Moody’s
INVESTORS SERVICE

New Issue: Moody’s assigns A2 to Philadelphia Red. Auth., PA’s $74M Series 2015A revenue bonds; outlook stable

Global Credit Research - 19 Mar 2015

Affirms A2 on $4.2 billion of outstanding GO and service fee debt

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

Moody's Rating

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<th>Sale Amount</th>
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<td>$73,475,000</td>
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Moody's Outlook  STA

NEW YORK, March 19, 2015 --Moody's Investors Service has assigned an A2 rating to the Philadelphia Redevelopment Authority, PA's $73.5 million Series 2015A Revenue Refunding Bonds (AMT) (City of Philadelphia Neighborhood Transformation Initiative). The outlook is stable. Concurrently, Moody's has affirmed the A2 rating on the city's outstanding general obligation and service fee debt. Post-sale, the city will have $4.2 billion of tax-backed debt.

SUMMARY RATING RATIONALE

The A2 rating reflects the city’s large tax base, and its position as a regional economic center anchored by a significant nonprofit institutional presence and a number of major corporations and other large employers. The rating also incorporates the city's heavy debt burden, high fixed costs, and below-average financial position, which has historically been pressured because of reliance on economically sensitive revenues.

OUTLOOK

The stable outlook reflects the stabilized trends in most of the city’s important tax revenues, driven by a growing economy and tax base. Many of the weak socioeconomic characteristics of the city - such as a high poverty rate and low income levels - have shown more positive trends in recent years. Although the city faces numerous pressures in the long term, including large unfunded pension liabilities and other benefit costs, comprehensive financial planning and a generally strengthening tax base will keep the city’s credit profile stable.

WHAT COULD MAKE THE RATING GO UP

Continued growth in the tax base and strengthening of the socioeconomic profile

Expansion of reserves to levels consistent with higher rating categories

Substantial decrease of unfunded pension liabilities

WHAT COULD MAKE THE RATING GO DOWN

Resumption of tax base declines

Return to lower or negative fund balance levels
Failure to fund pension plan on a sound basis going forward

STRENGTHS

Regional economic center with major institutional presence

Comprehensive long-term financial planning

Recent trend of improving revenues

Reversal of historical contraction in the tax base and loss of population

CHALLENGES

Below-average socioeconomic characteristics

Weaker than average reserve levels

Exposure to economically sensitive revenues

Heavy unfunded pension liabilities

Large debt burden

RECENT DEVELOPMENTS

The city ran a deficit in fiscal 2014, and its fund balance declined to a still-adequate 5.6% of revenues. A proposed sale of the Philadelphia Gas Works (Baa2 positive) was rejected by the city council; the sale would have improved pension funding.

DETAILED RATING RATIONALE

ECONOMY AND TAX BASE: LARGE ECONOMIC CENTER CONTINUES TO GROW

Philadelphia is the economic center of a large, multi-state region, and the tax base has begun to grow after decades of decline.

With a population of roughly 1.6 million, Philadelphia is the fifth-largest city in the US by population, and is at the center of the sixth-largest metropolitan area. The city underwent a protracted decline in the post-industrial era, with population falling 26% since 1950. The city’s socioeconomic profile is weak: poverty is among the highest of any large US city at 26.3%, the median family income is equal to 72% of the US median, and unemployment, at 6.2% as of December, was higher than the US rate of 5.6%.

The past half-decade has shown more positive trends for the roughly $97 billion tax base, however. The population is growing, getting better-educated, and personal income has increased 21% since 2009. We attribute the city’s growth to national demographic trends, as well as the appeal of the city’s substantial mix of universities, hospitals, and other employers. Of the 10 biggest employers in the city, nine are either higher education or healthcare entities, most prominently the University of Pennsylvania (Aa2 positive) and the University of Pennsylvania Health System (Aa3 stable). The city is home to about 30 hospitals, including Thomas Jefferson University Hospital and the Children’s Hospital of Philadelphia (Aa2 stable).

The city’s strong nonprofit sector provides some underlying strength to the economy that is not reflected in tax base valuation or socioeconomic statistics. Approximately 27% of the city’s base is exempt from property taxes. An estimated 155,000 college students live in Philadelphia, and about 300,000 people commute into the city daily. The traditional measures of tax base strength underestimate the city’s economic resilience, although persistent poverty and weak income indices remain a challenge. Despite the economic improvement, the tax base will remain challenged to continue growing at the current pace in the long term.

FINANCIAL OPERATIONS AND RESERVES: VOLATILE REVENUE COMPOSITION, HISTORICALLY NARROW RESERVES

The city’s mix of economically sensitive and volatile revenues will remain a challenge, particularly as it holds general fund reserves below the level of most peers.
The city’s $3.9 billion general fund budget is funded primarily by a wage tax (46% of revenues, including taxes pledged to Pennsylvania Intergovernmental Cooperation Authority bonds), a property tax (14% of revenues), business income and receipts taxes (11%), a real estate transfer tax (6%), and a sales tax (4%).

Other than property taxes, the city’s tax revenues are highly susceptible to economic downturns, and have pressured the city’s finances in previous recessions.

The economic recovery of the past few years has increased tax receipts and helped the city’s finances recover: the general fund balance rose from as low as negative 3.5% in 2010 to a six-year high of 7.7% in 2013.

The city ran a deficit of roughly $70 million in 2014, largely due to an appropriation of its fund balance that was not fully replenished. The fund balance, now at 5.6%, is below levels of most other cities, and remains a key risk for the city in light of the sensitivity of its revenues to economic downturns. Further, the city’s long-term plan is to continue cutting its wage tax, although management expects the rate cuts will be offset by growth in taxable wages.

Favorably, the city has shown a willingness to increase property taxes to balance its budget, raising the levy by 10% in 2011. It also reduced staff by more than 1,500, and negotiated higher pension contributions from all collective bargaining groups.

Ultimately, the city’s conservative budgeting, comprehensive long-term financial planning, and efforts to contain costs will contribute to the maintenance of adequate reserves and ongoing stability. The city is under oversight from the state-appointed Pennsylvania Intergovernmental Cooperation Authority (PICA), which continues to monitor and help stabilize the city’s financial operations.

Liquidity

The city’s liquidity at the end of fiscal 2014 (year ended 6/30/2014) was solid at roughly 12% of revenues. The intra-year low point in cash (net of cash flow notes) is usually March, before property taxes are collected. In 2014, the net cash low was roughly $100 million, which is about 2.5% of revenues. This marks a substantial improvement from five years ago, when net cash balances were frequently negative.

The city issues Tax and Revenue Anticipation Notes roughly midway through its fiscal year. The city’s reliance on TRANs has declined significantly as its cash balances have improved; the 2015 TRAN issuance of $130 million (3.5% of revenues) was well below the 2009 issuance of $350 million (9.7% of revenues).

DEBT AND PENSIONS: HEAVY DEBT AND PENSION LIABILITIES

The city’s debt and pension liabilities are heavy and will remain a drag on its credit profile for the long term. The city’s tax-supported debt totals roughly $4.2 billion, equal to 4.2% of full value and 1.1 times revenues. Debt is heavy in large part because of the city’s $1.4 billion of Pension Obligation Bonds outstanding. Debt will remain heavy as it amortizes slowly (51% of principal is scheduled to be repaid in 10 years), and the city has material capital reinvestment needs that will be largely funded by debt.

Debt Structure

Philadelphia’s tax-supported debt includes general obligation bonds ($1.4 billion), PICA wage tax bonds ($363 million), and authority-issued service fee or lease bonds ($2.4 billion). See the “legal security” section below for a discussion of the city’s authority-issued bonds. The city has about $217 million of variable rate demand debt, backed by liquidity facilities and hedged with swaps.

Debt-Related Derivatives

The city has hedged its variable rate demand debt with swaps. The city is also party to one basis swap. The total value of the swaps is approximately negative $80 million.

Pensions and OPEB

The city operates one defined-benefit plan: the City of Philadelphia Public Employees Retirement System (not including the pension plan for the Philadelphia Gas Works). The plan has roughly 65,000 members. On an actuarial basis, the plan had $4.8 billion of assets and $10.1 billion of liabilities as of the 2014 actuarial valuation, for a funded ratio of 47%.

Moody’s makes certain adjustments to pension data to improve comparability of reported pension liabilities. After
making these adjustments, the adjusted net pension liability for the city's pension plan has averaged $9.4 billion over the past three years, which is equal to almost 11% of full value and 2.7 times revenues, well above average for Moody’s-rated local governments. The heavy liability is reflected in a heavy fixed-cost burden: the required pension contribution is a very high 22% of revenues, which doesn’t include debt service on the city's Pension Obligation Bonds. The city has reduced its assumed rate of return on its pension plan, to 7.8% from 8.75%.

The city’s other post-employment benefit liabilities are more modest: OPEB contributions are about 2% of revenues.

MANAGEMENT AND GOVERNANCE

Pennsylvania cities have an institutional framework score of Aa, or strong. Cities enjoy the authority to adjust the property tax millage without limitation. While many cities rely on economically sensitive revenues such as income taxes, they have the authority to increase property taxes to offset any declines in these revenues. Organized labor does have a strong presence in the state, and state labor law gives bargaining groups significant leeway to seek arbitration. Most cities have been challenged to control and predict labor costs.

The city is under oversight of a state board, PICA, which requires an approved five-year plan. The city has demonstrated a willingness to increase property taxes and cut costs, as well as decrease its assumed rate of return on its pension fund at a budgetary cost and negotiate pension and healthcare contributions from labor groups.

KEY STATISTICS

- Tax base size (estimated): $97 billion
- Full value per capita (estimated): $61,000
- Median family income as % of US: 72%
- General fund balance as a % of revenues: 5.6%
- 5-year dollar change in fund balance as a % of revenues: 7.6%
- Cash balance as a % of revenue: 11.7%
- 5-year dollar change in cash as a % of revenues: 10.3%
- Institutional Framework: Aa
- Operating History: 5-year average of operating revenues/operating expenditures: 1.00x
- Net direct debt/full value: 4.46%
- Net direct debt/operating revenues: 1.11x
- Moody’s ANPL/Full Value: 10.9%
- Moody’s ANPL/operating revenues: 2.7x

OBLIGOR PROFILE

Philadelphia is the fifth-largest city in the US by population. It has a general fund budget of $3.9 billion, and $4.2 billion of tax-supported debt.

LEGAL SECURITY

The 2015A bonds are secured by service fees paid by the City of Philadelphia to the Redevelopment Authority, sufficient to cover debt service. The service fees are contractually required to be appropriated; they are valid and binding obligations of the city, and are not subject to appropriation or subordinate to GO debt service.

The city’s tax-supported debt encompasses three different security types: direct General Obligation bonds ($1.4 billion outstanding), which are secured by the full faith and credit and taxing power of the city; authority-issued service fee and lease bonds ($2.4 billion), which are secured by valid and binding contractual obligations of the
city to cover debt service; and PICA’s wage tax bonds ($364 million), which are secured by a first lien on a portion of the city’s resident wage tax.

We rate the PICA bonds Aa2, with a stable outlook (no action is taken on those bonds with this report). We rate the service fee and lease debt the same as the city’s GO debt, although they are not parity obligations.

USE OF PROCEEDS

Proceeds of the Series 2015A bonds will be used to currently refund the authority’s 2005C bonds for estimated net present value savings of 14%.

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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