Moody's Investors Service

New Issue: MOODY'S ASSIGNS A3 TO CITY OF WORCESTER'S (MA) $38 MILLION GO BONDS

Global Credit Research - 21 Oct 2009

LONG-TERM A3 RATING AFFIRMED, AFFECTING $593 MILLION OF OUTSTANDING GO DEBT

Municipality
MA

Moody's Rating

ISSUE	RATING
General Obligation Bonds	A3

Sale Amount	$38,075,000
Expected Sale Date	10/27/09
Rating Description	General Obligation

Opinion

NEW YORK, Oct 21, 2009 -- Moody's Investors Service has assigned an A3 rating to Worcester's $38 million General Obligation Bonds. Concurrently, Moody's has affirmed the long-term A3 rating assigned to the city's $555 million of previously-issued general obligation limited tax debt. The bonds are secured by the city's general obligation, limited tax pledge as debt service has not been excluded from the levy limitations of Proposition 2 ½. The bonds are issued to permanently finance a like amount of maturing BANs, which were originally issued for fiscal 2009 capital needs including roughly $25 million in self-supporting enterprise and other non-general fund capital projects. The A3 rating incorporates the city's satisfactory overall credit profile despite a strained financial position with limited flexibility and minimal reserves after significant reductions in state aid. The rating also incorporates management's commitment to implementation of its five-point financial management plan to establish long-term financial stability and enhanced reserves, anticipated medium-term expansion in the city's substantial economic base, which is anchored by multiple health and higher education institutions, and the city's above-average debt position which is expected to remain elevated for the medium term.

REDUCTION IN WORKFORCE IMPLEMENTED TO OFFSET STATE AID CUTS

Due to significant reductions in state aid in fiscal 2009 and 2010, Moody's expects Worcester's financial position to narrow in the near term but stabilize over the medium term as expenditure controls and a more conservative budgeting approach bring the city's operating budget closer to structural balance. Considerable draws on free cash in fiscal 2006 reduced total fund balance to $9.29 million, a very narrow 1.9% of general fund revenues. Operations were positive in fiscal 2007 and 2008 and free cash grew to nearly $2.8 million while general fund balance rose modestly to $10 million, a still-modest 2.2% of revenues. Available reserves, including unreserved general fund and stabilization fund, rose to roughly $15 million, a still-slim 2.8% of revenues. Favorably, the Worcester's combined stabilization funds totaled $5.07 million in fiscal 2008. Worcester has built a sizeable $12 million cushion of excess property tax levy capacity, and the city balanced the fiscal 2009 budget without tapping into this margin. However, despite significant expenditure reductions, including 130 layoffs, the city projects an operating deficit of roughly $5.4 million following a mid-year state aid reduction of $5 million and $3.1 million in over-expenditures for snow and ice removal. General fund balance is projected to drop to $6.1 million, a very modest 1.2% of revenues. Despite the strain on operations the city transferred approximately $12 million to various reserve accounts, improving combined stabilization funds to roughly $8.2 million.

The city has proposed a balanced budget for fiscal 2010 which includes an expenditure reduction of 2.8% over the initial fiscal 2009 budget, largely due to a $15 million decrease in aid from the commonwealth. Additional personnel reductions have resulted in a 12% drop in the city's workforce and city-wide department budgets have been reduced up to 18% over the fiscal 2009 budget. Notably, the city's unused property tax levy capacity of approximately $12 million has not been tapped, no free cash has been appropriated, and the city remains in compliance with its five-point plan by appropriating a total of $11.7

million to various reserve funds. A contingency reserve of $1 million has been budgeted to absorb mid-year budget cuts, however reductions are likely to exceed this reserve and additional personnel and expenditure reductions are likely. Moody's notes that state aid revenue is likely at best to remain flat for the medium term and balancing future operating budgets while building reserve levels consistent with the city's adopted fiscal policies will remain a challenge for Worcester without additional sources of revenue. Furthermore, limited use of Worcester's excess levy capacity to build financial flexibility is not likely to put negative pressure on the city's credit strength.

The city's water and sewer enterprises are expected to remain fully self-supporting, and rate increases have been recently enacted to offset increases in operating expenses and debt service. General fund operations are expected to improve following the anticipated sale of the city's airport to the Massachusetts Port Authority (revenue bonds rated Aa3/stable outlook), which the city had been subsidizing annually by roughly $1.2 million. In the long term, Worcester will also be challenged to address a large unfunded liability for post-employment health benefits (OPEB), initially calculated at $1.6 billion using the pay-as-you-go method, without the segregation of funds into a trust, or $810 million using the pre-funded method, which assumes the establishment of a trust fund and annual investment returns averaging 8.25%. Fully funding the Annual Required Contribution (ARC) under the pay-as-you-go option would have called for annual funding in fiscal 2008 of up to $111 million, while the pre-funded method would have required a fiscal 2007 appropriation of $66 million, a significant increase over the fiscal 2008 appropriation of $21 million. City management is evaluating strategies for managing the cost of post-employment health benefits and for funding the liability; the city's most recent actuarial evaluation indicates that the recent adoption of Section 18 requiring participation by Medicare-eligible employees could reduce the city's liability by as much as $110 million (on a pre-funded basis). The city remains moderately dependent on state aid, with over one-half of fiscal 2008 General Fund revenues received from the commonwealth, while property taxes accounted for the second largest revenue source at 34% of revenues. Although bank foreclosures have risen recently, tax collections remain strong, averaging 98% over the past five years, and the city has initiated an aggressive delinquent tax collection program.

IMPLEMENTATION OF COMPREHENSIVE POLICIES TO BUILD RESERVE LEVELS AND PROMOTE FISCAL STABILITY

The city's management team has begun frequent financial reporting to the city council to improve projections and enable timely mid-year adjustments when necessary. Additionally, the city has initiated long-range planning designed to stabilize the city's financial position and to replenish reserves. The city's management expects to receive up to $28.5 million in reimbursements over a 10-year period from the commonwealth from school building construction costs, and has earmarked these additional payments entirely for reserves including anticipated appropriations of $10 million to the capital campaign stabilization fund, with the balance to be used to construct a new high school, and to offset future general fund capital debt service expenses. The city does not anticipate any free cash to be generated when certified by the state later in fiscal 2010. Consequently, the city will be unable to add to its reserves from free cash in the near term. However, in years where free cash is positive, the city's policy requires a transfer of 50% of its certified free cash (net of deferred expenses to the subsequent fiscal year), to a separate "bond rating stabilization" reserve. Worcester continues to pursue opportunities to optimize the design of its health insurance plans to keep current costs and long-term liabilities manageable. Adherence to the city's five-point plan and other adopted policies will be critical to maintaining Worcester's long-term credit strength.

SIZEABLE AND DIVERSE TAX BASE ANCHORED BY UNIVERSITIES AND HEALTH CARE INSTITUTITONS

Moody's anticipates that Worcester, now the second most populous city in New England, will continue to experience steady expansion, although at a more modest rate, of its large $13.7 billion tax base as a result of economic revitalization efforts, leveraging of the city's important medical and higher education sectors, and moderate residential construction. Reversing a trend of significant tax base contraction since the early 1990s, equalized values have grown by double-digit annual percentages with annual gains averaging 11.2% from 2003 to 2009, although growth in the near term has begun to moderate as regional residential real estate markets remain weak, as reflected in the 4.6% decline in fiscal 2009 assessed valuation. City officials note that potential medium-term development could total up to $1.3 billion, including the $565 million redevelopment of the 20-acre CitySquare parcel, which is expected to include 2.14 million square feet of mixed-use development. Restoration of Worcester Common, Union Station Bus Terminal Improvements, redevelopment of the North Main Street District and several industrial sites are expected to add $435 million to the tax base in the medium term. The additional development, along with improvements to the Union Station intermodal transportation center serving MBTA commuter rail trains, Amtrak and bus service, as well as several commercial tenants, are expected to further enhance the already favorable location of the city, roughly equidistant - approximately 44 miles -- to the cities of Boston (rated Aa1/stable outlook) and Providence, Rhode Island (rated A3).

The city continues to demonstrate below-average socioeconomic indices as noted in the income levels that are approximately 70% of statewide medians. However, this is somewhat reflective of the large health care and educational components of the base that also represents a number of the city's top employers, including the UMass Memorial Medical Center (Baa1/stable outlook), College of the Holy Cross (Aa3/stable outlook), Clark University (A2/stable outlook), Worcester Polytechnic Institute (A1/stable outlook), Worcester State College (A3/stable outlook), and Massachusetts College of Pharmacy and Allied Health Sciences (A3/stable outlook). Unemployment historically trends higher than state and national rates and increased to 10.8% in August 2009, ahead of the state and national jobless rates of 8.9% and 9.6%, respectively. College students account for roughly 17% of the city's total 175,545 population and moderately depress income levels, which are low at roughly 86% of the national median for personal and median family incomes. Equalized value per capita is also relatively modest at $78,378, and increases to an above-average $94,709 if one were to consider the value of tax-exempt property in the city, estimated at $2.9 billion.

GENERAL FUND BORROWING SCALED BACK IN NEAR TERM

Moody's believes that Worcester's above-average 5.1% overall debt burden will continue to make a large claim on general fund operations (8.4% of fiscal 2008 General Fund expenditures) given the sizeable level of outstanding debt, below-average amortization of principal (63.6% repaid within 10 years), and approximately $270 million in authorized but unissued debt. Significant state school construction reimbursement (90%) mitigates the overall debt burden to a more affordable 4.2%, while water and sewer enterprise revenues support approximately $109 million in utility debt, roughly 17% of the city's outstanding obligations. The city's debt burden, which includes short-term bond anticipation notes, loans from the state revolving fund and fixed-rate general obligation bonds, is unusually high because of the issuance of $221 million of pension obligation bonds in 1998, which now represents just under one-third (29%) of the city's total outstanding long-term debt. Although the city initially eliminated its unfunded liability, several cycles of investment returns below target, as experienced by many retirement systems in this time period, dropped the pension system's funded ratio to below 70% in fiscal 2009. Worcester's capital improvement plan is under review and is likely to be more modest than previous plans in response to weak economic forecasts. Moody's expects Worcester's debt burden to remain above-average, with pressure on the general fund reduced somewhat by self-supporting enterprise debt, roughly $4 million in stabilization funds earmarked for future capital and debt service, together with anticipated increasing annual five-point plan appropriations dedicated to capital funding. To reduce pressure on future general fund budgets, fiscal 2009 general fund borrowing was scaled back to $13 million, well under Worcester's general fund annual debt service cap of approximately $18 million. Fiscal 2010 general fund borrowing is again expected to be reduced with up to $15 million issued throughout the fiscal year, along with additional enterprise debt. Worcester has no exposure to variable or auction rate debt or swap agreements.

KEY STATISTICS

2008 Population (estimated, US Census): 175,011 (+1.4% since 2000)

2008 Estimated Student Population: 31,000 (17.8%)

2000 Per Capita Income: $18,614 (71.7% of commonwealth, 86.2% of nation)

2000 Median Family Income: $36,261 (69.7% of commonwealth, 85.9% of nation)

2009 Equalized Value: $13.7 billion

2009 Equalized Value per capita: $78,378

Average Annual Equalized Value Growth (2003-2009): 11.2%

FY 2008 General Fund Balance: $11.9 million (2.2% of General Fund revenues)

Fy2009 General Fund Balance (unaudited): $6.1 million (1.2% of General Fund revenues)

FY 2008 Combined Stabilization Fund balances: $5 million (0.9% of General Fund revenues)

FY2009 Combined Stabilization Fund balances (unaudited): $8.2 million (1.5% of General Fund revenues)

Overall debt burden (unadjusted, includes pension obligation bonds): 5.1%

Overall debt burden, adjusted for school construction reimbursement: 4.2%

Amortization of principal (10 years): 63.6%

Long-term general obligation debt outstanding: $593 million

METHODOLOGY AND LAST RATING ACTION

The principal methodology used in rating the City of Worcester, Massachusetts was Moody's "Local Government General Obligation and Related Ratings," published in December, 2008 and available on www.moodys.com in the Rating Methodologies sub-directory under the Research & Ratings tab. Other methodologies and factors that may have been considered in the process of rating this issuer can also be found in the Rating Methodologies sub-directory on Moody's website.

The last rating action with respect to the City of Worcester, Massachusetts was on June 3, 2009 when a MIG 1 rating was assigned to its General Obligation Bond Anticipation notes and its long-term general obligation A3 rating was affirmed.

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