New Issue: Moody's assigns MIG 1 to Philadelphia, PA's $100M TRANs

Global Credit Research - 21 Nov 2013

Maintains A2 long-term rating and stable outlook on $4 billion in GO and unconditional debt obligations

PHILADELPHIA (CITY OF) PA
Cities (including Towns, Villages and Townships)
PA

Moody's Rating

ISSUE		RATING
Tax and Revenue Anticipation Notes, Series A of 2013-2014		MIG 1
Sale Amount	$100,000,000	
Expected Sale Date	11/27/13	
Rating Description	General Obligation	

Moody's Outlook

Opinion

NEW YORK, November 21, 2013 --Moody's Investors Service has assigned a MIG 1 rating to the City of Philadelphia's $100 million Tax and Revenue Anticipation Notes, Series A of 2013-2014, which mature on June 30, 2014. The notes are secured by a pledge of taxes and revenues to be received by the General Fund during fiscal 2014 (ending June 30), and are being issued to fund temporary cash flow imbalances in the city's General Fund during the fiscal year. Moody's also maintains an A2 rating and stable outlook on the city's $4 billion of outstanding general obligation bonds and unconditional General Fund obligations.

SUMMARY RATING RATIONALE

The best-quality short-term note rating reflects (i) the city's covenant to make deposits into a dedicated repayment fund held by the note trustee on May 23, 2014 (full principal amount) and June 26, 2014 (full interest requirement); (ii) the city's historically strong financial management practices, state-board oversight and a return to surplus operations in 2011 through 2013 following weak financial operations in fiscal 2008 and 2009; (iii) its long and successful track record as an issuer of short-term notes; (iv) improvement in cash flows from fiscal 2010 through 2013; and (iv) cash flow projections for fiscal 2014 that indicate adequate ending consolidated cash balances given the conservative nature of the city's projections.

Our A2 rating is supported by ongoing improvement in financial operations, which began to stabilize in fiscal 2011 following a period of severe stress. Finances have strengthened further in fiscal 2012 and 2013. The A2 rating also factors in our expectation that financial flexibility will remain relatively constrained over the course of the city's current five-year plan due to rising pension and contractual salary costs coupled with limited revenue-raising ability. These factors continue to pose long-term financial challenges for the city. The rating also incorporates Philadelphia's sizeable economy and tax base, weak demographics and above-average unemployment levels, modest property value growth, and a heavy burden of tax-supported debt and unfunded pension liabilities.

The stable outlook reflects our view that financial reserves and cash will be maintained at currently adequate levels over the near-term, with the potential for modest augmentation going forward. The rating and outlook also reflect the existence of a state oversight board, which mitigates the city's weak credit characteristics through well-established five-year planning and quarterly monitoring procedures.

STRENGTHS

-Large, diverse tax base; economic center for a multistate region

-Improved financial operations and reserve balance

-Strong state oversight and comprehensive five-year financial planning

CHALLENGES

-Constrained financial flexibility given narrow reserve levels

-Slow tax base growth coupled with weak demographics

-Very high debt burden and fixed cost pressure

-Significant unfunded pension liabilities

DETAILED CREDIT DISCUSSION

ADEQUATE CASH PROJECTED AT TIME OF NOTE PRINCIPAL SET-ASIDE

The city is a regular issuer of cash flow notes, reflecting level monthly expenditure patterns set against uneven revenue collections, as the majority of projected fiscal 2014 receipts from property tax (14.6% of General Fund receipts) and business privilege tax (12.2% of General Fund receipts) are collected in the fiscal year's second half. In the three years prior to fiscal 2012, the city issued cash flow notes of between $275 million and $350 million, but has since reduced its borrowings, to $173 million in fiscal 2012 and $127 million in fiscal 2013.

The city ended fiscal 2013 with a General Fund cash balance of $434 million, equal to 11.6% of General Fund receipts, well above projections at the time of the TRAN issuance, which were for $218 million, or 6.1% of General Fund receipts. Consolidated cash, which includes cash reserves outside the General Fund, ended the year at $504 million, or a healthy 13.5% of General Fund receipts. Without including the Capital Improvement Fund (which is largely made up of bond proceeds), consolidated cash equaled $481 million (12.9% of General Fund receipts) at the close of fiscal 2013. Following the covenanted set aside of principal in May 2013, General Fund cash balance was $410.5 million, or 11% of General Fund receipts; consolidated cash was $471.3 million (12.6% of General Fund receipts) and $446.3 million (12% of General Fund receipts) without the Capital Improvement Fund. These balances were all far higher than originally projected at the time of issuance.

The city's fiscal 2014 cash flow projections, developed as part of its budgeting process and required by the Pennsylvania Intergovernmental Cooperation Authority (PICA), its state-appointed oversight board, indicate that the city expects to end fiscal 2014 with a General Fund cash balance of $298 million (7.9% of General Fund receipts), a use of $137 million. The city also projects consolidated cash to be $428.5 million (11.6% of General Fund receipts) at fiscal 2014 year-end and $275.8 million (7.4% of General Fund receipts) without including Capital Improvement Fund moneys. Consolidated cash is projected to be less than General Fund cash for fiscal 2014 due to a projected negative balance in the Grants Revenue Fund to incorporate reimbursements of state aid that come after associated expenditures.

After the principal set aside date in May 2014, the city projects a General Fund cash balance of $336 million (9.1% of General Fund receipts), a consolidated cash balance of $461.9 million (12.9% of General Fund receipts), and consolidated cash of $331.7 million (8.7% of General Fund receipts) without the use of bond proceeds. We view the city's projections as conservative given its track record of better-than-projected cash flow results.

FISCAL RECOVERY PLAN RESULTED IN SURPLUS OPERATIONS IN FISCAL 2011 THROUGH 2013, LEADING TO IMPROVED RESERVES

The city's financial operations are improving following a period of severe stress. In response to significant strain beginning in fiscal 2008, city officials created a recovery plan in fiscal 2009 that included significant cost reductions and some revenue enhancements. Despite the plan's implementation and later refinement, General Fund balance remained negative - both on a budgetary and GAAP basis - in fiscal 2010. The city ended fiscal 2011 and fiscal 2012 with surpluses, raising GAAP General Fund balance to $88.6 million, or a narrow but positive 2.5% of General Fund revenues at fiscal 2012 year-end. Fiscal 2013 ended with a third operating surplus, boosting General Fund balance to $204.6 million (5.5% of revenues) and improving cash balances - to their highest level since fiscal 2007 - $468.3 million, equal to a healthy 12.7% of General Fund revenues.

The city's revised 5-year plan for fiscal 2010 built on the features of its 2009 plan, which featured a five-year delay in scheduled wage tax reductions, a hiring freeze and reduced overtime, and included further gap-closing measures such as fee increases, savings in employee pension and health benefits, and a temporary, 1% five-year increase in the city sales tax. The 2010 5-year plan also included the deferral of a portion of the city's required pension payments in fiscal 2010 and 2011, which generated a combined $230 million of savings. These changes were approved by the Pennsylvania legislature with the requirement that deferred pension payments be repaid in fiscal 2013 and 2014. The city ran a greatly reduced $54.7 million operating deficit in fiscal 2010 (compared to deficits of over $250 million in the two prior fiscal years), with General Fund balance finishing at a negative $130 million (-3.6% of revenues).

The fiscal 2011 budget included a 10% property tax increase that netted approximately $80 million in new revenues, and the city benefitted from a full year of the increased sales tax, which generated $37 million in new revenues. Thanks partly to these revenue enhancements, the city ran a GAAP-basis $106 million operating surplus in fiscal 2011, shrinking the General Fund balance deficit to $24 million, or -0.6% of revenues. The cost savings included in the updated five-year plan also contributed significantly to positive financial operations. Fiscal 2012 concluded with a second operating surplus of $111 million that raised General Fund balance to $88.6 million on a GAAP basis (2.5% of General Fund revenues) and assigned fund balance to $70.5 million, equal to a positive 2% of General Fund revenues.

The $3.7 billion fiscal 2013 budget was balanced with $36 million of reserves and did not include any tax increases. As per the city's unaudited financial report for fiscal 2013, the year ended much better than expected, with a $116 million addition to General Fund reserves based on fourth quarter estimates. As of June 30, 2013, revenues were $17.4 million above budget, driven mainly by local non-tax sources, business and net profits and property taxes that outperformed budget by $7.6 million, $38.5 million and $5.4 million, respectively. Expenditures were $61.9 million above-budget on a budgetary basis, but $18.8 million below target, reflecting increased prison and fire overtime costs and higher labor expenses that were partly related to a police wage reopener.

The approved $3.85 billion fiscal 2014 budget grew by $241 million (6.7%) year-over-year and is balanced with a $102.4 million reserve appropriation. The majority (70%) of cost increases relate to rising contractual salary and benefit cost. The city expects revenue growth to be muted in fiscal 2014 and 2015 given the city's reactivation of its wage tax reduction program in July 2013 and the anticipated use of a potential extension of the 1% sales tax in fiscal 2015 to provide added funding for the Philadelphia School District (GO rated Ba2/negative). If actual results match budget, fiscal 2014 will end with General Fund reserves at roughly $88 million on a GAAP basis, equal to 2.3% of revenues. We believe the city's five-year and fiscal 2014 revenue and cost projections to be conservative, and note that the city has often exceeded budgetary expectations under the present management team.

The city's finances are subject to oversight by a state body, the Pennsylvania Intergovernmental Cooperation Authority (PICA, special tax rating of Aa2/stable outlook), with well-established five-year planning and quarterly monitoring procedures in place. State oversight will continue until long-term bonds issued by PICA to finance the city's early 1990's accumulated operating and capital deficits are fully retired (scheduled final maturity is in 2023).

LARGE, REGIONALLY-IMPORTANT ECONOMY; WEAK SOCIOECONOMIC INDICES

Philadelphia is the economic center of a large, multi-state region, with a diverse, significantly-sized taxable base of approximately $100 billion as of fiscal 2014. A significant health care and higher education presence has acted as a stabilizing force on the local economy in recent years, although Federal spending cuts related to sequestration could affect these sectors in 2013 and beyond. The city's ten largest employers include the University of Pennsylvania (rated Aa2/stable), University of Pennsylvania Health System (rated Aa3/stable), Drexel University (rated A3/stable), Thomas Jefferson University (rated A1/stable) and Temple University (rated Aa3/negative), among others, illustrating the local economy's heavy weighting towards health care and higher education. The city is also a center for tourism and saw strengthened hotel occupancy in 2011 and 2012; development since 1993 has almost doubled the number of hotel rooms in the city. While the city's efforts to encourage tourism and spur redevelopment have stimulated some economic growth, the pace remains relatively slow.

After a prolonged period of population loss between 1950 and 2000 that included a sharp retreat in the 1980's, the city's population stabilized in the decade to 2010, which saw a slight increase in population. Philadelphia's population is currently just above 1.5 million, making it the fifth largest city in the US. After a long period of labor force declines, the late 1990's saw a gradual resumption of growth. After a modest decline between 2001 and 2003, employment growth resumed with employment up 1.1% in 2005, 0.9% in 2006, 0.7% in 2007, and 0.2% in 2008, before reversing temporarily in 2009. Employment figures have recovered strongly since 2010, with the labor force reaching 662,758 in August 2013, the highest figure since 2003.

Resident wealth indicators remain low, with 2010 per capita and median family incomes only about 77% and 72%

of the US median, respectively, with roughly a quarter (24.3%) of the population living below the poverty line. Unemployment remained stubbornly high at 11% in August 2013, well above the state (7.8%) and the nation (7.3%), and has historically been above average. The city did not have a significant run-up in real estate values during the last decade and subsequently did not suffer the sharp drop in values that other areas experienced. The $100 billion tax base benefits from significant economic and taxpayer diversity, with the 10 largest tax payers comprising less than 4% of total valuation. In 2013, the city completed implementation of its Actual Value Initiative (AVI), which abolished the city's historic assessment system in favor of a new system based more closely on actual market values. The AVI triggered a city-wide property reassessment that was completed in February 2013. According to the city's office of property assessment, the city's post-adjustment taxable assessed value is just under $100 billion. When tax-exempt properties are included, this figure rises to $137.4 billion.

SIGNIFICANT DEBT BURDEN; MODERATE VARIABLE RATE EXPOSURE

Philadelphia's total tax-supported debt is approximately $7.5 billion, inclusive of the city's $4 billion of G.O. debt and unconditional General Fund obligations, $409 million of PICA bonds, and overlapping school district debt ($3.3 billion). The ratio of direct debt to full property value is an above-average 3.2% (using the post-AVI full value figures), climbing to 5.5% when overlapping debts are included, well above the state and US averages. The city's high debt burden reflects its dual city and county responsibilities, special efforts to promote economic development (e.g. stadiums, cultural assets, convention center and blight remediation), the PICA deficit-funding bonds, and $1.4 billion in pension obligation bonds.

The city has moderate variable rate exposure representing approximately 8% of its total general obligation debt and unconditional General Fund obligations. The city's Series 2009B G.O. variable rate bonds are supported by a letter of credit (LOC) from the Bank of New York Mellon(BNY - rated Aa2/stable) that expires in March 2016. In conjunction with that issue, the city is party to a fixed payer swap with RBC for a notional amount equal to the remaining variable rate principal. The city also has exposure to variable rate debt through the Philadelphia Authority for Industrial Development's (PAID) Series 2007B bonds. Liquidity is provided by LOCs from three providers, JPMorgan Chase Bank, N.A. (rated Aa3/stable) for $117 million of principal, TD Bank, N.A. (rated Aa3/stable) for $72 million, and PNC Bank, N.A. (rated A2/stable) for $45 million. The JPMorgan Chase and PNC LOCs expire in May 2014; the TD Bank LOC expires in May 2015.

In conjunction with the PAID variable rate bonds, the city has entered into two fixed payer interest rate swaps, one with JPMorgan Chase for a notional amount of $217.3 million and one with Merrill Lynch Capital Services, Inc. (MLCS) for a notional amount of $72.4 million. In the case of all three of its fixed payer swaps, the city (either directly or through PAID) makes semi-annual payments based on a fixed rate and the counterparties make monthly payments based on the SIFMA Municipal Swap Index. The city is also a party to a basis swap, through PAID, with MLCS for a notional amount of $194 million. Under the swap, the city makes payments based on SIFMA and receives payments based on 67% of one-month LIBOR plus 20 basis points.

In the case of all of the swaps, regularly scheduled payments are General Fund obligations of the city. Early termination is optional for the city only. Termination events include either the city or the counterparty's rating falling below Baa3. Any termination payment by the city would be subordinate to the general obligation debt service payments.

SIGNIFICANT PENSION LIABILITIES

We expect the city to continue facing pressure from fixed costs, particularly related to pensions and other post-employment benefits (OPEB). The city sponsors two single-employer, defined benefit pension plans open to the majority of employees: the Municipal Pension Plan and the Gas Works Plan. As of July 2012, the Municipal Pension Plan was 48.1% funded on an actuarial basis, with the city contributing $556 million, or 77% of its ARC payment - an amount slightly above the state-mandated minimum municipal obligation (MMO) of $507 million - in fiscal 2012. The city resumed its regular MMO payment schedule in fiscal 2012 following two years of a partial MMO payment deferral allowed by the state for fiscal 2010 and 2011. The deferral was ultimately funded using debt proceeds that the city is amortizing through fiscal 2014 to match the amortization of the partial MMO payment deferral.

The Municipal Pension Plan's combined adjusted net pension liability, under Moody's methodology for adjusting reported pension data, is $8.5 billion, or approximately 2.2 times operating revenues, which is well above the national average. Moody's uses the adjusted net pension liability to improve comparability of reported pension liabilities. The adjustments are not intended to replace the city's reported information, but to improve comparability with other rated entities. The plan's reported unfunded actuarial accrued liability (UAAL) was $5 billion as of July 2012, according to the plan's 2012 actuarial report.

The city also offers an OPEB plan that is funded on a pay-go basis. The city's unfunded actuarial accrued liability for OPEB was $1.2 billion as of July 2011. The city contributed 72% ($76.3 million) of its annual OPEB cost in fiscal 2012. General Fund fixed costs, including debt service (6%), pensions (15.6%), and OPEB (2%) represented a sizable 23.5% of the city's General Fund expenditures in fiscal 2012 and would have accounted for over 29% if the city had contributed its full actuarial pension and OPEB ARCs for the year. The city's ability to manage these growing fixed costs will factor prominently into future rating reviews.

Outlook

Moody's stable outlook for Philadelphia's general obligation rating reflects the city's improved financial stability, albeit at narrow reserve levels, the likelihood of continued narrow fund balance levels over the medium term, and additional stability provided by a state-appointed oversight board, including enhanced budgetary disciple and five-year forecasting.

WHAT COULD MAKE THE RATING GO UP

- Continued improvement to financial operations and an increase in General Fund balance well above the current levels

- Ability to navigate significant additional pension contributions and reduce unfunded pension liability

WHAT COULD MAKE THE RATING GO DOWN

- A return to deficit General Fund operations

- Stagnant or further weakened reserve levels

KEY STATISTICS

2010 population: 1.53 million

FY2013 full value: $56.8 billion

FY2014 full value: $137.4 billion

FY2013 full value per capita: $41,308

FY2014 full value per capita: $89,428

2010 Per capita income as % of nation: 77.3%

2010 Median family income as % of nation: 72.4%

FY2013 direct debt burden, pre-AVI: 7.6%

FY2014 direct debt burden, post-AVI, 3.2%

FY2013 total debt burden, pre-AVI: 12.2%

FY2014 total debt burden, post-AVI: 5.5%

Payout of principal (10 years): 47.6%

FY12 General Fund balance (GAAP basis): $88.1 million (2.5 % of General Fund revenues)

FY12 Assigned General Fund balance (GAAP basis): $70.6 million (2% of General Fund revenues)

FY12 General Fund cash balance: $309.5 million (8.6% of General Fund revenues)

FY13 General Fund balance (budgetary basis): $204.6 million (5.5% of General Fund revenues)

FY13 Unassigned General Fund balance (budgetary basis): $89.9 million (2.4% of General Fund revenues)

FY13 General Fund cash balance (unaudited): $468.3 million (12.7% of General Fund revenues)

Post-sale parity debt outstanding: $4 billion

The principal methodology used for this rating was Short-Term Cash Flow Notes published in April 2013. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

REGULATORY DISCLOSURES

For ratings issued on a program, series or category/class of debt, this announcement provides certain regulatory disclosures in relation to each rating of a subsequently issued bond or note of the same series or category/class of debt or pursuant to a program for which the ratings are derived exclusively from existing ratings in accordance with Moody's rating practices. For ratings issued on a support provider, this announcement provides certain regulatory disclosures in relation to the rating action on the support provider and in relation to each particular rating action for securities that derive their credit ratings from the support provider's credit rating. For provisional ratings, this announcement provides certain regulatory disclosures in relation to the provisional rating assigned, and in relation to a definitive rating that may be assigned subsequent to the final issuance of the debt, in each case where the transaction structure and terms have not changed prior to the assignment of the definitive rating in a manner that would have affected the rating. For further information please see the ratings tab on the issuer/entity page for the respective issuer on www.moodys.com.

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