MOODY'S
INVESTORS SERVICE

Rating Update: Moody's upgrades Central Falls' (RI) GO rating to Ba3 from B1; outlook is stable

Global Credit Research - 23 Jun 2014

City has $8.7M of outstanding GO debt

CENTRAL FALLS (CITY OF) RI
Cities (including Towns, Villages and Townships)
RI

Opinion

NEW YORK, June 23, 2014 --Moody's Investors Service has upgraded the City of Central Falls' (RI) general obligation rating to Ba3 from B1, affecting $8.7 million in outstanding general obligation bonds; the outlook has changed to stable from positive. Moody's has also affirmed the Ba1 underlying rating with a stable outlook on the Rhode Island Health and Educational Building Corporation's (RIHEBC) Series 2007B bonds, affecting $4.9 million in rated RIHEBC pooled debt.

SUMMARY RATINGS RATIONALE

The upgrade to Ba3 reflects the city's recent trend of favorable operating results following emergence from Chapter 9 bankruptcy in October of 2012 and transition to local control in April 2013 with an adopted six year bankruptcy plan which was accepted by a federal court. The bankruptcy process has significantly reduced the financial pressure related to growing employee salaries, pensions and healthcare insurance costs. The rating also incorporates Moody's expectation that the city has and will continue to make general obligation debt service payments, given the state law creating a priority lien for general obligation bondholders and the absence of challenges to the payments by other creditors. Despite the city's exit from bankruptcy, it continues to face significant challenges stemming from high fixed costs and years of deferred capital expenditures and projected weakness in revenue growth, including the loss of an annual Impact Fee payment and back taxes owed from the Wyatt Detention Center. The city also has a limited tax base characterized by weak socioeconomic indicators, including the highest poverty rate in the state, and an elevated debt burden.

The stable outlook reflects our expectation that the city's maintenance of structural balance will continue, in line with its bankruptcy plan and as reflected in its six-year financial projections. We also expect the city to continue to fund 100% of its pension ARC, resulting in an increasing funded ratio and a reduced unfunded pension liability for the city's single employer plan.

The underlying Ba1 rating and stable outlook assigned to RIHEBC's 2007B bonds incorporates Central Falls' underlying general obligation rating as well as the city's limited (6.6%) portion of the pooled debt. A significant amount of debt service (34.22% of the pool) is directly paid to RIHEBC by the State of Rhode Island (GO rated Aa2/negative outlook) and, in addition, the state can intercept additional aid for debt service, providing strong additional security. Additional factors incorporated in the RIHEBC rating are the strong mechanics, included in the RIHEBC pool agreement and historic state support for school construction projects. Proceeds from the 2007B bonds were originally loaned to the four participating units of government to fund various school capital improvement projects.

STRENGTHS

-Recent trend of stability in financial operations

-The city's successful exit from bankruptcy without significant challenges by creditors

-Transition to local control with adherence to a bankruptcy plan, which projects balanced budgets through 2017

- Reduced expenditures related to personnel costs and benefits

- Continued oversight of financial operations pursuant to the state Fiscal Stability Act

CHALLENGES

-Limited tax base and weak demographic profile

-Large unfunded pension liability, despite significant reductions

-Reduced levels of state aid and a statutory property tax levy limitation

-Elevated debt burden with a significant amount of deferred capital projects

DETAILED CREDIT DISCUSSION

STABLIZATION OF FINANCES FOLLOWING BANKRUPTCY EXIT; HIGH FIXED COSTS REMAIN A CHALLENGE

Following an exit from Chapter 9 bankruptcy, the city's financial operations have improved, although fixed costs and pension liabilities remain high and will pose a challenge to the city going forward. General Fund reserves have increased to $1.2 million or 6.6% of revenues in fiscal 2013 from a recent accumulated $2.3 million deficit or -14.1% of revenues in fiscal 2010. The city's bankruptcy plan was originally filed in August 2011 and was confirmed by the federal bankruptcy court in September 2012. The federal court cleared the path for the city's exit from bankruptcy on October 25, 2012 and the city regained local management of day-to-day operations from the state-appointed receiver in April of 2013. Pursuant to the Fiscal Stability Act, the state appointed Administration and Finance Officer will remain in place for at least five years, providing support for the city during the transition back to local control.

The bankruptcy plan reduced pension benefits to employees and retirees and non-bondholder creditors' claims by up to 55%, which, together with other cuts, helped close an estimated $6 million budget gap in fiscal 2012. The ratification of collective bargaining agreements expiring June 30, 2016 between the city and its three public employee unions reduce costs for personnel-related expenses, overtime, health care and pension benefits, and provide a measure of stability to the city's forward looking financial projections. A separate Settlement Agreement was conducted with the city's retirees and was conditioned on the state's approval of $2.6 million in annual transitional payments to retirees over five years.

Fiscal 2013 ended with a $166,000 reduction to the General Fund balance after sending $1.8 million toward much needed capital maintenance. The favorable result was primarily related to stronger than anticipated property tax collections ($759,000 positive variance) and improving revenues related to building permits. Property taxes accounted for 75% of total General Fund revenues in fiscal 2013 with state aid making up 15% and fees and other taxes representing the final 10%.

The fiscal 2014 budget included a 4% levy increase in accordance to the city's six-year plan. By year end, management anticipates sending $700,000 toward capital with no significant change to fund balance levels. The fiscal 2015 budget was recently adopted and included a 4% levy increase.

The remaining portion of the six year financial recovery plan incorporates limited expenditure growth and is balanced through required property tax levy increases up to the limit (4%) allowed under Rhode Island's property tax levy cap. Given the weak socioeconomic profile, improvement of long-term credit strength will depend on the continued adherence to the recovery plan and maintenance of structural balance while addressing capital needs that have built up due to years of deferral.

From fiscal 2007 to fiscal 2011, the city relied on annual cash flow note borrowing for operational liquidity. The city has not issued cash flow notes since that time as a result of the expenditure reductions, and under the updated six-year financial recovery plan, the city projects sufficient cash flow to meet all obligations, including full debt service and pension payments, without the use of cash flow borrowing.

LIMITED TAX BASE WITH VERY WEAK SOCIOECONOMIC INDICATORS AND LOSS OF IMPACT FEE REVENUES

The city's limited $480 million tax base will likely remain very weak due to reduced taxable values, high poverty and unemployment rates, and the loss of impact fee revenues related to Wyatt Detention Center. Prior to the recession, development largely consisted of the redevelopment of abandoned properties in this small, densely populated and built-out city. Due to the subsequent decline in regional housing values and ongoing weakness in the real estate market, the city's taxable base declined by 34% in fiscal 2011 and then declined by an additional 5.6% during the city's next full revaluation, which took effect for the fiscal 2014 year. Although the number of foreclosures have declined, they remain relatively high. The city also has a high proportion of older, multi-family dwellings inhabited by renters, with 21% of the housing stock owner-occupied compared to a 60% median for the state and 66.2% for the nation. Income levels are well below average, with median family income 55% of the state and 61% of the nation as of the 2010 census. The city's poverty rate is very high at 29%, well above the national median of 12.4% and ranks only second in the state behind the City of Providence (GO rated Baa1/stable) at 29.1%. Full value per capita of $23,388 reflects the city's low housing values. Unemployment remains high at 10.4% as of April 2014, above the 7.8% rate for the state and 5.9% for the nation.

A privately owned property was leased to the Wyatt Detention Center detention center beginning in 2006 and was primarily used as a training center by a federal agency. The city budgeted to receive $1.2 million in impact fee revenues in fiscal 2010, an amount that was equal to 6.8% of the city's total revenues. After undergoing operational changes at the facility in fiscal 2009, however, the detention center ceased all impact fee payments to the city. Although the detention center still remains operational, it is no longer paying impact fees to the city and the city no longer budgets for them. In August 2011, the property was deemed taxable, resulting in existing back taxes owed of $243,000 as of fiscal 2013.

ELEVATED DEBT BURDEN BEING PAID ON TIME AND IN FULL

All of the city's general obligation debt service payments (including those for the RIHEBC pooled financings) have been made on time and in full throughout the bankruptcy process. A statewide municipal lien statute prioritizes city and town general obligation bondholders and gives them an unimpaired creditor status. The city's debt burden remains a high 3.7% of full value, but is adjusted down to 2.7% after deducting state building aid that offsets debt service on school debt. Total debt service represents a significant 14.1% of General Fund expenditures as of fiscal 2013. The bankruptcy plan incorporates additional debt service to address deferred capital improvements to school buildings, of which the state is expected to reimburse 96%. The plans have not been finalized.

PENSION AND OPEB BENEFITS REDUCED FOR ACTIVE AND RETIRED EMPLOYEES

Central Falls City employees currently participate in one of two pension plans. The combined Moody's adjusted net pension liability (ANPL), under Moody's methodology for adjusting reported pension data, was $41.97 million, equivalent to a high 8.7% of full value, or 2.3 times revenues. Moody's uses the adjusted net pension liability to improve comparability of reported pension liabilities. The adjustments are not intended to replace the district's reported liability information, but to improve comparability with other rated entities. We determined the district's share of liability for the state-run plans in proportion to its contributions to the plans.

Reducing the pension obligation during bankruptcy was key to restoring the city's financial operations to structural balance. One of the city's pension funds, the John Hancock Plan, was expected to cease payments to 73 retirees in 2011 due to the city's insolvency. After pension reductions were imposed, the city was able to make reduced payments to those retirees. The city is required to pay 100% of the ARC on their Civilian Employees Municipal Employee Retirement System (MERS) pension plan which remains 69% funded, with a reported $2.2 million unfunded liability as of June 2013. The city's six-year financial plan includes full ARC funding for all plans and actuarial assumptions include a 7.5% investment return.

OPEB was also reduced during bankruptcy. According to actuarial valuations the total unfunded OPEB liability was reported to be $12 million in 2013, which is a significant reduction from $30 million in fiscal 2010.

Funding for the city's annual fixed costs (including pension, OPEB and debt service obligations) totaled a significant 29% of the fiscal 2013 budget, still high, but lower than the 40.8% for these costs in fiscal 2010. Future increases in the share of the budget claimed by these fixed obligations could pressure operations and impair the city's ability to maintain structural balance in the future.

OUTLOOK

The stable outlook reflects our expectation that the city's maintenance of structural balance will continue, in line with its bankruptcy plan and as reflected in its six-year financial projections. We also expect the city to continue to fund 100% of its pension ARC, resulting in an increasing funded ratio and a reduced unfunded pension liability for the city's single employer plan.

WHAT COULD MAKE THE RATING GO UP:

-Adherence to the six year financial plan and improvements in the financial reserves

-Improved funding for the city's pension, OPEB and maintenance of capital

-Significant decrease in debt burden

WHAT COULD MAKE THE RATING GO DOWN:

-Deviation from the six-year financial plan that results in financial deterioration

-Inability to improve funding of long-term liabilities including pension and health care

-Significant increases in debt burden or pension liability

KEY STATISTICS

Full Value, Fiscal 2014: $453 million

Full Value Per Capita, Fiscal 2014: $23,388

Median Family Income as % of US Median (2012 American Community Survey): 53.6%

Fund Balance as % of Revenues, Fiscal 2013: 6.6%

5-Year Dollar Change in Fund Balance as % of Revenues: 3.3%

Cash Balance as % of Revenues, Fiscal 2013: 10.1%

5-Year Dollar Change in Cash Balance as % of Revenues: 13.19%

Institutional Framework: "A"

5-Year Average Operating Revenues / Operating Expenditures: 1.01x

Net Direct Debt as % of Full Value: 3.7%

Net Direct Debt / Operating Revenues: 0.98x

3-Year Average ANPL as % of Assessed Value: 18.32%

3-Year Average ANPL / Operating Revenues: 4.84x

The principal methodology used in this rating was US Local Government General Obligation Debt published in January 2014. An additional methodology used in this rating was Public Sector Pool Financings published in July 2012. Please see the Credit Policy page on www.moodys.com for a copy of these methodologies.

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.

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Analysts

Vito Galluccio
Lead Analyst
Public Finance Group
Moody's Investors Service

Thomas Compton
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