

## CREDIT OPINION

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New Issue

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## State of New Mexico

New Issue – Moody's assigns Aa1 to New Mexico's \$307M GO bonds, 2017A&B; outlook negative

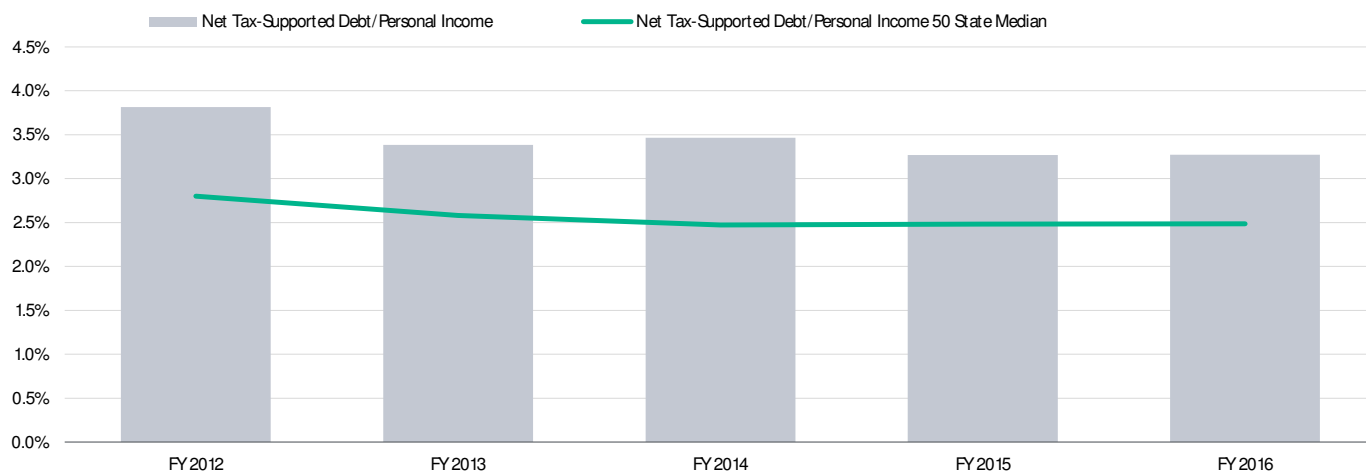
### Summary Rating Rationale

Moody's Investors Service has assigned Aa1 ratings to the State of New Mexico's Capital Projects General Obligation Bonds Series 2017A and its General Obligation Bonds Refunding Series 2017B, expected to be issued in a total amount of approximately \$307 million. Following this issuance, the state will have approximately \$403 million general obligation bonds outstanding, all rated Aa1. The outlook on these ratings remains negative.

The Aa1 rating on the state's general obligation bonds incorporates recent positive financial developments including timely action by the state to rebalance the fiscal 2017 budget and bolster reserves in response to lower revenue estimates released in December; the stabilization of, even slight improvement in, the General Fund's financial position; and recent, albeit limited, favorable revenue trends. An additional factor is the state's establishment of a Rainy Day Fund to capture future growth in oil- and gas-related revenues, which should enhance budget discipline in periods of increasing revenue.

At the same time, the Aa1 rating reflects a number of strengths, including the state's history of taking timely action to maintain budgetary balance and the expectation that it will act to rebuild reserves in the near future. Debt levels are moderate and have been declining. The state's GO bonds represent only a small portion of its net tax-supported debt and benefit from particularly strong security provisions. Pension liabilities, while notable, are comparable to the medians for US states. Balanced against these strengths are an economy that has lagged the nation's, below-average wealth levels, and financial reporting practices which, while improving, are weaker than typical for a US state.

Exhibit 1

**State's Debt Levels Are Moderate and Decreasing**

Source: Moody's Investors Service state debt medians reports.

**Credit Strengths**

- » Governor and legislature acted quickly to replenish reserves which would have been negative as result of revenue shortfalls in 2016 and 2017.
- » Debt levels and pension liabilities are moderate.
- » General obligation bonds benefit from very rapid payout and particularly strong security provisions.

**Credit Challenges**

- » Despite actions taken by the state, general fund reserves are below prior forecasts and recent history.
- » State's economy has lagged the nation's; economic diversity is relatively low, with concentration in energy and government employment; wealth levels are below average.
- » State faces spending pressures, in the near term, to restore programs cut in recent years, and in the longer term, to assist school districts in addressing their pension liabilities.
- » Financial reporting practices, while improving, are weaker than typical for a US state.

**Rating Outlook**

The outlook on the state's general obligation bonds and related ratings is negative reflecting the risk that further revenue declines could pose new budget challenges for the state and impair its ability to rebuild reserves.

**Factors that Could Lead to an Upgrade**

- » Return to robust revenue growth and rapid restoration of reserves to historical levels or higher.

**Factors that Could Lead to a Downgrade**

- » Further declines in revenues.

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- » Failure to rebuild reserves.
- » Deterioration in unemployment rates or other economic indicators.

## Key Indicators

Exhibit 2

New Mexico	FY 2012	FY 2013	FY 2014	FY 2015	FY 2016
General Fund Recurring Revenues (000s)	5,802,100	5,708,000	6,040,100	6,194,700	5,708,800
Balances as % of Recurring Fund Revenues	12.3%	11.8%	10.6%	9.9%	2.6%
Net Tax-Supported Debt (000s)	2,745,360	2,519,445	2,622,700	2,563,850	2,623,075
Net Tax-Supported Debt/Personal Income	3.8%	3.4%	3.5%	3.3%	3.3%
Net Tax-Supported Debt/Personal Income 50 State Median	2.8%	2.6%	2.5%	2.5%	2.5%
Debt/Own-Source Governmental Funds Revenue	37.0%	31.9%	30.2%	28.4%	N/A
Debt/Own-Source Governmental Funds Revenue Median	37.4%	36.1%	35.8%	34.4%	N/A
ANPL/Own-Source Govt. Funds Revenue	112.6%	78.1%	73.6%	65.6%	N/A
ANPL/Own-Source Govt. Funds Revenue Median	92.6%	90.8%	83.0%	84.9%	N/A
Total Non-Farm Employment Change (CY)	0.3%	0.9%	1.0%	1.0%	0.4%
Per Capita Income as a % of US (CY)	80.0%	78.1%	79.0%	78.9%	78.3%

Source: State of New Mexico audited financial statements; Moody's Investors Service state debt and pension medians reports; US Bureau of Economic Analysis; US Bureau of Labor Statistics.

## Recent Developments

In its December 2016 consensus revenue forecast, the state projected that fiscal 2017 General Fund recurring revenues would be \$108.2 million below the August forecast, primarily due to lower estimates for sales and income taxes. In its regular session, beginning January 2017, the legislature enacted and the governor approved a second round of mid-year adjustments, primarily \$125.5 million in one-time measures, to rebalance the fiscal 2017 budget in response to the December forecast.

Also in its regular session, the legislature adopted a budget for fiscal 2018, including tax increases, but the governor vetoed the tax increases and appropriations for the legislature and higher education. In a special session in late May, the legislature amended the budget for fiscal 2018, restoring the appropriations for the legislature and higher education and again including tax increases. The governor approved the appropriations budget, but again vetoed the tax increases.

Recent revenue trends have been positive compared to the December forecast, with fiscal 2017 revenues expected to exceed the forecast by approximately \$130 million. The state currently estimates that, after giving credit for the additional fiscal 2017 revenues, General Fund balances will increase from \$147.8 million (2.6% of recurring revenue) at the end of fiscal 2016 to \$316.1 million (5.5%) at the end of fiscal 2017. Based on the final adopted budget and again accounting for the additional fiscal 2017 revenues, reserves are currently projected to be \$178.3 million (3.0%) at the end of fiscal 2018.

## Detailed Rating Considerations

### Economy

The state's economy has below-average diversity, with a concentration in government, and oil and gas extraction. Income levels are below average; per-capita personal income is 78.3% of the US level. While the state's unemployment rate remained below the US rate during the recession, it has exceeded the US rate in since mid-2014 and in some recent monthly data has been the highest in the nation. GDP growth has been more volatile than the US, and has fallen short of the US rate in every year but one since 2012.

The significant government sector is primarily attributable to the presence of two national laboratories and several major military facilities. While generally a stabilizing factor in the state's economy, government-related employment did experience some reductions due to federal budget cuts. With recent budget agreements, the laboratories have received appropriations that enable the resumed hiring of contractors. Proposed increases in defense spending for the coming years, if approved, could benefit the state's government sector.

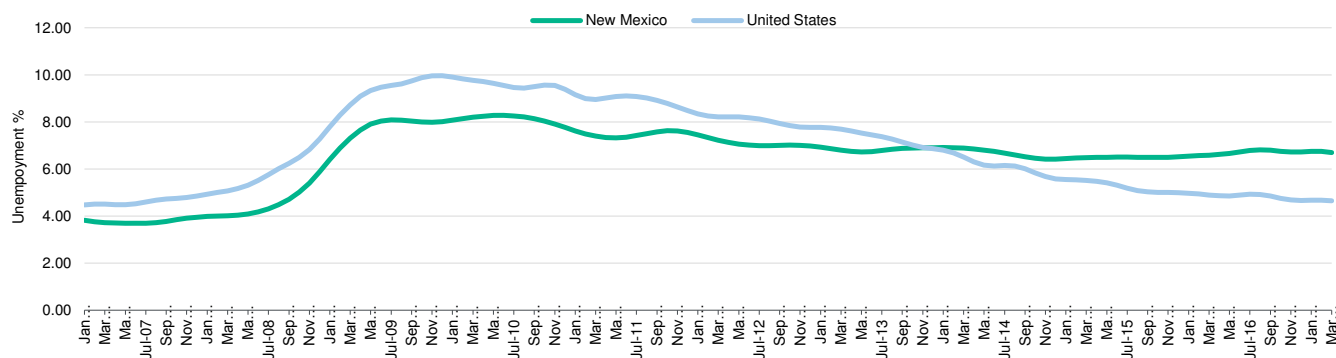
New Mexico is the sixth-largest producer of crude oil in the nation. The majority of the state's oil is produced in the Permian Basin in the southeastern portion of the state. The volume of oil production has increased rapidly since fiscal 2009, reaching a record level in

fiscal 2016. Oil prices and the taxable value of oil produced peaked in fiscal 2014. The state is the seventh-largest producer of natural gas in the nation, with the majority of the state's production in the San Juan Basin in the northwestern corner of the state. The volume of gas production has been in gradual decline since fiscal 2005. Gas prices and the taxable value of gas produced peaked in fiscal 2008.

Economic activity and state revenues vary considerably based on the prices of oil and gas, the levels of production, and the amount of new drilling. Oil and gas activity was fairly strong during the economic downturn, moderating the recession's effect on New Mexico compared to other states. But the significant decline in oil prices after 2014 caused a steep reduction in energy-related employment and state revenues. Job losses in oil and gas were largely offset by gains in health care, driven in part by Medicaid expansion; professional services, including contractor hiring at the federal labs; and hospitality and tourism.

Exhibit 3

### State's Unemployment Rate Now Exceeds US Rate



Source: US Bureau of Labor Statistics.

## Finances and Liquidity

General fund revenues from mineral extraction are derived primarily from oil and gas production and consist of a number of "severance" taxes, primarily the Emergency School Tax, and rents and royalties from production on public, primarily federal, land. These revenues are separate from the tax which secures the state's severance tax bonds. Other general fund revenues consist primarily of general sales, personal income, and corporate income taxes.

The oil- and gas-related revenues in the general fund have historically been volatile and declined significantly after fiscal 2014 with the steep fall in oil prices. These revenues fell by 13.8% in fiscal 2015 and 29.1% in 2016. With the stabilization of oil prices, oil- and gas-related revenues have shown some improvement—they are currently projected to increase by 9.5% in fiscal 2017 and 4.9% in 2018.

Despite the sharp decline in oil and gas revenues in fiscal 2015, the state was able to maintain relatively stable and adequate reserves in that year as a result of cautious budgeting and continued growth in other revenues, primarily income taxes. At the end of fiscal 2015, available general fund reserves totaled \$713 million (11.6% of recurring revenues), roughly comparable to prior years' levels.

At the time the fiscal 2017 budget was adopted in February 2016, the state projected that based on the budget and the January revenue forecast, total reserves would remain adequate: \$491 million in 2016 and \$595 million in 2017. But the state's August revenue estimates showed an extremely large reduction in estimated General Fund revenues for both fiscal 2016 and fiscal 2017, compared to the January forecast, primarily the result of shortfalls in sales and income taxes. The fiscal 2016 revenue estimate was reduced by \$348 million, resulting in a significant drawdown of total General Fund reserves to \$132 million or 2.3% of recurring revenues. The fiscal 2017 revenue estimate was reduced by \$556 million, throwing the budget into structural imbalance. Absent any legislative action, the August estimates would have resulted in an ending reserve deficit for 2017 of \$323 million, or -5.7% of recurring revenues.

The legislature met in special session in September and enacted a number of measures to address the shortfall. These actions included \$22.5 million of recurring revenues, primarily closing some tax loopholes; \$130.2 million in non-recurring revenues, including transfers of balances from other funds; and \$210 million in recurring expenditure reductions including cuts to K-12 and higher education. Despite these actions, the fiscal 2017 budget still had a structural deficit (recurring revenues less recurring appropriations) of \$285 million, or

5.0% of recurring revenues. And general fund reserves were expected to remain extremely narrow, well below prior forecasts and recent history – \$148 million (2.6% of recurring revenues) in fiscal 2016 and \$59 million (1.0%) in fiscal 2017.

The state made a second round of mid-year adjustments for fiscal 2017 in February and adopted its final budget for fiscal 2018 in May, (see Recent Developments). Current estimates show a notable improvement in fiscal 2017 general fund ending balances (\$316.1 million or 5.5% of recurring revenues) due to the mid-year budget adjustments made in regular session, revenues coming in stronger than December forecasts, and reimbursement of general fund for capital expenditures from severance tax fund. The final adopted budget for fiscal 2018 is projected to draw down balances to \$178.3 million or 3.0% of recurring revenues.

## LIQUIDITY

Liquidity levels have been quite strong in recent years. The state has not issued TRANs since fiscal year 2010. With the depletion of general fund reserves, liquidity levels have declined but remain adequate. Month-end liquid assets excluding bonds funds averaged \$1.3 billion in the most recent 6 months.

## Debt and Pensions

### DEBT STRUCTURE

Although they have declined over the last four years, New Mexico's debt levels remain somewhat above [Moody's 50-state medians](#). Net tax-supported debt as a percent of personal income was 3.3% for 2016, compared to the median of 2.5%. Net tax-supported debt per capita was \$1,260, compared to the median of \$1,006. General obligation bonds represent only a small portion, 12.5%, of the state's \$2.6 billion net tax-supported debt, the majority of which consists of transportation revenue bonds and severance tax bonds.

The state's general obligation bonds are issued with a maximum maturity of 10 years. As a result, payout is extremely rapid; approximately 60% of principal will be repaid in three years. The general obligation bonds also benefit from strong security features. The bonds are paid from a dedicated statewide property tax levy without limit as to rate. The treasurer is required to keep tax proceeds separate from all other funds. Payment of debt service from property taxes does not require appropriation. The state's practice is to levy the tax in advance so that debt service is pre-funded.

### DEBT-RELATED DERIVATIVES

The state has no derivatives related to its general obligation or severance tax bonds. The New Mexico Department of Transportation has \$420 million in interest-rate swaps related to its variable rate transportation revenue bonds issued through the New Mexico Finance Authority. The swaps hedge interest rate risk, but add counterparty risk and make it difficult for the department to reduce its variable rate exposure.

### PENSIONS AND OPEB

New Mexico's pension liabilities are below [Moody's 50-state medians](#). The state's pensions are primarily provided through the multi-employer Public Employees Retirement Association (PERA). Moody's adjusted net pension liability (ANPL) for the state for fiscal 2015 is \$5.9 billion. Its three-year average ANPL through 2015 equaled 68% of total governmental own-source revenues, below the 88% median for all US states. The state also reports a UAAL for other post-employment benefits (OPEB) of approximately \$3.4 billion. The state's fixed costs—including debt service, Moody's calculated "tread water" pension cost, and OPEB contribution—equal 6.7% of revenues, below the median of 8.5%.

## Governance

The state has many best governance practices including a consensus revenue forecasting process, multi-year revenue projections, and timely budget adoption. In addition, in conjunction with the FY 2018 budget, the state has established a Rainy Day Fund to capture future growth in oil- and gas-related revenues. While it will likely take some time before the fund builds up any sizable balance, the mechanism should enhance budget discipline in periods of increasing revenue.

At the same time, the state's financial reporting has had numerous weaknesses. Prior to fiscal 2013, the financial statements in New Mexico's Comprehensive Annual Financial Report (CAFR) were not audited. The statements were only "reviewed," which indicates a substantially lower standard of verification. In addition, the CAFRs have not been released on a timely basis. Prior to fiscal 2007, CAFRs were issued on average 19 months after the end of the fiscal year.

The state has made significant progress in improving its financial reporting. The fiscal year 2013 and 2014 CAFRs were audited, but these audits contained numerous findings related to cash reconciliations and consolidations. The state is committed to a number of initiatives to eliminate the findings and improve the timeliness of its CAFRs. The audited 2015 CAFR was released in early July 2016, 12 months after the end of the fiscal year, and the number of audit findings was substantially reduced. The 2015 audits reflected enough progress on cash reconciliation to allow the state to release the \$100 million special reserve it had established to cover any adjustments necessary to resolve the cash discrepancies. The fiscal 2016 CAFR is expected to be released in July 2017. Moody's expects that the state will make continued improvement in its financial reporting.

The state does provide timely, audited financial statements for its major agencies and for its statutory General Fund. The statutory General Fund, also known as the "Component Appropriation Accounts" or the "Component Appropriation Funds," is not exactly equivalent to the GAAP-basis General Fund shown in the CAFR. In particular, it excludes certain departmental revenue accounts that are included in the GAAP General Fund. Even so, the two representations of the General Fund have tracked very closely. These agency statements provide sufficient verified information to evaluate the state's financial performance, but the absence of timely, unqualified comprehensive statements remains a credit challenge.

### Legal Security

New Mexico's general obligation bonds are secured by the full faith and credit of the state and specifically secured by and paid from a statewide property tax levy without limit as to rate. The treasurer is required to keep the property tax proceeds separate from all other funds. The payment of general obligation bonds from other than ad valorem taxes collected for that purpose requires an appropriation by the legislature. If at any point there is not a sufficient amount of money from ad valorem taxes to make a required payment of principal or interest on state general obligation bonds, the governor may call a special session of the legislature in order to secure an appropriation of money sufficient to make the required payment.

### Use of Proceeds

Proceeds of the Series 2017A bonds will be used to fund elements of the state's capital program. Proceeds of the Series 2017B bonds will be used to refund outstanding bonds for debt service savings.

### Obligor Profile

New Mexico is the 36th-largest state by population, at 2.1 million. Its state gross domestic product, \$93.3 billion, is the 37th-largest. The state's wealth levels are below average, with per capita personal income equal to 78.3% of the US level and a poverty rate among the highest for US states.

### Methodology

The principal methodology used in this rating was US States Rating Methodology published in April 2013. Please see the Rating Methodologies page on [www.moody's.com](http://www.moody's.com) for a copy of this methodology.

### Ratings

Exhibit 4

#### New Mexico (State of)

Issue	Rating
Capital Projects General Obligation Bonds Series 2017A	Aa1
Rating Type	Underlying LT
Sale Amount	\$153,600,000
Expected Sale Date	07/18/2017
Rating Description	General Obligation
General Obligation Bonds Refunding Series 2017B	Aa1
Rating Type	Underlying LT
Sale Amount	\$153,600,000
Expected Sale Date	07/18/2017

Rating Description  
*Source: Moody's Investors Service*

General Obligation

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