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Fitch Downgrades Illinois' $2.5B Build Illinois Bonds to 'A-'; Outlook Negative.

Fitch Ratings-New York-25 May 2018: Fitch Ratings has downgraded and removed from rating watch negative the ratings on the following Build Illinois sales tax revenue bonds of the state of Illinois to 'A-' from 'AA+':

–$1.41 billion senior obligation bonds;
–$1.08 billion junior obligation bonds.

Fitch placed the bonds on Rating Watch Negative on April 4 following release of its revised criteria for rating U.S. state dedicated tax bonds. With the annual update to its "U.S. Public Finance Tax-Supported Rating Criteria", Fitch specified more limited situations in which a state dedicated tax security can be rated without regard to the state's general credit quality. Additionally, the revised criteria include detail on circumstances in which a state dedicated tax security, while not considered distinct from the state's Issuer Default Rating (IDR), can nonetheless be treated as stronger than but still linked to the state's general credit risk. In these cases, Fitch limits the rating to no more than three notches above the state's IDR.

Under the revised criteria, the degree of allowable notching above the state's IDR, for those credits that do not meet Fitch's requirements for rating without regard to the state's IDR, is informed by: the breadth of the dedicated revenues (the narrower the better); the nature of the borrowing program (the more specific the better); and the use of residual revenues (the more segregated the better).

This downgrade is based on a review of the Build Illinois bonds under the revised criteria.

The Rating Outlook is Negative, reflecting the Negative Outlook on the state's IDR, to which the Build Illinois bond ratings are now linked.

SECURITY
Build Illinois bonds have a first and prior claim on the state share of the 6.25% unified sales tax and a first lien on revenues deposited into the Build Illinois Bond Retirement and Interest Fund (BIBRI). Debt service payments on the junior obligation bonds are subordinate to outstanding senior lien debt service; the senior lien is not closed.

KEY RATING DRIVERS

RATING LINKED TO STATE IDR: Dedicated revenues for the Build Illinois bonds are structurally protected from the state of Illinois' general operations through statutory and bond document provisions, warranting a rating above the state's IDR of 'BBB', Outlook Negative. However, because the bond security includes a statutory pledge of the state share of sales tax revenues, and those revenues flow to state general operations after debt service set-asides, the bonds cannot be rated without regard to the state IDR under Fitch's revised criteria.

TWO-NOTCH DISTINCTION: The narrowness of the pledged revenue stream, based on the additional bonds test leverage limitations for the senior and junior liens, and the statutorily defined nature of the borrowing program support a rating two notches above the Illinois IDR.

ROBUST COVERAGE AND RESILIENCE: Debt service coverage on both the senior and junior lien bonds from the state share of sales tax revenues (pledged revenues) is very high. Given the legal leverage limitations, pledged revenues can sustain a significant level of decline and still maintain ample debt service coverage on both the senior and junior liens. This is consistent with a 'aaa' assessment of resilience through economic declines.

MODEST GROWTH ANTICIPATED: Illinois' economic performance, while positive, has lagged that of the U.S. as a whole and Fitch anticipates pledged revenues will grow essentially in line with inflation. This is consistent with a 'a' assessment for pledged revenue growth prospects.

RATING SENSITIVITIES
STATE IDR LINKAGE: The ratings on the Build Illinois bonds are sensitive to changes in the state of Illinois' IDR, to which they are linked.

PLEDGED REVENUE TRENDS: The ratings are also sensitive to the performance of sales tax revenues and resulting debt service coverage, although the state IDR linkage currently limits the rating to well below what an analysis of the pledged revenue stream alone would support. Limits on additional debt issuance that require very high historical coverage provide significant cushion against revenue declines.

CREDIT PROFILE

Illinois is a large, wealthy state at the center of the Great Lakes region. It benefits from a diverse economy centered on the Chicago metropolitan area. Illinois' economy has gradually shifted, similarly to the rest of the U.S., away from manufacturing to professional and business services. The remaining manufacturing sector is less concentrated in the auto sector than surrounding states but remains vulnerable to cyclical downturn. By most measures the economy has grown slower than the nation for many years, and population levels have been stagnant.

Build Illinois bonds are secured by a first priority pledge of the state share of sales tax revenues (80% of total state sales tax revenues) up to the amounts needed annually to meet debt service requirements, as well as a lien on the moneys in the fund (BIBRI) that receives monthly transfers of the state share of sales tax revenues. The state sales tax rate has been 6.25% since 1990 and the state share is defined statutorily as 80%, or 5% out of the 6.25% levy. The state share was $8.5 billion in fiscal 2017 (essentially flat with 2016), providing 26x coverage of annual debt service on aggregate debt, including the junior obligations. Debt service declines steadily each year.

Certain of the Build Illinois bonds authorized by legislation enacted in July 2009 also benefit from revenues deposited in the state's Capital Projects Fund. These revenues include sales taxes levied on candy and grooming products, and on certain beverages. Ultimate security for these bonds is the same as all other Build Illinois bonds and Fitch's analysis focuses on the pledge of the more significant state share of sales tax revenues.

LINKED TO STATE IDR
To rate a state dedicated tax security above the state's IDR, dedicated revenues must be structurally insulated from the state's general financial operations. Strong legal provisions for the Build Illinois bonds establish a flow of funds where the state share of sales tax revenues (pledged revenues) is segregated from Illinois' general operations to first meet requirements under the Build Illinois

bonds' master indenture, including for debt service. This structure enhances the prospects for full and timely payment, allowing for a rating above the state's IDR, but does not meet Fitch's criteria for rating without regard to the IDR.

As there is no bankruptcy framework available to U.S. states, evaluation of the prospects for varying security structures at a time of fiscal distress is by necessity somewhat judgemental. Absent a bankruptcy framework, the primary limit on state action and source of protection for state bondholders is the contract clause of the U.S. constitution and equivalent clauses in state constitutions. Although contract clause protections under federal and state constitutions restrict the ability of a state government to impair its obligation to pay bondholders from dedicated tax revenue, the judicial interpretations of the contract clause indicate that it does not impose an absolute constraint. One of the key legal tests of whether a contract can be impaired is whether the impairment is necessary and reasonable.

Given this legal backdrop, under the revised criteria, the only cases in which Fitch can rate a state dedicated tax bond distinct from and without regard to the state IDR are rare situations where Fitch believes that the nature of the dedicated revenue stream or the legal structure render remote the possibility of a successful impairment argument. The security must be very clearly segregated from state operations and have no nexus with general state functions. Examples include bonds issued to fund state unemployment compensation and worker's compensation systems.

STRONG LEGAL PROVISIONS
In the Build Illinois Bond Act and the 1985 master indenture for the Build Illinois bonds, the state pledges and establishes a first and prior claim on the state share of pledged revenues for payment of the bonds. The pledge is limited to the greater of the amount necessary to meet annual debt service requirements, or 3.8% of the state share – the indenture defines this amount as the Required Bond Transfer and this has been the 3.8% of pledged revenues since fiscal 2013. The Act and the indenture require the State Treasurer and Comptroller to make monthly payments of the greater of 1/12th of 150% of the certified annual debt service or 3.8% of the state's share of sales tax revenues to the trustee.

The Act serves as an irrevocable and continuing appropriation and provides irrevocable and continuing authority for the Comptroller and Treasurer to make these monthly payments, as directed by the Governor. Under the Act and Indenture, the state also covenants not to impair the rights of bondholders, and specifically not to limit or alter the basis of the pledged revenues.

TWO-NOTCH DISTINCTION
The Build Illinois bond structure warrants a rating two notches higher than the state's IDR given the narrowing of the dedicated revenues through the additional bonds tests (ABT) and the specific nature of the borrowing program. The open-ended use of residual revenues for general state operations keeps the rating below the maximum three notches above the state's IDR allowable under Fitch's criteria.

While the state share of the sales tax revenues is a broad revenue source, the leverage limitations imposed by the senior and junior liens' ABTs' significantly narrow the scope of the dedicated (pledged) revenues. At full leverage under the ABTs, 9.8% of the state share of sales tax revenues would be used for debt service.

Specific uses for Build Illinois bond proceeds are defined in the Act. While the four defined uses are broad, the Act also explicitly lists specific projects or types of projects to be funded with Build Illinois bond proceeds. The state has targeted its use of the Build Illinois program with bond proceeds primarily used by three agencies (Department of Commerce and Economic Opportunity, Department of Natural Resources, and the Environmental Protection Agency) and for smaller economic development projects. The state has not used the program for general capital borrowing.

The state share of sales tax revenues in excess of the annual Required Bond Transfer is available for general operations. Sales tax revenues are a key revenue source for Illinois' general operations, comprising between 25%-30% of annual general fund revenues in most years. The recent increase in income tax rates will reduce the portion of general fund revenues derived from sales tax revenues, but they will remain significant. Also the indenture permits the state to transfer excess pledged revenues at the end of each fiscal year to its general fund. The state reports that $2.5 million is typically kept within the indenture with any amounts above this transferred to the general fund. Between fiscal 2015 and 2017, the state transferred an average of approximately $125 million of excess pledged revenues to its general fund.

EXCEPTIONAL RESILIENCE OF PLEDGED REVENUES

To evaluate the sensitivity of the dedicated revenue stream to cyclical decline, Fitch considers the results of the Fitch Analytical Sensitivity Tool (FAST), using a 1% decline in national GDP scenario, as well as assessing the largest decline in revenues over the period covered by the revenue sensitivity analysis.

Based on a 15-year pledged revenue history, FAST generates a 3% scenario decline for the state share of sales tax revenues in the first year of a moderate economic downturn. The largest peak-t--trough historical decline was 12% between fiscal 2008 and 2010.

Additional bonds tests require debt service be no more than 5% of the state's prior year sales tax receipts to issue senior lien bonds and 9.8% to issue junior obligation bonds; this effectively requires 20x coverage to issue senior lien bonds and 10.2x coverage to issue junior obligation bonds. With issuance up to the 10.2x ABT for junior lien bonds (the maximum legal leverage on the pledged revenues), the state share of sales tax revenues could withstand a 90% decline – equivalent to 31x the projected decline in Fitch's scenario of a moderate economic downturn and 7.5x the largest historical peak-to-trough decline – and still cover maximum annual debt service . This is an exceptional level of resiliency.

MODEST GROWTH IN REVENUES

With a relatively slowly growing state economy, Fitch expects pledged revenues will grow essentially in line with inflation. Sales tax revenues are economically sensitive, as illustrated by the cumulative 12% decline during the Great Recession. Revenue performance was more robust after the end of the Great Recession. But growth has tailed off recently and fiscal 2017 collections were roughly equal to fiscal 2015. The state reports that the current softness is caused in part by lower gasoline prices. The state levies its sales tax on gasoline as a percentage of the per-gallon price. Over the past decade and including the Great Recession, average annual growth in pledged revenues has been 1.4%, just below inflation. Fitch anticipates pledged revenues will grow modestly on a real basis over the long term.

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In addition to the sources of information identified in Fitch’s applicable criteria specified below, this action was informed by information from Lumesis and InvestorTools.

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