FitchRatings

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;
--$56,265,000 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.

SECURITY

The bonds are a general obligation of the city backed by its full faith and credit and unlimited taxing power.

KEY RATING DRIVERS

STRONG FINANCIAL FLEXIBILITY: The city maintains a healthy unrestricted fund balance that is solidly 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, telecommunications 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 cost burden is an aggressive debt structure that repays close to 70% of outstanding principal in 10 years and contributions to a trust for future other post-employment benefits (OPEB).

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 revenue to provide funds for working capital and unforeseen emergencies. 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 totaling $7.8 million related to capital investments and a reduction in state highway user revenue. Actual total expenditures were $3.6 million lower than budget in fiscal 2015 helping to eliminate the forecasted use of $2.6 million in fund balance on the year. Management reviews departmental budgets monthly and prepares formal quarterly reports for review by the city's Board of Aldermen.

A similar amount of fund balance usage is budgeted for fiscal 2016 but management reports year-to-date operations are tracking better than forecast by several hundred thousand dollars. The budget also funds a $1.1 million contribution to the city's long-term capital improvement program. Property taxes fund 70% of the general fund budget. The city's property tax rate and levy are not limited by state law or city charter and its tax rate of $0.7305 per $100 in assessed value (AV) was last increased effective fiscal 2013. The tax base is very diverse and tax collections are excellent averaging 99.9% over the prior 10 years.

HIGH CARRYING COSTS

Fixed charges associated with governmental fund debt service and retiree pension and OPEB costs represented a high 28.9% of total spending in fiscal 2015. Debt service accounted for a moderate 8.8% of spending in fiscal 2015. Annual debt service requirements descend by roughly 25% in fiscal 2024 and 50% by fiscal 2028 providing potential budget relief and/or capacity to meet new debt demands. Pension payments, which were 12.3% of spending in fiscal 2015, have declined following several benefit reforms - the city has budgeted $10.9 million in fiscal 2016 compared to $11.75 million in fiscal 2013. Pension reforms impact new hires after June 30, 2012 and include a reduction in cost-of-living-adjustments and benefit multiplier, an increase in employee contributions, change in vesting periods, normal and early retirement age, and pensionable salary. Employer contributions for OPEB were $6.85 million or a high 7.8% of spending in fiscal 2015 but 40% of this amount or $2.75 million represented a deposit to a trust fund to pre-pay future benefits.

MODERATE LONG-TERM LIABILITY BURDEN

Fitch estimates the city's overall debt burden at 3.9% of market value (MV) or $4,063 per capita. These metrics include the proposed bonds and debt of the golf and airport funds, for which the city's general fund provides debt service and at times operational support. The city administers three separate defined benefit pension plans which have a Fitch estimated combined 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 plans' 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 during the same period.

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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 Lumesis.

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 Lumesis.

Applicable Criteria
Exposure Draft: Incorporating Enhanced Recovery Prospects into US Local Tax-Supported Ratings (pub. 02 Feb 2016) (https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=875108&cft=eyJ0eXAiOiJKV1QiLCJhbGciOiJIUzI1NiJ9.eyJleHAiOjE0NTc3NTIwODcsInNlc3Npb25LZXkiOiJZVldMT05ESDJHQVdHTVJEUldMMUtFVlFFTjFOUVpVNUZYSVg2RTRaIn0.pkyqs_TL_ssO1QslxN7GvPKX-kW7L4F199Mne9ebz5I)
Exposure Draft: U.S. Tax-Supported Rating Criteria (pub. 10 Sep 2015) (https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=869942&cft=eyJ0eXAiOiJKV1QiLCJhbGciOiJIUzI1NiJ9.eyJleHAiOjE0NTc3NTIwODcsInNlc3Npb25LZXkiOiJZVldMT05ESDJHQVdHTVJEUldMMUtFVlFFTjFOUVpVNUZYSVg2RTRaIn0.pkyqs_TL_ssO1QslxN7GvPKX-kW7L4F199Mne9ebz5I)
Tax-Supported Rating Criteria (pub. 14 Aug 2012) (https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=686015&cft=eyJ0eXAiOiJKV1QiLCJhbGciOiJIUzI1NiJ9.eyJleHAiOjE0NTc3NTIwODcsInNlc3Npb25LZXkiOiJZVldMT05ESDJHQVdHTVJEUldMMUtFVlFFTjFOUVpVNUZYSVg2RTRaIn0.pkyqs_TL_ssO1QslxN7GvPKX-kW7L4F199Mne9ebz5I)
U.S. Local Government Tax-Supported Rating Criteria (pub. 14 Aug 2012) (https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=685314&cft=eyJ0eXAiOiJKV1QiLCJhbGciOiJIUzI1NiJ9.eyJleHAiOjE0NTc3NTIwODcsInNlc3Npb25LZXkiOiJZVldMT05ESDJHQVdHTVJEUldMMUtFVlFFTjFOUVpVNUZYSVg2RTRaIn0.pkyqs_TL_ssO1QslxN7GvPKX-kW7L4F199Mne9ebz5I)

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_ssO1QslxN7GvPKX-kW7L4F199Mne9ebz5I)
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