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Ratings

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Summary:

Ohio; Appropriations

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US$21.5 mil certs of part (Ohio Enterprise Data Center Solutions Proj) ser 2020 due 09/01/2029		
Long Term Rating	AA/Stable	New
US$14.03 mil certs of part (Unemployment Insurance Sys Proj) ser 2020 due 03/01/2030		
Long Term Rating	AA/Stable	New

Rating Action

S&P Global Ratings assigned its 'AA' long-term rating to Ohio's approximately $35.53 million tax-exempt series 2020 certificates of participation (COPs). The outlook on the long-term rating is stable.

Securities and use of proceeds

Lease-rental payments and all other amounts paid by the Ohio Department of Administrative Services (the lessee) to the State of Ohio Leasing Corporation, Inc. (the lessor) and The Bank of New York Mellon Trust Company (the trustee), pursuant to separate master lease-purchase agreements and supplemental lease and trust agreements, secure the series 2020 bonds. The lease-rental payments are subject to biennial appropriation by the Ohio legislature to the Department of Administrative Services (DAS).

The state will use approximately $21.5 million of proceeds from the series 2020 COPs to finance the acquisition, installation, and implementation of hardware and software to expand and improve the state's cloud computing and support upgrades to enterprise shared solutions (known as the Enterprise Data Center Solutions Project). The state will use approximately $14.03 million of proceeds to finance the acquisition of an unemployment insurance and information and technology system (known as the Unemployment Insurance System Project), which will be managed by the Ohio Department of Job and Family Services.

Credit overview

Certificates of Participation

The one-notch differential for the state's COPs reflects appropriation risk associated with annual lease-rental payments. We view these bonds as having a strong relationship to the obligor. DAS has pledged its best efforts to seek appropriations from Ohio's biennial operating budget, and the state has considered the affordability of the lease payment in its long-term planning. We considered the affordability and likelihood of the lease payment, which is reflected in the (appropriation) rating and in our view of the Ohio's general creditworthiness ('AA+'/stable). In our view, provisions and terms within the master and supplemental lease agreements have no unusual political or administrative risks that may disrupt the timely payment of debt. We consider Ohio to have a strong relationship with the lessee and projects and believe the intended payment sources are strong.

The 'AA' long-term rating on the COPs reflects our view of:

- The strong contractual provisions of the master lease structure securing the COPs, including an absolute and unconditional payment provision once funds are appropriated;
- The state's longstanding and demonstrated commitment, within both the administrative and legislative branches, to allocate sufficient funds biennially to support appropriation-backed obligations; and
- The importance of appropriation debt to Ohio's overall capital bonding structure.

Strong budgetary management and recent reserve deposits cushion Ohio from near-term economic and financial effects of COVID-19

Ohio entered the fiscal 2020-2021 biennium well positioned financially, having demonstrated sound budget management during a strong period of economic growth over the last biennia and setting aside surpluses in its budget stabilization fund (BSF) to achieve the highest rainy days savings in state history at the end of the fiscal 2018-2019 biennium. Through much of the first three quarters of the current fiscal year, the state continued to experience slowing, but sustained economic growth, and a combination of expenditure savings (0.9% below estimate) and revenue growth (1.7% above estimate) through February 2020 had Ohio outperforming its budget plan, indicating that the state built some financial capacity to alleviate near-term budget pressures.

In our view, however, the global spread of COVID-19 is an evolving public health and social risk to state credit quality that has the potential to strain the Ohio's economy and financial resources in order to protect public health and safety of its residents. However, we believe Ohio's demonstrated proactive fiscal management and its buildup of strong reserves and very strong internal liquidity underpin the stable outlook, which place it in a firm financial position to address COVID-19 related social risks relative to other states. Concerted efforts at the state and national level to prevent further spread of the pandemic are ongoing, leading to the closure of large segments of the state's economy since mid-March. S&P Global Economics now forecast that the resulting economic consequences will be substantial globally, and that the baseline recession will likely be on par with economic losses experienced during the Great Recession. We estimate that the annualized U.S. real GDP will contract 5.2% this year and 34.6% in the second quarter (See "An Already Historic U.S. Downturn Now Looks Even Worse," published on April 16 on Ratings Direct). In addition, Ohio's policy response includes orders to close all public schools for the remainder of the 2019-2020 school year, restrict non-essential business operations, and limit public gatherings to contain the spread of the virus.

Due to the swift onset of an economic recession and resulting fiscal headwinds across the sector, S&P Global Ratings revised its broader U.S. public finance sector-level outlooks as an indication that credit trends, while not immediate, will likely generate more negative than positive rating actions for the remainder of 2020. For more information, see "All U.S. Public Finance Sector Outlooks Are Now Negative," published April 1, 2020 on RatingsDirect.

While the uncertainty of public health, social, and economic risks that lie ahead for Ohio will likely depend on the depth and duration of the COVID-19 pandemic, the state's historically strong government framework and disciplined budgetary management become increasingly important to manage liquidity and mitigate the demand shocks to its economic and its budget. Should the state endure a period of a nearly complete economic shutdown, its successful recovery will depend largely on the present policy responses both at national and state levels to help minimize the damage to the state's longer-term economic stability. In addition, the state's current BSF balance of nearly $2.7 billion (approximately 8% of general revenue fund expenditures) and Treasurer's liquidity fund position of nearly $6.3 billion, will in our view, afford it a degree of flexibility to manage challenges as they arise. Based on its constitutional framework, the state is effectively precluded from ending a biennium in a deficit position.

Ohio's monthly financial report for March 2020 provides some early evidence of the decline in economic activity and consumer spending brought on by the COVID-19, which dampened the state's general revenue fund receipts. General revenue fund tax revenues were $159.4 million (or 10.5%) below estimate for March, although the state's year-to-date tax receipts remain nearly or 0.5% above the budgeted estimate. Monthly non-auto sales and use tax collections were approximately $67 million (or 9.7%) below estimate for the month, although fiscal year-to-date receipts remain above estimate by 0.5%. Ohio's auto sales tax revenues were only $1.4 million (or 1.1%) below the budgeted estimate, indicating that the impact to auto sales were largely insulated in March due to a lag in sales tax remittance, but officials expect this source to experience a more material drop-off in performance in future months. Personal income tax receipts were approximately $22 million (or 5.1%) below the monthly estimate, and are 0.7% below the fiscal year estimate. Withholding growth has remained somewhat muted throughout fiscal 2020 as maximum withholding tax rates were reduced to 4.797% from 4.997% for the 2019 tax year. In our view, the effect of rising unemployment and furloughs that began in the second-half of March on withholdings and the postponement of personal income tax filings to July 15 are likely to pressure income tax receipts further, compounding negative variances through the end of the current fiscal year.

At present, Ohio has identified current budget capacity to respond, including implemented reductions to non-essential expenditures, and, the state has implemented immediate freezes on hiring for most positions, pay increases and promotions for exempt and non-exempt staff, and new contract services except those necessary for emergency services. In addition, state agencies have been directed to cut unnecessary spending up to 20% for the remainder of fiscal year 2020 and for fiscal year 2021. In our view, these responsive budgetary measures are likely to blunt the initial impact of potential revenue shortfalls and allow the state to shift resources to meet new expenditure demands, while is likely to alleviate the impact to its reserve balances and short-term liquidity.

The U.S. government's recent passage of Coronavirus Aid, Relief, and Economic Security (CARES) Act appropriates $150 billion across all states and local governments, of which Ohio will receive approximately $4.53 billion in CARES Act extraordinary federal funding to offset direct costs related to the COVID-19 pandemic and alleviate future liquidity pressures. Ohio has received a portion of the CARES Act funding disbursement, but the state is awaiting additional guidance from the federal government on eligible expenditures and other reporting requirements.

The outlook further reflects our expectation that employer contributions to the state's pension plans will continue to meet or exceed actuarially determined levels. In our opinion, Ohio's active management of the retirement system and meaningful postretirement-liability reform efforts over the past decade, coupled with a long-standing constitutional debt limit that positions the state well to manage its fixed-cost profile relative to other states, lending to our view of Ohio's long-term credit stability. Over the medium- to long-term, however, we will continue to watch for latent credit stressors for the state, including the impact of market volatility on liquidity in the state's temporary investment and pension funds.

The 'AA+' GO rating reflects what we view as Ohio's:

- Long track record of proactive financial and budget management, including the state's implementation of frequent and timely budget adjustments over time to mitigate lower revenue conditions;
- Commitment to funding budget reserves that have been, and are expected to remain, instrumental in managing budget gaps through the current and future economic cycles;
- Improved revenue and budget performance and the restoration of the budget stabilization fund (BSF), which was increased to a statutory target of 8.5% of revenue as part of the enacted 2016-2017 budget;
- Vast, broad, and diverse economy that had benefitted from steady expansion following weak performance during the past two recessions, although there is some concentration in manufacturing relative to the U.S., which anchors the employment base and is sensitive to exogenous demand shocks;
- Moderate debt levels, with rapid amortization and a conservatively managed capital and debt program, with very strong self-liquidity to withstand temporary volatility to its outstanding VRDO and interest rate swaps; and
- Significant pension reform changes and steady progress in funding other postemployment benefits (OPEB), although we continue to monitor the state's funding policy to assess the sustainability of this progress trend under more subdued investment return conditions.

Environmental, social, and governance factors

We consider Ohio to have elevated social risks given population demographic pressures of the state's aging prime working-age population and low population replacement rates statewide. We believe these long-term social risks could hamper statewide economic growth forecasts and the demographic shift could meaningfully alter revenue and spending demands that weigh on the state's financial position. However, we believe Ohio historically strong management policy framework and economic diversification efforts will help manage this risk. Although temporary, we also believe the social risk related to health and safety and COVID-19 may have an indirect impact on the state. At the same time, we view the state's environmental and governance risks as being in line with the sector and Ohio has historically maintained a strong management and policy framework to respond to developing risks.

Based on the analytic factors we evaluate for states, we have assigned a total score of '1.6' to Ohio under our state ratings methodology, in which '1.0' is the strongest score and '4.0' the weakest. This score corresponds to a 'AA+' GO rating.

For more information, see the full analysis published Feb. 04, 2020.

Stable Outlook

While our outlook horizon is up to two years, given the fluid nature of developments relating to the direct and indirect financial and economic challenges of COVID-19 pandemic over the near-term, we will continue to actively assess the implications to Ohio's credit fundamentals and debt obligations over the outlook period.

Downside scenario

Although unlikely based on recent operating trends and a strong framework for making fiscal policy decisions, sustained structural budget misalignment and a sharp decline in Ohio's reserve or liquidity position could pressure the rating. The state's concentration in the manufacturing sector could intensify this downside risk due to this exogenous economic shock or international trade conditions that materially weaken the state's core economic metrics. We recognize that state governments across the nation will face unprecedented public health and economic challenges in the near term to contain the community spread of COVID-19. The duration and severity of recent events affecting the state's fiscal profile may result in faster deterioration of its credit quality as economic conditions change.

Upside scenario

If the state is able to preserve financial stability throughout the economic recession, including maintaining strong reserve balances and very strong liquidity at least at current levels while addressing near-term financial challenges, in conjunction with exhibiting resiliency and strong growth of its economic metrics relative to peers as conditions recover, we may consider a higher rating or outlook change.

Bond provisions and structure: Series 2020 Certificates of Participation

Ohio Revised Code (ORC), Section 133.01(N) and various enabling acts provide DAS authorization to issue obligations and acquire the projects associated with the series 2020 COPs. Payments under these agreements are payable from funds budgeted and appropriated by the state legislature to the DAS. Under the Ohio Constitution, appropriations may not be made for a current lease term for more than a two-year period (current lease term end June 30, 2021), and are subject to biennial appropriation by the Ohio legislature.

Lease payments for the enterprise data center solutions project are due on the 15th day of the month preceding debt service payment, and debt service payments are due on Sept. 1 for principal and interest, and March 1 for interest only. Lease payments for the unemployment insurance system project are due on the 15th day of the month preceding debt service payment, and debt service payments are due on March 1 for principal and interest, and Sept. 1 for interest only. Ohio's biennium end is June 30 of every odd numbered year (current biennium is July 1, 2019 to June 30, 2021).

No debt service reserve fund is required under the trust indenture, which is acceptable under our criteria for leases. In our view, the timing difference between the beginning of the previous fiscal year and when debt service payments are due mitigates late budget adoption risk. This authorization continues from one fiscal year to the next unless the lessee gives written notice on or before Jan. 1 (120 days' notice) before biennium-end or immediately on incidence of non-appropriation of its intention to terminate the lease. In our view, the master-lease structure provides a strong incentive to appropriate. Under lease provisions, a lessee is required to discontinue lease payments on all leases if it discontinues payments with respect to any leases. The obligation to make lease payments is absolute and unconditional, except as expressly provided under the lease.

If sufficient funds are not appropriated to make annual lease payments to cover principal and interest on the bonds and the necessary insurance and maintenance on the leased assets, the lessee can terminate its obligations under the lease as of the end of the then-current fiscal biennium. At the same time, the lessee will not withhold any lease payments or assert any right of set-off or counterclaim, and no provision for the abatement of lease payments exist. Based on our assessment of bond documents, we do not believe these include unusual structural features that impair DAS' ability to make timely debt service payments, or permissive events of default that increase the risk of non-appropriation.