Moody's Investors Service

Global Credit Research
New Issue
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New Issue: Philadelphia (City of) PA

MOODY'S ASSIGNS Baa1 RATING AND STABLE OUTLOOK TO THE CITY OF PHILADELPHIA'S (PA) $184.7 MILLION G.O. BONDS

AFFIRMS Baa1 RATING AND STABLE OUTLOOK ON APPROXIMATELY $4.1 BILLION OF G.O. DEBT OUTSTANDING

Municipality
PA

Moody's Rating

ISSUE	RATING
General Obligation Bonds, Series 2008	Baa1

Sale Amount	$184,700,000
Expected Sale Date	12/08/08
Rating Description	General Obligation

Opinion

NEW YORK, Dec 1, 2008 -- Moody's Investors Service has assigned a Baa1 rating and stable outlook to the City of Philadelphia's $184.7 million General Obligation Bonds, Series 2008. At this time, Moody's has affirmed the Baa1 rating and stable outlook on $1.17 billion in parity debt previously issued by the city as well as the Baa1 rating and stable outlook on $2.75 billion in other unconditional General Fund obligations. The bonds are secured by the city's general obligation, unlimited tax pledge and proceeds will be used for various capital projects, including streets, buildings and park/recreation projects.

Affirmation of the Baa1 rating and stable outlook reflects the city's relatively weak finances, which had improved over the past three fiscal years, but weakened in fiscal 2008 and are expected to further deteriorate in fiscal 2009. The rating also reflects weak demographic and economic trends, modest property value growth, and a heavy burden of tax-supported debt. Mitigating these weaknesses, city finances are subject to oversight by a state body, with well-established five-year planning and quarterly monitoring procedures in place. The city's budgetary management has been effective in recent years, which had contributed to maintenance of a positive unreserved General Fund balance for over a decade; three years of large operating deficits, however, depleted reserves and created a negative unreserved fund balance at the end of fiscal 2004. The city returned to surplus operations in fiscal 2005, 2006 and 2007. The city expects to run an operating deficit in fiscal 2008, reducing General Fund balance to $119.5 million. The city is also projecting potentially significant operating deficits for fiscal 2009 through 2013, driven by expected weakness in the Business Privilege and other taxes, as well as anticipated increases in pension funding needs due to recent investment volatility. Moody's stable outlook reflects the expectation that, despite these fiscal challenges, the city will address the current financial stress adequately through fiscal 2009 and beyond. Moody's rating also acknowledges that a potential large pension obligation bond issue issued in the future could significantly increase the city's debt burden.

FINANCES WEAKEN IN FISCAL 2008 AND ARE EXPECTED TO REMAIN WEAK THROUGH 2009

Prior to fiscal 2008, the city experienced three years of surplus operations that increased reserves since substantial operating deficits in 2002 through 2004 reduced unreserved General Fund balance to -$148 million, or a negative 4.8% of 2004 General Fund revenues. Prior to 2004, the city had maintained a positive unreserved General Fund balance for 11 years, even with gradual reductions in the city's wage tax rate since 1995, intended to enhance the city's competitive position.. Through fiscal 2009, the rate has been reduced by approximately 16%, with additional reductions originally planned through fiscal 2013.

Philadelphia's responsibility for both city and county government services, a trend of loss of middle-class residents, already high tax rates and sluggish tax base growth have combined to present significant challenges to the maintenance of balanced financial operations. The city's finances are subject to oversight by a state body, the Pennsylvania Intergovernmental Cooperation Authority (PICA), with well-established five-year planning and quarterly monitoring procedures in place. State oversight is to continue until long-term bonds sold by PICA to finance the city's early 1990's accumulated operating and capital deficits are fully retired (scheduled final maturity is in 2022). In response to these challenges, the city's financial management processes have been prudent, with cautious revenue forecasts, moderate contingency reserves, and other smaller layers of cushion included in recent years' annual budgets.

In fiscal 2007, the city experienced its third year of surplus operations of approximately $180 million (on a GAAP basis), increasing total General Fund balance to $488 million (a healthy 14.8% of General Fund revenues) and unreserved General Fund balance to $153 million (a narrow 3.9% of General Fund revenues) on a GAAP basis; on a budgetary basis, General Fund balance grew to $297 million (8.0% of General Fund revenues). While real estate transfer taxes were lower than the previous year, they were still ahead of budget, and business privilege and wage taxes remained strong in fiscal 2007. While back in March 2008, the city projected that fiscal 2008 would end with an $88 million use of reserves, officials now project a total use of reserves to be $178.3 million, reducing General Fund balance, on a budgetary basis, to $119.5 million, a narrow 3% of General Fund revenues, driven by weaker-than-budgeted Business Privilege, Real Estate Transfer, and Wage tax collections, due to the national economic downturn, as well as increased employee costs related to health care collective bargaining agreement settlements.

The city's fiscal 2009 adopted budget, developed in conjunction with the city's 2009-2013 five-year plan, anticipated a use of General Fund balance of approximately $136 million, reducing reserves to $62.5 million, a very narrow 1.6% of budgeted General Fund revenues.. The budget assumed modest growth in business privilege tax. The city has revised its revenue forecasts downward and developed a plan to reduce the budget gap. The plan includes a delay in the scheduled city-funded wage tax reductions until 2015 as well as various expenditure cuts, such as a reduction in force, hiring freeze, and closure of some libraries and pools. While the plan will not achieve its full effect until fiscal 2010, the city expects that these reductions will help prevent depletion of the city's General Fund balance; even so, the city still expects reserves to fall to approximately $41 million in fiscal 2009.

City officials have projected that the slowdown in revenue growth and a probable increase in pension costs due to poor investment performance could create a deficit of $1.0 in the total five-year plan. The 2009-2013 plan, as approved by the city's oversight board in June 2008, originally maintained General Fund balance at approximately $30 million through 2010-2013. With the implementation of the budget-balancing plan, the city still expects to run operating deficits in 2009 and 2010 that will sharply limit financial flexibility and may affect credit quality. Moody's will continue to monitor the city's plans to reduce and eliminate the large gap in the five-year plan.

WEAK LONG-TERM DEMOGRAPHIC AND ECONOMIC TRENDS

Philadelphia has experienced a long trend of industry and population loss since 1950, with a particularly sharp economic retreat hitting in the late 1980's and early 1990's. The late 1990's saw a resumption of growth, with employment up 5.7% between 1998 and 2001. After a decline between 2001 and 2003, reflecting the slowdown in the national economy, modest growth in employment resumed, with growth of about 1.1% in 2005, 0.9% in 2006, and 0.7% in 2007. Results for the first six months of 2008 demonstrate continued growth, with each month showing an increase over the same month of the prior year, although results for July and August show zero growth. Given an increase in unemployment rates (7.6% in September, 2008 vs. 6.1% in September, 2007) and the national economic slowdown, we believe it is likely there will be job losses in the latter half of the calendar year. Manufacturing has continued to decline in importance, and as of 2005, diversified services account for 54% of total employment (or more than 60% including the finance/insurance/real estate sector). Population loss during the 1990's was just over 4%, although this was only about half the loss that had been estimated prior to the 2000 census count. With an estimated 1.45 million residents, the city is the nation's sixth most populous.

Resident wealth indicators are low, with per capita and median family incomes only about 77% and 74% of the national median, respectively, and 23% of residents below the poverty level. A relatively large portion of the city's job base is in low-paying sectors, with healthcare, social services, and state and local government accounting for about 30% of total jobs (a large share of which are likely held by city residents, as opposed to commuters).

The city's taxable base has grown modestly over the past decade, averaging 2.8% growth annually since 2002. The approximately $60 billion tax base does benefit from significant diversity, with the 10 largest tax payers comprising less than 5% of total valuation.

SIGNIFICANT DEBT BURDEN; SOME VARIABLE RATE EXPOSURE

Including this issue, Philadelphia's total tax-supported debt is approximately $7.4 billion, inclusive of overlapping school district debt. The ratio of debt to full property value is high at 12.1%, one of the highest ratios among the nation's 10 largest cities. The city's high debt burden reflects its dual city and county responsibilities, special efforts to promote economic development (e.g. convention center, stadiums, and blight remediation), the PICA deficit-funding bonds sold in the early 1990's, and a $1.3 billion pension bond issued several years ago. In addition, the school district has faced significant capital needs associated with its aging facilities. With city G.O. bond issuance tightly constrained by a debt cap in the Pennsylvania Constitution, there will likely be continued use of non-G.O. debt structures going forward.

The city has proposed issuing additional pension obligation debt, possibly resulting in an additional $3 billion in borrowing. The city is currently reviewing various plans for the debt issuance and it would require approval of the city council. City management has indicated that the debt would only be issued if it resulted in significant annual savings over the current plan of funding the unfunded liability over time. Moody's will review any POB proposal that the city presents, and while we acknowledge that the unfunded pension obligation represented a long-term liability, the issuance could increase the city's debt burden considerably.

The city has variable rate exposure representing approximately 14.7% of its total general obligation and unconditional General Fund debt. In conjunction with the Series 2007B bonds issued last year, the city entered into an interest rate swap with Royal Bank of Canada (RBC - Issuer Rating of Aaa) for a notional amount equal to the Series B issuance amount. The city makes semi-annual payments based on a fixed rate and RBC makes monthly payments based on the SIFMA (formerly BMA) Municipal Swap Index. Regularly scheduled payments will be parity with the general obligation debt of the city. Early termination is optional for the city only. Termination events include deterioration of either the city or RBC's rating falling below Baa3 and the downgraded party has not transferred the agreement to an acceptable party or provided for a Credit Support Provider. The rating of the insurer of the swap (FSA, currently rated Aa3 with a developing outlook) would also have to fall below A3. The potential termination payment is currently assessed at a manageable $4.6 million for the city. A termination payment by the city would be subordinate to the general obligation debt service payments.

The last rating action was on October 23, 2008 when the general obligation rating of the City of Philadelphia was affirmed.

The principal methodology used in rating the City of Philadelphia's General Obligation Bonds, Series of 2008 was The Determinants of Credit Quality, which can be found at www.moodys.com in the Credit Policy & Methodologies directory, in the Index of Special Reports - U.S. Public Finance subdirectory. Other methodologies and factors that may have been considered in the process of rating this issuer can also be found in the Credit Policy & Methodologies directory.

Outlook

Moody's rating outlook for Philadelphia is stable, reflecting the city's multiple years of surplus operations and management's commitment to reducing the expected budget gap going forward. Moody's believes the city will continue to benefit from the five-year planning and quarterly monitoring procedures required by the state oversight board.

What could make the G.O. rating go UP:

- Strengthening of financial operations resulting in substantial fund balance improvement

- Improvement in economic/demographic trends

What could make the G.O. rating go DOWN:

- Further financial deterioration in fiscal 2009 and beyond

KEY STATISTICS

2006 estimated population: 1.45 million

2008 full value: $60.8 billion

Full value per capita: $42,025

1999 Per capita income as % of state: 79.1%

1999 Median family income as % of state: 75.3%

Direct debt burden: 7.5%

Total debt burden: 11.8%

Payout of principal (10 years): 38.4%

FY2007 General Fund balance: $487.8 million (14.8% of General Fund revenues)

FY2007 Unreserved General Fund balance: $152.7 million (3.9% of General Fund revenues)

FY2007 General Fund balance (budget basis): $297 million (8.0% of General Fund revenues)

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