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Fitch Rates Philadelphia, Pennsylvania's $180MM GOs 'BBB+'; Outlook Stable

Ratings
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Fitch Ratings-New York-01 December 2008: Fitch assigns a 'BBB+' rating to Philadelphia, Pennsylvania's (the city's) $180 million general obligation (GO) bonds, series 2008. The bonds are scheduled for negotiated sale the week of December 8. Fitch also affirms its 'BBB+' rating on the city's $1.1 billion in outstanding parity bonds. The Rating Outlook is Stable. Bond proceeds will be used to fund various capital improvement projects.

The 'BBB+' rating balances the city's stable employment base, anchored by its role as a regional economic center and a strong higher education and health care sectors, with limited financial flexibility, exceptionally high debt levels, a significantly under-funded pension position, a rapidly growing fixed-cost burden related to employee benefits, and below-average economic indicators.

While the unfolding economic downturn has already had a substantial impact on the city's operating budget, further deterioration of general fund revenues beyond recently modified financial projections could result in a revision of the Rating Outlook, a rating downgrade, or both. Although Fitch believes the city's management team has been proactive in making significant budgetary adjustments, a high fixed cost burden and a historically narrow general fund balance severely limits the city's ability to absorb further revenue declines. Fitch will continue to monitor the city's progress in dealing with the economic downturn and evaluate the impact on the city's overall credit profile.

Philadelphia, with an estimated population of 1.5 million residents, benefits from its role as a regional economic center and a stable employment base weighted in the education and health care sectors led by the University of Pennsylvania and Jefferson Health System as the largest private employers. Despite a slowing economy, commercial and retail development projects have continued, including the transitioning of the city's naval yard into a large private sector business park consisting of approximately 80 companies. In addition, Children's Hospital of Philadelphia, the Fox Chase Cancer Center, and the University of Pennsylvania are each making a significant capital investment to expand their respective research facilities. However, despite the size and stability of its employment anchors, the city's unemployment rate, like national trends, has experienced a notable increase over the past year, growing to an above-average 7.6% in September 2008 from a more moderate 6.1% one year prior. Income levels are also weak; approximately one-fourth of the city's residents lives at or below the poverty rate according to the U.S. Census Bureau.

Fitch notes that the city out-performed its multi-year plan (MYP) financial projections in each of fiscal years 2005-2007 as several tax sources exceeded budgeted expectations. The strong revenue growth in recent years prompted a favorable increase in general fund unreserved balance to an adequate 4.1% of spending and transfers out at the close of fiscal 2007. However, much of the overall gain in revenue was driven by increases in economically sensitive business privilege and real estate transfer taxes, which on a combined basis, came in significantly below budget in fiscal 2008. Coupled with increased pension costs related to weak investment returns, fiscal 2008 ended with a sizeable operating deficit, reducing the total fund balance by more than one-half. Based upon first quarter results for fiscal 2009, a continued and more pronounced softening in general fund revenues would have led to a budget shortfall of $108 million for the current fiscal year and a projected structural deficit of approximately $1 billion over the city's 2009-2013 MYP had management not addressed the growing gap.

However, management prudently responded by delaying through fiscal 2015 wage and business privilege tax cuts previously included in the MYP, implementing significant employee reductions, mostly through attrition and vacancy elimination, reducing the number of active fire companies, and decreasing certain city services, among other cost-cutting initiatives. While acknowledging these actions, Fitch remains concerned that the city's limited financial flexibility due to its high fixed cost burden and narrow level of financial cushion will leave the city strained in its response to further operating pressures. Also of concern is the city's historical practice of only funding the minimum municipal obligation for its pension fund, which has resulted in a funding ratio of only 51% according to the most recent actuarial valuation.

The city's overall debt burden remains very high at $5,533 per capita and 19.3% of market value. Even excluding $1.4 billion in outstanding pension obligation bonds, these ratios remain well above average. The 2009-2014 capital improvement plan is estimated at $7 billion with slightly more than half supported by operating revenues of and revenue bond issuance by the city's airport and water department. The balance of capital funding will come from state and federal sources as well as from city-supported debt issuance expected to total approximately $320 million, which Fitch believes will keep debt ratios at a high level for the foreseeable future.

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