

New Issue: Philadelphia (City of) PA

MOODY'S ASSIGNS Baa1 TO PHILADELPHIA'S (PA) \$203.8 MILLION G.O. REFUNDING BONDS

AFFIRMATION OF Baa1 RATING AND STABLE OUTLOOK APPLIES TO APPROXIMATELY \$4.6 BILLION OF PARITY DEBT OUTSTANDING

Municipality
PA

Moody's Rating

ISSUE	RATING
General Obligation Refunding Bonds, Series 2008A	Baa1
Sale Amount \$203,770,000	
Expected Sale Date 04/15/08	
Rating Description General Obligation, Unlimited Tax	

Opinion

NEW YORK, Apr 2, 2008 -- Moody's Investors Service has assigned a Baa1 rating and stable outlook to the City of Philadelphia's \$203.8 million General Obligation Refunding Bonds, Series 2008A. At this time, Moody's has affirmed the Baa1 rating and stable outlook on \$972.4 million in parity debt previously issued by the city as well as the Baa1 rating and stable outlook on \$2.96 billion in other unconditional General Fund obligations. The bonds are secured by the city's general obligation, unlimited tax pledge and proceeds will be used to refund the city's Series 2003B auction rate bonds in order to convert them to fixed rate.

Affirmation of the Baa1 rating and stable outlook reflects the city's improving, although still weak, demographic and economic trends, modest property value growth, and a heavy burden of tax-supported debt. Mitigating these weaknesses, city finances are subject to oversight by a state body, with well-established five-year planning and quarterly monitoring procedures in place. The city's budgetary management has been effective, which contributed to maintenance of a positive unreserved General Fund balance for over a decade; three years of large operating deficits, however, depleted reserves and created a negative unreserved fund balance as of the end of fiscal 2004. The city returned to surplus operations in fiscal 2005, 2006 and 2007, although a budget deficit is projected for fiscal 2008, which ends on June 30. Moody's stable outlook reflects the expectation that financial operations will remain stable going forward, as reflected in the city's Five Year Plan which currently demonstrates narrow, but adequate reserves for the next few years. Moody's rating also acknowledges that a potential large pension obligation bond issue later this year could significantly increase the city's debt burden.

STRENGTHENING FINANCIAL OPERATIONS REPLENISH RESERVES TO ADEQUATE LEVELS

Prudent financial processes, cautious revenue forecasting, and growth in tax receipts have resulted in three years of surplus operations that increased reserves since substantial operating deficits in 2002 through 2004 reduced unreserved General Fund balance to -\$148 million, or a negative 4.8% of 2004 General Fund revenues. Prior to 2004, the city had maintained a positive unreserved General Fund balance for 11 years, even with gradual reductions in the city's wage tax rate since 1996, intended to enhance the city's competitive position.. Through fiscal 2008, the rate has been reduced by approximately 15%, with additional reductions included through 2013.

Philadelphia's responsibility for both city and county government services, a trend of loss of middle-class residents, already high tax rates and sluggish tax base growth have combined to present significant challenges to the maintenance of balanced financial operations. The city's finances are subject to oversight by a state body, the Pennsylvania Intergovernmental Cooperation Authority (PICA), with well-established five-year planning and quarterly monitoring procedures in place. State oversight is to continue until long-term bonds sold by PICA to finance the city's early 1990's accumulated operating and capital deficits are fully retired (scheduled final maturity is in 2022). In response to these challenges, the city's financial management processes have been prudent, with cautious revenue forecasts, moderate contingency reserves, and other smaller layers of cushion included in recent years' annual budgets.

The fiscal 2004 deficit fund balance was exacerbated by a late payment from the state of \$90 million,

received in September, 2004. That state payment was booked in the fiscal 2005 year, which contributed to a GAAP surplus of \$150 million, increasing total General Fund balance to \$154 million (7.5% of General Fund revenues), although the unreserved GAAP General Fund balance was still negative at -\$36 million. On a budgetary basis, however, the fiscal 2005 surplus increased General Fund reserves from -\$47 million (-1.4% of General Fund revenues) to \$96 million (2.8% of General Fund revenues). The city experienced another surplus of \$150 million in fiscal 2006, increasing total General Fund balance to \$305 million (8.5% of General Fund revenues), with the unreserved portion at \$111 (3.1% of General Fund revenues), on a GAAP basis. General Fund reserves on a budgetary basis grew to \$254 million (7.4% of General Fund revenues). The surpluses have been driven by strict expenditure controls and strong tax revenues, most notably in the business privilege, wage and real estate transfer taxes. We note that the city's ending balances on a budgetary basis have been higher than the unreserved GAAP balance, due to changes in some tax payment dates that were positive on a cash basis but not on a GAAP basis.

In fiscal 2007, the city experienced an additional surplus of approximately \$180 million (on a GAAP basis), increasing total General Fund balance to \$488 million (14.8% of General Fund revenues) and unreserved General Fund balance to \$153 million (3.9% of General Fund revenues) on a GAAP basis; on a budgetary basis, General Fund balance grew to \$297 million (8.0% of General Fund revenues). While real estate transfer taxes were lower than the previous year, they were still ahead of budget, and business privilege and wage taxes remained strong in fiscal 2007. The city projects that fiscal 2008 will end with an \$88 million use of reserves, reducing General Fund balance, on a budgetary basis, to \$209 million, in line with the budget. Although the city projects revenues to come in approximately 2% better than budget, driven by better-than-budgeted collections of wage and business privilege taxes, as well as additional state revenues, the city also faced one-time payments related to health care collective bargaining agreement settlements that increased expenditures as well.

The city is currently undergoing its budget process for fiscal 2009 in conjunction with the 2009-2013 Five Year Plan. The Mayor's proposed budget, which needs to be passed by the city council and approved by PICA, includes an increase in revenues from the wage, earnings and net profits tax (2.2%) which accounts for about 1/3 of total revenue and where a program of gradual reductions in the tax rate is ongoing. The city's budget also assumes modest growth in the business privilege tax (0.23%), which is also currently under a reduction program through 2012. These revenues are projected to grow while the rates are decreasing given an expectation of a growing workforce. Overall, the fiscal 2009 proposed budget assumes a 2.4% increase in General Fund revenues and 1.4% increase in General Fund expenditures over 2008 projections, resulting in a budgeted \$56 million use of reserves. Moody's expects that during the passage and approval process, the city is likely to make some adjustments in its estimates.

In addition to this use of reserves in fiscal 2009, the city's Five Year Plan currently calls for additional General Fund balance appropriations of approximately \$121 million from fiscal 2010 through fiscal 2013, although Moody's believes that this incorporates some conservative revenue estimates. Moody's notes, however, that the fiscal 2013 ending fund balance would represent the low point at \$35 million and that there is no year where reserves will dip to very narrow levels (i.e. below \$10 million). Despite the relative improvement, the city still faces financial challenges, including negotiations with police and fire personnel this year.

WEAK LONG-TERM DEMOGRAPHIC AND ECONOMIC TRENDS, SOME IMPROVEMENT INDICATED

Philadelphia has experienced a long trend of industry and population loss since 1950, with a particularly sharp economic retreat hitting in the late 1980's and early 1990's. The late 1990's saw a resumption of growth, with employment up 5.7% between 1998 and 2001, and then down about 1.6% between 2001 and 2003, reflecting the slowdown in the national economy. The decline flattened in fiscal 2004 and then grew by about 1.0% in 2005, 0.9% in 2006, and 0.7% in 2007. Results for the first two months of 2008 demonstrate continued growth, with each month showing an increase over the same month of the prior year. Manufacturing has continued to decline in importance, and diversified services now account for 54% of total employment (or more than 60% including the finance/insurance/real estate sector). Population loss during the 1990's was just over 4%, although this was only about half the loss that had been estimated prior to the 2000 census count. With an estimated 1.45 million residents, the city remains the nation's fifth most populous.

Resident wealth indicators are low, with per capita and median family incomes only about 77% and 74% of the national median, respectively, and 23% of residents below the poverty level. A relatively large portion of the city's job base is in low-paying sectors, with healthcare, social services, and state and local government accounting for about 30% of total jobs (a large share of which are likely held by city residents, as opposed to commuters). City unemployment rates have moderated in recent years, from approximately 7.5% for 2004 to 5.8% in December of 2007, although still above the state (4.3%) and nation (4.8%).

The city's taxable base has grown modestly over the past decade, averaging 2.7% growth annually since 2002. The \$56.7 billion tax base does benefit from significant diversity, with the 10 largest tax payers comprising less than 5% of total valuation.

OVER \$7.0 BILLION OF TAX SUPPORTED DEBT NOW OUTSTANDING, INCLUDING OVERLAPPING OBLIGATIONS; CITY'S ANNUAL SERVICING BURDEN IS HIGH BUT MANAGEABLE

Including this issue, Philadelphia's total tax-supported debt is just over \$7.2 billion, inclusive of overlapping school debt. The ratio of debt to full property value is high at 12.7%, one of the highest ratios among the nation's 10 largest cities. The city's high debt burden reflects its dual city and county responsibilities, special efforts to promote economic development (e.g. convention center, stadiums, and blight remediation), the PICA deficit-funding bonds sold in the early 1990's, and a \$1.3 billion pension bond issued several years ago. In addition, the school district has faced significant capital needs associated with its aging facilities. With city G.O. bond issuance tightly constrained by a debt cap in the Pennsylvania Constitution, there will likely be continued use of non-G.O. debt structures going forward.

The city has proposed issuing additional pension obligation debt, possibly resulting in an additional \$3 billion in borrowing. The city is currently reviewing various plans for the debt issuance and it would require approval of the city council. City management has indicated that the debt would only be issued if it resulted in significant annual savings over the current plan of funding the unfunded liability over time. Moody's will review any POB proposal that the city presents, and while we acknowledge that the unfunded pension obligation represented a long-term liability, the issuance could increase the city's debt burden considerably.

After this issue, the city will have variable rate exposure representing 13.4% of its total general obligation and unconditional General Fund debt. In conjunction with the variable rate Series 2007B bonds issued last year, the city entered into an interest rate swap with Royal Bank of Canada (RBC - Issuer Rating of Aaa) for a notional amount equal to the Series B issuance amount. The city will make semi-annual payments based on a fixed rate and RBC will make monthly payments based on the SIFMA (formerly BMA) Municipal Swap Index. Regularly scheduled payments will be parity with the general obligation debt of the city. Early termination is optional for the city only. Termination events include deterioration of either the city or RBC's rating falling below Baa3 and the downgraded party has not transferred the agreement to an acceptable party or provided for a Credit Support Provider. Potential termination payment requirements are remote given the city's and the counterparty's current ratings. A termination payment by the city would be subordinate to the general obligation debt service payments.

Outlook

Moody's rating outlook for Philadelphia is stable, reflecting the city's multiple years of surplus operations and the expectation of satisfactory reserves going forward. Moody's believes the city will continue to benefit from the five-year planning and quarterly monitoring procedures required by the state oversight board, as well as the conservative budgeting provided by the financial management team.

What could make the GO rating go UP:

- Continued strengthening of financial operations resulting in substantial fund balance improvement
- Improvement in economic/demographic trends

What could make the GO rating go DOWN:

- Financial deterioration in fiscal 2008 and beyond

KEY STATISTICS

2006 estimated population: 1.45 million

2007 full value: \$56.7 billion

Full value per capita: \$39,179

1999 Per capita income as % of state: 79.1%

1999 Median family income as % of state: 75.3%

Direct debt burden: 8.0%

Total debt burden: 12.7%

Payout of principal (10 years): 38.4%

FY2007 General Fund balance: \$487.8 million (14.8% of General Fund revenues)

FY2007 Unreserved General Fund balance: \$152.7 million (3.9% of General Fund revenues)

FY2007 General Fund balance (budget basis): \$297 million (8.0% of General Fund revenues)

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