Fitch Downgrades Birmingham, AL's GO's to 'AA-'; Outlook Negative

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Fitch Ratings-New York-13 January 2017: Fitch Ratings has downgraded the following general obligation (GO) bonds of the city of Birmingham, AL to 'AA-' from 'AA':

--$332 million of outstanding GO bonds;
--$123 million of outstanding GO warrants;
--$67 million of outstanding revenue bonds (civic center improvements projects) issued by the Commercial Development Authority of the City of Birmingham (the CDA).

Fitch has also downgraded the city's Issuer Default Rating (IDR) to 'AA-' from 'AA'.

The Rating Outlook is revised to Negative from Stable.

SECURITY
All debt obligations in this press release constitute a general obligation of the city backed by its full faith and credit, payable from all legally available revenues of the city. However, there is no specific revenue pledged to bondholders. The city does levy certain limited ad valorem taxes, which may only be used for the payment of debt service on the GO bonds.

KEY RATING DRIVERS

The downgrade of the city's GO and IDR and the CDA revenue bonds to 'AA-' from 'AA' and the revision of the Rating Outlook to Negative from Stable reflects a combination of credit factors and the application of Fitch's revised criteria for U.S. state and local governments, which was released on April 18, 2016. Updated pension disclosure depicts a significant increase in the city's net pension liability (NPL) and the revised criteria highlights risk associated with the city's pension plans from the standpoint of long-term affordability and limitations on spending flexibility. The 'AA-' rating is supported by the city's strong financial position and resilience to economic and revenue stress given its very high reserves, ability to adjust rates or charges on its principal revenue sources, and still adequate expenditure flexibility despite moderately high carrying costs for debt and retiree benefits.

Economic Resource Base
Birmingham is located in north central Alabama, mainly within Jefferson County. Birmingham has an estimated population of 212,237 in 2015 making it the most populous city in the state.

Revenue Framework: 'aa' factor assessment
Solid revenue growth prospects exist given Birmingham's central role in a prominent regional economy. Operations are largely funded from a variety of economically driven taxes and fees which the city has unilateral authority to modify. Strict limitations are imposed on property taxes, which account for a low percentage of total revenue.

Expenditure Framework: 'a' factor assessment
Fixed costs associated with the servicing of debt and retiree benefits are viewed as moderately high, and the city's practice of consistently underfunding the actuarially-based pension contribution is expected to result in higher obligations in the future. Flexibility exists particularly in the large budget for various cultural and recreational facilities and broad legal control over employee wage and benefits.

Long-Term Liability Burden: 'a' factor assessment
The city has a moderately high long-term liability burden estimated at 27% of personal income and likely to rise further given the slow amortization of existing debt and consistent pension underfunding.

Operating Performance: 'aa' factor assessment
The city demonstrates an exceptionally strong resilience to revenue stress associated with a moderate economic downturn due to the strength of its available reserves and other budgetary tools. Careful revenue and expenditure assumptions are viewed favorably but the city's approach to managing its pension liabilities constrains the overall

assessment of its operating performance.

RATING SENSITIVITIES

Pension Funding Deficits: Continuation of the city's pension underfunding beyond the near term is expected to weaken the city's long-term liability burden and expenditure flexibility and could place further pressure on the ratings.

CREDIT PROFILE

Birmingham anchors the seven-county Birmingham-Hoover metropolitan statistical area (MSA), which has a population of more than 1.1 million people and accounts for approximately one-quarter of Alabama's total non-farm employment and gross domestic product according to IHS Connect. Numerous higher education and health care institutions, including the University of Alabama at Birmingham, St. Vincent's Health System, Baptist Health, and Grandview Medical Center serve as stable employment anchors for the city and stimulate significant investment in capital and research and development.

Regions Bank ranks among the city's largest employers and solidifies the city's role as the banking center of the state while proximity to Honda, Mercedes-Benz, and Hyundai assembly plants fuels a growing parts-supply business and employment opportunities for area residents. The city has also established itself as a strong regional retail center with per capita retail sales significantly stronger than the Alabama and U.S. metric.

Despite these strengths the city has struggled with a declining population and a comparatively weaker economic profile. The city's unemployment rate and estimated per capita personal income perform poorly relative to the MSA and the state and close to 30% of Birmingham residents live below the individual poverty line.

Revenue Framework

Approximately 80% of the general fund budget is financed through a combination of economically sensitive taxes and charges. Sales tax is the leading source at roughly 30% of revenues followed by occupational taxes at 20% and general business licenses at 15%. These revenues tend to respond to changes in economic conditions more quickly than property taxes, however, actual revenue volatility is relatively low and a history of accurate revenue forecasting and maintenance of high reserves temper this risk. The city has fairly broad legal authority to adjust rates and fees associated with its key revenue streams. Ad valorem taxes are constitutionally limited but account for less than 10% of budgeted general fund revenue in fiscal 2017.

The city's central role in the MSA economy has supported solid general fund revenue growth with a 10-year CAGR through fiscal 2016 of 2.8% which trails by a slim margin the rate of U.S. GDP growth over the same period. Fitch would anticipate similar to slightly more moderate growth in the foreseeable future. The city's downtown area features many of the amenities contributing to a trend of urbanization across the U.S. Favorable trends in building permit activity are reported with construction projects underway including residential, hotel, retail, and office space. One potential drag on economic growth for the MSA reported by IHS Connect is the outlook for slower growth in the financial services sector which accounts for larger share of employment relative to the nation.

The city's revenue raising capacity is limited to its ability to increase the various sales and business taxes and permits that make up the bulk of its general fund revenue base. Increases in property tax rates are subject to prior state legislative approval. In Fitch's view the ability to increase property taxes would be a stronger budgetary tool to counter periods of revenue volatility associated with a normal economic downturn. Property taxes constitute a foreclosable lien on real property providing a strong incentive to pay, whereas sales and business taxes are more likely to exhibit some elasticity to increases in rates or fees. Despite this, Fitch believes a reasonable increase in the rates or fees for the basket of economically sensitive revenues would translate to a level of revenue raising authority that is consistent with a 'aa' assessment when viewed in the context of the city's cyclical revenue volatility.

Expenditure Framework

The city's general fund budget for fiscal 2017 totals $426 million - public safety is the largest category of spending accounting for roughly 55% of the budget. General government services (equipment management, IT, finance, etc.) account for about 17% of the budget followed by spending for libraries, parks, the museum of art, and other cultural and recreational activities and venues at more than 10%.

Absent changes in the city's approach to pension funding Fitch would expect the trend of general fund spending to eventually outpace revenues. The recent relationship between revenue and expenditure growth has been very balanced as the city has deferred an increasingly higher percentage of the actuarially-determined annual pension contribution. Other spending pressures are believed to be more moderate.

Fitch views the city's expenditure flexibility at times of an economic downturn as adequate. Fixed costs associated with debt service, the actuarially calculated pension contribution level (whether or not it is fully funded) and the annual other post-employment benefits (OPEB) payments, are estimated at 23%-25% of governmental spending for fiscal 2017, which Fitch considers moderately high. Debt service costs have ranged from 12% to 15% in recent years and are expected to remain fairly stable. Debt service on outstanding GO warrants declines by more than $10 million over the next several years, but Fitch expects the city will likely back-fill the reduction in costs with new debt to help fund its ongoing capital needs.

The trajectory of the ADC is a more material credit concern. The pension actuarially determined contribution (ADC) for fiscal 2017 is almost $44 million or approximately 8% spending compared to $25.5 million or 5% in fiscal 2013. The increase reflects various factors including market performance but also the city's gross underfunding of the ADC, which Fitch considers a form of deficit financing. From fiscal 2013-2016 the aggregate contribution to the city's pension plans totaled approximately $75 million compared to the actuarial recommendation of $133 million. The city is evaluating several reform options but neither closes the ADC funding gap; as such, Fitch expects the fixed cost burden to continue to rise sharply.

Expenditure flexibility exists in the city's broad legal control over employee-related costs given the absence of collectively-bargained wages and benefits. Other points of flexibility exist in the significant size of the city's budget for cultural and recreational spending at more than $45 million in the fiscal 2017. This portion of the budget is considerable relative to the level of revenue volatility generated by the Fitch Analytical Sensitivity Tool (FAST) in a normal economic downturn. Although important to the city and its residents this portion of the budget is viewed as less critical to the core operations of the city government. The city is not bound by considerable service mandates and the number of budgeted general fund positions has increased moderately in recent years.

Long-Term Liability Burden
Fitch estimates the city's long-term liability burden at 27% of personal income. About 55% of the burden is derived from the combined NPL of the city's three single-employer defined benefit pension plans: the Retirement and Relief System, the Firemen's and Policemen's Supplemental Pension System and the Unclassified Employee's Pension and Relief System. The estimated Fitch-adjusted NPL for the Firemen's and Policemen's Supplemental Pension System is moderate at less than $65 million while the Unclassified Employee's Pension and Relief System has only 16 total participants and is fully funded.

However, the Retirement and Relief System reports a current NPL of more than $1 billion and a ratio of assets-to-liabilities of 49%. As recently as 2008 the plan reported an unfunded actuarial accrued liability of less than $100 million and a funded ratio of near 90%. The city's actuary, Segal, now projects a depletion date for the plan, meaning the point at which plan assets are no longer sufficient to satisfy benefit obligations, in 23 years. The city expects to increase the eligibility age and lower the benefit multiplier for new hires only and phase-in a modest increase in its annual pension contribution. Absent higher contributions and/or more meaningful benefit changes Fitch expects the city's long-term liability burden to approach the 40% ratio consistent with a 'bbb' assessment. The city's net overall debt (direct and overlapping) is also viewed as high estimated by Fitch at 12% of personal income (or 5-6% of market value) and paid off at a fairly slow pace of about 40% over the next 10 years. The city's 2016-2020 capital plan approximates $115 million which is manageable in the context of an already high long-term liability burden.

Operating Performance

FAST generates a 2.1% decline in general fund revenue under a -1% U.S. GDP scenario. Fitch believes the city's resilience to scenario-estimated changes in general fund revenue is exceptionally strong and anchored by its very high reserves. In each of the prior seven fiscal years from 2010 to 2016 the city has recorded available reserves in excess of 40% of general fund spending. Available reserves include the unrestricted fund balances reported in both the general fund and the Birmingham Fund - each approximating $87 million to $88 million in fiscal 2016. The Birmingham Fund was originally funded from proceeds of the sale of the city's Industrial Water Board assets several years ago. An amount up to 5% of its rolling five-year average market value can be used for general spending, otherwise the balance held therein is set aside for unanticipated budgetary shortfalls or emergency situations. Other important resilience factors center on the city's budget flexibility, which is derived from its legal authority to adjust its key revenue streams and adequate expenditure flexibility.

The city's underfunding of the actuarially-determined pension contribution is viewed by Fitch as a form of deficit financing or liability deferral that essentially creates higher future obligations on the operating budget. Fitch believes the city has the financial capacity to absorb the full pension contribution. The difference is currently estimated at $15 million or 3% of governmental spending. Payment of the full ADC would, at a minimum, help stem the tide of rising pension costs down the road. Pension funding concerns notwithstanding, Fitch views the management of the city's operating budget as a positive rating factor in that actual revenues and expenditures tend to outperform forecast and reported operating deficits are typically associated with non-recurring capital investments.