Tax Supported
New Issue

Philadelphia, Pennsylvania

Ratings

New Issue	
General Obligation Bonds, Series 2011	A–
Outstanding Debt	
General Obligation Bonds	A–

Rating Outlook

Stable

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New Issue Details

Sale Information: $272,230,000 General Obligation Bonds, Series 2011, expected to sell during the week of April 4 via negotiation.
Security: The city's full faith and credit and its ad valorem taxing power, without limitation as to rate or amount.
Purpose: Approximately $133 million of the series 2011 bonds to refund outstanding GO bonds for a net present value savings of about 4% of the refunded par. The remaining $139,150,000 will fund the city's ongoing capital program.
Final Maturity: June 30, 2031.

Related Research

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

Applicable Criteria
- *Tax-Supported Rating Criteria, Aug. 16, 2010*
- *U.S. Local Government Tax-Supported Rating Criteria, Oct. 8, 2010*

Other Research
- *Philadelphia School District, Pennsylvania, March 4, 2010*
- *Fitch Rates Pennsylvania's $1B GOs 'AA+'; Outlook Negative, Nov. 5, 2010*

Rating Rationale

- Philadelphia's financial flexibility is severely constrained due to significant 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 taken meaningful steps 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 underfunded pension, unsettled labor agreements with no budgeted contingency, and a negative general fund balance on both a budgetary and 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 for unsettled union contracts, the city's ability to absorb increased labor costs and 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 to ultimately address its large unfunded pension liability.

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 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. 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 the unemployment rate, the city's January 2011 unemployment rate of 10.8% remains higher than the regional, state, and national figures. The housing downturn has had a relatively modest impact on the city, despite moderate declines in both residential home sales and prices through the third and fourth quarter of 2010. Nevertheless, the average residential home value was down on a cumulative basis just 15% 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

Rating History

Rating	Action	Outlook/ Watch	Date
A–	Affirmed	Stable	3/28/11
A–	Revised	Stable	4/30/10
BBB	Downgraded	Stable	12/7/09
BBB+	Affirmed	Negative	7/14/09
BBB+	Affirmed	Stable	6/11/09
BBB+	Affirmed	Stable	12/1/08
BBB+	Affirmed	Stable	3/28/08
BBB+	Affirmed	Stable	12/4/07
BBB+	Affirmed	Stable	11/29/07
BBB+	Affirmed	Stable	7/24/07
BBB+	Affirmed	Stable	11/21/06
BBB+	Affirmed	Stable	7/7/06
BBB+	Affirmed	Negative	9/29/05
BBB+	Affirmed	Negative	2/14/05
BBB+	Downgraded	Negative	10/19/04
A–	Assigned	Negative	11/13/03

and housing downturn in 2008 prompted significant declines in tax revenues that led to multiple years of operating deficits. Management prudently responded with significant midyear expenditure cuts in fiscal 2009, including employee reductions, a hiring freeze, furloughs, a 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 negative $137.2 million (also budgetary basis), equal to negative 3.5% of general fund spending.

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 longstanding annual wage and business privilege tax cuts. Despite the prudent budget balancing measures taken in recent years, Fitch remains concerned regarding the city's ability to execute its multiyear financial plan with no budgeted contingency for expired labor contracts. Currently, two of the city's four municipal union contracts remain expired and a portion of a third contract recently settled through binding arbitration with fire fighters is under appeal. Negotiations with the other two municipal unions are ongoing.

In total, the city's budgetary adjustments would have produced an 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 negative $114 million; on a GAAP basis the unreserved fund balance improved from negative $274.5 million to negative $251.8 million, equal to negative 6.8% of spending. The city relies on annual cash flow notes for liquidity. The $285 million note issuance for fiscal 2011 was well below historical borrowings, and the fiscal 2012 borrowing is expected to be $250 million. The fiscal 2011 adopted budget prudently included a nearly 10% property tax increase and a full year of sales tax receipts at the increased rate. Coupled with the receipt of the late state-aid reimbursement, second quarter results point to surplus operations for fiscal 2011 and a positive, albeit narrow, general fund balance of approximately $13.5 million by year-end, on a budgetary basis. Fitch Ratings notes that year-end projections incorporate timely receipt of state-aid budgeted for the fiscal year, although a portion of these payments have been consistently delayed over recent years. 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, which includes debt associated with the Philadelphia School District, remains exceptionally high at close to $4,500 per capita and 16% of market value, although Fitch believes the market value ratio is overstated due to antiquated property assessment practices. Management continues to work toward correcting the valuation and appeals process for property owners and expects to eventually implement a more accurate assessment process based on full value over the forecast period. Even excluding $1.4 billion in outstanding pension obligation bonds, debt ratios remain well above average. The proposed fiscal years 2012—2017 CIP totals $8.9 billion, although $6.1 billion will be for the city's airport and water and sewer utility system, both of which are self-supporting. The remaining $2.8 billion will be funded from state and federal sources ($1.9 billion), and much of the balance will be derived from city-supported annual debt issuance totaling an estimated $539 million (including the current offering).

Despite some recent cost-saving changes to pension benefits, pension funding continues to be a key credit concern for Fitch. The city funds the annual statutory pension requirement, which is below the actuarially required contribution, and plans to resume making the full payment in fiscal 2012 after a break for budgetary relief. Based on the most recent actuarial report from July 2010, the pension was funded at a low 47% with an unfunded liability of $4.9 billion. Using Fitch's more conservative 7% discount rate assumption, the city's pension plan would be 47% funded. The city's OPEB liability is also sizable 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-as-you-go amount.

General Fund Financial Summary

($000, Audited Fiscal Years Ended June 30)

	2006	2007	2008	2009	2010
Total Tax	2,358,243	2,434,020	2,395,229	2,259,321	2,316,271
Intergovernmental	701,055	791,060	782,441	715,693	775,587
Other	251,803	270,571	265,657	276,042	245,944
General Fund Revenue	**3,311,101**	**3,495,651**	**3,443,327**	**3,251,056**	**3,337,802**
Public Safety	1,013,301	1,118,668	1,220,791	1,189,959	1,420,371
Health and Social Services	820,343	879,527	917,220	889,881	859,096
Culture and Recreation	130,098	147,848	159,177	147,895	127,135
Educational	59,895	64,041	65,468	67,176	71,625
Debt Service	—	4,240	5,495	—	—
General Government and Other	1,282,818	1,380,820	1,502,359	1,516,644	1,107,422
General Fund Expenditures	3,306,455	3,595,144	3,870,510	3,811,555	3,585,649
General Fund Surplus/(Deficit)	**4,646**	**(99,493)**	**(427,183)**	**(560,499)**	**(247,847)**
Transfers In	241,218	255,431	271,649	373,245	316,360
Other Sources	10,002	142,357	394,824	0	0
Transfers Out	105,623	114,999	103,353	122,747	126,388
Other Uses	0	0	389,329	0	0
Other Net Adjustments	0	0	0	0	0
Net Transfers and Other	**145,597**	**282,789**	**173,791**	**250,498**	**189,972**
Net Surplus/(Deficit)	150,243	183,296	(253,392)	(310,001)	(57,875)
Total Fund Balance	304,539	487,835	234,443	(75,558)	(133,433)
As % of Expenditures, Transfers Out, and Other Uses	8.9	13.1	5.4	(1.9)	(3.6)
Unreserved Fund Balance	111,206	152,733	(24,346)	(274,554)	(251,847)
As % of Expenditures, Transfers Out, and Other Uses	3.3	4.1	(0.6)	(7.0)	(6.8)

Note: Numbers may not add due to rounding.