MOODY'S
INVESTORS SERVICE

New Issue: Moody's assigns A2 to Philadelphia's $358 million GO Bonds, Ser. 2013; outlook stable

Global Credit Research - 12 Jun 2013

City has $3.9 billion of rated GO debt including current offering

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

Moody's Rating

ISSUE		RATING
General Obligation Bonds, Series 2013A		A2
Sale Amount	$200,000,000	
Expected Sale Date	06/26/13	
Rating Description	General Obligation	
General Obligation Refunding Bonds, Series 2013B		A2
Sale Amount	$158,000,000	
Expected Sale Date	06/26/13	
Rating Description	General Obligation	

Moody's Outlook STA

Opinion

NEW YORK, June 12, 2013 --Moody's Investors Service has assigned an A2 rating to the City of Philadelphia's (PA) $358 million General Obligation Bonds, Series 2013, consisting of the $200 million General Obligation Bonds Series 2013A and the $158 million General Obligation Refunding Bonds, Series 2013B. Concurrently, we have affirmed the A2 rating and stable outlook assigned to the city's $3.7 billion of previously-issued general obligation (G.O.) bonds and unconditional General Fund obligations. The current issue is secured by the city's general obligation tax pledge. Proceeds of the Series 2013A bonds will fund capital improvements to the city, while proceeds of the Series 2013B bonds will refund prior series of bonds for an estimated net present value savings of approximately $24.7 million, or 16.9% of refunded par.

SUMMARY RATING RATIONALE

The A2 rating reflects ongoing improvement in the city's financial operations, which stabilized in fiscal 2011 and continued to strengthen modestly in fiscal 2012, although the city continues to face long-term financial challenges. The A2 rating also reflects 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. 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 operations, reserves and cash will be maintained at currently narrow levels over the near-term, with the potential for modest augmentation going forward, as well as our expectation that the current management team will continue to seize opportunities to streamline operations and improve pension funding. 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 very 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

FISCAL RECOVERY PLAN RESULTS IN SURPLUS OPERATIONS IN FISCAL 2011 AND 2012; STABLE RESERVES EXPECTED FOR FISCAL 2013

The city has experienced recent improvements to financial operations against a backdrop of severe stress. In response to significant recession-driven financial strain beginning in fiscal 2008, city officials created a fiscal recovery plan in fiscal 2009 that included a temporary sales tax increase and pension payment deferral in fiscal 2010 and 2011. Despite the plan's implementation and later refinement, General Fund balance remained negative - both on a budgetary and GAAP basis - in fiscal 2010. Fiscal 2011 ended with a surplus, although General Fund reserves were still negative on a GAAP basis. Fiscal 2012 concluded with an additional surplus that raised GAAP General Fund balance to a positive figure: $88.6 million, or a narrow 2.5% of General Fund revenues. Cash balances improved greatly in fiscal 2012, reaching $309.5 million, equal to 8.6% of revenues and their highest level since fiscal 2007. The initial recovery plan, implemented in early 2009, featured a five-year delay to scheduled wage tax reductions as well as deep cost reductions that included layoffs, employee furloughs, a hiring freeze, and reduced overtime. Despite these efforts, fiscal 2009 ended with a GAAP-basis General Fund balance deficit of $76 million (-2.1% of revenues) including an unreserved fund balance deficit of $275 million (-7.6% of General Fund revenues), partially due to a late state aid payment received in fiscal 2010.

The city's updated 5-year plan for fiscal 2010 included further gap-closing measures such as staff reductions, fee increases, savings in employee pensions and health benefits and other cost-related adjustments. The plan also included a temporary, 1% five-year increase in the city sales tax, updated pension fund assumptions and deferral of a portion of the city's required pension payments in fiscal 2010 and 2011, the last of which generated $150 million and $80 million of savings, respectively. These changes were approved by the Pennsylvania legislature in September 2009 with the requirement that the deferred pension payments be repaid in fiscal 2013 and 2014. With these enhancements, the city was able to generate, on a budgetary basis, an operating surplus of $23 million and reduce its General Fund deficit to $114 million (-3.1% of revenues) in fiscal 2010. On a GAAP basis, however, the city ran a $55 million operating deficit, increasing the fiscal 2010 General Fund balance deficit to $130 million (-3.6% of revenues) and the undesignated fund balance deficit to $252 million (-6.9% 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 rate, generating $37 million in new revenues. Partly as a result of 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, and lowering the unassigned General Fund balance deficit to $46 million, or -1.2% of revenues. The aforementioned cost savings included in the city's updated five-year plan also contributed significantly to fiscal 2011's return to positive financial operations. The fiscal 2012 budget reflected moderate increases in tax revenues, net of the removal of approximately $500 million in social service-related aid (and the corresponding expenditures) that were permanently transferred to the Grants Fund. Fiscal 2012 concluded with a second consecutive operating surplus of $111 million that raised the General Fund balance to $88.6 million on a GAAP basis (2.5% of General Fund revenues) and eliminated the prior deficit in unassigned fund balance, which finished fiscal 2012 at $70.5 million, equal to a narrow, albeit much improved, 2% of General Fund revenues.

The $3.68 billion fiscal 2013 budget was balanced with $36 million of reserves and did not include any tax increases. Management projects fiscal 2013 will end better than expected, with only a $5.8 million reduction in reserves based on third quarter 2013 projections. As of March 31, 2013, revenues were $108 million above budget, driven by wage, business privilege and property taxes outperforming the budget by $24 million, $20.2 million and $40 million, respectively. Expenditures were $95 million above-budget over the same period, reflecting increased overtime costs and the city's decision to appropriate $42 million in reserves to cover the potential costs of a labor settlement currently under appeal. Current projections are for General Fund cash to close fiscal 2013 at $296.8 million (8.1% of General Fund receipts), a rise of $16.8 million from the prior year. Management projects consolidated cash at $240.1 million (6.5% of General Fund receipts) at year-end, but without the benefit of the Capital Improvement Fund this figure drops to $226.7 million (6.2% of General Fund receipts). Consolidated cash is less than General Fund cash due to a projected negative balance in the Grants Revenue Fund due to reimbursements of fiscal 2013 state aid that will be received in early fiscal 2014.

The proposed $3.7 billion fiscal 2014 budget is set to grow by $151 million (4.2%) year-over-year and is balanced with a $22.4 million reserve appropriation. The majority (70%) of cost increases relate to rising contractual salary and benefit cost. The city expects revenue growth in fiscal 2014 to be muted given the looming expiration of the 1% sales tax increase in 2014 combined with city's simultaneous reactivation of its wage tax reduction program. If actual results match budgeted figures, fiscal 2014 will end with General Fund reserves at roughly $60 million on a GAAP basis, equal to 1.6% 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 current 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). From 1995 until fiscal 2010, the city had pursued a program of gradual reductions in the wage tax rate, intended to enhance the city's competitive position. Through fiscal 2009, the rate had been reduced by approximately 16%. In fiscal 2010, the city suspended the wage tax reductions due to its financial challenges, but will reactivate the tax reduction program in fiscal 2014.

LARGE, REGIONALLY-IMPORTANT ECONOMY; WEAK SOCIOECONOMIC INDICES

Philadelphia is the economic center of a large, multi-state region, with a diverse, significantly-sized tax base of approximately $58 billion as of 2012. 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 in the future. 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/stable), among others, illustrating the heavy weighting of the local economy towards the health care and higher education sectors. The city is also a center for tourism and experienced strengthened hotel occupancy in 2011 and 2012; hotel development since 1993 has almost doubled the number of hotel rooms available in the city. While the city's efforts to encourage tourism and spur redevelopment have stimulated some economic growth, the pace remains relatively slow.

The city experienced a prolonged period of industry and population loss between 1950 and 2000 that included a particularly sharp economic retreat in the late 1980's and early 1990's. The city's population stabilized in the decade between 2000 and 2010, which saw a slight increase in the city's 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, with employment up 5.7% between 1998 and 2001. 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 sharply in 2009 with a 3.1% drop in employment levels. Employment figures have recovered gradually since 2010, with the labor force reaching 652,344 in April 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 national median, respectively, with roughly a quarter (24.3%) of the population living below the poverty line. Unemployment remained high at 9.6% in April 2013, well above the state (7.2%) and the nation (7.1%), and have historically been above average. The city's taxable base has grown over the past few years, averaging 1.6% annually since 2006; full valuation growth has been more rapid, averaging 3% annually since 2006. The city did not have the significant run-up in real estate values during the last decade and has subsequently not suffered from the sharp drop in values that other areas have experienced. The $58 billion tax base benefits from significant economic and taxpayer diversity, with the 10 largest tax payers comprising less than 4% of total valuation. In 2012, the city council voted to implement the Actual Value Initiative (AVI), abolishing the city's historic assessment system in favor of a new system to be based more closely on actual market values. The vote triggered a city-wide property reassessment that was completed in February 2013. According to preliminary city assessor data, the city's post-adjustment assessed value will be approximately $100 billion.

SIGNIFICANT DEBT BURDEN; MODERATE VARIABLE RATE EXPOSURE

Philadelphia's total tax-supported debt is approximately $7.5 billion, inclusive of the city's $3.9 billion of G.O. debt and unconditional General Fund obligations, $452 million of PICA deficit-funding bonds, and overlapping school district debt ($3 billion). The ratio of direct debt to full property value is high at 7.6% (using pre-AVI full value figures), climbing to 12.2% when overlapping debts are included, 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. 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 (BNY - rated Aa1/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 JP Morgan 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 to face growing 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 $539.5 million, or 77.2% 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 schedule of the partial MMO payment deferral.

The Municipal Pension Plan's unfunded actuarial accrued liability (UAAL) was $5 billion as of July 2012. The 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 liability information, but to improve comparability with other rated entities.

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

2012 full value: $58.9 billion

Full value per capita: $41,308

2010 Per capita income as % of nation: 77.3%

2010 Median family income as % of nation: 72.4%

Direct debt burden: 7.6%

Total debt burden: 12.2%

Payout of principal (10 years): 47.5%

FY2012 General Fund balance (GAAP basis): $88.1 million (2.5 % of General Fund revenues)

FY2012 Unassigned General Fund balance (GAAP basis): $70.6 million (2% of General Fund revenues)

FY2012 General Fund cash balance: $309.5 million (8.6% of General Fund revenues)

Post-sale parity debt outstanding: $3.9 billion

RATING METHODOLOGY

The principal methodology used in this rating was General Obligation Bonds Issued by US Local Governments 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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Analysts

Michael D'Arcy
Lead Analyst
Public Finance Group
Moody's Investors Service

Geordie Thompson
Additional Contact
Public Finance Group
Moody's Investors Service

Contacts

Journalists: (212) 553-0376
Research Clients: (212) 553-1653

Moody's Investors Service, Inc.
250 Greenwich Street
New York, NY 10007
USA