FitchRatings

Fitch Rates Philadelphia Auth for Industrial Development, PA's Rev Rfdg Bonds 'A-'

Fitch Ratings-New York-22 December 2015: Fitch Ratings has assigned an 'A-' rating to the following Philadelphia Authority for Industrial Development (PAID) city agreement revenue refunding bonds:

--$53.545 million series 2016A (Cultural and Commercial Corridors Program);
--$6.005 million series 2016B (Philadelphia Central Library Project).

The bonds are expected to sell through a negotiated sale the week of January 4. The bonds are being issued to refund outstanding series 2005 and 2006A bonds.

The Rating Outlook is Stable.

SECURITY
Bonds issued by the PAID are payable from an annual service fee or lease rental payments payable by the city under non-cancelable agreements. The city's obligation to make payments required by the service agreements or lease agreements is absolute and unconditional.

KEY RATING DRIVERS

CONSTRAINED FINANCIAL FLEXIBILITY: Financial flexibility is constrained by a high overall tax burden, a low general fund balance position, and a sizable level of fixed costs. After a period of positive operating results and notable improvement to general fund balance, a third straight year of reserve declines is budgeted for fiscal 2016.

SOLID BUDGETARY CONTROLS: Fitch views positively management's efforts in recent years to contain costs and raise available revenues, although significant budgetary pressures remain.

ELEVATED FIXED-COST BURDEN: The city's pension fund is poorly funded. The city has made some effort to improve funding, but Fitch expects the liability to remain high. Debt ratios will likely remain above average over the long term.

WEAK SOCIOECONOMIC PROFILE: Wealth levels remain notably low and above-average unemployment persists. Despite this weakness, Philadelphia has shown recent employment growth and remains an important center for healthcare and higher education with good prospects for long-term economic stability.

RATING SENSITIVITIES

CHANGES IN FINANCIAL FLEXIBILITY: Sustained structural balance would aid the city's financial flexibility, while deficits beyond current projections would cause concern.

PENSION FUNDING IMPROVEMENT: Material reductions to the unfunded actuarial accrued liability for the city's pension plan would be viewed positively.

CREDIT PROFILE

IMPORTANT ECONOMIC CENTER, CHALLENGING DEMOGRAPHICS

Philadelphia is both a city and county, with a population of slightly more than 1.5 million. The city serves as a regional economic center, with a stable employment base weighted toward the higher education and healthcare sectors. The city is home to several large colleges and universities, as well as multiple hospitals and health systems, led by the University of Pennsylvania, Jefferson Health System, and Temple University. Several of these institutions are engaged in sizeable expansion projects, and the city has also benefitted from notable investments by local corporations including Comcast and Urban Outfitters.

Above-average unemployment and weak income indicators persist, although current data suggest some recent improvement. The city's unemployment rate is well below recent highs, but remains significantly above the broader metropolitan statistical area (MSA), commonwealth and national averages.

City income levels grew at a slightly better clip over the last decade than the state's and nation's but remain well below state and national averages. The city's poverty rate stands at 26%, well above the MSA, state and U.S figures. The population has grown slightly over the last decade after nearly 50 years of population loss.

RECENT GAINS RESTORED RESERVES; DEFICIT IN FISCAL 2014

The city has diverse sources of revenues. Primary revenue sources include taxes on wages and earnings (the largest at 46% of general fund tax revenues), real estate, business income and receipts (BIRT), sales, and property; various charges for services; and state aid. Many of the primary revenue streams have historically shown significant volatility.

The city experienced three years of large operating deficits (fiscal 2008 - 2010) and during this time, management responded by cutting expenditures and adjusting several revenue sources. The impact of these changes combined with three years of substantial tax revenue growth in fiscal 2011 - 2013 resulted in sizable surpluses. The improved performance restored the unrestricted general fund balance to $188 million or 4.7% of expenditures at fiscal 2013 year-end, up from an unreserved fund deficit of $252 million at the end of fiscal 2010.

The fiscal 2014 budget originally projected a $102 million fund balance draw. BIRT revenue was projected to decline after a rapid increase in fiscal 2013. The city finished the year ahead of budget, with a $73 million draw that reduced unrestricted fund balance to $126 million or 3.1% of expenditures. BIRT revenue was $11 million greater than in fiscal 2013, or $52 million ahead of budget.

The city implemented the actual value initiative (AVI) in fiscal 2014, the first revaluation of the city's property tax base in many years. The AVI resulted in an approximately 2.5x increase in market value. The city prudently implemented steps to mitigate the impact on residents facing steep tax increases, and the tax rate was lowered so that property taxes were actually down 3% for fiscal 2014. Fitch believes the AVI is a credit positive, as the city will be better able to tax all properties in the city accurately.

DRAWS PROJECTED FOR FISCAL 2015 AND 2016

The fiscal 2015 operating budget included a $78 million decline in fund balance. Revenues saw the impact of the end of the city's allocation of a temporary (five-year) 1% increase in the sales tax. The sales tax was extended, but the bulk of the revenues are allocated to the school district with excess funds devoted to the city's pension plan. The current estimate is for increased spending levels to contribute to a $59 million deficit. The improvement from budget was driven by the wage and earnings tax and the real property transfer tax, both of which trended well ahead of budget. All non-audited results and budgets are presented on a budgetary, non-GAAP basis.

The fiscal 2016 budget includes a $70 million deficit, which would drain most of the unrestricted fund balance on a GAAP basis. Pension costs are slated to increase by $35 million. Similarly, the city's contribution to the school district is up $35 million, funded largely by increases to the property and parking taxes. After several years of significant growth, BIRT revenues are budgeted down 2.7%. Through one quarter, results are close to budget. The delay in passing the commonwealth of Pennsylvania's budget has not had a material impact on the city's finances, though delays continuing into 2016 could create short-term cash flow demands for the city.

The city annually puts together a comprehensive five-year plan as part of its required planning process. The current plan for fiscal years 2016 - 2020 features fund balance declines in fiscal 2016 and 2017, bringing budgetary fund balance down to $33 million from $145 million at the end of fiscal 2015. The plan then anticipates three straight years of fund balance growth that restore budgetary fund balance to $155 million by fiscal 2020, slightly above the estimate for the current year.

The Philadelphia School District (the district; underlying rating of 'BB-', Negative Outlook) remains a challenge for the city. The district has had multiple years of budgetary structural imbalance. The city has contributed funds to assist the district, and the need to continually do so in the future could be a drain on the city's resources.

LABOR PROGRESS

The accuracy of at least the early years of the five-year plan is strengthened by the settled state of labor contracts. After years of contentious relationships with its unions, the city has reached agreements with all of them, generally lasting through fiscal 2016 or 2017. All of the agreed-upon contracts feature annual pay increases of 2.5%-3.5% with no retroactive payments, and revised health benefits and work rules. They also include pension reform, particularly for new employees who generally have to choose between higher contributions or joining a hybrid plan.

HIGH DEBT LEVELS; PENSION FUNDING EXPECTED TO IMPROVE

The city's aggregate debt burden, which includes debt associated with the Philadelphia School District, remains above average at over $4,500 per capita and 5.2% of market value (using the new market value calculated after AVI, well down from pre-AVI levels). Debt amortization is average with 56% repaid within 10 years.

Pension funding continues to be a key credit concern for Fitch despite the recent implementation of cost-saving changes to pension benefits for newly settled contracts. Full funding of the annual pension obligation resumed in fiscal 2012 following a partial deferral for budgetary relief in the previous two years. The deferral was fully repaid ahead of schedule, as annual pension payments rose by 13% and 5% in fiscals 2013 and 2014, respectively, to meet the repayment obligation.

The most recent actuarial report shows a low pension funded ratio of 46% and an unfunded liability of $5.7 billion (4% of market value). Using a 7% discount rate assumption, the city's pension plan would be about 42% funded. The city is funding its full actuarially required contribution, and it has made some contributions of excess funds to the pension plan.

The city's other post-employment benefit liability is also sizable at $1.7 billion (1.2% of market value). The city pays for five years of post-retirement health care for all employees. Despite the large benefit liabilities, carrying costs were in the moderate range at 18% of fiscal 2014 governmental fund expenditures.

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Fitch recently published an exposure draft of state and local government tax-supported criteria (Exposure Draft: U.S. Tax-Supported Rating Criteria, dated Sept. 10, 2015). The draft includes a number of proposed revisions to existing criteria. If applied in the proposed form, Fitch estimates the revised criteria would result in changes to less than 10% of existing tax-supported ratings. Fitch expects that final criteria will be approved and published by Jan. 20, 2016. Once approved, the criteria will be applied immediately to any new issue and surveillance rating review. Fitch anticipates the criteria to be applied to all ratings that fall under the criteria within a 12-month period from the final approval date.

In addition to the sources of information identified in the Tax-Supported Rating Criteria, this action was additionally informed by information from Creditscope, University Financial Associates, S&P/Case-Shiller Home Price Index, IHS Global Insight, Zillow.com, and the National Association of Realtors.

Applicable Criteria
Exposure Draft: U.S. Tax-Supported Rating Criteria (pub. 10 Sep 2015)
(https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=869942)
Tax-Supported Rating Criteria (pub. 14 Aug 2012)
(https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=686015)
U.S. Local Government Tax-Supported Rating Criteria (pub. 14 Aug 2012)
(https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=685314)

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