FitchRatings

Tagging Info

Fitch Rates Philadelphia Auth for Industrial Development, PA's Lease Rev Rfdg Bonds 'A-'

Ratings Endorsement Policy

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Fitch Ratings-New York-29 May 2014: Fitch Ratings has assigned an 'A-' rating to the following Philadelphia Authority for Industrial Development (PAID) lease revenue refunding bonds:

--$57.3 million 2014 series B.

The bonds are expected to sell through a negotiated sale the week of June 9. The bonds are being issued to refund PAID's outstanding 2007B4 bonds.

At this time, Fitch has also affirmed the following ratings:

--$1.4 billion in city general obligation (GO) bonds at 'A-';
--$262 million in Philadelphia Municipal Authority (PMA) bonds at 'A-';
--$2 billion in bonds issued by PAID at 'A-';
--$212 million in bonds issued by the Philadelphia Redevelopment Authority (RDA) at 'A-';
--$14 million in bonds issued by the Philadelphia Parking Authority (PPA) at 'A-'.

The Rating Outlook is Stable.

SECURITY

Bonds issued by the PMA, RDA, PAID and PPA are secured by an annual service fee or lease rental payments payable by the city of Philadelphia (the city) under non-cancelable agreements. The city's obligation to make payments required by the service agreements or lease agreements is absolute and unconditional. The city's GO bonds are secured by the full faith and credit general obligation and its ad valorem tax pledge, without limitation as to rate or amount.

KEY RATING DRIVERS

CONSTRAINED FINANCIAL FLEXIBILITY: Fund balance has shown notable improvement beginning in fiscal 2011. However, financial flexibility is constrained by a high overall tax burden, a somewhat low general fund balance position, and a high level of fixed costs.

SIZEABLE DEBT BURDEN: Debt ratios will likely remain elevated over the long term.

LARGE UNFUNDED PENSION LIABILITY: The city's pension fund is poorly funded. The city has made some effort to improve funding, but Fitch expects the liability to remain high.

WEAK SOCIOECONOMIC PROFILE: Wealth levels remain notably low and above-average unemployment persists. Despite this weakness, Philadelphia remains an important center for healthcare and higher education with good prospects for long-term economic stability.

SOLID BUDGETARY CONTROLS: Fitch views positively management's efforts in recent years to contain costs and raise available revenues, although significant budgetary pressures remain.

RATING SENSITIVITIES

MAINTENANCE OF FINANCIAL FLEXIBILITY: Sustained structural balance would aid the city's financial flexibility, while recurring deficits would cause concern.

PENSION FUNDING IMPROVEMENT: Successful implementation of plans to improve pension funding levels would be viewed positively.

CREDIT PROFILE

IMPORTANT ECONOMIC CENTER TEMPERED BY CHALLENGING DEMOGRAPHICS

Philadelphia is both a city and county with a population of slightly more than 1.5 million. The city serves as a regional economic center with a stable employment base weighted in the higher education and healthcare sectors. Led by the University of Pennsylvania, Jefferson Health System, and Temple University, the city is home to several large colleges and universities and is anchored by multiple hospitals and health systems. Several of these institutions are engaged in sizeable development projects, and the city has also benefitted from notable investments by local corporations including Comcast and Urban Outfitters.

Above-average unemployment and weak income indicators persist, although current data suggests some recent improvement. The unemployment rate was measured at 8% in March 2014, while the unemployment rates of the broader metropolitan statistical area (MSA) and commonwealth were appreciably lower at 6.7% and 6.4%, respectively.

Income levels grew at a slightly better clip over the prior decade in comparison to the state and nation but continue to be weak at just 68% of the MSA and 78% of the commonwealth and nation in 2011. The city's poverty rate stands at 26%, approximately twice the MSA, state and nation. The population has grown slightly over the last decade after nearly 50 years of population loss.

The Philadelphia School District (the district; rated 'BB,' Outlook Negative) remains a challenge for the city. The district has had multiple years of structural imbalance. The city has contributed funds to assist the district, and the need to continually do so in the future could be a drain on the city's resources.

CONSECUTIVE SURPLUSES REVERSE TREND OF DECLINES

The city has diverse sources of revenues. Primary sources include the wage and earnings tax (the largest at 45% of general fund tax revenues), the real estate tax, the business income and receipts tax, the sales tax, the property tax, various charges for services, and state aid. Although recent performance has been strong, many of the primary revenue streams have historically shown significant volatility.

Recessionary pressure coupled with a depressed housing market prompted a significant decline in tax revenues between fiscals 2008-2010 (fiscal year end June 30), leading to multiple years of large operating deficits. Management responded favorably with a number of expenditure cuts. The city also suspended through fiscal 2014 long-running annual rate cuts in its wage and business privilege taxes as part of a comprehensive budget-balancing plan. In fiscal 2010, the city implemented a temporary five-year sales tax increase and the partial deferral of annual pension costs over the ensuing two fiscal years.

Fiscal 2011 ended with a sizeable $106.4 million general fund operating surplus (after transfers) on a GAAP basis, which improved the unrestricted general fund balance to a still weak negative $46 million or -1.2% of spending. On a budgetary basis, the city reported a minimal year-end general fund balance of $92,000.

Fiscal 2012 continued the improvement shown in fiscal 2011, with a $113 million operating surplus on a GAAP basis, bringing the unrestricted general fund balance to $71 million or 2% of expenditures. On a budgetary basis, the surplus was $147 million, notably better than the budgeted $60 million surplus. The surplus and outperformance of budget resulted from tax revenues growing 4.4% over fiscal 2011 and $34 million of one-time pension aid from the commonwealth.

LARGE PROJECTED DEFICIT IN 2014 OFFSETS 2013 SURPLUS

Fiscal 2013 showed further improvement, with the unrestricted general fund balance on a GAAP basis increasing $118 million to $188 million or 4.7% of expenditures. On a budgetary basis, the surplus was $110 million, increasing fund balance to $257 million, well ahead of budget. The surplus was driven by a $163 million (6.3%) increase in tax revenues, with the Business Income and Receipts tax (BIRT) showing 16% growth. Employee compensation costs were up $96 million (4%).

The fiscal 2014 budget projects a $102 million fund balance draw and included the reservation of an additional $85 million to fund a portion of unsettled labor contracts. BIRT revenue was projected to decline after the rapid increase in fiscal 2013. After three quarters, the projected fund balance draw has been increased to $137 million, with a budgetary basis fund balance of $120 million. The weakening projections are largely due to increased labor costs from the city's withdrawal of its appeal of a ruling on firefighter compensation and the settlement of another labor contract. BIRT revenue is again well ahead of budget, offsetting projected underperformance by the wage tax.

The city is implementing the actual value initiative (AVI) in fiscal 2014, the first revaluation of the city's property tax base in many years. The city is currently projecting an approximately 2.7x increase in market value, though the sizable reduction of the tax rate and increased collections are designed to make the change revenue neutral for fiscal 2014. The city prudently implemented steps to mitigate the impact on residents facing steep increases. Fitch believes the AVI is a credit positive as the city will be better able to accurately tax all of the city's properties.

The city recently released its latest five-year plan for fiscal years 2015-2019. Fund balance is projected to continue declining in fiscal 2015 and 2016 before gradually growing in the final three years of the plan to finish at $72 million. The five-year plan includes the reservation of funds for future settled and unsettled labor agreements. Several tax rates are projected to gradually decline.

The plan assumes the sales tax is extended, but the first $120 million of the projected $138 million to be received from the sales tax in fiscal 2015 will go to the school district. The next $15 million will be used from fiscal 2015-2018 to pay debt service on a borrowing to aid the school district.

Additional funds beyond this will be devoted to the city's pension fund. Excess sales tax revenues are forecasted at $2.8 million in fiscal 2015 and grow to $39 million in fiscal 2019, assuming growth in the sales tax and the end of the four years of debt service payments.

This sales tax extension plan is subject to approval by the city council and state legislature in the next month. There are also other plans being considered that would direct more sales tax revenues to the city's pension plan and less to the school district.

The city relies on annual cash flow notes for liquidity. The $173 million note issuance for fiscal 2012 was well below historical borrowings and the fiscal 2013 borrowing was $127 million, reflecting further improvement in the city's liquidity. The fiscal 2014 borrowing of $100 million continued this trend, and liquidity is now at a more stable level.

LABOR PROGRESS

The majority of the city's labor contracts are in various states of negotiations or legal challenges, but the city has recently made progress on resolving some contracts. The city has prudently budgeted for cost increases from the unsettled contracts. Positively, some contracts that have been settled and contain features that are expected to lower the city's future pension costs. The city recently reached an agreement with DC 47 for the period from 2009-2017. This contract featured no retroactive payments but wage increases going forward, increased employee pension contributions with new employees being given the option of entering a hybrid plan, and revised health benefits and work rules.

HIGH DEBT LEVELS; PENSION FUNDING EXPECTED TO IMPROVE

The city's aggregate debt burden, which includes debt associated with the Philadelphia School District, remains notably high at almost $4,700 per capita and 17% of market value using the result of prior, antiquated property assessment practices. The projected new market value using AVI would lower the debt ratio to a still-high approximately 6.4% of market value. Debt amortization is average with 55% amortizing within 10 years.

Pension funding continues to be a key credit concern for Fitch, despite the recent implementation of cost-saving changes to pension benefits for newly settled contracts. Full funding of the annual obligation resumed in fiscal 2012 following a partial deferral for budgetary relief in the previous two years. Annual pension payments rose by 13% and 5% in fiscals 2013 and 2014, respectively, to meet the repayment obligation.

Pension costs consumed a high 17% of annual general fund spending in fiscal 2013, including repayments. The most recent actuarial report shows a low funded ratio of 47% and an unfunded liability of $5.3 billion. Using Fitch's 7% discount rate assumption, the city's pension plan would be about 44% funded.

The city has made some contributions of excess funds to the pension plan, and it has proposed several actions that could materially improve pension funding. Should the sales tax extension plan noted above be implemented, any excess receipts beyond what would be given to the school district would be contributed to the pension plan, above the required contribution.

The city is also in contract to sell Philadelphia Gas Works to a private buyer; the contract is awaiting city council approval. The city has pledged approximately $425 million of proceeds of the sale to the pension plan, again in addition to the required annual contribution. This payment will also lower the city's required contribution going forward, but the city plans to continue contributing at its current level, effectively over-funding its actuarially required contribution. The city's actuary projects that the $425 million contribution would improve the plan's funded level by approximately 4%. Fitch views positively this effort to reduce the large unfunded pension liability.

The city's other post-employment benefit liability is also sizable at $1.5 billion. Carrying costs are 17% of government fund expenditures.

Contact:

Primary Analyst
Eric Friedman
Director
+1-212-908-9181
Fitch Ratings, Inc.
33 Whitehall Street
New York, NY 10004

Secondary Analyst
Karen Wagner
Director
+1-212-908-0230

Committee Chairperson
Amy Laskey
Managing Director
+1-212-908-0568

Media Relations: Elizabeth Fogerty, New York, Tel: +1 (212) 908 0526, Email: elizabeth.fogerty@fitchratings.com.

Additional information is available at 'www.fitchratings.com'.

In addition to the sources of information identified in Fitch's Tax-Supported Rating Criteria, this action was additionally informed by information from Creditscope, University Financial Associates, S&P/Case-Shiller Home Price Index, IHS Global Insight, Zillow.com, and National Association of Realtors.

Applicable Criteria and Related Research:
--'Tax-Supported Rating Criteria' (Aug. 14, 2012);
--'U.S. Local Government Tax-Supported Rating Criteria' (Aug. 14, 2012).

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Additional Disclosure
Solicitation Status

FOR WHICH THE LEAD ANALYST IS BASED IN AN EU-REGISTERED ENTITY CAN BE FOUND ON THE ENTITY SUMMARY PAGE FOR THIS ISSUER ON THE FITCH WEBSITE.