Fitch Rates Philadelphia Redevelopment Authority, PA's Revenue Refunding Bonds 'A-'

Ratings Endorsement Policy
19 Mar 2015 4:55 PM (EDT)

Fitch Ratings-New York-19 March 2015: Fitch Ratings has assigned an 'A-' rating to the following Philadelphia Redevelopment Authority (PRA) city service agreement revenue refunding bonds:

--$73.475 million series 2015A.

The bonds are expected to sell through a negotiated sale the week of April 6. The bonds are being issued to refund PRA's outstanding series 2005C bonds.

Fitch has also affirmed the following ratings at 'A-':

--$1.4 billion in city general obligation (GO) bonds;
--$263 million in Philadelphia Municipal Authority (PMA) bonds;
--$1.9 billion in bonds issued by the Philadelphia Authority for Industrial Development (PAID);
--$212 million in bonds issued by PRA;
--$14 million in bonds issued by the Philadelphia Parking Authority (PPA).

The Rating Outlook is Stable.

SECURITY

Bonds issued by the PMA, PRA, PAID and PPA are payable from an annual service fee or lease rental payments payable by the city of Philadelphia (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. The city's GO bonds are payable from the full faith and credit general obligation and its ad valorem tax pledge, without limitation as to rate or amount.

KEY RATING DRIVERS

CONSTRAINED FINANCIAL FLEXIBILITY: Fund balance has shown notable improvement in the last several years. However, financial flexibility is constrained by a high overall tax burden, a somewhat low general fund balance position, and a sizable level of fixed costs.

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 remains an important center for healthcare and higher education with good prospects for long-term economic stability.

RATING SENSITIVITIES

MAINTENANCE OF FINANCIAL FLEXIBILITY: Sustained structural balance would aid the city's financial flexibility, while recurring deficits 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 TEMPERED BY 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 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 including Comcast and Urban Outfitters.

Above-average unemployment and weak income indicators persist, although current data suggest some recent improvement. The unemployment rate was measured at 6.2% in December 2014, well down from 8.3% a year earlier. The unemployment rates of the broader metropolitan statistical area (MSA) and commonwealth were appreciably lower at 5.0% and 4.6%, respectively.

City income levels grew at a slightly better clip over the prior decade than the state's and nation's but continue to be weak at just 68% of the MSA, 78% of the commonwealth and 79% of the nation in 2013. The city's poverty rate stands at 26%, well above the MSA, state and nation. The population has grown slightly over the last decade after nearly 50 years of population loss.

The Philadelphia School District (the district; rated 'BB-' Outlook Negative by Fitch) remains a challenge for the city. The district has had multiple years of 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.

CONSECUTIVE SURPLUSES REVERSE TREND OF DECLINES

The city has diverse sources of revenues. Primary tax 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.

Although recent performance has been strong, many of the primary revenue streams have historically shown significant volatility.

Recessionary pressure 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 tax and BIRT 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.

Three years of substantial tax growth in fiscal 2011-2013, particularly for the BIRT which was up 16% in fiscal 2013, resulted in sizable surpluses. This restored the unrestricted fund balance to $188 million or 4.7% of expenditures in fiscal 2013 from an unreserved fund deficit of $252 million at the end of fiscal 2010.

FISCAL 2014 OUTPERFORMS BUDGET; DRAWS PROJECTED FOR FISCAL 2015

The fiscal 2014 budget projected a $102 million fund balance draw. BIRT revenue was projected to decline after the rapid increase in fiscal 2013. The city finished the year ahead of budget with a $73 million draw, reducing 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, though the tax rate was lowered accordingly so that property taxes were down 3% for fiscal 2014. The city prudently implemented steps to mitigate the impact on residents facing steep increases. Fitch believes the AVI is a credit positive as the city will be better able to accurately tax all of the city's properties.

The fiscal 2015 budget included a $78 million decline in fund balance. A major driver of the decline was the end of the allocation to the city of the extra 1% 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 revised estimate is for a $57 million deficit. The improvement from budget is being driven by the wage and earnings tax and the real property transfer tax both trending well ahead of budget. Fitch believes further improvement is possible.

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 the $145 million projection for the end of fiscal 2015, before three straight years of growth restore budgetary fund balance to $155 million in fiscal 2020, slightly above the estimate for the current year. Five-year plans have historically been fairly conservative in their assumptions.

LABOR PROGRESS

The accuracy of at least the early years of the five-year plan is heightened by the settled state of the majority of labor contracts. After years of contentious relationships with its unions, the city has reached agreements with most 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. They also include pension reform, particularly for new employees who generally have to choose between increased contributions or switching to a hybrid plan, revised health benefits and work rules.

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 $4,700 per capita and 5.4% of market value using the new market value calculated after AVI, well down from pre-AVI levels. Debt amortization is average with 56% amortizing 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 obligation resumed in fiscal 2012 following a partial deferral for budgetary relief in the previous two years which was fully repaid ahead of schedule. Annual pension payments rose by 13% and 5% in fiscals 2013 and 2014, respectively, to meet the repayment obligation.

Pension costs consumed a high 17% of annual general fund spending in fiscal 2014, including repayments of the pension deferral. The most recent actuarial report shows a low funded ratio of 46% and an unfunded liability of $5.7 billion. Using Fitch's 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 assessed value). Carrying costs are in the moderate range at 18% of fiscal 2014 governmental fund expenditures.

Contact:

Primary Analyst
Eric Friedman
Director
+1-212-908-9181
Fitch Ratings, Inc.
33 Whitehall Street
New York, NY 10004

Secondary Analyst
Bernhard Fischer
Director
+1-212-908-9167

Committee Chairperson
Amy Laskey
Managing Director
+1-212-908-0568

Media Relations: Elizabeth Fogerty, New York, Tel: +1 (212) 908 0526, Email: elizabeth.fogerty@fitchratings.com.

Additional information is available at 'www.fitchratings.com'.

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).

Applicable Criteria and Related Research:
Tax-Supported Rating Criteria
U.S. Local Government Tax-Supported Rating Criteria

Additional Disclosure
Solicitation Status