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Rating Update: MOODY'S DOWNGRADES STATE OF NEVADA'S GENERAL OBLIGATION BONDS TO Aa2 FROM Aa1, CERTIFICATES OF PARTICIPATION TO Aa3 FROM Aa2; REVISES OUTLOOK TO STABLE

Global Credit Research - 24 Mar 2011

STATE HAS $2.3 BILLION IN NET TAX-SUPPORTED DEBT OUTSTANDING

State
NV

Opinion

NEW YORK, Mar 24, 2011 -- Moody's Investors Service has downgraded the rating of the State of Nevada's outstanding General Obligation bonds to Aa2 from Aa1 and the rating on the state's Certificates of Participation to Aa3 from Aa2. At the same time, Moody's has revised the outlook on the state to stable from negative.

SUMMARY RATING RATIONALE

The downgrade to Aa2 rating reflects three main factors: (1) a structural shift in Nevada's economy caused by the profound economic impact of the recession, (2) an economy that is relatively narrow and driven by gaming and tourism and (3) decreased financial flexibility. The factors are interrelated; the collapse of the real estate market has contributed to large declines in sales tax revenues (one quarter of total revenues), which in turn has led to the state's depletion of available reserves and has put into focus the state's reliance on volatile discretionary spending. The gaming industry had traditionally not been adversely affected by recessions but the recent protracted recession had a negative impact on the industry. Our expectation is that the gaming sector's recovery will be subdued. A substantial real estate inventory overhang will prolong recovery in residential construction and diminish housing's role in the economy going forward. The stable outlook reflects our belief that while the economy is very weak and will remain weak for the near to medium future, there are some early signs of economic and revenue stabilization in the state.

CREDIT STRENGTHS:

- Healthy liquidity: the state maintains ample cash and has not needed to resort to deficit financing or cash-flow borrowing.

- Good governance including a history of expenditure restraint below projected revenues, strong executive powers to make mid-year budget cuts, timely publication of audited financial information and debt affordability studies and conservative revenue estimation.

- Below-median combined debt and unfunded pension liability ratios.

CREDIT CHALLENGES:

- A highly concentrated economy that is dependent on discretionary spending on gaming and tourism.

- Lack of revenue diversity - no personal income tax. The State has missed out on the increase in income tax revenues seen elsewhere.

- A large structural imbalance between recurring revenues and expenditures that has been reconciled previously by temporary taxes, the depletion of available reserves and fund sweeps. The renewal of revenue enhancements requires approval of 2/3rds of a divided legislature.

DETAILED CREDIT DISCUSSION

HIGH UNEMPLOYMENT PRESSURES SALES TAX REVENUE; LACK OF REVENUE DIVERSITY EXACERBATES VOLATILITY

Nevada is lagging other states coming out of the recent recession. January's unemployment rate was the highest of any state at 14.2%, having fallen from 14.9% in December as discouraged workers exited the labor market. The construction industry shed 87 thousand jobs since peaking at 146 thousand in 2006. Persistently high unemployment has taken its toll on sales tax revenues, one quarter of total revenues. Sales tax revenues were down 23% in fiscal 2010 compared to 2007.

The lack of revenue diversity exposes the State to the risk that either sales tax revenues or gaming-related revenues may falter. Most other states have a personal income tax while Nevada's constitution prohibits one. Although most other states experienced revenue shortfalls during the recession, Nevada's other main source of income, the gaming sector, was negatively impacted by the downturn in consumer spending. Gaming taxes, fees and license revenue in fiscal 2010 was 18% lower than in 2007.

BURSTING OF HOUSING BUBBLE DEFLATES ECONOMY

Nevada grew 35.1% between 2000 and 2010, the fastest growth rate of any state. The population growth fueled a boom in construction and a bubble in home prices that exceeded the national average. The nation-wide real estate bust affected Nevada the worst in terms of changes in activity, foreclosures and prices. After averaging 3.5% and leading the nation for two decades, population growth fell to 1% in the last two years. The job-creating engine of the construction industry collapsed in the face of a supply glut and diminished underlying economic factors such as gaming and tourism sector employment.

With homes prices in metro Las Vegas 58% below their peak, the large overhang of foreclosed homes will prolong Nevada's exit from the recession and prevent that sector from contributing to economic growth to the extent that it did during previous periods of economic expansion. Increases in home equity in Nevada supported consumer spending and state sales tax revenues. Coming out of the recession, this source of revenue growth support is no longer present.

The national decline in home prices affects discretionary spending via the wealth effect. With a quarter of Las Vegas visitors coming from California, the sharp decline in home prices and slow rebuild of home equity there will continue to sap spending per visitor.

EXTENSION OF REVENUE ENHANCEMENTS REQUIRES LEGISLATIVE SUPERMAJORITY

In responding to revenue shortfalls, the State enacted various temporary taxes to balance the budget such as increasing business taxes, requiring the advanced payment of mining taxes, implementing a room tax and diverting certain property taxes to the General Fund. The reserves Nevada built up during economic expansion have been depleted eliminating that financial cushion.

The need to renew taxes on a biennial basis, should revenues continue to lag spending, presents a challenge to maintaining fiscal balance. Also, a 2/3rds majority of each house of the legislature is required to renew the taxes into the 2012-2013 biennium and beyond. The supermajority requirement to raise taxes presents a hurdle to achieving balance on an ongoing basis going forward.

BELOW AVERAGE DEBT RATIOS IS A CREDIT POSITIVE

Nevada has a below average amount of debt outstanding; it ranks 30th in terms of debt as a percentage of personal income. One reason for the State's low historical use of debt is that its Constitution limits debt to 2% of assessed valuation. As of June 30th, 2010, the State has $490 million remaining in debt capacity, providing the State with financial flexibility should borrowing be needed.

When Nevada's approximately $1.6 billion unfunded pension liability is added to its outstanding debt, it ranks 42nd among states in terms of combined debt and pension liability as a percentage of personal income. Although the State makes required contributions to its main Public Employees Retirement System, the funded ratio was 70.5% at the end of fiscal 2010. Pension reforms enacted last year include increasing the retirement age and increasing early retirement penalties and are expected to aid in raising the funding level over time.

GAMING SECTOR RECOVERY UNDERWAY- ALBEIT SLOWLY; SHOULD SUPPORT ECONOMIC GROWTH

Nevada's principal source of exogenous growth has historically been the gaming and tourism sectors. The gaming sector is recovering and we expect this trend to continue but at a significantly slower pace than before. Statewide gaming revenues and collections were up 1.2% fiscal year-to-date January as Las Vegas visitor volumes increased 8.6% in January after having grown 2.7% in 2010.

Increased gaming activity should translate into greater employment in the leisure and hospitality sector, which is down 12% from its high in 2007. This, in turn, should lead to some recovery in real estate markets where construction industry employment is off 60% from its peak in 2006 and metro Las Vegas home prices have slid 58%. The glut of housing supply built up during the boom years will take some time to work through as population growth begins to recover.

Outlook

The stable outlook reflects our expectation that the economy will recover slowly in the state and that the state's finances will be weak in the next biennium.

What could change the rating - UP

- Diversification of economy and revenue sources combined with steady, sustained economic growth.

- Structural build-up of healthy reserves to buffer future revenue downturns.

What could change the rating - DOWN

- Revenue underperformance with budgetary solutions that delay achievement of structural balance.

- A sustained decline in Nevada gaming and tourism brought about by a decrease in consumer discretionary spending.

- Decline in quality of financial management; failure to cut spending should revenues fall short of projections.

The principal methodology used in this rating was Moody's State Rating Methodology published in November 2004.

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