MOODY'S
INVESTORS SERVICE

New Issue: Moody's assigns Aa1 to Newport News, VA's $111.4M GO Bonds, Series A, B of 2014

Global Credit Research - 24 Apr 2014

Affirms Aa1 on $529.8M outstanding GO debt

NEWPORT NEWS (CITY OF) VA
Cities (including Towns, Villages and Townships)
VA

Moody's Rating

ISSUE		RATING
Taxable General Obligation Refunding Bonds, Series B of 2014		Aa1
Sale Amount	$6,190,000	
Expected Sale Date	04/29/14	
Rating Description	General Obligation	
General Obligation General Improvement and Refunding Bonds, Series A of 2014, and General Obligation Water Refunding Bonds, Series A of 2014		Aa1
Sale Amount	$105,205,000	
Expected Sale Date	04/29/14	
Rating Description	General Obligation	

Moody's Outlook NOO

Opinion

NEW YORK, April 24, 2014 --Moody's Investors Service has assigned a Aa1 rating to the City of Newport News' (VA) $105.2 million General Obligation General Improvement and Refunding Bonds, Series A of 2014 and General Obligation Water Refunding Bonds, Series A of 2014 (Tax-Exempt), and $6.2 million Taxable General Obligation Refunding Bonds, Series B of 2014. The bonds are secured by the city's general obligation, unlimited tax pledge. Concurrently, Moody's has affirmed the Aa1 rating on $529.8 million of outstanding General Obligation debt, including $74.8 million that was issued by the city's Economic Development Authority (EDA). These EDA bonds are payable solely from payments made by the city according to a Payment Agreement, where in the city irrevocably pledges it full faith and credit for payments to the Authority.

A portion of the proceeds from the Series 2014A bonds will be used to fund the construction of a replacement Magruder Elementary School, redevelopment of the Upper Warwick Corridor and Southeast Community, and various water and storm water projects. The remainder of the Series A proceeds will be used to refund the Series 2004B, Series 2004C, Series 2006A, Series 2007A, Series 2008A, Series 2008B, and Series 2012C bonds for an estimated net present value savings of $3.4 million, or 5.5% of refunded principal, with no extension of maturity. Proceeds from the Series 2014B bonds will refund the Series 2005A bonds for an estimated net present value savings of $440,000, or 7.6% of refunded principal, with no extension of maturity.

SUMMARY RATINGS RATIONALE

The Aa1 rating reflects a sizable and increasingly diversified tax base that had been historically centered on shipbuilding, below-average wealth levels, sound financial management, and above-average, but manageable debt position.

STRENGTHS:

- Sizable and diverse tax base

- Healthy reserve levels

CHALLENGES:

- Above-average debt burden

- Below-average wealth levels

- Fully fund pension ARC for Newport News Employee Retirement Fund (NNERF) by 2017

- Exposure to reductions in federal spending

DETAILED CREDIT DISCUSSION

ADDITIONAL DECLINES IN TAX BASE EXPECTED; SHIPBUILDING INDUSTRY REMAINS STABLE

At the end of fiscal 2013, the city's $16.3 billion tax base is expected to experience further declines despite a sizable military presence and continued efforts to attract and retain business outside the military to diversify the local economy from a historical focus on shipbuilding. The U.S. Army's Joint Base Langley-Eustis and Huntington Ingalls Industries, Inc. (Senior Unsecured rated Ba3/positive) account for a large percentage of the employment base, with more than 10,000 and 20,000 employees, respectively. As a result of the 2009 Base Closure and Realignment Commission (BRAC), the U.S. Army's Training and Doctrine Command was relocated to Joint Base Langley-Eustis, raising the status of the base from a one-star to a four-star command, in addition to increasing employment by approximately 1,700 personnel. Huntington Ingalls is expected to remain stable with a long-term $63 billion contract with the U.S. Navy for the construction of 25 nuclear submarines over the next 30 years. In addition, the U.S. Navy has reaffirmed its commitment to an 11-carrrier fleet over the next three decades. Nonetheless, service and manufacturing firms such as Riverside Regional Medical Center, Canon, Inc. (issuer rating Aa1/stable), Ferguson Enterprises, and Christopher Newport University have become significant employers as well. Each has a headcount of at least 1,000 employees and has continued to expand. Current developments include a $310 million upgrade at Jefferson Lab whose focus is to conduct basic research on the atom, a $45.4 million expansion at Liebherr that will double its manufacturing capacity, a $27 million investment from Canon to expand its toner manufacturing operation, and a $6.6 million investment from High Liner Foods Incorporated (B1/stable) to expand food service production.

The city's economic development efforts have spurred significant growth in recent years, boosting assessed values by 72% over the last 10 years (2003-2013). Due to the recent economic environment, annual assessed value growth has slowed from a high of 15.4% in fiscal 2007 to declining by 5.3% in fiscal 2010. Additional declines of 1.2% and 3.4% were realized in fiscal 2012 and 2013, respectively. Going forward, the city expects additional declines in assessed valuations in fiscal 2014 (1.1%) and fiscal 2015 (0.2%), as the economy continues to lag. The city increased its property tax rate ($0.12 per $100 of assessed valuation) in fiscal 2014, as well as other consumer tax rates to help offset any loss in property tax revenue. Unemployment decreased to 6.9% as of January 2013 from a high of 8.1% in 2011, and remains above the state's 5.4% unemployment rate, but slightly below the national rate of 7.0%. Wealth levels are below both state and national medians, with per capita income representing 75.4% and 88.7%, and median family income representing 78.9% and 92% respectively, which is typical for Virginia jurisdictions with a strong military presence outside the more wealthy Washington, D.C. region.

SOUND RESERVE LEVELS DRIVEN BY EXPENDITURE CONTROLS; LOW PENSION FUNDING

Despite expected declines in the city's tax base and above-average fixed costs including a continued ramp-up in pension funding for NNERF, the city, as expected, has maintained sound reserve levels due to continued expenditure controls and conservative budgeting of revenues. Since fiscal 2008, the city has been able to generate operating surpluses in four out of the past five fiscal years (2009-2013) due to various restraints that the city implemented including the elimination of multiple employment positions and implementation of a hiring freeze, in conjunction with positive revenue performance due to conservative budgeting. The $13.3 million decline in fiscal 2011 resulted from a planned $16 million transfer to the Special Project Reserve Fund for various capital costs. Most recently, fiscal 2013 ended with a $272,000 increase in General Fund balance to $93.7 million (22.7% of General Fund revenues). Unassigned General Fund balance ended at $45.4 million (11% of General Fund revenues) in fiscal 2013, well above the city's formal policy to maintain 7.5% of revenues. The slight increase in General Fund balance was the result of positive revenue performance related to property, sales and use, and food taxes, as well as charges for service. Expenditures were over-budget due to the redirection of year-end savings for capital. In addition to General Fund revenues, the city maintains available reserves in the Debt Service Fund

($1.5 million) and the Capital Improvements Fund ($26.4 million). Total available fund balance at year-end fiscal 2013 totaled $108.2 million or a sound 26.2% of General Fund revenues. Property taxes were the city's largest revenue source (55.3% of total revenues), followed by revenue from the Commonwealth (10.1%) in fiscal 2013.

The fiscal 2014 budget represents a 4.6% increase from the fiscal 2013 budget and includes a $0.12 (per $100 of assessed valuation) property tax rate increase. In addition to raising the property tax rate, the city also increased the lodging rate (7.5% to 8.0%) and amusement tax rate (7.5% to 10.0%) to help offset previous decline in the tax base. Based on preliminary estimates, the city expects to end fiscal 2014 with a $4 million operating surplus, $3 million of which would be utilized for capital, resulting in a $1 million overall increase to General Fund balance. Revenues are currently tracking to budget, while expenditures are expected to end the year under-budget due to conservative estimates. The proposed fiscal 2015 budget represents a 3.1% increase from fiscal 2014. The budget reflects growth in all the major revenue categories (personal property taxes, machinery and tools taxes, BPOL taxes, meals taxes, and sales taxes) as the economy begins to recover from the recession, which will help offset increase in pension contributions, health care premiums, and debt service. The proposed budget also includes a 3% merit based increase and $4 million additional pay-go contributions.

MANAGEMENT IMPLEMENTS PENSION AND OPEB REFORMS

In 2010, the city adopted a pension reform package to not only address the low funded ratio of the Newport News Employee Retirement Fund (NNERF), but also to reduce the city's future liability. Some of the major changes to the pension plan include closing the fund to new hires and rehires for all School Board personnel and city employees, who will now be entered into the Virginia Retirement System (VRS). In 2012, the city adopted additional pension reforms including requiring NNERF employees to contribute 5% of their salary to retirement fund (offset by 5.75% salary increase); reducing multiplier for non-public safety employees to 1.65% from 1.85%; increasing maximum annual retirement benefit to 80% from 75% of Average Final Compensation over a three-year period; requiring new retirees to wait a minimum of 12 months before receiving COLA; and changing COLA computation for retirees to 70% of current formula, each of which helped to further lower the ARC.

In addition, the city's strategy includes annual incremental increases in the city's contribution with a goal of reaching the full ARC by fiscal 2017. During fiscal 2013, the city contributed $34 million (7.9% of operating expenditures) or 59.8% of the ARC. When including the employee contribution in FY 2013 of $3.1 million, the ARC contributions approaches 65%. This remained relatively level compared to fiscal 2012 when the city contributed $32.7 million or 59.6% of the ARC. The city is expected to fund 73% of the ARC in fiscal 2014 and 82% of the ARC in fiscal 2015. Going forward, the city will be challenged with maintaining a solid financial position and making progress toward fully funding the pension ARC by 2017. Any failure to progress towards this goal could result in negative credit pressure.

In addition to NNERF, the city, schools and airport contribute to VRS, an agent, multiple employer defined benefit pension plan administered by the Commonwealth. During fiscal 2013, the ARC for the city was $2.3 million (0.5% of operating expenditures), $25.6 million (6.0% of operating expenditures) for the schools, and $216,015 (0.05% of operating expenditures) for the airport. The ARC for each of these plans was 100% funded in fiscal 2013. The city contributed 100% of the ARC for both plans in fiscal 2013. The city's combined adjusted net pension liability (ANPL), under Moody's methodology for adjusting reported pension data, is $1.2 billion, or an above average 2.71 times operating revenues. The three year average of the city's ANPL to Operating Revenues is an above average 2.22 times, while the three-year average of ANPL to full value is also an above average 5.45%. Moody's ANPL reflects certain adjustments we make to improve comparability of reported pension liabilities. The adjustments are not intended to replace the city's reported liability information, but to improve comparability with other rated entities.

The city also adopted an OPEB reform package in 2010. This reform included closing the fund to new hires and rehires, who will now participate in health reimbursement account, to which the city will contribute 3% of average employee salary, as well as establishing a new dollar cap for the city premium contribution related to those employees who do not elect single coverage. At the end of fiscal 2013, the city's OPEB plan was 12% funded ($152 million UAAL), with the city contributing $10.5 million (2.5% of operating expenditures) or 62.1% of the ARC. The school OPEB plan was 11% funded at the end of fiscal 2013, with the schools contributing $8.6 million (2.0% of operating expenditures) or 98.9% of the ARC. Overall, fixed costs including annual pension, OPEB and debt service expenditures summed to a significant 32.4% of fiscal 2013 expenditures. Going forward, if the city is not able to maintain its solid reserve levels due to these increasing long-term obligations, negative credit pressure is possible.

ABOVE AVERAGE DEBT LEVELS; LIMITED EXPOSURE TO SWAPS

The city's above average debt burden to remain manageable due to average payout and management's plans to limit borrowing in the near-term. The city's direct debt burden is an above average 3.3% of full valuation when considering the self-supporting utility debt. Of note, Newport News' direct debt burden includes $5.8 million in moral obligations for the Economic Development Authority (EDA), $74.8 million of EDA debt secured by payment agreements with the city, and $23.5 million in recently issued moral obligation debt related to the new Apprentice School parking garage. The city began making debt service payments for the Apprentice School beginning in fiscal 2013, which is expected to last through the lifetime of the bonds and will be partially offset by property tax revenues generated from the school. Outstanding principal for all outstanding debt (inclusive of the EDA and Apprentice School issues) is amortized at a healthy 73% within 10 years and debt service represented a moderate 13.4% of operating expenditures in fiscal 2013.

The city's $384.4 million capital improvement plan (2014-2018) includes $73.9 million of pay-as-you-go capital and $170.7 million of debt-funded projects. The majority of these funds will be used for streets and bridges (25%), utility improvements (23%), schools (12%), and community development (9%). Positively, given a concerted effort to retire more debt than issued, the city was able to comply with its goal of reducing the debt burden to 3% of assessed valuation (GO debt only) by the end of fiscal 2009, three years ahead of schedule. The city's current debt burden (GO debt only) is 2.3% of full valuation. The city's continued progress towards reducing its overall debt burden remains an important consideration in maintaining long-term credit strength.

Newport News has limited exposure to variable rate debt and swap agreements through its Economic Development Authority/Industrial Development Authority-issued debt. The city's exposure is limited to two bond issues and swap agreements that represent 1% of the city's total debt burden. The city maintains a moral obligation on a swap associated with the EDA's 2004 bonds, with an outstanding notional amount of $1.2 million as of April 2014. The swap was entered in April 2004 with Bank of America, NA (senior unsecured rating A2/stable), whereby the EDA will pay a fixed interest rate of 5.58% in exchange for a monthly-adjusted floating rate based on LIBOR (plus 0.95%). The current mark-to-market indicates swap termination would result in a payment to Bank of America of $40,421. Notably, there have been no failed remarketings of this debt and no trigger payments from the city.

The city also has a swap on the EDA's Series 2000A bonds, with a notional amount of $3.0 million as of April 2014. The swap was entered with Wells Fargo Bank, NA (senior unsecured debt rated Aa3/stable). Under the terms of the swap, the EDA pays a fixed rate of 7.64% in exchange for a weekly-adjusted floating rate based on LIBOR. These bonds briefly became bank bonds from September 2008 through January 2009, but have been successfully remarketed. In the event of a termination, the maximum swap termination fee would be $927,831. As of April 2014, the mark-to-market value of termination was $440,095, in favor of Wells Fargo.

WHAT COULD MAKE THE RATING GO UP:

- Continued increase in reserves

- Improved wealth levels

- Decreased debt burden

- Full funding of NNERF ARC

WHAT COULD MAKE THE RATING GO DOWN:

- Substantial decline in tax base and wealth levels

- Reduction in reserves

- Significant increase in debt burden

- Inability to fully fund NNERF ARC

KEY STATISTICS

2013 Tax Base Size - Full Value (in 000s): $16,307,403

2013 Full Value Per Capita: $90,233

2010 Median Family Income as % of US median: 92.00%

2013 Fund Balance as % of Revenues: 18.88%

Five-Year Dollar Change in Fund Balance as % of Revenues: -1.74%

2013 Cash Balance as % of Revenues: 15.35%

Five-Year Dollar Change in Cash Balance as % of Revenues: -0.22%

Institutional Framework: Aaa

Operating History - Five-Year Average of Operating Revenues/ Operating Expenditures: 1.00x

Net Direct Debt/Full Value: 3.35%

Net Direct Debt/Operating Revenues: 1.28x

Three-Year Average of Moody's Adjusted Net Pension Liability/Full Value: 5.45%

Three-Year Average of Moody's Adjusted Net Pension Liability/Operating Revenues: 2.22x

The principal methodology used in this rating was US Local Government General Obligation Debt published in January 2014. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

REGULATORY DISCLOSURES

For ratings issued on a program, series or category/class of debt, this announcement provides certain regulatory disclosures in relation to each rating of a subsequently issued bond or note of the same series or category/class of debt or pursuant to a program for which the ratings are derived exclusively from existing ratings in accordance with Moody's rating practices. For ratings issued on a support provider, this announcement provides certain regulatory disclosures in relation to the rating action on the support provider and in relation to each particular rating action for securities that derive their credit ratings from the support provider's credit rating. For provisional ratings, this announcement provides certain regulatory disclosures in relation to the provisional rating assigned, and in relation to a definitive rating that may be assigned subsequent to the final issuance of the debt, in each case where the transaction structure and terms have not changed prior to the assignment of the definitive rating in a manner that would have affected the rating. For further information please see the ratings tab on the issuer/entity page for the respective issuer on www.moodys.com.

Regulatory disclosures contained in this press release apply to the credit rating and, if applicable, the related rating outlook or rating review.

Please see www.moodys.com for any updates on changes to the lead rating analyst and to the Moody's legal entity that has issued the rating.

Please see the ratings tab on the issuer/entity page on www.moodys.com for additional regulatory disclosures for each credit rating.

Analysts

Jennifer Diercksen
Lead Analyst
Public Finance Group
Moody's Investors Service

Edward Damutz
Additional Contact
Public Finance Group
Moody's Investors Service

Contacts

Journalists: (212) 553-0376
Research Clients: (212) 553-1653

Moody's Investors Service, Inc.

250 Greenwich Street
New York, NY 10007
USA