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Fitch Rates Virginia College Building Auth Ed Facilities Rev Bonds 'AA+'; Outlook Stable

Fitch Ratings-New York-05 November 2019: Fitch Ratings has assigned a 'AA+' rating to the following Virginia College Building Authority (VCBA) bonds:

--\$125.22 million educational facilities revenue bonds (21st century college and equipment programs), series 2019B;

--\$227.54 million educational facilities revenue refunding bonds (21st century college and equipment programs), series 2019C.

The bonds are expected to price via competitive sale on Nov. 13, 2019.

The Rating Outlook is Stable.

Transaction Details

The 2019 series B and C bonds are payable under a 1996 master indenture from amounts appropriated by the Virginia General Assembly, pursuant to a payment agreement. Proceeds will finance capital projects for the commonwealth's public higher education institutions and refund a portion of certain outstanding series of educational facilities revenue bonds. The projects have been legislatively approved and involve central commonwealth agencies, including the authority and the commonwealth's treasury board, which approves all bond issues payable from commonwealth appropriations.

SECURITY

The bonds are limited obligations of the authority, payable from annual legislative appropriations.

ANALYTICAL CONCLUSION

The 'AA+' rating on the VCBA bonds is based on the commonwealth's annual legislative appropriations for debt service.

Virginia's 'AAA' Issuer Default Rating (IDR) and general obligation (GO) bond ratings reflect its solid fiscal resources, conservative approach to financial operations and exceptional financial flexibility. The state's strong fundamental economic profile provides a stable revenue base and solid growth prospects. In addition, Virginia maintains a low long-term liability burden relative to economic resources.

Economic Resource Base

Virginia's economic profile remains strong with a diverse mix of industries and high wealth levels. Fitch expects the commonwealth to absorb negative effects of any federal contraction and maintain economic growth. Government and professional and business services, the state's leading sectors, drive the commonwealth's steady but slightly below national-level employment gains. Growth prospects are solid with above-average population growth and high education levels signaling a well-positioned workforce.

KEY RATING DRIVERS

Revenue Framework: 'aa'

Fitch expects Virginia's revenues, primarily income and sales taxes, will continue to reflect the depth and breadth of the economy, as well as its volatility. The commonwealth has complete control over its revenues, with an unlimited legal ability to raise operating revenues as needed.

Expenditure Framework: 'aaa'

Virginia 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 the state will be able to actively manage without threatening fiscal stability.

Long-Term Liability Burden: 'aaa'

Virginia's long-term liability burden is low and well managed. Debt issuance is carefully monitored through both constitutional limitations and more stringent policy and institutional practices. A budget-driven deferral of pension contributions weakened the funded position during the Great Recession, but has since been restored. Virginia's net pension liabilities remain below those of most states.

Operating Performance: 'aaa'

The commonwealth remains well positioned to deal with economic downturns, with exceptionally strong gap-closing capacity derived from its control over revenues and spending. Virginia has also demonstrated an ability to restore financial flexibility at times of economic recovery and expansion.

RATING SENSITIVITIES

IDR LINKAGE: The ratings on the appropriation-backed bonds are sensitive to changes in the Commonwealth's IDR, to which they are linked.

SOLID FINANCIAL MANAGEMENT: The commonwealth's IDR is sensitive to shifts in Virginia's fundamental credit characteristics including its history of timely action to address budgetary challenges.

CURRENT DEVELOPMENTS

Strong Commonwealth Revenue Growth in Fiscal Years 2018 and 2019

Fiscal 2018 general fund revenue collections grew at a robust 6%, well ahead of the 3.1% forecast, led by individual income tax revenues, which were up more than 8% from the prior year. Virginia ended the fiscal year on June 30 with over \$550 million of revenue surplus relative to the forecast. Nonwithholding revenues accounted for more than one-half of the surplus at \$326 million, primarily related to capital gains. Nonwithholding revenues can be very volatile, often heavily influenced by state or federal tax policy changes, such as the changes enacted by the U.S. Congress in December 2017 (commonly referred to as the Tax Cuts and Jobs Act, or TCJA). Importantly, withholding revenues were also up significantly, accounting for \$227 million of the surplus, indicating the sustainability of the revenue gains.

Fiscal 2019 revenue collections were up 7.1% (\$1.5 billion) yoy, above the commonwealth's official forecast of 3.2% growth. The above-forecast revenue growth was partly due to the growth in the state's net individual income tax (IIT) collections, which picked up substantially in the fourth quarter of fiscal 2019 as the commonwealth implemented legislation conforming Virginia's tax code with the TCJA and taxpayers filed more returns with clearer guidance on state tax provisions.

IIT withholding revenues, which account for the bulk of the state's gross income tax revenues, were up 3.6% (\$447.3 million) in fiscal 2019 versus a forecast 3.8%. Nonwithholding IIT revenues increased 14.5% (\$503.9 million) versus a forecast 1.5% decline, mainly due to individual nonwithholding payments that were received for the May 1 filing date. As in other states, Fitch anticipates a portion of the growth in nonwithholding was attributable to changes in taxpayer behavior related to TCJA and may not be sustained in future years at these levels.

Revised Biennial Budget Includes Reserve Contributions

Under terms of the revised biennial budget bill for fiscal years 2019 and 2020 and the tax conformity

legislation, the nearly \$800 million revenue surplus will be split primarily between one-time taxpayer refunds (\$455 million) and reserves (\$344.4 million). The taxpayer refunds were distributed in October, ranging from up to \$110 for individuals and \$220 for joint returns. The reserve allocation will be split between a constitutionally required allocation to the Revenue Stabilization Fund (RSF) of \$73.6 million and a statutory allocation of \$270.8 million to the Revenue Reserve Fund (RRF).

For fiscal 2020, the current revenue forecast reflected in the revised biennial budget bill anticipates a modest 1% increase in general fund revenue collections from actual fiscal 2019 results. This includes a 4.2% gain in gross IIT withholding revenues and 4.2% gain in sales and use tax (SUT) revenues. Overall, the budget calls for adding more than \$1 billion combined to Virginia's RSF and RRF (which includes the contributions noted above), bringing the total reserves to \$1.6 billion, or approximately 6%-7% of fiscal 2020 general fund revenues by June 30, 2020. The reserve build-up is consistent with Fitch's view of Virginia's commitment to prudent budgetary management.

The revised budget also includes a series of transportation tax and fee changes to fund interstate highway improvements, primarily for I-81. The administration estimates the revenue changes will generate \$151 million annually for I-81 improvement projects and another \$130 million for other areas of the state, including I-95, I-64 and the Northern Virginia Transportation Authority.

Revenue Framework

Virginia's income tax serves as its primary revenue source, accounting for approximately two-thirds of general fund revenues. The sales tax is the next largest component, and, together, these economically sensitive taxes provide the primary basis for the commonwealth's revenue framework.

Historical revenue growth, adjusted for the estimated effects of policy changes, has been in line with inflation over the past 10 years. Robust growth in years of economic gains is offset by sometimes sharp declines when the economy contracts. Since 2016, the commonwealth's legislature and governor have agreed to cap estimated growth in the most volatile portion of Virginia's key tax revenues (the nonwithholding components of personal income taxes) to support budget stability.

The cap, or nonwithholding collar, limits the amount of nonwithholding revenues available for appropriation at the 10-year average of nonwithholding payments as a percentage of total revenues, limited to 1% of general fund revenues. A portion of revenue received over the cap is deposited to the state's reserves. For fiscal 2019, the collar reduced the revenue forecast by \$213 million. Fitch anticipates the long-term trend for revenue growth will remain in line with historical performance given its expectations for a solidly growing economy.

Virginia has no legal limitations on its 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 are Virginia's largest operating expenses. Education is the larger line item, as the state provides significant funding for local school districts and an extensive 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 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 appears less likely in the near term given divided control in the U.S. Congress.

Overall, Virginia retains ample ability to adjust expenditures to meet changing fiscal circumstances. The state's carrying costs for debt service and retiree benefits are minimal.

Long-Term Liability Burden

Virginia maintains a low long-term liability burden that should remain well within the commonwealth's capacity to manage given its strong economic resource base. As of Fitch's November 2018 State Pension Update report, the commonwealth's total direct debt and Fitch-adjusted net pension liabilities (using a 6% investment rate of return) of \$24.5 billion made up 5% of 2017 personal income, just below the U.S. state median of 6%. Based on more recent data including the state's fiscal 2018 comprehensive annual financial report and debt outstanding as of June 30, 2018 as disclosed in recent official statements, Fitch estimates the liability ratio remained largely unchanged at approximately 5%.

GO debt constitutes less than 15% of Virginia's direct debt, with the remainder principally represented by various appropriation credits. Higher education and transportation capital needs remain large, with substantial authorized but unissued bonds. Virginia uses a statutorily established joint executive-legislative committee to annually assess its debt capacity. The committee's findings are recommendations, but the governor and legislature typically abide by them.

The commonwealth's last round of pension changes affected required contributions and plan design, with the intent of limiting further growth in its pension liabilities. System wide funding of the primary state retirement system (Virginia Retirement Systems, or VRS) declined after the Great Recession, in part due to underfunding of actuarial contributions (partially as a budget balancing measure).

Positively, the commonwealth returned to full ADC payments, ahead of its original schedule.

Operating Performance

Virginia's ability to respond to cyclical downturns rests with its superior budget flexibility, and the underlying strength of its broad economic profile allows it to restore that flexibility quickly once utilized. The strength of Virginia's economy drives solid revenue growth during economic recoveries, but during even modest downturns, declines can be abrupt and material. The commonwealth has implemented policy measures in its revenue forecasting process to mitigate fluctuations, but Fitch expects volatility to remain a feature of Virginia's revenue profile.

The commonwealth is generally able to reduce direct spending by shifting responsibilities down to lower levels of government or by deferring expenditures. Such measures are usually temporary with funding restored once state revenues recover, ensuring flexibility in future downturns. Similarly, Virginia has been able to employ short-term revenue measures to address short-term fiscal distress, such as acceleration of sales tax collection from retailers. While not sustainable over the long term, Fitch views these as reasonable measures at times of revenue decline.

Virginia also maintains a constitutionally supported RSF that provides another source of material, short-term budget relief. Consistent with the revenue volatility noted above, recoveries are quickly reflected in tax revenues and allow the commonwealth to resume its more typical practice of structurally sound budget management while restoring flexibility by rebuilding the RSF balance. Additionally, the commonwealth established a separate reserve fund, the Revenue Reserve Fund (RRF: formerly the Revenue Cash Reserve), in 2017 to provide added buffer in the event of future revenue shortfalls.

The RSF has strict constitutional limitations on its usage, and requirements for timely repayment of withdrawals, supporting restoration of reserves in times of economic expansion. Just as important, the conservative budget management approach is institutionalized, as reflected most recently in the governor and legislature's joint commitment to devote a significant portion of recent revenue surpluses toward the RRF. The nonwithholding tax revenue collar described above is another example of strong budgetary management.

These measures offset concerns around the commonwealth's relatively slow rollback of certain budget tools implemented during the Great Recession and its immediate aftermath. In 2010, Virginia implemented an accelerated sales tax collection (AST) program to shift certain tax revenues ahead one fiscal year and provide budgetary relief. While the commonwealth has gradually limited the applicability of the AST, it remains in effect for some retailers in fiscal 2020.

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Date of Relevant Rating Committee: Jul. 10, 2019

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[U.S. Public Finance Tax-Supported Rating Criteria \(pub. 03 Apr 2018\)](#)

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