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Fitch Rates New York City's (NY) $650MM GOs 'AA'; Outlook Stable

Ratings Endorsement Policy

28 Feb 2014 5:01 PM (EST)

Fitch Ratings-New York-28 February 2014: Fitch Ratings assigns an 'AA' rating to the following New York City general obligation (GO) bonds:

--Approximately $650 million fiscal 2014 series I, subseries I-1.

In addition, Fitch affirms the 'AA' rating on the city's approximately $41.2 billion in outstanding GO bonds.

The affirmation applies to $45 million of fiscal 2004 series A, subseries A-6 bonds, which are expected to be reoffered and converted to fixed rate mode from weekly mode on March 25. The affirmation also includes the following bonds, which are expected to be reoffered and converted to index rate mode from weekly mode on March 25:

--$50.25 million general obligation bonds, fiscal 2004 series A, subseries A-6;
--$100 million general obligation bonds, fiscal 2008 series J, subseries J-9;
--$100 million fiscal 2008 series J, subseries J-11.

The Rating Outlook is Stable.

The series 2014 bonds are expected to be priced via negotiation on March 5. Proceeds will be used for capital projects and to pay costs of issuance.

SECURITY

The bonds are general obligations of the city secured by a pledge of the city's full faith and credit and the levy by the city of ad valorem taxes (without limit as to rate or amount) on all real property within the city subject to taxation. The city is not subject to New York State's property tax cap.

KEY RATING DRIVERS

SOLID ECONOMIC UNDERPINNINGS: The city has a broad economic base and serves a unique role as a national and international center for commerce, culture, and tourism. Recession-related job declines have been well under comparable national averages and job recovery has been strong, although the unemployment rate remains elevated.

HIGHLY EFFECTIVE BUDGET MANAGEMENT: The city's sound approach to budget development features reasonable revenue and expenditure forecasting, proactive budget monitoring, and effective actions to eliminate projected deficits. Currently forecasted budget gaps through fiscal 2018 are modest. However, risks to the forecast are significant given the number and magnitude of variables involved.

LABOR SETTLEMENTS UNCERTAIN: Fitch believes one of the biggest near-term risks to continued financial stability is the resolution of long-expired labor contracts. The city's preliminary budget for fiscal 2015 provides little detail on the approach to resolving the contracts. Fitch's rating assumes they will be resolved in a manner that preserves budgetary balance.

HIGH & GROWING LONG-TERM LIABILITIES: Fitch anticipates a continued high debt burden given the city's significant capital commitments and expected future tax-supported issuance. Post-employment liabilities are also sizable. Fitch expects the combined burden on the budget of long-term liabilities will remain fairly stable.

REVENUE DIVERSITY BUT CYCLICALITY: Economically sensitive revenues, including personal income, business, and sales tax, comprise a sizable share of the city's budget and are highly vulnerable to variability in the financial services industry. Recent performance shows a trend of sound growth with some year-to-year variability.

RATING SENSITIVITIES

PRUDENT BUDGET MANAGEMENT: Despite recent reductions in the magnitude of out-year imbalances, other credit risks make improvement in the rating unlikely. However, notable growth in these gaps could lead to negative rating action.

LONG-TERM LIABILITIES: An increase in the city's long-term liabilities could negatively affect the rating. Fitch believes the most likely avenue for controlling this growth is through retiree healthcare benefits, although pressure to control wage and salary costs may make obtaining savings in benefits difficult.

CREDIT PROFILE

EXPECTATION FOR CONTINUED BUDGET BALANCE

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The key credit strength underpinning Fitch's 'AA' rating is the city's tight budget monitoring and control as well as a demonstrated ability to achieve balance and manage out-year gaps. Regular reviews by various external financial oversight entities enhance the city's own internal analysis which includes monthly reporting and three detailed budget updates annually.

Fiscal year-end results generally show modest, positive variation from budget. Current fiscal 2014 estimates show revenues about 5.6% above budget, due largely to a surge in real estate transaction-related taxes. On Feb. 12, the city released its preliminary fiscal 2015 budget and four-year financial plan. Total fiscal 2015 budgeted spending of $75.5 billion is slightly higher than current fiscal 2014 estimates net of prepayments and an increase in the general reserve to $600 million (still less than 1% of spending) from $150 million.

LOW RESERVES MITIGATED BY STRUCTURAL PREPAYMENTS

The city's inability to carry a fund balance somewhat limits financial flexibility. Management has offset this constraint by using operating surpluses to prepay debt service and other expenses in subsequent years. Fitch expects the city to retain a modicum of accumulated surplus and continue the practice of prepaying out-year expenses. A marked change in this long-standing approach would be viewed negatively by Fitch.

The city accumulated an $8 billion surplus to roll forward prior to the economic downturn, with several consecutive years of operating surpluses. Between fiscal years 2009 and 2012, annual operating deficits eroded the amounts available for future years' budgets, but fiscal 2013 again reversed the trend, showing a moderate operating surplus. A surplus is forecast for fiscal 2014, of which the city plans to use a portion to maintain $1 billion in a retiree health benefits trust that had been budgeted to be used for operations. Fitch views the retention of this reserve positively.

DOWNWARD TREND IN OUT-YEAR GAPS

The financial plan continues to show meaningful reductions in projected future deficits. As recently as fiscal 2012, the executive budget showed gaps of $4.8 billion-$5.3 billion, or 6%-7% of the budget, in each of the out-years of the plan (fiscal 2013-2015). In contrast, the current financial plan shows minimal out-year gaps of $1.1 billion, $530 million and $370 million in fiscal 2016, 2017, and 2018, respectively.

The improvement in out-year gaps is a result of revenue strength, the city's continual efforts to control spending and enhance revenue through its programs to eliminate the gap (PEGs). Fitch believes these gaps are likely understated, as the plan makes little funding available for employee salary increases.

HIGHLY DETAILED ESTIMATES OF DIVERSE REVENUE MIX; RISKS REMAIN

The city benefits from a diversity of revenue sources, although many are subject to economic volatility. Fitch believes that the city's revenue estimates, based on a highly detailed and frequently-reviewed analysis, are reasonable.

The property tax is the largest source, at 27% of fiscal 2013 audited funds, followed by personal income tax at 14% and sales tax at 9%. Intergovernmental sources are primarily for education and social services programs and make up 28% of fiscal 2013 revenue. Combined taxes make up 64% of total revenue. The city has a modest amount of room to increase the property tax levy under the cap.

The full value of real estate grew by a healthy 6.2% in fiscal 2013 and an even stronger 10.7% in fiscal 2014, following modest growth the prior two fiscal years. Officials expect the final roll for fiscal 2015 to be up 5.7%. The five-year phase-in of market value changes should promote solid property tax performance for at least the next few fiscal years.

Areas of revenue risk beyond forecast tax variations include state revenue shortfalls that could result in reduced aid to municipalities including New York City and federal actions that could result in reduced funding to the city. Recent budgets have included modest amounts of non-recurring revenue; Fitch would be concerned if such funding sources grew to be significant.

The city hopes to obtain approval from the state to increase the income tax rate on filers, with more than $500,000 in taxable income to fund the implementation of a universal pre-kindergarten program and an afterschool program for middle school students. Both the revenue ($530 million in fiscal 2015, with slight increases thereafter) and the spending for these programs are included in the preliminary budget, but approval of the tax increase is widely reported to be uncertain at best.

Management estimates the gross cost to public sector facilities from Hurricane Sandy to be $5.1 billion. Of this amount, $1.8 billion will come from the operating budget and the rest from reimbursable capital spending. The city expects all costs to be reimbursed from non-city sources. The damage cost estimate does not include the cost of enhancements for future damage mitigation.

ACUTE SPENDING PRESSURE FROM LABOR

The biggest current budgetary uncertainty is the potential cost of expired labor contracts. The rating assumes the city will resolve open contracts in an affordable and prudent manner.

The budget includes no retroactive salary adjustments, but a modest reserve of 1.25% per year for contracts that have been expired for three years. Fitch is concerned that the resolution of expired contracts will result in sizable spending pressures going forward. A fact-finding procedure with the UFT has occurred, though the timing of recommendations (which are non-binding) is uncertain. Other labor unions are subject to binding arbitration if a settlement cannot otherwise be reached.

The city estimates the cost of each 1% salary increase at $317 million annually. Fitch believes that the budget could accommodate an ongoing increase that approximates inflation. However, given how long ago many of the contracts expired, the compounding effect of such

an increase on a retroactive payment would create both a significant one-time payment and a large ongoing budget gap.

CARRYING COSTS EXPECTED TO REMAIN MANAGEABLE
Debt service consumes $5.7 billion, or a moderate 7.8% of fiscal 2014 forecast spending. Debt service is projected to increase to $7.8 billion (9.6% of total spending) by fiscal 2018. Debt amortization is average. Fitch recognizes the city's conservative budgeting of debt service expense and views positively the city's ability to achieve sizable interest rate savings from debt refinancing over the last several years. Fitch does not view the reduction in the subsidy for federal tax credit bonds such as Build America Bonds as a risk for the city, as the financial exposure is minimal.

A more notable concern is the cost of pension and other post-employment benefits (OPEB), which total $8.3 billion and $2.2 billion, respectively (a combined 14.2% of expenditures), in the fiscal 2014 forecast. The city projects that following rapid escalation in pension costs (from $1.5 billion in fiscal 2002), costs will grow slowly during the financial plan period. OPEB payments, while lower, grow more quickly and reflect funding on a pay-as-you-go basis.

Fitch believes cost pressures associated with pensions will continue. As of the most recent actuarial valuation date of June 30, 2011, pension funded ratios were weak at an aggregate of 60.7%, and the unfunded liability was a large $72 billion. The city uses an expected investment return rate of 7%. The city's actuary projects the aggregate funded ratio will increase to 67% by fiscal 2018. Fitch would be concerned if pension payments increased more than anticipated or unfunded liabilities grew measurably.

The unfunded OPEB liability was similar at $69.3 billion as of the last actuarial valuation date of June 30, 2012. There are no signs of an effort to reduce it either by adding to the retiree health benefit trust or reducing benefits. Fitch estimates the liability is now modestly higher as the annual payments in fiscal 2013 and 2014 are far below the ARC and $1 billion was transferred from the trust for operations. Favorably, the new administration has decided to preserve the remaining $1 billion in the trust, which will slightly reduce the rate of increase in the liability.

HIGH AND RISING DEBT IS A CREDIT CONCERN

Debt metrics are expected to remain high but stable relative to the city's vast tax base. Fitch-calculated net tax-supported debt including Transitional Finance Authority (TFA) future tax secured bonds equals approximately $8,830 per capita, and 8.2% of fiscal 2014 full value. If unfunded pension and OPEB obligations were included, the long-term obligation burden would roughly triple. Carrying costs for debt service, pensions and OPEB were 19.7% of spending in fiscal 2013, which Fitch considers to be in the moderate range.
The city's capital commitments are extensive, totaling $36.5 billion for fiscal 2014-2017, including $7.5 billion for self-supporting water and sewer projects and $8.4 billion for education. Tax-supported issuance plans for fiscal 2014-2017 include $9.8 billion of city GOs and $10.5 billion of TFA future tax-secured bonds. The new administration anticipates reviewing the capital plan over the next few months; Fitch does not expect significant deviation in the overall size of the plan or debt needs.

The city and related issuers have approximately $10.4 billion in outstanding variable-rate debt (16% of tax-supported debt). Fitch considers this exposure manageable given the hedge provided by the city's substantial short-term assets and its sophisticated management, diversity of liquidity providers, and strong demonstrated access to the capital markets.

ECONOMY HAS INHERENT STRENGTHS BUT NOT WITHOUT CHALLENGES

Fitch considers the city's unique economic profile, which centers on its singular identity as an international center for numerous industries and major tourist destination, to be a credit strength. The character of the New York City economy has contributed to its relative employment stability during the recession and ability to regain by March 2012 the number of private sector jobs that existed prior to the recession. The city's tourism sector is performing exceptionally well, attracting a record 52 million visitors in 2012, the third record year in a row. Preliminary figures indicate over 54 million visitors in 2013.

The city's economic profile also benefits from good wealth levels; per capita personal income is 130% of the U.S. and market value per capita is over $100,000. However, the above-average individual poverty rate of 19.4% in 2011, compared to 14.3% for the U.S., indicates significant income disparity.

The city's economy (and operating budget) is strongly linked to the financial sector, which accounts for approximately 12% of total employment but 30% of earnings. Financial activities employment was flat in 2013. However, the high-earning securities and commodities component of the sector dropped 0.6% jobs following a 1.5% decline in 2012.

The city's resident employment base increased by 1% in 2012, above the state's slight 0.4% growth but behind the U.S. at 1.9%. The unemployment rate increased to an average of 9.2% in 2012 from 9% in 2011. Recent data are more encouraging.The December 2013 preliminary rate of 7.5% is a significant improvement over the December 2012 rate of 8.8% despite a solid 2.2% increase in employment. However, the most recent rate is still well above the state and federal averages.

The city assumes continued strong visitor-related spending and moderate economic growth will yield sales tax growth of 4.8% in fiscal 2014, after 5.5% growth in fiscal 2013. The latter recognizes the temporary slow-down, and then acceleration, in spending following Hurricane Sandy.

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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, CoreLogic Case-Shiller Home Price Index, and Global Insight.

Applicable Criteria and Related Research:
--'Tax-Supported Rating Criteria' (Aug. 14, 2012);
--'U.S. Local Government Tax-Supported Rating Criteria' (Aug. 14, 2012).

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Tax-Supported Rating Criteria
U.S. Local Government Tax-Supported Rating Criteria

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