Municipal Market Comments

Ascent Investment Partners

August 14, 2014

from Montage Investments

Kansas Downgraded by S&P Over Budget Concerns

On August 6, S&P downgraded its ratings on the State of Kansas by one notch lowering the state's Issuer Credit Rating (ICR) to AA from AA+. Since Kansas does not issue general obligation (G.O.) bonds at the state level, the rating agencies assign an issuer rating to reflect what the general credit quality of the state would be. They then use that rating as the baseline to determine the credit ratings of appropriation-backed and other non-G.O. debt. As a result, S&P also downgraded the ratings of certain Kansas state and local agency bonds that are secured by a pledge of funds appropriated by the state legislature. The affected issues include a wide variety of issues from the Kansas Development Finance Authority (KDFA) as well as certain issues sold through the Topeka Public Building Commission and the Wichita Public Building Commission.

State of Kansas Bond Ratings (As of August 10,2014)

	Ratings	Outlooks
Issuer Rating[1]	Aa2/AA/AA	stable/negative/stable
Appropriation bonds[2]	Aa3/AA-/AA-	stable/negative/stable
KDOT Highway Revenue Bonds	Aa2/AAA/AA+	stable/stable/stable

[1] No G.O. debt outstanding. Listed ratings and outlooks reflect the issuer rating or the highest rating on state-supported debt.

[2] Bonds secured by state appropriations and issued through KDFA or local agencies.

Sources: Fitch Ratings; Moody's; S&P

S&P's downgrade follows a similar one-notch downgrade by Moody's in April 2014. ***As we noted in our credit review at the time of the Moody's downgrade, we continue to view the State of Kansas as a high-quality issuer that presents very little credit risk to investors.*** The state's phased income tax rate cut presents the possibility of steep revenue declines and growing budget pressures. It is these cuts, without identified revenue or expenditure offsets, that have raised rating agencies' concerns over future budget gaps. However, we believe Kansas has a history of effective financial management that has generally maintained solid financial operations with adequate reserves. For example, the state extended a temporary sale tax increase to offset some of the income tax revenue losses and has taken other one-time actions to redistribute state funds. ***We believe that Kansas will take the necessary steps to ensure that it maintains a solid financial position and high credit quality, and Ascent will not reduce its holdings of Kansas state bonds as a result of this rating action.***

Kansas' top income tax rate dropped to 4.8% in 2014 and is scheduled to decline to 4.6% in 2015. In 2018, the state's top income tax rate is scheduled to drop to 3.9%, with future cuts that will be phased in if state revenues grow faster than 2% per year. Kansas projected that income tax revenues to the state will reduce state receipts by over $100 million in each year through 2018 and by over $300 million in 2019. The governor's plan envisions a more competitive tax environment that will boost economic growth and generate additional revenues under the revised tax structure. In the near term, the state closed budget shortfalls in Fiscal Years (FYs) 2014 and 2015 (the current budget year) by tapping the state's general budget reserve.

S&P's analysis of Kansas notes that it believes "there will be additional budget pressure as income tax cuts scheduled in future years go into effect, or if mid-year revenue shortfalls resume." The factors weighing on the state's credit quality include:

- The likely need for expenditure cuts to offset revenue declines from the already-approved income tax reductions;
- The expectation that Kansas' budget reserves will be substantially depleted by the end of Fiscal Year 2015 (ending June 30, 2015) absent unexpected growth in revenues from other sources; and
- Significant unfunded pension liabilities that offset the state's low direct debt level. Kansas has made some structural changes to its future employee benefits and has raised contributions in 2014 and 2015. However, the state's funding level in FY2013 stood at 59.9%, well below the average state funding level of approximately 75%.

Like Moody's did in May, we expect that S&P will review other Kansas issuers with direct or indirect financial ties to state appropriations, including the Kansas Department of Transportation (KDOT), the University of Kansas, and Kansas State University. While we don't expect ratings on KDOT or the state's universities to necessarily decline just because of a drop in the state's ratings, it is possible that S&P could place those ratings on CreditWatch or assign negative rating outlooks if it believes that the level of state support could come under pressure in future state budgets. Kansas local school districts should be fairly well insulated from this action, given that recent court rulings could force the state to dedicate more funds to local districts.

We continue to believe that the State of Kansas has a solid credit foundation that will support strong ratings over the long term. Kansas' credit strengths include:

- Historically strong governance with a proven track record of conservative financial management;
- An economy that has improved in line with national averages despite a heavier-than-average concentration in manufacturing (especially aerospace);

- Solid financial performance in recent fiscal years that has rebuilt reserves to adequate levels, though these are projected to draw down substantially in the next year; and
- Relatively modest debt levels that somewhat offset the above-average unfunded contingent pension liabilities.

We will continue to closely monitor developments and their potential impacts on the state's credit rating.

Brian Tournier
Director of Research
Ascent Investment Partners

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