



Tagging Info

Fitch Rates Philadelphia, PA's General Obligation Bonds 'A-' Ratings Endorsement Policy
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Fitch Ratings-New York-12 June 2013: Fitch Ratings has assigned an 'A-' rating to the following city of Philadelphia, PA (the city) general obligation (GO) bonds:

- \$200 million GO bonds, series 2013A;
- \$158.475 million GO refunding bonds, series 2013B.

The bonds are expected to sell through a negotiated sale the week of June 24. The series 2013A bonds are being issued to finance various capital projects. The series 2013B bonds are being issued to refund outstanding GO bonds.

At this time, Fitch also affirms the following:

- \$1.2 billion in city of Philadelphia GO bonds at 'A-'.

The Rating Outlook is Stable.

SECURITY

The city's GO bonds are secured by the full faith and credit general obligation and its ad valorem tax pledge, without limitation as to rate or amount.

RATING RATIONALE

CONSTRAINED FINANCIAL FLEXIBILITY: Fund balance has shown notable improvement beginning in fiscal 2011. However, financial flexibility is constrained by a high overall tax burden, a low general fund balance position, and a high level of fixed costs.

SIZEABLE DEBT BURDEN: Debt ratios will likely remain elevated over the long term.

LARGE UNFUNDED PENSION LIABILITY: The city's pension fund is poorly funded, and costs will continue to rise.

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

SOLID FINANCIAL MANAGEMENT: Fitch views positively management's efforts in recent years to contain costs and raise available revenues to address an ongoing budget imbalance, although significant budgetary pressures remain.

RATING SENSITIVITIES:

DIRECTION OF FUND BALANCE: Continued growth of the city's fund balance levels through operating surpluses would increase the city's financial flexibility, while a reversal of recent positive trends would cause concern.

LABOR OUTCOMES: Several of the city's primary labor contracts have been unsettled for four years. Resolution of these contracts could have a material impact on the city's finances, particularly regarding its elevated pension costs.

PENSION CHALLENGES: Failure to develop strategies to improve low pension funding levels could have a negative rating impact. Conversely, a material improvement in pension funding levels would be viewed positively.

CREDIT PROFILE

IMPORTANT ECONOMIC CENTER TEMPERED BY CHALLENGING DEMOGRAPHICS

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

Above-average unemployment and weak income indicators persist, although current data suggests some recent improvement. Unemployment, measured at 9.6% in April 2013, remains elevated but is down from its recent high. The unemployment rates of the broader metropolitan statistical area (MSA) and commonwealth were appreciably lower at 7.7% and 7.2%, respectively. Income levels grew at a slightly better clip over the prior decade in comparison to the state and nation but continue to be weak at just 68% of the MSA and 78% of the commonwealth and nation in 2011. The city's poverty rate stands at 25%, approximately twice the MSA, state and nation. The population has grown slightly over the last decade after nearly 50 years of population loss.

CONSECUTIVE SURPLUSES REVERSE TREND OF DECLINES

The city has a diverse source of revenues. Primary revenue sources include the wage and earnings tax (the largest at 46% of general fund tax revenues), the real estate tax, the business income and receipts tax, the sales tax, various charges for services, and state aid.

Recessionary pressure in recent years coupled with a depressed housing market prompted a significant decline in tax revenues between fiscals 2008-2010 (fiscal year end June 30), leading to multiple years of large operating deficits. Management responded favorably with a number of expenditure cuts. The city also suspended through fiscal 2014 long-running annual rate cuts in its wage and business privilege taxes as part of a comprehensive budget-balancing plan.

In fiscal 2010 the city implemented a temporary five-year sales tax increase and the partial deferral of annual pension costs over the ensuing two fiscal years. These changes have been key drivers of recent positive operating results. Fitch believes the sustainability of these improved results once temporary measures are lifted in fiscal 2015 is uncertain.

Fiscal 2011 ended with a sizeable \$106.4 million general fund surplus on a GAAP basis, which improved the unrestricted general fund balance (the sum of the unassigned, assigned and committed fund balance under GASB 54) to a still weak negative \$46 million. On a budgetary basis, the city reported a minimal year-end general fund balance of \$92,000. Fiscal 2012 continued the improvement shown in fiscal 2011, with a \$113 million surplus on a GAAP basis, bringing the unrestricted general fund balance to \$71 million or 2% of expenditures. On a budgetary basis, the surplus is \$147 million, notably better than the budgeted \$60 million surplus. The surplus and outperformance of budget result from tax revenues growing 4.4% over fiscal 2011 and \$34 million of one-time pension aid from the commonwealth.

FISCAL 2013 ON PACE TO OUTPERFORM BUDGET

The fiscal 2013 general fund budget raised spending by almost 3%, mostly due to the repayment of previously deferred pension costs. Through three quarters, total revenue is projected to be \$108 million (3%) ahead of budget, or 2% ahead of fiscal 2012 results. The city projects year-over-year growth from all of its major taxes. The budget featured a \$17 million deficit but the city currently projects a deficit of under \$6 million on a budgetary basis, including an additional \$43 million of unbudgeted funds conservatively reserved for potential unfavorable labor resolutions.

The fiscal 2014 budget projects a \$48 million fund balance deficit, including the reservation of an additional \$25.6 million to fund a portion of unsettled labor contracts. The budget includes a 4% increase in expenditures, driven by higher wage and benefits costs. In fiscal 2014, the city will be implementing the actual value initiative (AVI), the first revaluation of the city's property tax base in many years. The city is currently projecting an approximately 2.7x increase in market value, though the sizable reduction of the tax rate and increased collections will make the change approximately revenue neutral for fiscal 2014. The city is prudently evaluating steps to mitigate the impact on residents facing steep increases, and has undertaken an effort to educate taxpayers about the change. However, the city faces risk regarding implementation of the revaluation, particularly from appeals.

The city relies on annual cash flow notes for liquidity. The \$173 million note issuance for fiscal 2012 was well below historical borrowings and the fiscal 2013 borrowing is \$127 million, reflecting further improvement in the city's liquidity.

FUTURE BUDGETARY CHALLENGES

The city faces several budgetary challenges in future years. The five-year increase in the sales tax ends after fiscal 2014, resulting in an expected decline of approximately \$130 million in revenue that has been factored into the city's five-year plan. The majority of the city's labor contracts have been unsettled since fiscal 2009, and are in various states of legal challenges. The city has prudently budgeted for some cost increases from these contracts. Positively, the contracts that have been settled, most notably the police contract, contain features that are expected to lower the city's future pension costs.

ELEVATED LONG-TERM LIABILITIES

The city's aggregate debt burden, which includes debt associated with the Philadelphia School District, remains notably high at over \$5,000 per capita and 17% of market value, although Fitch incorporates into its analysis the likely overstated market value ratio, the result of antiquated property assessment practices. As noted above, the city expects to implement the AVI in fiscal 2014, and the projected new market value would lower debt to a still-high approximately 6.6% of market value. Debt amortization is average with 53% amortizing within 10 years.

The city's fiscal 2014-2019 government-wide capital improvement plan (CIP) totals \$10 billion, of which about \$6.7 billion is for the city's self-supporting airport and water and sewer utility system. Of the remaining \$3.3 billion in capital projects, the city expects the state and federal government to fund about \$2.4 billion while the balance, estimated at \$953 million, will be derived almost entirely from city-supported annual debt issuance.

Pension funding continues to be a key credit concern for Fitch, despite the recent implementation of cost-saving changes to pension benefits for uniformed employees. The city funds on an annual basis the amount actuarially required by state law, which is less than the amount actuarially determined by the city's policy. Full funding of the annual obligation resumed in fiscal 2012 following a partial deferral for budgetary relief in the previous two years. The five-year plan shows annual pension payments rising by 13% and 5% in fiscals 2013 and 2014, respectively, to meet the repayment obligation. Pension costs are forecast to consume a high 17% of annual general fund spending in fiscal 2013.

The most recent actuarial report shows a low funded ratio of 48% and an unfunded liability of about \$5.1 billion. Using Fitch's 7% discount rate assumption, the city's pension plan would be about 43% funded. The city's other post-employment benefit liability is also sizable at \$1.2 billion based on the latest valuation available, although benefits are only provided for the first five years following retirement. Carrying costs are a sizable 23% of government fund expenditures, and are expected to rise with increased pension costs.

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In addition to the sources of information identified in Fitch's 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 National Association of Realtors.

Applicable Criteria and Related Research:

- 'Tax-Supported Rating Criteria' (Aug. 14, 2012);
- 'U.S. Local Government Tax-Supported Rating Criteria' (Aug. 14, 2012).

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Tax-Supported Rating Criteria
U.S. Local Government Tax-Supported Rating Criteria

Additional Disclosure

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