FitchRatings

**RATING ACTION COMMENTARY**

# Fitch Affirms Vermont's IDR and GO Bonds at 'AA+'; Outlook Stable

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Fitch Ratings - New York - 26 Jun 2020: Fitch Ratings has affirmed the following ratings for the state of Vermont:

--Issuer Default Rating (IDR) at 'AA+';

--Outstanding general obligation (GO) bonds at 'AA+';

--Outstanding Vermont Municipal Bond Bank (VMBB) bonds issued under the 1988 general resolution rated by Fitch at 'AA-'.

The Rating Outlook is Stable.

### SECURITY

The GO bonds are general obligations of the state of Vermont backed by the state's full faith and credit.

The Vermont Municipal Bond Bank's 1988 General Resolution bonds rated by Fitch benefit from enhancement provided by Vermont's moral obligation pledge.

### ANALYTICAL CONCLUSION

The 'AA+' IDR and GO rating reflect conservative financial management, including prompt action to address projected budget gaps as they emerge and maintenance of sound reserves, both of which position the state well to absorb budgetary implications of the coronavirus pandemic. The moderate long-term liability burden, measured as a percentage of personal income, is above the median for U.S. states but should remain relatively stable given Vermont's close oversight and management of debt issuance and policy changes to improve pension sustainability over time.

The 'AA-' rating on the Vermont Municipal Bond Bank's 1988 General Resolution bonds is due to the linkage with the state's IDR. The rating reflects the enhancement provided by Vermont's moral obligation pledge. The two-notch distinction is warranted by the broad state purposes served by the bonds and the state's involvement in the program as evidenced by the makeup of the board of directors (including the state treasurer and gubernatorial appointees) and a related state aid intercept provision.

### ECONOMIC RESOURCE BASE

Vermont's small and modestly growing economy has a larger-than-average reliance on health and educational services, manufacturing, and tourism and remains exposed to several key large employers. During the Great Recession, Vermont's peak-to-trough monthly employment loss of 4.8% (seasonally adjusted levels) was less severe than the national 6.3% decline. But the state's jobs decline in the current coronavirus-driven downturn has been materially weaker than the rest of the nation with a 22.9% peak-to-trough decline versus 14.5% for the nation. The state's initial rebound in on-farm payrolls off that trough has outpaced national gains, though overall levels remain depressed across the U.S.

Vermont's population is older than most states, and growth has been relatively limited. The state's labor force has been flat to declining over the past decade, in contrast to slow growth at the national level. As with several other New England states, high educational attainment levels provide some potential for economic gains, but Vermont has not fully benefited from that potential to date.

## KEY RATING DRIVERS

**Revenue Framework: 'aa'**

Fitch anticipates Vermont's revenues used for state operations will grow at a modest pace, consistent with our long-term expectations for the state's economy. Property taxes represent the largest component of state revenues and have grown at a robust rate, but these revenues do not drive the state's overall revenue framework. Property tax revenues are essentially passed through to school districts and are adjusted annually based on multiple factors including decisions of voters in those school districts. The state has complete legal control over its revenues.

**Expenditure Framework: 'aaa'**

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. Vermont has been particularly focused on addressing healthcare spending, including Medicaid, which is a key expense driver.

**Long-Term Liability Burden: 'aa'**

Vermont's long-term liabilities burden is above the median for U.S. states but remains moderate.

**Operating Performance: 'aaa'**

Fitch anticipates Vermont will utilize its broad gap-closing capacity to manage through economic downturns while maintaining a high level of fundamental financial flexibility. The state has taken steps during the expansion to expand its flexibility and position itself well for the next downturn.

## RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

Material and sustained improvement in the state's demographic profile, such as through consistent population and labor force gains, could support stronger revenue growth prospects and a more robust revenue framework assessment.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

--A severe economic contraction extending well into the second half of the year or beyond, consistent with Fitch's coronavirus downside scenario, which triggers greater than anticipated, sustained and deep revenue declines and materially erodes the state's gap-closing capacity.

--Once economic recovery begins, an unanticipated and sustained deviation from Vermont's demonstrated commitment to improving its fiscal resilience and carefully managing its long-term liability burden, particularly in the context of modest long-term revenue growth expectations.

## BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Public Finance issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

## CURRENT DEVELOPMENTS

Sector-Wide Coronavirus Implications

The coronavirus outbreak creates an uncertain global environment for U.S. state and local governments and related entities in the near term. As severe limitations on economic activity have only affected states in recent months, state governments' fiscal and economic data have yet to fully reflect the implications. Material changes in revenues and expenditures are occurring across the country and likely to worsen in the near term. Fitch's ratings are forward looking, and Fitch will monitor developments in state and local governments as a result of the virus outbreak as it relates to severity and duration and incorporate revised expectations for future performance and assessment of key risks.

In its baseline scenario, Fitch assumes sharp economic contractions hit major economies in the first half of 2020 at a speed and depth that is unprecedented since World War II. Recovery begins from the third quarter of 2020 onward as the health crisis subsides after a short but severe global recession. GDP remains below its fourth quarter 2019 level until mid-2022. Additional details, including key assumptions and implications of the baseline scenario and a downside scenario, are described in the April 2020 report 'Fitch Ratings Coronavirus Scenarios: Baseline and Downside Cases - Update' and 'Fitch Ratings Updates Coronavirus Scenarios for U.S. State and Local Tax-Supported Issuers' on www.fitchratings.com.

Federal Aid Provides Some Support for State Budgets

Federal aid measures enacted in recent months will benefit state budgets, although details remain fluid. The Families First Coronavirus Response included a 6.2 percentage point (pp) increase in the Federal Medical Assistance Percentage (FMAP) for Medicaid for every quarter of the national public health emergency. FMAP is the rate at which the federal government reimburses states for Medicaid spending. Vermont anticipates receiving $38 million in the first half of 2020 from the enhanced FMAP. The ultimate value of the FMAP rate increase will depend primarily on the state's actual Medicaid spending.

Under the Coronavirus Aid, Relief and Economic Security (CARES) Act enacted on March 27, the U.S. Treasury department distributed $150 billion to state and local governments using a population-based formula. The statute limits the use of funds to coronavirus expense reimbursement rather than to offset anticipated state tax revenue losses. Vermont received the statutory minimum of $1.25 billion. The legislature and governor have put forward various proposals to utilize the funding including support for higher education and healthcare institutions, expanded broadband capacity and businesses affected by the coronavirus. The state also anticipates reserving between $200 million - $250 million for revenue replacement in case Congress revises the statutory limitations on the funding, as some recent federal legislation has proposed.

CARES also provides for supplemental federal aid for local school districts, passed through state departments of education with the Elementary and Secondary School Emergency Relief Fund (ESSER). The act allocates $31 million to Vermont, with a minimum of approximately $28 million designated for local school districts, all to be spent within one year of receipt for a fairly broad set of allowable uses.

Coronavirus - Vermont Liquidity Update

Fitch anticipates Vermont will address short-term liquidity pressure with no interruption in timely payments for key operating expenses, including debt service. The state does not intend to access the Federal Reserve's $500 billion Municipal Liquidity Facility.

Vermont extended its due date for personal and corporate income tax (PIT and CIT) payments by 90 days, to July 15, aligning with the federal government's extension. The state currently estimates the extension could shift receipt of approximately $130 million in income tax collections to July 15, which Vermont will accrue back into fiscal 2020 for accounting and reporting purposes. Other tax deferrals increase the total shift to almost $140 million. Fitch estimates these deferrals at about 9% of the state's most recent (June 8) fiscal 2020 forecast for general fund revenues of $1.5 billion. Lower tax collections attributable to the economic downturn will also reduce liquidity. In its June 8 forecast, the state estimates a $60 million YOY decline in general fund revenues in fiscal 2020, or approximately 4%, attributable to economic weakening. The shortfall versus the January 2020 consensus forecast (the last pre-pandemic estimate) is $41 million or 3%.

Vermont retains ample resources to address the potential cash flow gap of nearly $200 million (estimated shift plus economic decline). As of May 31, 2020, the state held just under $300 million in unrestricted cash balances, which includes $224 million of dedicated general fund operating reserves, $14 million in the transportation fund reserve and $37 million in the education fund reserve. The state also has the $1.25 billion in CARES Act funding noted earlier. While the state is developing specific plans for allocating this funding, only a small portion has actually been spent to date and therefore remains a potential source of short-term liquidity, particularly to bridge the delayed PIT and CIT payments.

Coronavirus - Vermont Budgetary Update

Vermont is well positioned to utilize its superior gap-closing capacity to manage through the current downturn, despite initial economic data implying substantial job losses exceeding that of other states. Following a steep decline in April of more than 20% from the prior month, Vermont's non-farm payrolls jumped up more than 6% in May. This compares to a national decline of just under 14% in April and a more modest nearly 2% increase in May. Payrolls for Vermont, and the nation, remain well below pre-pandemic levels reflecting the deep and sustained economic dislocation. High-frequency economic data indicates similar trends. Tracktherecovery.org reports consumer spending in Vermont declined nearly 38% in early April from January 2020 levels, compared to a 31% to 32% trough for the U.S. As of mid-June Vermont's consumer spending is down 6% versus 9% for the U.S.

In the June 8 revenue forecast, Vermont estimated a less than 3% ($41 million) fiscal 2020 decline in the general fund versus the January 2020 forecast and a 4% decline in its combined primary operating funds of $106 million. Primary operating funds include the general, education and transportation fund, net of the statewide property tax and transportation infrastructure bond revenues allocated for dedicated tax bond debt service. Versus the prior year, the revenue shortfall is $87 million across the primary operating funds, also 4%. The state's estimate of PIT and CIT revenues deferred until the July 15 deadline mitigates the projected revenue loss but also creates some uncertainty as those levels are unknown until collected.

To address the revenue gap for fiscal 2020, the state recently enacted a fiscal 2020 budget adjustment act that primarily uses a combination of the enhanced FMAP ($35 million), additional fund transfers ($8 million) and previously unallocated balances ($8 million in the education fund). The state also made immediate spending reductions including a hiring freeze effective in April, travel restrictions for state employees and holding off on new programs and expansion of existing programs.

For fiscal 2021, the revenue forecast is considerably more negative and uncertain, and the state is taking reasonable measures to position itself to address the resulting fiscal challenges. The June 8 forecast anticipates an 11% YOY general fund revenue decline ($176 million), and a nearly 9% decline across primary operating funds ($203 million). The state legislature and governor are negotiating a short-term budget covering the first quarter of fiscal 2021 (through September 30) to allow the state government to continue operating while providing additional time to assess economic and revenue conditions before adopting a full-year spending plan. The budget essentially holds funding flat with most agencies authorized to spend up to 25% of their fiscal 2020 funding levels. Debt service and retirement costs are fully funded for the year. Vermont's legislature will reconvene in August and anticipates receiving an updated consensus revenue forecast reflecting new economic and fiscal data, including final collections of income taxes deferred to the new July 15 deadline.

The state retains $224 million in general fund dedicated operating reserves and $274 million across all primary operating funds, covering 11% of projected fiscal 2020 revenues across all primary operating funds. Neither the fiscal 2020 budget adjustment act nor the anticipated interim fiscal 2021 budget utilize the dedicated operating reserves. The state may utilize a portion of the transportation funding reserve (currently $14 million) to balance fiscal 2020 for that fund on a cash basis. During the Great Recession, and again in a more recent shortfall, the governor, legislature, and other key stakeholders including employee unions, worked quickly to develop spending rescission plans to address emerging deficits. The state's recent trend has been to focus on expenditure cuts, such as negotiated wage reductions or programmatic cuts, rather than revenue increases, and Fitch anticipates that trend will continue. Vermont projects that the spending restrictions implemented several months ago and noted above will lead agencies to end fiscal 2020 with unspent appropriations that can be carried forward into fiscal 2021 to help mitigate overall tax revenue losses.

May 2020 revenue collections reported by the state are generally consistent with the June 8 forecast, after accounting for the state's estimate of the effects of delaying income tax payment deadlines. General fund collections of $1.5 billion were down 8% YOY ($117 million). Across all three primary operating funds, total revenues were down 6% YOY ($124 million).

Updated FAST Scenario Analysis for Vermont

The Fitch Analytical Stress Test (FAST) scenario analysis model, which relates historical tax revenue volatility to GDP to support the assessment of operating performance under Fitch's criteria, has now been adjusted to reflect GDP parameters consistent with Fitch's global coronavirus forecast assumptions. FAST is not a forecast, but it represents Fitch's estimate of possible revenue behavior in a downturn based on historical revenue performance. Hence, actual revenue declines will vary from FAST results. FAST does provide a relative sense of the risk exposure of a particular state compared to other states.

Vermont has robust financial resilience that should allow it to absorb the budgetary effects of Fitch's coronavirus baseline scenario and ultimately rebuild that resilience through the eventual recovery period. The state appears to be less vulnerable to cyclical revenue declines tied to economic downturns than most other states. The current coronavirus baseline scenario results in a 9% first-year decline in Vermont's revenues, followed by a 7% increase in year two and a cumulative 1.5% increase over the three-year scenario. This compares to the states' median decline of 16.6% in the first year and negative 5.8% over the three-year scenario.

A more severe recession of the depth and duration of Fitch's downside scenario would pose more of a challenge to the state's financial resilience but one Vermont still appears positioned to absorb without materially affecting its long-term ability to restore and then maintain robust financial resilience. Under this scenario Vermont's first-year decline would be 18%, followed by a rebound of 9% in the second year. The cumulative three-year decline of 7% is stronger than the median 21.5% decline for all states reflecting the state's lower revenue sensitivity to national economic downturns.

### CREDIT PROFILE

For additional information on the state's general credit, please see Fitch's press release " Fitch Downgrades Vermont's IDR to 'AA+'; Rates $125MM GOS 'AA+'; Outlook Stable" dated July 10, 2019 and available at 'www.fitchratings.com.

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

### REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

### ESG CONSIDERATIONS

The highest level of ESG credit relevance, if present, is a score of 3. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity(ies), either due to their nature or to the way in which they are being managed by the entity(ies). For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

**RATING ACTIONS**

| ENTITY/DEBT | RATING | | | PRIOR |
|---|---|---|---|---|
| Vermont, State of (VT) [General Government] | LT IDR | AA+ Rating Outlook Stable | Affirmed | AA+ Rating Outlook Stable |
| • Vermont Municipal Bond Bank (VT) /Revolving Fund Revenues - 1988 General Resolution/1 LT | LT | AA- Rating Outlook Stable | Affirmed | AA- Rating Outlook Stable |
| • Vermont, | LT | AA+ Rating Outlook Stable | Affirmed | AA+ Rating |

VIEW ADDITIONAL RATING DETAILS

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## APPLICABLE CRITERIA

U.S. Public Finance Tax-Supported Rating Criteria (pub. 27 Mar 2020) (including rating assumption sensitivity)

## APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

FAST States & Locals - Fitch Analytical Stress Test Model, v2.4.0 (1)

## ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

## ENDORSEMENT STATUS

| | |
|---|---|
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| Vermont, State of (VT) | EU Endorsed |

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