MOODY'S
INVESTORS SERVICE

New Issue: Moody's assigns A1 to Lancaster County's (PA) $8.3M G.O. Bonds, Series of 2014; revises outlook to negative

Global Credit Research - 11 Feb 2014

A1 rating applies to $280M of G.O. debt

LANCASTER (COUNTY OF) PA
Counties
PA

Moody's Rating

ISSUE		RATING
General Obligation Refunding Bonds, Series of 2014		A1
Sale Amount	$8,300,000	
Expected Sale Date	02/18/14	
Rating Description	General Obligation	

Moody's Outlook NEG

Opinion

NEW YORK, February 11, 2014 --Moody's Investors Service has assigned an A1 rating to Lancaster County's (PA) $8.3 million General Obligation Refunding Bonds, Series of 2014. Concurrently, we have revised our outlook to negative from stable and affirmed the A1 rating on $280 million of the county's G.O. debt outstanding rated by Moody's.

Debt service on the bonds is secured by the county's general obligation unlimited tax pledge. Proceeds will be used to advance refund the county's Series A of 2004 bonds for an estimated net present value savings of $579,654 equal to approximately 7.2% of par outstanding, with no extension of the maturity structure.

SUMMARY RATING RATIONALE

The A1 rating reflects the county's sizeable and relatively stable rural-suburban tax base with average socioeconomic levels and low unemployment, along with a manageable debt burden. These positives are offset by the county's limited financial flexibility, given its narrow liquidity position, along with a recent history of operating deficits and modest variable rate debt and swap exposure. Further declines in General Fund reserves and weakening of liquidity will result in additional negative pressure on the rating.

The negative outlook incorporates a probable sixth consecutive operating deficit in fiscal 2013, and our concerns that county will be unable to manage expenditures in a manner sufficient to offset additional near-term declines in reserves, as well as the absence of a clear plan by county management to replenish fund balances.

STRENGTHS

-Large and diverse tax base in favorable location

-Stable revenues derived primarily from property tax receipts

-Manageable debt burden

WEAKNESSES

-Narrow General Fund cash position

-Pattern of operating deficits and declining reserves

DETAILED CREDIT DISCUSSION

NARROW FINANCIAL POSITION FOLLOWING FIVE CONSECUTIVE OPERATING DEFICITS, AND A POSSIBLE SIXTH

Lancaster County's narrow financial position results from a five-year pattern of General Fund operating deficits driven by weak revenue forecasting and repeated appropriations of General Fund reserves to balance annual budgets prior to fiscal 2013. The county was generally able to replenish a significant portion of these appropriations due to strong cost controls, but General Fund reserve levels nevertheless declined from a recent high of $21.1 million in fiscal 2007 (equal to 16.8% of revenues) to $8.2 million, or a much weaker 5.4% of operating revenues (including $9.2 million of appropriated reserves) in fiscal 2012. Fiscal 2012 audited results were inflated by the inclusion of $26.4 million of capital lease proceeds in the General Fund; when these proceeds are backed out the remaining fund balance equaled $8.2 million and cash was less than $1 million. The capital lease proceeds are being used to fund capital improvements to the county's 911 system in fiscal years 2012 through 2015. In our view, the narrow reserves and limited cash provide a weakened margin with which to offset potential cost pressures, including those related to the county's modest amount of variable rate debt and swap exposure.

Excluding capital lease proceeds, fiscal 2012 (December 31 year-end) concluded with a fifth consecutive operating deficit, despite the county's strong cost containment measures, with General Fund reserves declining by $3 million from fiscal 2011. The final draw on reserves was slightly greater than expected; projections had been for $2.5 million. Reasons for the draw included $2.8 million in below-budget departmental income and state revenue transfers, as well as higher-than-expected corrections costs related to employee overtime at the county jail. The county was able to replenish nearly half of a $9.2 million reserve appropriation by realizing strong cost variances in general government ($6.1 million), judicial ($1.7 million), and capital costs ($2.5 million). General Fund cash, not counting the capital lease proceeds, was a very weak $586,300 (0.4% of revenues), providing a limited cushion to offset unexpected costs.

The county's $161 million fiscal 2013 budget was the first in six years to be structurally balanced without the use of reserves and included a 9.5% property tax rate increase that generated $10.3 million in new revenues. County officials report that revenues tracked closely to budget and rose by $14 million over fiscal 2012 (although the use of $5 million capital lease proceeds to cover 911 improvements partly accounts for this increase).

While officials had initially anticipated a modest surplus, the issuance of a $4.9 million arbitration award for the county's correctional officers union in August 2013 mooted that outcome. Officials stated in October 2013 that they would divide payment of the award between late fiscal 2013 and early 2014 in order to conserve fund balances, but ultimately decided to pay the entirety of the award in fiscal 2013, leading to an estimated $1.2 million draw on General Fund balance (unaudited). This sixth consecutive draw - if borne out - would reduce General Fund reserves to $6.9 million, or about 4.5% of revenues, which is well below the median for similarly-rated US counties. The situation highlights the risks of low reserve balances, as the county was unable to preserve its already-thin fund balances due to the award payment.

The $166 million fiscal 2014 budget is balanced without the use of reserves, did not include a property tax increase and is structured to add $880,000 to reserves. Management has not, as of this time, articulated a coherent plan to restore reserves back to historical levels. Future rating reviews will factor the county's ability to maintain financial flexibility and adequate reserve levels going forward. Further operating deficits will negatively pressure the rating.

LARGE AND RELATIVELY STABLE TAX BASE WITH DIVERSE ECONOMY

We believe that growth within the county's sizeable $39.1 billion tax base will remain relatively stable despite experiencing slight declines in 2010 through 2013 totaling 6.3% of full valuation given a weak residential housing market. The county is primarily residential (70% of assessed value), with a solid agricultural base and strong healthcare industry presence. The county ranks first in agricultural production for counties east of the Mississippi River, and is one of the top 20 in the nation for agriculture. Lancaster General Hospital (revenue bonds rated Aa3/stable outlook), the county's largest employer with over 7,000 employees, provides economic stability as the dominant regional health services provider.

New growth and development in both the residential and commercial sectors has been slow since 2008, but is expected to increase in the near term; the five-year annual average rate of full value decline was -1.0% for 2009 to 2013. The county's population grew by 10.4% between 2000 and 2010, rising to 519,445 and indicating that the county remains an attractive place to relocate given a low cost of living and far below average unemployment rate (5.5% in November 2013) relative to the commonwealth (6.8%) and nation (6.6%). Income levels are average, with per capita and median family income at 95.6% and 102.1% of the state medians. The county's full value per capita is a solid $74,747 (close to the US median). Recent economic development includes the planned construction of an Urban Outfitters fulfillment center in Salisbury Township (not rated) is expected to generate 500 new jobs in the county.

MANAGEABLE DEBT POSITION WITH MODEST VARIABLE RATE AND SWAP EXPOSURE

We expect the county's debt position will remain manageable, although its above average debt service costs - an estimated 16.2% of fiscal 2012 expenditures - and slow principal amortization (61.2% paid within 10 years) could present future challenges given limited revenue growth. Management reports that outside of jail and ongoing bridge repair costs, capital and facility needs have been addressed for the foreseeable future, and little new debt is likely to be issued in the near-term. The jail is presently at capacity and discussions for addressing potential increased demand are ongoing. The direct debt burden is manageable at 0.7% of full valuation, just above the US median for counties. Significant overlapping municipal and school district debt increase the overall debt burden to an above-average 5% of full valuation.

Approximately 14% of the county's outstanding debt is in variable rate mode and consists of the Series A of 2002 Notes ($25 million) issued through the Delaware Valley Regional Finance Authority (rated A2/stable outlook) and the Series C of 2013 Bonds ($20 million), which is a floating rate note (FRN) provided by Wells Fargo Municipal Finance LLC. The FRN pays interest at a floating rate equal to 70% of LIBOR plus a 55 basis point spread during the initial three-year index period, and is subject to a mandatory tender on August 1, 2016. The Series A of 2002 notes bear interest at a floating rate linked to SIFMA and are not putable.

The county has one active floating-to-fixed rate swap and one fixed-to-floating swaption agreement. The county entered into a floating-to-fixed interest rate swap with JP Morgan Chase & Co. (senior unsecured rated A3/stable outlook) in 2001 for an original notional amount of $24.9 million related to the county's Series A of 2002 Notes. The swap amortization schedule mirrors that of the bonds and the swap terminates at the bond maturity date of October 25, 2030. The county also entered into three fixed-to-floating swaption agreements in 2004 that were initially eligible for exercise on November 1, 2009. The three fixed-to-floating swaption agreements were restructured into a single agreement with the Royal Bank of Canada (senior unsecured rated Aa3/stable) in November 2013. The exercise date of the new, single swaption is October 28, 2016. If not exercised on that date by the counterparty, then the swaption will expire. According to county management, there is no indication that the counterparty plans to exercise the swaption.

The county's current total aggregate mark-to-market position for its swap and swaption is a negative $10 million. Although the county's combined cash reserves are sufficient to cover this amount in the event that all the derivative agreements were terminated simultaneously, this would severely limit the county's ability to respond to normal budget fluctuations. However, the county is able to bond for termination payments, which would provide added financial flexibility to help mitigate this risk. Future rating reviews will incorporate the county's ability to effectively manage its derivative and variable rate debt exposures.

ADEQUATE PENSION FUNDING LEVELS

The county sponsors the Lancaster County Employee Retirement Plan, a single-employer cost-sharing defined benefit plan covering substantially all employees. The county's Annual Required Contribution (ARC) was $7.1 million in fiscal 2012, representing a manageable 4.8% of General Fund expenditures; the county funded its entire ARC payment in 2012. The pension plan's funding level was 80.1% as of December 2012. The plan's unfunded actuarial accrued liability (UAAL) was $46.9 million as of December 2012. The plan's adjusted net pension liability, under Moody's methodology for adjusting reported pension data, is $174.2 million, or approximately 1.23 times operating revenues, which is just slightly above the national average. Moody's uses the adjusted net pension liability to improve comparability of reported pension liabilities. The adjustments are not intended to replace the county's reported liability information, but to improve comparability with other rated entities.

The county also offers an OPEB plan that is funded on a pay-go basis. The unfunded actuarial accrued liability for OPEB was $71.6 million as of December 2011. The county contributed 36% ($2.2 million) of its annual OPEB cost in fiscal 2012. General Fund fixed costs, including debt service (16.2%), pensions (4.8%), and OPEB (1.5%) represented a sizable 22.5% of county General Fund expenditures in fiscal 2012. The county's ability to manage these growing fixed costs will factor prominently into future rating reviews.

OUTLOOK:

The negative outlook incorporates a probable sixth consecutive operating deficit in fiscal 2013, and our concerns that county will be unable to manage expenditures in a manner sufficient to offset further near-term reserve appropriations, as well as the absence of a clear plan by county management to replenish financial reserves.

WHAT COULD CHANGE THE RATING - UP:

-A trend of surplus operations and material improvement in cash and reserves.

-Established trend of structurally balanced budgets and operations.

WHAT COULD CHANGE THE RATING - DOWN:

-Failure to maintain adequate reserve and liquidity position.

- Unbudgeted increases in expenditures related to operations, variable rate debt, or swaps that deplete liquidity.

KEY STATISTICS:

2010 Population: 519,445 (10.4% increase since 2000)

2013 Full Valuation: $39.1 billion

2013 Full Value Per Capita: $74,747

2010 Median Family Income (as % of PA and US): (102.1% and 102.7%)

Unemployment Rate (November 2013): 5.5%

Payout of Principal (10 years): 61.2%

Operating fund balance, fiscal 2012: 5.4%

5-year dollar change in fund balance as % of revenues (2007 to 2012): -9.10%

Cash balance, fiscal 2012: 0.25%

5-year dollar change in cash balance as % of revenues (2007 to 2012): -15.30%

Institutional framework, PA counties: Aa

5-year average of operating revenues/operating expenditures: 0.98x

Debt to full value: 0.80%

Debt to operating revenues 2.1x

3-year average of Moody's adjusted net pension liability to full value: 0.37%

3-year average of Moody's adjusted net pension liability to operating revenues: 1.05x

Post-sale Parity Debt Outstanding: $310 million ($280 million rated by Moody's)

RATING METHODOLOGY

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.

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