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State of Kansas: Issuer Credit Rating

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Credit Profile
AFFIRMED
Kansas Issuer Credit Rating
AA+

OUTLOOK:
STABLE

Rationale

Kansas' 'AA+' issuer credit rating (ICR) reflects the state's general creditworthiness. Credit factors include the state's:

- Relatively diverse economic base, which limits the effects of softness in manufacturing and agriculture;
- Conservative fiscal management that has so far maintained financial stability through revenue shortfalls;
- Very low debt burden; and
- Good liquidity, ensured by statutorily mandated cash reserves.

Kansas' economic growth slowed in 1999-2000 from its rapid levels in the mid-to late 1990s. Employment growth has slowed to less than 1.0% from 3.5%, driven by manufacturing employment declines. Virtually all segments of the aerospace industry initiated additional cuts following September 11th, although the full effect of these cuts will not be felt until 2002 when many of the layoffs occur. Services and telecommunications growth is expected to slow, in addition to large layoffs at companies like Sprint. Despite these economic blows, the state's unemployment rate and personal income growth have so far remained stable.

The state's finances continue to be stressed by revenue shortfalls and growing entitlement expenditures. Without additional revenue sources, cuts in important state services like education and transportation could be necessary in the coming fiscal year. Although the state's general fund balances are expected to decline to about 4% of expenditures by the end of fiscal 2002, state statutes help ensure that Kansas' liquidity position will not become dangerously low in the future; statutes require lawmakers to pass each annual budget with measures to restore the state's balances to a level equal to 7.5% of budgeted expenditures.

Although the Kansas Constitution allows for the issuance of GO debt under certain circumstances, the state has not exercised this ability since 1919. Instead, debt issuance consists of highway bonds issued by the Kansas Department of Transportation (KDOT) and lease revenue bonds and certificates of participation issued through the Kansas Development Finance Authority (KDFFA). Along with the strength of legal provisions and high project essentiality, the state's creditworthiness is an important factor in assessing its appropriation-backed debt. Debt service as a percent of budget remains low at about 1%, and the state has one of the lowest per capita debt ratios in the nation. Kansas' highway revenue bonds, representing the majority of debt outstanding, currently enjoy 6 times (x) coverage of maximum annual debt service by pledged taxes and fees.

Outlook

Kansas' stable outlook reflects Standard & Poor's expectation that ongoing strong financial management and conservative statutory provisions should enable the state to maintain adequate reserve levels while addressing expenditure pressures resulting, in part, from slowed revenue growth.

Economy

Kansas, with a population of 2.6 million, is the 14th-largest state in terms of size, encompassing more than 82,000 square miles, and the geographic center of the 48 contiguous states. Although much of the state is rural, the ongoing development of its highway transportation network has led to significant commercial and industrial investment, decreasing dependence on farming and agribusiness. Kansas' leading economic regions are centered on the northeastern and south-central portions of the state. Much of the recent development has occurred in northeastern Kansas, specifically in the Kansas City MSA.

The Kansas economy had already slowed during 1999-2000, well before September 11th. Growth in total nonfarm employment decreased to 1.1% in 1999 and 1.4% in 2000 from 3.5% in 1998. Total employment increased 2.6% in 1999 but fell 2.4% in 2000. Unemployment, however, remains below 4%. Nominal personal income growth remained above 5% through 2000.

With significant layoffs enacted and planned by several of the state's leading private employers, continued economic softness appears likely.

Although the potentially volatile transportation equipment industry accounts for about 28% of the state's manufacturing jobs, Kansas' diversity of firms catering to different segments of the aerospace industry has often buffered it—and Wichita specifically—from past volatility. Due, in part, to the events of September 11th, however, most aerospace segments appear to be suffering. In Wichita, Raytheon, Boeing, and Bombardier laid off more than 4,000 employees combined during 2001; an additional 3,000 jobs are expected to be cut next year. On the eastern side of Kansas, layoffs are also hitting the state's telecommunications industry through Sprint's decision to lay off 3,000 Kansas City area employees. Like the Wichita cutbacks, most of Sprint's layoffs will actually occur in the coming year despite the fact that they were announced well in advance.

Weakness in agricultural prices continues to make the state's farmers more dependent on federal subsidies, therefore influencing farmers' decisions about what crops to plant. Kansas accounts for about 20% of the nation's wheat production. While the state plays a large role in the U.S. agricultural sector, agriculture has now declined to a small part of the state's overall economy. Many rural communities, however, remain closely tied to agriculture; additional declines without federal assistance could put pressure on the state to provide further assistance, as well.

Finances

After cutting taxes and simultaneously increasing spending without harming fund balances during the mid- to late 1990s, fiscal 1999 revenues failed to meet budget estimates. This led to a \$315 million general fund deficit at the

end of the year, cutting the general fund balance by 23% to \$599 million (or 14% of actual expenditures). Facing further revenue shortfalls in fiscal 2000, Gov. Bill Graves ordered agencies to begin reducing their current-year budgets by 1% in September 1999. Fiscal 2000 consensus revenue estimates were later revised downward by \$37.2 million, leading to a lower initial 2001 revenue estimate. In response, Gov. Graves proposed a \$65 million, or 1.5%, reduction to the fiscal 2000 budget. The state Legislature adopted the proposal with minor revisions; the final measure's cuts affected all agencies, with the exception of primary and secondary education, services for the aged, and juvenile justice. Kansas realized a \$189 million general fund deficit during fiscal 2000, leaving reserves at 9.9% of actual expenditures and transfers.

In May 2000, the Legislature adopted a fiscal 2001 budget, allowing for expenditure growth of just 0.4% in order to maintain the mandated ending fund balance equal to 7.5% of budgeted expenditures. This lean budget allowed the state to keep its liquidity relatively stable during the fiscal year despite continued revenue shortfalls. Kansas ended fiscal 2001 with a relatively small \$6.7 million deficit.

In response to a \$185 million predicted revenue shortfall in April 2001, the final 2002 budget passed by the Legislature diverted \$51 million, which was originally intended for the senior services trust fund, to other areas and reduced general fund spending for transportation by \$20 million. Additional spending cuts were included; Gov. Graves, however, vetoed the cuts, which dealt with agency shrinkage and state employee pay. In November 2001, revenue forecasters again slashed fiscal 2002 estimates by \$113 million and established an initial revenue estimate for 2003—more than \$400 million below the amount needed to meet the upcoming demands on the state, according to Gov. Graves. Additional expenditure cuts are not expected during fiscal 2002, which will bring the state's balances down to around 4% of expenditures by year-end.

State law requires the governor to present a 2003 budget in January that restores general fund balances to 7.5% of budgeted expenditures without proposing additional taxes. Because of this requirement, the proposed budget is expected to include significant cuts in state priorities, such as education and transportation. Adding to the problems are the state's growing Medicaid and other entitlement expenditures, which are adding an additional \$120 million to the coming year. Although Gov. Graves is required to take these budgetary actions, he recently introduced restoration proposals that would provide funding for some of the items cut through increases in sales, motor fuel, and cigarette taxes. Some legislators opposed to tax increases favor increasing gaming across the state in order to fill some of the gap.

Debt

Kansas has no GO debt outstanding. Historically, the state financed most general capital projects through ad valorem taxes and other dedicated revenues attributable to educational, institutional, and correctional facilities' building funds. The KDFA was created in 1987 as a state agency to provide access to long-term capital financing resources. Historically, projects financed under the auspices of KDFA have included correctional facilities, office buildings, and energy conservation improvements. In recent years, the scope of financed projects has expanded somewhat to include the state capitol,

Kansas National Guard Armories, and public broadcasting facilities. Bonds issued to finance such projects are secured by annual appropriations made by the Kansas Legislature.

The largest area of capital spending has been, and will likely remain, highway transportation. Following the success of KDOT's 11-year, \$5.8 billion comprehensive highway program enacted in 1989, the 1999 Kansas Legislature overwhelmingly approved a new 10-year, \$12.9 billion comprehensive transportation plan, including provisions for an additional \$980 million of highway revenue bonds ('AA+', stable outlook). The next largest area of capital spending has been for the Kansas Board of Regents, or the education building fund, which is used to build, renovate, or replace buildings on the campuses of the state's universities. The education building fund has been supported by a statewide property tax mill levy since 1984. Funds are appropriated by the state Legislature and pledged for repayment of the bonds.

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