, Indiana's job growth has been largely in line with the national trend since the Great Recession, with education and health services becoming nearly as important as manufacturing. A recent slowing of manufacturing employment gains indicates state growth may slip below national levels in the near term.

Revenue Framework: 'aa' factor assessment

Fitch expects Indiana's revenues, primarily income and sales taxes, will continue to reflect the state's broad economy that is tilted towards manufacturing, with a slower pace of growth than national trends. The state has complete legal control over its revenues.

Expenditure Framework: 'aaa' factor assessment

The state maintains ample expenditure flexibility with a low burden of carrying costs for liabilities, and the broad expense-cutting ability common to most U.S. states. 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

Indiana's long-term liability burden is just below the median for states and is well managed. The state issues debt infrequently, has been active in the public private partnership (PPP) market, and also relies on pay-go capital funding. Unfunded pensions make up a larger share of the long-term liability burden than debt issuance. The closed Teacher's pre-1996 account utilizes a dedicated Pension Stabilization Fund to manage growth of annual contributions, offsetting the plan's unfunded liability.

Operating Performance: 'aaa' factor assessment

Indiana remains extremely well-positioned to deal with economic downturns, with very strong gap-closing capacity in the form of ample budgetary reserves, robust control over revenues and spending, and a demonstrated willingness to take timely budgetary action. The state tends to rely on its significant expenditure control to deal with budgetary stress. As revenues recover, Indiana restores many of those cuts and focuses on reserve restoration.

RATING SENSITIVITIES

FUNDAMENTAL CREDIT CHARACTERISTICS: The state's ratings are sensitive to shifts in fundamental credit characteristics, including its proactive and conservative financial management, and very low long-term liabilities.

APPROPRIATION-BACKED BONDS; TIFIA LOAN: The ratings for Indiana's appropriation-backed debt are sensitive to changes in the state's 'AAA' IDR, to which they are linked.

CREDIT PROFILE

Revenue Framework

Indiana primarily relies on its sales and use tax and individual income tax for general operating revenues. Together, they account for 80%-90% of general fund revenues. The sales and use tax has gradually become more important and this trend will likely continue given recent personal income tax rate reductions.

Historical revenue growth, adjusted for the estimated impact of policy changes, has been essentially flat on a real basis over the last 10 years. Sharp declines during the recession offset strong gains in the years leading into it. Since then, revenue growth has generally been slow. Fitch anticipates the long-term trend for revenue growth will be in line with historical performance.

Indiana 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

Education is the dominant spending item for Indiana given that the state essentially fully funds basic education costs for K-12. Local education aid consumes roughly half of general fund expenditures annually. Medicaid is the next largest area of spending for the state, and the most rapidly growing one. Between 2009 and 2017, Medicaid spending grew nearly 6% on an average annual basis while overall general fund expenditures increased at a 2.6% average annual rate.

Spending growth, absent policy actions, will likely be slightly ahead of revenue growth driven primarily by Medicaid, requiring regular budget measures 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.

Federal action to revise Medicaid's programmatic and financial structure remains a possibility given recent federal legislative and administrative efforts. Most proposals to date include a basic restructuring of federal Medicaid funding to a capped amount. Whether a change in federal Medicaid funding has consequences for Fitch's assessment of a state's credit quality would depend on the state's fiscal response to those changes. Responses that create long-term structural deficits or increase liability burdens could negatively affect both the expenditure framework assessment and the IDR.

Indiana 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 for liabilities are minimal. Like most states, Indiana's operating budget (outside of Medicaid) 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. This is true even for education spending where the state directly appropriates money to local school districts.

Long-Term Liability Burden

Indiana maintains a modest long-term liability burden that should remain very manageable. Per Fitch's November 2016 State Pension Update report, the state's total net tax-supported debt and unfunded pension liabilities of \$14 billion made up just 5.1% of 2015 personal income compared to the 50-state median of 5.1%. Using more recent data and applying Fitch's revised and more conservative 6% investment return assumption, the metric remains low at 5.8%.

The state maintains close control over its pension system, with all but one small system under the oversight of the Indiana Public Retirement System (INPRS). The Public Employees' Retirement Fund (PERF) and the Indiana Teachers' Retirement Funds (TRF) are the state's primary retirement systems. The TRF includes a pay-go pre-1996 account (closed to new members) that is supported by a substantial reserve fund (Pension Stabilization Fund) meant to smooth annual growth in state contributions to support benefits.

Debt is limited to capital needs and the state is not a regular issuer. General obligation (GO) bonds are prohibited under state law resulting in a long history of using appropriation-backed bonds to meet state capital borrowing demands. The state has been a leader in utilizing PPPs, particularly for transportation needs. The largest of these projects use an availability-payment structure with payments derived from state appropriations. Fitch incorporates estimates for the outstanding related project debt on these PPPs in its assessment of long-term liabilities. While the total amounts are substantial and account for approximately one-third of total net tax-supported debt, overall debt levels remain very modest.

The current bond offering is related to the termination of one of the state's availability payment-based PPP projects for I-69, Section 5. Due to various issues with the project company, the state is in the process of taking control of the project, including redeeming outstanding private activity bonds. The series 2017 highway revenue bonds will essentially provide a portion of the financing to transition of the project to state control. Fitch anticipates additional outlays by the state in order to finish the original project, and these will be largely consistent with the state's construction-related payments under the now-terminated project agreement for the PPP.

Operating Performance

Indiana's ability to respond to cyclical downturns rests with its superior budget flexibility. Conservative fiscal practices and a somewhat concentrated, but still diverse, economy provide sufficient resources to the state to gradually restore fiscal flexibility once utilized. Indiana typically responds to budgetary stress with spending restraint and use of budgetary reserves. After enactment, 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.

As revenues recover in economic expansions, the state works toward restoring prior year cuts and rebuilding reserves. By fiscal 2012, the state had essentially reached its statutory cap for budgetary reserves (12.5% of operating revenues in the final year of each biennium); since then, excess funds have been refunded to taxpayers, directed towards pay-go capital needs, or used to defease outstanding debt. Reserve balances are held across several funds including unrestricted general fund balance, a Medicaid reserve, the rainy day fund, and a tuition reserve for K-12 education.

Current Developments

Indiana ended fiscal 2017 essentially break even on an operating basis (\$42 million surplus, or less than 1% of operating revenues) with general fund revenues falling just short (1%) of the original budget forecast although up 3.1% from the prior year. The state, as it regularly does, utilized spending reversions to bring down expenditures throughout the year as revenue collections showed signs of weakness relative to the forecast. In total, the

governor implemented over \$300 million in agency spending reversions to ensure budgetary balance. Based on the April 2017 revenue forecast technical committee projection, the state forecasts operating revenues will be up a slightly narrower 2.1% in fiscal year 2018. Given its continued prudent budget management Fitch expects the state will end the current year in structural balance with stable reserves.

Transportation funding has been a major legislative and administration priority in recent years and the state implemented a significant enhancement for transportation revenues in the most recent legislative session. The governor signed HB 1002 into law earlier this year, which will provide an estimated \$2 billion in new transportation funding between fiscal 2018 and fiscal 2021 through measures including a gas tax increase. Last year, the legislature enacted legislation drawing down just over \$400 million in the state's sizable reserves as a one-time boost for transportation projects in fiscal 2017.

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Applicable Criteria

U.S. Public Finance Tax-Supported Rating Criteria (pub. 31 May 2017)
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