Fitch Rates City of Frederick, MD's GO Bonds 'AA+'; Outlook Stable

Fitch Ratings-New York-11 March 2016: Fitch Ratings has assigned a rating of 'AA+' to the following general obligation (GO) bonds to be issued by the city of Frederick, MD:

- $25,900,000 taxable refunding bonds, series 2016A;
- $18,870,000 tax-exempt public improvement bonds, series 2016B;
- $25,900,000 tax-exempt refunding bonds, series 2016C.

The bonds will be offered through competitive sale on March 16. Proceeds of the series 2016A and 2016C bonds will defease and refund for debt service savings all or a portion of the outstanding tax-exempt public improvement bonds, series 2009A and taxable public improvement bonds, series 2009B. The series 2016B bonds will finance general capital and water and sewer related projects.

In addition, Fitch affirms the 'AA+' rating on the city's $161.2 million of outstanding GO bonds.

The Rating Outlook is Stable.

STRONG FINANCIAL FLEXIBILITY: The city maintains a healthy unrestricted fund balance that is boldly above its 12% rainy day reserve policy. Fitch views the city's capacity to increase revenue as legally and economically ample.

STRONG DEMOGRAPHIC PROFILE: Population has been growing at a solid rate, residents exhibit a high level of educational attainment, and the city's unemployment rate typically registers below that of the state and nation. The city exhibits good affluence as measured by a market value in excess of $100,000 per capita and median household income equivalent to 129% of the U.S. standard.

FORT DETRICK DRIVES ECONOMY: The main driver of the economy is the presence of Fort Detrick. A solid history of growth for the fort and its leading role in the U.S. Army's efforts in biomedical research, telecommunication services and the study of infectious disease risk offsets the concentration risk attributable to its size (9,100 employees).

The balance of the city's economy is fairly diverse and the city lies in relatively close proximity to Washington D.C. and Baltimore.

MODERATE LIABILITY BURDEN: Limited existing capital needs and borrowing plans, combined with a rapid payout of debt and pension reform efforts, point to debt and pension liabilities remaining moderate when measured against the city's fairly affluent tax base.

ELEVATED FIXED COSTS: Debt service and retiree benefits consume roughly one-third of annual spending, which Fitch considers high. Recent benefit reforms have reversed the trend of rising pension payments, tempering this risk. Reflected in the high fixed costs are the city's large retiree benefit obligations.

RATING SENSITIVITIES

OPERATING STABILITY: The rating may become sensitive to the city's high cost of debt and pension liabilities relative to spending. However, the Stable Rating Outlook reflects the city's favorable financial management track record, good revenue flexibility that would allow it to respond to unforeseen budgetary pressures, and a current economic environment exhibiting moderate growth.

CREDIT PROFILE

The city of Frederick occupies a land area of more than 23 square miles in Frederick County, for which the city serves as the county seat. Frederick is situated along I-70 and I-270 approximately 50 miles distance from both Washington, D.C. and Baltimore. The city is the second largest in Maryland by population, which is estimated at 68,400 in 2014, a 4.8% increase since 2010.

ECONOMIC PROFILE LINKED TO FORT DETRICK AND INCLUSION IN D.C. METRO AREA

The city's economy is fueled by its proximity to the region's key governmental, technological, and biomedical economic assets. Frederick is home to the U.S. Army's Fort Detrick, site of the U.S. Army Medical Research Institute of Infectious Diseases, the National Cancer Institute, and the National Interagency Biodefense Campus. The fort has grown steadily in size and now employs 9,100 or the equivalent of 7.3% of total resident employment in Frederick County. Fort Detrick's economic impact extends beyond its own direct payroll stimulating investment from private sector firms. MedImmune (AstraZeneca), one of the city's top 10 taxpayers, is expanding its Frederick biopharmaceutical manufacturing plant by $250 million and 300 new employees over the next three years. Other large employers within the city include the Frederick County Board of Education (5,650), Frederick Memorial Healthcare (2,696), Ledios Biomedical Research (1,836), Wells Fargo Home Mortgage (1,881), and State Farm Insurance (839).

The city's average annual unemployment has registered below that of the state and U.S. in each of the last 10 years and its December 2015 monthly rate was a low 4.3%. City median household and per capita income are equal to 115% and 129% of the national average, respectively, but income growth has been flat since 2010. The city's tax base has expanded at a compound annual growth rate of 1.7% the last five years, including growth of 3.2% in fiscal 2015 and 2.8% in fiscal 2016. New construction activity was very strong in 2015, particularly in the commercial sector, but median home prices reported by Zillow (at roughly $253,000) remain about 33% less than the pre-recession peak.

HEALTHY RESERVE POSITION

The general fund position remains healthy with an unrestricted fund balance totaling $14.7 million or the equivalent of 20.3% of operating expenditures and transfers out in fiscal 2015. The city has maintained an unrestricted or unreserved fund balance of at least 17% since fiscal 2006. The city has a formal rainy day reserve policy set at 12% of general fund operating expenditures to provide additional resources during lean years. Liquidity is sound with general fund cash and investments at year end totaling $19.2 million equal to 3.5x total liabilities or 26% of annual spending. The general fund reports a $5 million interfund payable related to losses from the operation of a municipal golf course, offset by a nonspendable reservation of fund balance in the same amount. The golf course was not subsidized by the general fund in fiscal 2015 but reported a very modest $91,699 in surplus cash from operations on the year.

GOOD EXPENDITURE MANAGEMENT AND REVENUE FLEXIBILITY

The general fund recorded an operating surplus after transfers of $1.4 million (1.9% of spending) in fiscal 2015 following two consecutive years of fund balance use. Operating performance has been good for the past two fiscal years as the city has reported a very modest $91,699 in surplus cash from operations on the year.
which have a +1 rating assigned to them. The estimated net pension liability (NPL) of $93.3 million in fiscal 2015 or 1.5% of MV, when adjusted by Fitch to assume a 7% investment rate of return in place of the plan’s 7.5% rate. The Fitch adjusted ratio of assets to liabilities is an estimated 56.6%.

The combined debt and pension burden is viewed as moderate and stable. The pension NPL has declined from $100.1 million in fiscal 2012 following pension reform and the city’s payments to the plan have equaled or exceeded 100% of the actuarial required payment.

The city’s five-year capital plan totals $147.8 million including $43.1 million for the water and sewer enterprises that Fitch expects will be fully supported from user fee revenue. The capital plan calls for the issuance of $24 million in new water and sewer debt and $44.7 million in new tax-supported debt, compared to $70.2 million in outstanding debt to be repaid in the ongoing year.

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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, IHS Global Insight, and Luminis.

Fitch recently published exposure drafts of state and local government tax-supported criteria (Exposure Draft: U.S. Tax-Supported Rating Criteria, dated Sept. 10, 2015 and Exposure Draft: Incorporating Enhanced Recovery Prospects into U.S. Local Tax-Supported Ratings, dated Feb. 2, 2016). The drafts include a number of proposed revisions to existing criteria. If applied in the proposed form, Fitch estimates the revised criteria would result in changes to less than 10% of existing tax-supported ratings.

Fitch expects that final criteria will be approved and published in the beginning of the second quarter of 2016. Once approved, the criteria will be applied immediately to any new issue and surveillance rating review. Fitch anticipates the criteria to be applied to all ratings that fall under the criteria within a 12-month period from the final approval date.

In addition to the sources of information identified in the applicable criteria specified below, this action was informed by information from CreditScope and Luminis.

Applicable Criteria
Exposure Draft: Incorporating Enhanced Recovery Prospects into US Local Tax-Supported Ratings (pub. 02 Feb 2016) (https://www.fitchratings.com/creditdesk/press_releases/content/ridf_frame.cfm?rpt_id=855314&cft=eyJ0eXAiOiJKV1QiLCJhbGciOiJIUzI1NiJ9.eyJleHAiOjE0NTc3NTIwODcsInNlc3Npb25LZXkiOiJZVldMT05ESDJHQVdHTVJEUldMMUtFVlFFTjFOUVpVNUZYSVg2RTRaIn0.pkyqs_TL_tlP96qthXCBjZd9h6uKg42qZn3z1n6Zn1hMvJyBtPEm_CUaIC5Wn5JxuOpNzn9lsGctY81sMA=mjMu6EhJy4o=)

Additional Disclosures
Dodd-Frank Rating Information Disclosure Form (https://www.fitchratings.com/creditdesk/press_releases/content/ridf_frame.cfm?pr_id=1000796&cft=eyJ0eXAiOiJKV1QiLCJhbGciOiJIUzI1NiJ9.eyJleHAiOjE0NTc3NTIwODcsInNlc3Npb25LZXkiOiJZVldMT05ESDJHQVdHTVJEUldMMUtFVlFFTjFOUVpVNUZYSVg2RTRaIn0.pkyqs_TL_tlP96qthXCBjZd9h6uKg42qZn3z1n6Zn1hMvJyBtPEm_CUaIC5Wn5JxuOpNzn9lsGctY81sMA=mjMu6EhJy4o=)

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