Birmingham, Alabama

New Issue Report

Ratings

Long-Term Issuer Default Rating	AA–

New Issues

$46,000,000 General Obligation Refunding Bonds, Series 2018-A	AA–
$40,000,000 General Obligation Warrants, Series 2018-B	AA–

Outstanding Debt

Birmingham (AL) General Obligation Warrants and Bonds	AA–
Commercial Development Authority of the City of Birmingham (AL) (Civic Center Improv Proj) General Obligation Revenue Bonds	AA–

Rating Outlook

Negative

Analysts

Parker Montgomery
+1 212 908-0356
parker.montgomery@fitchratings.com

Michael Rinaldi
+1 212 908-0833
michael.rinaldi@fitchratings.com

New Issue Summary

Sale Date: Via negotiation on Aug. 13.

Series: GO Refunding Bonds, Series 2018-A; and GO Warrants, Series 2018-B.

Purpose: 2018-A bonds will refund outstanding series 2007-A GO debt for present value savings; and 2018-B warrants will finance capital projects of the city including transit, industrial and recreational parks, and library improvements.

Security: GOs of the city backed by its full faith and credit, payable from all legally available revenues of the city.

Analytical Conclusion

The 'AA–' GO ratings are supported by the city's strong financial position and resilience to economic and revenue stress. The ratings and Negative Outlook also reflect Fitch's expectation for the diminished long-term affordability of the city's pension plans. The pay-go funding of the city's primary pension plan is well below actuarially determined amounts and plan assets are not projected to be available to make benefits payments to current plan members over time. This trend is expected to materially pressure spending flexibility. Fitch expects the city's ongoing pension reform discussions and updated pension valuation information could resolve the Negative Outlook by the end of the first quarter of calendar 2019.

Economic Resource Base: Birmingham is located in north central Alabama and is the seat of Jefferson County. Birmingham is the largest city in the state with a Census-estimated population of 210,710 in 2017. Population inside the city has declined for several decades and the most recent Census estimates show this trend continuing despite overall growth in the greater Birmingham metro area. However, management reports some ongoing growth and expects improvement in upcoming population figures based on migration into the downtown core.

Key Rating Drivers

Revenue Framework: 'aa'
Revenue growth prospects are solid given Birmingham's central role in a prominent regional economy and ability to levy various business taxes. 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'
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 amount is expected to result in higher outlays in the future. A degree of spending flexibility resides in the large budget for various cultural and recreational facilities and broad legal control over employee wage and benefits.

Long-Term Liability Burden: 'a'
The city has a moderately high long-term liability burden for debt and pensions at an estimated 22% of personal income, including the current issuance. The metric is likely to climb further given the consistent underfunding of the city's pension plans.

Rating History (IDR/GO)

Rating	Action	Outlook/ Watch	Date
AA–	Affirmed	Negative	8/6/18
AA–	Affirmed	Negative	4/27/18
AA–	Downgraded	Negative	1/13/17
AA	Revised	Stable	4/30/10
AA–	Affirmed	Stable	3/18/03
AA–	Downgraded	—	5/15/01
AA	Assigned	—	7/10/95

Operating Performance: 'aa'

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 would further increase the city's long-term liability burden and erode expenditure flexibility, and likely would result in further negative rating action.

Credit Profile

Birmingham anchors the seven-county Birmingham-Hoover MSA, which has a population of more than 1.1 million people and accounts for approximately one-quarter of Alabama's population and total non-farm employment 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.

Regions Bank ranks among the city's largest employers and reflects the city's role as the banking center of the state. Proximity to Honda, Mercedes-Benz, and Hyundai assembly plants drives a growing parts-supply business that provides 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. Metro area home values, as reported by Zillow Group, have now returned to pre-recession levels with a median value of $137,000.

Despite these more recent gains the city has struggled with long-term population declines 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 (nearly double the national average).

Revenue Framework

Over 80% of the fiscal 2019 general fund budget is derived from a combination of economically sensitive taxes and charges, with ad valorem taxes accounting for less than 10% of budget. Of the economically sensitive taxes, sales and use taxes are the largest source at about 40% of the fiscal 2019 budget followed by the occupational tax and general business license at over a third of the budget. The city adjusted revenues as necessary over the previous decade to negotiate through the recession leading to a relatively stable revenue stream despite the concentration in sensitive revenues.

The city's central role in the metro economy and ability to adjust revenue has generated solid general fund revenue growth, with 10-year CAGRs in recent years just trailing the rate of U.S. GDP. Net of policy action Fitch anticipates growth in line with inflation. Management reports favorable trends in building permit activity, with construction projects underway in the residential, hotel, retail, manufacturing, and office sectors.

Fitch believes the city's ability to increase the various sales and business taxes and permits (which make up the bulk of its general fund revenue base) provides substantial legal independent flexibility relative to the city's modest level of historical revenue volatility. While

Related Research

Fitch Rates Birmingham, AL's $86MM GOs 'AA-'; Outlook Remains Negative (August 2018)

Related Criteria

U.S. Public Finance Tax-Supported Rating Criteria (April 2018) increases in property tax rates would be a stronger budgetary tool to counter periods of revenue volatility associated with a normal economic downturn than economically sensitive revenues, any changes to these taxes would require prior state legislative approval.

Expenditure Framework

The city's general fund budget for fiscal 2019 totals $436 million. Public safety is the largest category of spending at more than 50% of the total, with general government services (equipment management, IT, finance, among others) the next largest category at less than 20%.

Culture and recreational spending -- e.g. libraries, parks, the art museum and other venues -- accounts for 10% of spending. This spending is considerable relative to the level of potential 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, $44 million in fiscal 2017, is viewed as less critical to the core operations of the city government. Other levers of expenditure flexibility include the city's broad legal control over employee-related costs given the absence of collectively bargained wages. The city is not bound by considerable service mandates, and the number of budgeted general fund positions has increased only moderately in recent years.

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 otherwise 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.

Overall, Fitch views the city's current expenditure flexibility as adequate. Fixed costs for debt service, pension and OPEB in fiscal 2017 were 16% of governmental spending, down from previous years due to a declining debt payment schedule. Debt service costs are scheduled to decline by more than $10 million (another 2% of spending) over the next several years; however, Fitch expects the city to back fill the reduction in debt service costs with new debt to help fund its ongoing capital needs and commitments, including $40 million issuances each in fiscals 2018 and 2019. Similarly, OPEB pay-go contributions have declined from previous levels by about $5 million, or 1% of budget, since fiscal 2015. The OPEB liability has increased very slowly to about 2% of personal income, which Fitch considers a moderate burden.

Required Pension Costs to Increase

The trajectory of required pension costs is a more material credit concern. The city continues its policy of pay-go funding the largest of its pension plans, which Fitch considers a form of deficit financing. As recently as 2008, the city's large plan, the Retirement and Relief System, was nearly 90% funded and reported an unfunded liability of less than $100 million. Since then, the net pension liability (NPL) has ballooned to over $700 million as of June 30, 2017. The increase is largely due to the city postponing about half of its required contributions (approximately $40 million) from fiscal 2015 to 2017 since GASB 67 pension disclosure requirements were implemented. The city's actuary, Segal Consulting, now projects the plan will spend through its trust assets within 29 years. This depletion date is considered after incorporating new less conservative assumptions including increasing the investment rate of return to 7.5% from 7% and lowering the payroll growth assumption to 2.5% from 3%.

Pension reform discussions within the city are ongoing. The new mayor has a transition team studying options available to address the pension funding situation from both the contribution side and the benefits side. On the contribution side, the city's fiscal 2017 actual contribution was $16.5 million, which compared to the $30.6 million actuarially determined contribution (ADC) is an underfunding of approximately 3% of total governmental spending. The city has begun phasing in modest increases in its annual pension contribution; however, the estimated contribution for fiscal 2018 ($17.7 million) remains far less the ADC. Further, assuming a more conservative 20-year amortization period using Fitch's benchmark pension contribution methodology would require more than doubling annual contributions to meet the actuarially determined amount.

While the city has reduced pension benefits for new hires employed after January 2018, other more significant reform remains a challenge due to benefits being set in state statute and requiring an act of legislature to reform. As such, Fitch expects the fixed cost burden to increase sharply.

Long-Term Liability Burden

Fitch estimates the city's long-term liability burden at 22% of personal income. The Retirement and Relief System alone represents an NPL of about 9% of personal income, which reported assets to liabilities of 60% at a 5.4% blended discount rate assumption as of June 30, 2017. Fitch's 'a' long-term liability burden assessment currently captures the expectation that the pension liability will continue to increase as a percentage of the city's personal income, as outlined in the above carrying costs discussion.

The city's direct debt alone is estimated by Fitch at a moderate 8% of personal income. Direct debt is paid off at a fairly slow pace of about 40% over the next 10 years; however, a few large principal payments scheduled in fiscal years 2018 and 2019 ($36 million and $30 million, respectively) will free up room in the debt program. The city is discussing potential debt issuances in the near term totaling at least $70 million, which Fitch expects will trail the replacement rate of the city's direct debt, and additionally made financial commitments to fund a portion of the new $174 million downtown stadium financing project with the Birmingham Jefferson County Civic Authority.

Operating Performance

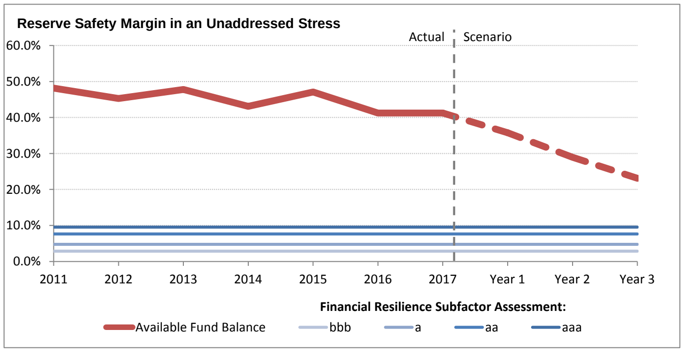
For details, see Scenario Analysis, page 5.

The city's underfunding of the actuarially determined pension contribution is viewed as a form of deficit financing or liability deferral that essentially creates larger future obligations on the operating budget. Fitch believes the city has the financial capacity to annually absorb the full actuarial pension contribution; the difference over the last several years would cost the city an additional 4% of governmental spending annually under the current plan assumptions. Payment of the full ADC would, at a minimum, help stem the tide of climbing 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.

The city estimates the surplus for fiscal 2018 at roughly $4 million in the general fund. The $436 million fiscal 2019 budget is a 1.6% increase over the 2018 budget without any appropriation of fund balance. An expected increase in revenues (largely from strong performances in sales and occupational taxes) are being devoted to a cost of living adjustment of 1% for all employees, a 5% merit increase for certain eligible employees, and other more flexible items like the $5.5 million (about 1.3% of budget) in economic development initiatives.

Birmingham (AL)

Scenario Analysis v. 2.0 2017/03/24



Analyst Interpretation of Scenario Results:

FAST generates a 1.9% 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 healthy available reserves. In each of the prior eight fiscal years from 2010-2017 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 $80-90 million in fiscal 2017. 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 the fund's rolling five-year average market value can be used for general spending; otherwise, the balance is set aside for unanticipated budgetary shortfalls or emergency situations. Other resilience considerations include the city's midrange budget flexibility, which is derived from a combination of its legal authority to adjust its key revenue streams and adequate expenditure flexibility.

Scenario Parameters:	Year 1	Year 2	Year 3
GDP Assumption (% Change)	(1.0%)	0.5%	2.0%
Expenditure Assumption (% Change)	2.0%	2.0%	2.0%
Revenue Output (% Change)	(1.9%)	0.5%	2.9%
Inherent Budget Flexibility	Midrange		

Revenues, Expenditures, and Fund Balance	Actuals							Scenario Output		
	2011	2012	2013	2014	2015	2016	2017	Year 1	Year 2	Year 3
Total Revenues	374,043	375,387	372,838	376,945	397,859	405,030	410,282	402,442	404,357	415,930
% Change in Revenues	-	0.4%	(0.7%)	1.1%	5.5%	1.8%	1.3%	(1.9%)	0.5%	2.9%
Total Expenditures	372,303	376,820	363,131	383,303	382,203	412,465	412,797	421,053	429,474	438,063
% Change in Expenditures	-	1.2%	(3.6%)	5.6%	(0.3%)	7.9%	0.1%	2.0%	2.0%	2.0%
Transfers In and Other Sources	8,977	1	1,084	5,972	4,112	15,747	4,433	4,348	4,369	4,494
Transfers Out and Other Uses	3,780	5,669	9,406	13,538	6,630	11,574	5,534	5,645	5,758	5,873
Net Transfers	5,197	(5,668)	(8,322)	(7,566)	(2,518)	4,173	(1,101)	(1,296)	(1,389)	(1,379)
Bond Proceeds and Other One-Time Uses	-	-	-	-	-	-	-	-	-	-
Net Operating Surplus(+)/Deficit(-) After Transfers	6,937	(7,101)	1,385	(13,924)	13,138	(3,262)	(3,616)	(19,908)	(26,505)	(23,512)
Net Operating Surplus(+)/Deficit(-) (% of Expend. and Transfers Out)	1.8%	(1.9%)	0.4%	(3.5%)	3.4%	(0.8%)	(0.9%)	(4.7%)	(6.1%)	(5.3%)
Unrestricted/Unreserved Fund Balance (General Fund)	97,298	90,198	91,581	77,769	91,009	86,994	83,335	63,427	36,922	13,409
Other Available Funds (Analyst Input)	83,700	82,973	86,312	93,161	91,972	87,803	89,108	89,108	89,108	89,108
Combined Available Funds Balance (GF + Analyst Input)	180,998	173,171	177,893	170,930	182,981	174,797	172,443	152,535	126,030	102,517
Combined Available Fund Bal. (% of Expend. and Transfers Out)	48.1%	45.3%	47.8%	43.1%	47.1%	41.2%	41.2%	35.7%	29.0%	23.1%

Reserve Safety Margins	Inherent Budget Flexibility				
	Minimal	Limited	Midrange	High	Superior
Reserve Safety Margin (aaa)	30.6%	15.3%	9.6%	5.7%	3.8%
Reserve Safety Margin (aa)	22.9%	11.5%	7.6%	4.8%	2.9%
Reserve Safety Margin (a)	15.3%	7.6%	4.8%	2.9%	2.0%
Reserve Safety Margin (bbb)	5.7%	3.8%	2.9%	2.0%	2.0%

Notes: Scenario analysis represents an unaddressed stress on issuer finances. Fitch's downturn scenario assumes a -1.0% GDP decline in the first year, followed by 0.5% and 2.0% GDP growth in Years 2 and 3, respectively. Expenditures are assumed to grow at a 2.0% rate of inflation. Inherent budget flexibility is the analyst's assessment of the issuer's ability to deal with fiscal stress through tax and spending policy choices, and determines the multiples used to calculate the reserve safety margin. For further details, please see Fitch's US Tax-Supported Rating Criteria.

The ratings above were solicited and assigned or maintained at the request of the rated entity/issuer or a related third party. Any exceptions follow below.