

Memorandum



CITY OF DALLAS

DATE October 9, 2020

TO Honorable Mayor and Members of the City Council

SUBJECT **Fitch Ratings Affirms 'AA' Rating and Stable Outlook for City of Dallas
General Obligation Bonds – RATING ACTION**

Last week, Fitch Ratings (Fitch) assigned its 'AA' credit rating and stable outlook to the anticipated General Obligation Refunding and Improvement Bonds, Series 2020A, General Obligation Refunding Bonds, Taxable Series 2020B, and Equipment Acquisition Contractual Obligation Notes, Series 2020B, and affirmed the City's 'AA' credit rating and stable outlook on outstanding general obligation bonds. Fitch previously affirmed the City's rating on April 2, 2020 and again in an updated report on June 22, 2020.

According to the report, the City's 'AA' rating is reflective of, "strong revenue growth prospects, conservative budgeting practices, and solid reserve levels." Fitch also reiterates that, "reforms to both the city's civilian and public safety plans have had a positive effect on the city's long-term liability burden, and recent operating performance has been positive despite increased spending on both pensions and public safety salaries." In the analysis, Fitch again assigns 'aaa' grades to two Key Rating Drivers, Revenue Framework and Operating Performance, citing "expectations for continued economic expansion," adding that the City's "healthy reserves position it to maintain the highest financial resilience through both the pandemic-induced economic uncertainty and future business cycles."

The rating decision by Fitch today is another positive indicator of the City's strategic efforts and resiliency during these ongoing unprecedented times. Attached is the rating report provided by Fitch today.

Please let me know if you need additional information.

A handwritten signature in blue ink that reads "M. Elizabeth Reich".

M. Elizabeth Reich
Chief Financial Officer

Attachment

c: T.C. Broadnax, City Manager
Chris Caso, City Attorney
Mark Swann, City Auditor
Biliera Johnson, City Secretary
Preston Robinson, Administrative Judge
Kimberly Bizzor Tolbert, Chief of Staff

Majed A. Al-Ghafry, Assistant City Manager
Jon Fortune, Assistant City Manager
Joey Zapata, Assistant City Manager
Dr. Eric A. Johnson, Chief of Economic Development & Neighborhood Services
M. Elizabeth (Liz) Cedillo-Pereira, Chief of Equity and Inclusion
Directors and Assistant Directors



RATING ACTION COMMENTARY

Fitch Rates Dallas, TX \$293MM GOs, COs 'AA'; Outlook Stable

Tue 29 Sep, 2020 - 3:34 PM ET

Fitch Ratings - Austin - 29 Sep 2020: Fitch Ratings has assigned a 'AA' rating to the following City of Dallas, TX obligations:

--\$190.1 Million General Obligation (GO) Refunding and Improvement Bonds Series 2020A;

--\$77.6 Million General Obligation Refunding Bonds Taxable Series 2020B;

--\$25.0 Million Equipment Acquisition Contractual Obligations Series 2020B.

All three series of bonds are scheduled for a competitive sale on October 7. The series 2020A GO bond proceeds will finance infrastructure improvements and refund outstanding tax-supported debt; series 2020B GO bond proceeds will refund outstanding tax-supported debt; contractual obligation proceeds will finance the acquisition of various departmental equipment.

Fitch also has affirmed the following ratings:

--Issuer Default Rating (IDR) at 'AA';

--\$1.6 billion of outstanding limited tax (LT) debt at 'AA'.

The Rating Outlook is Stable.

SECURITY

The GOs and contractual obligations are payable from a limited ad valorem tax levied against all taxable property in the city.

ANALYTICAL CONCLUSION

The city's 'AA' IDR and LT bond rating reflect strong revenue growth prospects, conservative budgeting practices, and solid reserve levels. Reforms to both the city's civilian and public safety plans have had a positive effect on the city's long-term liability burden, and recent operating performance has been positive despite increased spending on both pensions and public safety salaries. Budgeting pressure is likely to continue as the city attempts to build up police staffing levels and continues with increasing pension contributions; these pressures will be exacerbated by the current economic environment but are expected to be manageable given the city's high degree of inherent budget flexibility.

ECONOMIC RESOURCE BASE

Dallas is the anchor of the large and diverse Dallas-Fort Worth regional economy. The city is a center for technology, trade, finance and healthcare; it also ranks among the top visitor and leisure destinations in the state.

KEY RATING DRIVERS

Revenue Framework: 'aaa'

Strong post-pandemic revenue growth prospects are based on expectations for continued economic expansion. The assessment also reflects the city's diminished, though still high, independent legal ability to increase ad valorem revenues as a result of recently approved state legislation effective in fiscal 2021.

Expenditure Framework: 'a'

The city's pace of spending is expected to be generally in line with revenue growth given its mature residential base. Increased pension contributions will keep carrying costs at an elevated level; a rapid debt amortization rate also contributes to the elevated carrying costs.

Long-Term Liability Burden: 'aa'

The long-term liability burden currently represents a moderate 14% of personal income. Recent pension reforms to both the civilian and uniform plans have reduced the combined total liability by roughly 40%. These reforms, in conjunction with continued economic growth, are expected to keep the long-term liability burden within the current range.

Operating Performance: 'aaa'

The city of Dallas' gap-closing capabilities and healthy reserves position it to maintain the highest financial resilience through both the pandemic-induced economic uncertainty and future business cycles. Elevated debt and retiree benefit outlays will maintain a certain amount of pressure on the city's budget management practices.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

--Continued positive operating performance and successful absorption of additional public safety-related spending.

--An improvement in Fitch's assessment of the city's expenditure flexibility, due to moderation in fixed debt service and retiree benefit costs as a percentage of spending.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

--A return to economic contraction in the U.S., consistent with Fitch's coronavirus downside scenario, which triggers sustained and deep revenue declines and materially erodes the city's gap-closing capacity.

--Failure to consistently fund annual pension contributions at the actuarially determined levels.

--Longer term, poor operating performance and resulting material decline in operating reserves.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit [<https://www.fitchratings.com/site/re/10111579>].

CURRENT DEVELOPMENTS

Sector-Wide Coronavirus Implications

The outbreak of coronavirus and related government containment measures worldwide has created an uncertain global environment for U.S. state and local governments and related entities. Fitch's ratings are forward-looking in nature, and Fitch will monitor the severity and duration of the budgetary impact on state and local governments and incorporate revised expectations for future performance and assessment of key risks.

While the initial phase of economic recovery has been faster than expected, GDP in the U.S. is projected to remain below its 4Q19 level until at least 4Q21. In its baseline scenario, Fitch assumes continued strong GDP growth in 3Q20 followed by a slower recovery

trajectory from 4Q20 onward amid persisting social distancing behavior and restrictions, high unemployment and a further pullback in private-sector investment. Additional details, including key assumptions and implications of the baseline scenario and a downside scenario, are described in the report entitled, "Fitch Ratings Coronavirus Scenarios: Baseline and Downside Cases - Update"

(<https://www.fitchratings.com/research/sovereigns/fitch-ratings-coronavirus-scenarios-baseline-downside-cases-update-08-09-2020>), published Sept. 8, 2020 on www.fitchratings.com

As is the case with other cities, Dallas has experienced the effects of coronavirus mitigation and the related economic shutdown. The governor directed a gradual reopening of the state's economy in late April, but amid rising levels of coronavirus cases throughout the state he mandated a pause in reopening further businesses and a return to certain social distancing measures in late June. Following a downward trend in reported cases during the following months, the governor on Sept. 17 issued an order allowing certain businesses (e.g. restaurants, museums, libraries and gyms) to operate at 75% capacity, up from 50%.

Coronavirus - City Budgetary Update

Fiscal 2020 (FYE September 30) general fund revenues currently are projected to fall nearly \$50 million (3.5%) below the \$1.438 billion original budgeted, as sales tax and other economically sensitive revenues have been impacted by the economic contraction. Sales tax revenues are projected to total \$309.3 million, \$16 million or 5% below the originally budgeted amount. The city responded to the revenue weakness with spending reductions projected to total nearly \$35 million by fiscal year-end. Administrators plan to eliminate the remaining \$15 million gap through a combination of measures, including application of federal assistance for coronavirus-related expenses--resulting in essentially break-even general fund results at fiscal year-end.

The adopted fiscal 2021 general fund budget is balanced and anticipates revenue of \$1.437 billion, unchanged from the fiscal 2020 budget (reimbursements and transfers add another \$118 million to total resources). Sales tax receipts are budgeted at \$296 million, or nearly 10% below the prior year budget. Property tax revenues are budgeted at \$825 million, up 5% from fiscal 2020 due to a comparable increase in TAV. General fund spending is slated to increase \$28 million (1.8%) from fiscal 2020 to \$1.56 billion. Management cites additional police hiring and increased public safety pension contributions as the primary spending drivers.

External pandemic-related financial assistance either received or anticipated totals roughly \$323 million, led by roughly \$234 million in Coronavirus Aid, Relief and Economic Security (CARES) Act proceeds and an estimated \$54 million in airport grant. Management reports spending related to the coronavirus pandemic is targeted to public health and safety (\$146.6 million), service delivery expenses (\$102 million), and community support initiatives (\$81.7 million).

CREDIT PROFILE

Dallas is located in north central Texas and with a population of 1.34 million ranks among the top 10 U.S. cities by population. The city serves as corporate headquarters for AT&T, Southwest Airlines, Texas Instruments, 7-Eleven, Inc., HollyFrontier Corp., Pizza Hut, Inc. and other large corporate concerns. The city reported new construction permit activity in 2019 of more than \$2.5 billion, continuing a recent trend of strong economic expansion. Large employers in the education, government and health services sectors lend stability to the city's employment base.

The city's role as a wholesale and retail trade center is enabled by a strong transportation network of airports, rail and interstate highways. Dallas Area Rapid Transit (DART) provides major employers easy access to a highly skilled work force to support growing technology, finance, business and medical service sectors. Top taxpayers represent utility, air transportation, developers, real estate, manufacturing and retail industries, and the tax base has no significant concentration. Fitch expects the underlying strength, size and diversity of Dallas' economy will support the city in its recovery from the current economic downturn.

REVENUE FRAMEWORK

General fund operations are supported by a diverse mix of revenues led by ad valorem tax revenues (52% of the fiscal 2019 total), sales tax revenues (24%), and franchise fees (10%). General fund revenue growth has accelerated the past several years after sluggish gains following the Great Recession; annual increases have averaged more than 5% over the past six years.

Near-term revenue growth prospects have weakened due to the pandemic-induced economic downturn, primarily due to reductions in economically-sensitive revenues. Longer term, the city's revenue growth prospects remain strong due to expected resumption of healthy economic expansion.

The city's fiscal 2021 total tax rate of \$0.7763 per \$100 of TAV is essentially unchanged from the prior year and is well below the constitutional and city charter caps of \$2.50. However, the recently enacted Texas Senate Bill 2 (SB 2) makes a number of changes to local governments' property tax rate setting process. Most notably, SB 2 will reduce the rollback tax rate (now the 'voter approval tax rate') from 8% to 3.5% for most local taxing units and require a ratification election (replacing the current petition process) if any local taxing unit exceeds its voter approval rate, effective fiscal 2021. The revenue cap does not apply to debt service tax levies. The governor's March 13 declaration of a statewide disaster triggered an SB 2 provision that gives cities and counties the option of using the previous 8% cap for at least two years.

The tax rate limitation in SB2 excludes new additions to tax rolls and allows for banking of unused margin for up to three years. Dallas' remaining control over property taxes and other local revenues such as fines, fees and charges for services is still sufficient to maintain high revenue-raising flexibility, a credit strength that will likely be critical during the current environment.

EXPENDITURE FRAMEWORK

As is typical with U.S. cities, public safety is Dallas' largest operating spending category (60% of fiscal 2019 general fund outlays), followed by general government (13%) and culture and recreation (11%). General fund spending growth has generally kept pace with revenue gains in recent years.

Fitch expects the pace of spending growth to generally track what is projected to be a positive trajectory in revenues, as future service demands from a relatively mature residential base and increasing public safety and pension outlays should align with increasing operating receipts over the near to medium term.

The recent pension reforms have reduced required contribution amounts but the city's annual carrying costs (debt service, actuarially determined pension contributions, actual OPEB outlays) remain elevated -- 27% of fiscal 2019 governmental spending. Fitch expects actual carrying costs to remain high, the result of both increased pension contributions to the police and fire plan and debt service associated with a \$1.05 billion GO bond authorization approved by voters in 2017. Fitch's supplemental pension metric, which estimates the annual pension cost based on a level dollar payment for 20 years with a 5% interest rate, indicates that carrying costs are vulnerable to future increases.

The current carrying costs also reflect a rapid 69% debt amortization rate over the next 10 years, which will lessen somewhat the burden associated with new debt (debt service was equivalent to more than 14% of fiscal 2019 governmental spending). The city's ability to control headcount and salary costs is strong, providing additional operational flexibility.

LONG-TERM LIABILITY BURDEN

Dallas' long-term liability burden is moderate at slightly less than 14% of personal income, with roughly 47% of the total attributable to unfunded pension liabilities. The liability calculation is adjusted by Fitch to assume a more conservative 6% investment return. The overall burden is down from roughly 19% of personal income recently as a result of the various pension reforms. The city currently has roughly \$2.2 billion in GO debt outstanding (including these offerings), about 20% of the total long-term liability burden. Overlapping debt of \$3.8 billion comprises the remainder of the liability (33% of the total).

Dallas participates in three single employer defined benefit pension plans. The ERF covers non-uniformed employees. The DPFP (combined plan) and the smaller Supplemental Police and Fire Pension Plan of the city of Dallas (supplemental plan) cover police and firefighters.

Changes to the ERF benefit plan were approved by the ERF board, city council and voters in 2016. They apply to employees hired on or after January 1, 2017 and include an increase in the normal retirement age from 60 to 65, an increase in service retirement from 30 to 40 years, elimination of the health benefit supplement, and a reduction in the benefit multiplier from 2.75% to 2.5%. These changes are expected to boost to the long-term viability of the plan.

In response to a steady weakening of the DFPF plan--attributable primarily to issues associated with the deferred retirement option program (DROP) feature--the Texas Legislature in its 2017 regular session approved legislation that made a number of noteworthy changes to the DFPF plan. The modifications included increases in retirement ages for the various tiers of employees, a reduction in the benefit multiplier for most employees and elimination of the current COLA benefit. The legislation also made changes to the troubled DROP, including a 10-year limitation on participation, elimination of interest on DROP accounts after Sept. 1, 2017, and modifications to DROP account distribution options. The legislation also called for increased plan contributions from both the city and employees. These reforms should stabilize the city's obligations to the plan and reduce the risks presented by the DROP feature of the retirement plan, and should enhance the plan's long-term viability.

The combined net pension liability (NPL) for all three plans as reported in the city's fiscal 2019 CAFR totaled \$4.7 billion, with assets covering 53% of liabilities. The NPL increases to \$5.37 billion and the ratio of assets to liabilities declines to 50% when a 6% investment return assumption is used.

OPERATING PERFORMANCE

The Fitch Analytical Stress Test (FAST) scenario analysis tool, which relates historical tax revenue volatility to GDP to support the assessment of operating performance under Fitch's criteria, has now been adjusted to reflect GDP parameters consistent with Fitch's global coronavirus forecast assumptions. FAST is not a forecast, but it represents Fitch's estimate of possible revenue behavior in a downturn, based on historical revenue performance. Hence, actual revenue will vary from FAST results and Fitch expects the city will implement necessary corrective actions to offset them. FAST does provide a relative sense of the risk exposure of a particular local government compared to other U.S. local governments.

The city's FAST results under both the coronavirus baseline and downside scenarios indicate a manageable amount of pressure on the city's financial resilience in the near term, absent policy interventions. The 'aaa' resilience assessment reflects Fitch's expectation that the city will make spending cuts and maintain a strong reserve cushion, maintaining the highest level of financial resilience through both the current economic environment as well as through future business cycles.

The city has demonstrated positive budget management practices historically, and the recent positive operating results (that included sharply higher pension contribution amounts) have continued that trend and enabled the city to maintain a strong financial cushion. However, increased annual pension contributions and public safety salary outlays will maintain a degree of pressure on the city's budget management practices for the foreseeable future. Audited fiscal 2019 general fund results included a net surplus after transfers of \$40 million and unrestricted reserves of more than \$272 million (18.5% of spending), as both revenues and expenditures outperformed budget.

CRITERIA VARIATION

None

In addition to the sources of information identified in Fitch's applicable criteria specified below, this action was informed by information from Lumesis.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

RATING ACTIONS

ENTITY/DEBT	RATING	PRIOR
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ENTITY/DEBT	RATING			PRIOR
Dallas (TX) [General Government]	LT IDR	AA Rating Outlook Stable	Affirmed	AA Rating Outlook Stable
● Dallas (TX) /General Obligation - Limited Tax/1 LT	LT	AA Rating Outlook Stable	Affirmed	AA Rating Outlook Stable

[VIEW ADDITIONAL RATING DETAILS](#)

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APPLICABLE CRITERIA

[U.S. Public Finance Tax-Supported Rating Criteria \(pub. 27 Mar 2020\) \(including rating assumption sensitivity\)](#)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

FAST States & Locals - Fitch Analytical Stress Test Model, v2.4.0 (1)

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Dallas (TX)

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