MOODY'S
INVESTORS SERVICE

# New Issue: Moody's assigns A2 to Philadelphia's (PA) $158.6M GO Refunding Bonds, Series 2014A

Global Credit Research - 15 Jan 2014

**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 |
|---|---|
| General Obligation Refunding Bonds, Series A of 2014 | A2 |

| | |
|---|---|
| **Sale Amount** | $158,600,000 |
| **Expected Sale Date** | 01/27/14 |
| **Rating Description** | General Obligation |

**Moody's Outlook** STA

**Opinion**

NEW YORK, January 15, 2014 --Moody's Investors Service has assigned an A2 rating to the City of Philadelphia's $158.6 million General Obligation Refunding Bonds, Series A of 2014. The bonds are secured by the city's general obligation unlimited tax pledge. Moody's maintains an A2 rating and stable outlook on the city's $4 billion of previously-issued general obligation (GO) bonds and unconditional General Fund obligations. Proceeds of the current issue will refund the city's outstanding Series B of 2008 bonds for an estimated net present value savings of $15.5 million, or 10.8% of refunded par.

SUMMARY RATING RATIONALE

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

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 (unaudited), boosting total General Fund balance to $204.6 million (5.5% of revenues), unassigned reserves to $89.8 million (2.4% of revenues) and improving General Fund 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 that generated $230 million of immediate budgetary savings, although this amount was later repaid, with interest, in fiscal 2013 and 2014. 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 note, however, that the city has often exceeded budgetary expectations under its present management team, and we believe the revenue and cost projections included in the fiscal 2014 budget and the city's current five-year plan (extending through June 2018) to be conservative.

City 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 2014 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 through 2013; hotel 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 78% and 73% of the US median, respectively, with roughly a quarter (24.3%) of the population living below the poverty line. Unemployment remained persistently high at 10.1% in October 2013, well above the state (6.9%) and the nation (7%), 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 $7.7 billion, inclusive of the city's $4 billion of G.O. debt and unconditional General Fund obligations, $409 million of PICA deficit-funding 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 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 $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: 78.2%

2010 Median family income as % of nation: 72.7%

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): 50.7%

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

RATING METHODOLOGY

The principal methodology used in this rating was US Local Government General Obligation Debt published in January 2014. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

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