FitchRatings

Fitch Rates Philadelphia, PA's $287.5MM GO Bonds 'A-'; Outlook Stable
Ratings
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Fitch Ratings-New York-22 November 2010: Fitch Ratings assigns an 'A-' rating to the following Philadelphia, Pennsylvania (the city) general obligation (GO) bonds:

--$152 million GO bonds, series 2010A;
--$132 million GO bonds, series s2010B (Federally taxable - Issuer Subsidy - Build America Bonds).

The bonds are expected to sell through a negotiated sale the week of Dec. 5, 2010. Approximately $145 million of the series 2010A bonds will be used to refund outstanding GO bonds for a net present value savings of about 3% of the refunded par. Proceeds from the series 2010B together with the balance of 2010A bonds will be used to fund the city's ongoing capital program.

In addition, Fitch affirms the city's approximately $1.3 billion of outstanding GO bonds at 'A-'.

The Rating Outlook is Stable.

RATING RATIONALE:
--Financial flexibility is severely constrained due to high fixed cost obligations and an already high tax burden for businesses and residents.
--While financial results have been weak over the past three fiscal years, management has demonstrated a willingness to raise revenue and reduce expenditures.
--Debt ratios are exceptionally high, and given limited growth prospects for the city's tax base and population, should remain so for the foreseeable future.
--The city faces numerous short- and long-term challenges, including a significantly under-funded pension, unsettled labor agreements with no budgeted contingency, and a negative general fund balance on both a budgetary and a GAAP basis.
--Demographic and economic indicators are weak, although the city's economy is anchored by the presence of several large healthcare and higher education institutions.

KEY RATING DRIVERS:
--The elimination of the negative general fund balance over the medium term is important to restoring some degree of financial stability.
--Should there be a costly outcome with regard to unsettled labor contracts, the city's ability to absorb increased labor costs and still stay within projected results included in the current five-year plan is critical.
--Long-term credit quality will depend in large part on the city's ability ultimately to address its large unfunded pension liability.

SECURITY:
The GO bonds are secured by the city's full faith and credit and its ad valorem taxing power, without limitation as to rate or amount.

CREDIT SUMMARY:
Philadelphia, as both a city and county and with an estimated population of almost 1.5 million residents, benefits from its role as a regional economic center with a stable employment base weighted in higher education and health care 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.

Economic and housing indicators are mixed. High unemployment and weak income indicators persist as slightly more than 40% of total employment remains concentrated in lower-paying jobs related to healthcare, retail and government. As a result, the city's poverty rate remains at or close to 25%, and income levels on both a per capita and median household level are just 75% of the state and national averages. Despite positive, albeit minimal, improvement in unemployment rates for the state and nation on a year-over-year comparison, the city's September 2010 unemployment rate of 11.2% is slightly higher than one year ago. The housing downturn has had a relatively modest impact on the city as both residential home sales and prices continued to grow through the second quarter of 2010, and the average residential home value was down just 7% from the peak of the housing market in 2007.

Following three consecutive years of positive operating results that built general fund reserves to a healthy level by the end of fiscal 2007, the onset of the national recession and housing downturn in 2008 prompted significant declines in tax revenues that led to multiple years of operating deficits. Management prudently responded with significant mid-year expenditure cuts in fiscal 2009, including employee reductions, a hiring freeze, furloughs, the reduction in the number of active fire companies, and a decrease in overtime and certain city services. The city also suspended long-running annual rate cuts in its wage and business privilege taxes as part of a comprehensive budget balancing plan. Nevertheless, general fund revenues in fiscal 2009 came in well below budget and a portion of state-aid was delayed, leading to a $256.7 million deficit (on a budgetary basis) that reduced the available general fund balance to -$137.2 million (also budgetary basis), equal to -3.5% of general fund spending and transfers.

To help balance the fiscal 2010 budget and provide budgetary relief in fiscal 2011 the city deferred a portion of its annual pension payments for both years and imposed a five-year, one-cent state-approved sales tax increase that began in October 2009. According to the city's five-year plan, a portion of the expected revenue from the sales tax increase will be used to repay the city's pension fund in fiscal years 2013 and 2014 with interest based on an assumed rate of return on investments of 8.25%. Other measures already enacted include extending the amortization of the city's unfunded pension liability to 30 years from 20 and the continued delay until fiscal 2014 of long-standing annual wage and business privilege tax cuts.

In total, the city's budgetary adjustments would have produced a operating surplus of approximately $94 million if not for a late state-aid payment that was received early in fiscal 2011. Instead, the fiscal year ended with a modest $23.2 million surplus that left the ending general fund balance on a budgetary basis for fiscal 2010 at -$114 million; on a GAAP basis the unreserved fund balance improved from -$274.5 million to -$251.8 million, equal to -6.8% of spending transfers out. The fiscal 2011 adopted budget included a nearly 10% property tax increase and a full year of the increased sales tax rate. Coupled with the receipt of the late state-aid payment, the city's five-year plan shows a return to surplus operations for fiscal 2011 and a positive, albeit narrow, general fund balance of approximately $34 million. The city's forecasting is generally conservative, although the deep economic impact on tax revenues in recent years has resulted in below budget performance.

The city's overall debt burden remains exceptionally high at close to $5,000 per capita and 18% of market value, although Fitch believes the market value ratio is overstated due to antiquated property assessment practices. Management continues to work towards correcting the valuation and appeals process for property owners and expects to eventually implement a more accurate assessment process based on full value. Even excluding $1.4 billion in outstanding pension obligation bonds, debt ratios remain well above average. The 2011-2016 CIP is unchanged from the prior year at $7.9 billion. Of the total amount of projected spending, about $5.7 billion will be for the city's airport and water and sewer utility system, both of which are self-supporting. The remaining $3 billion will be funded from state and federal sources ($2.1 billion), and the balance will be derived from city-supported annual debt issuance totaling an estimated $555 million (including the current offering).

Pension funding continues to be a key credit concern for Fitch. Based on the most recent actuarial report from July 2009 the pension was just 45% funded with an unfunded liability of $4.9 billion. The city's OPEB liability is also sizeable at $1.2 billion based on the latest valuation available, although benefits are only provided for the first years following retirement and the city's five-year financial plan consistently includes the annual pay-go amount.

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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, LoanPerformance, Inc., Underwriter, and Bond Counsel.

Applicable Criteria and Related Research:
--'Tax-Supported Rating Criteria', Aug. 16, 2010.
--'U.S. Local Government Tax-Supported Rating Criteria', Dec. 21, 2009.

For information on Build America Bonds, visit 'www.fitchratings.com/BABs'.

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Tax-Supported Rating Criteria
U.S. Local Government Tax-Supported Rating Criteria