FitchRatings

Fitch Affirms Kissimmee, FL's Capital Improvement Revs at 'AA'; Outlook Stable

Fitch Ratings-New York-16 February 2017: Fitch Ratings has affirmed the 'AA' rating on the following Kissimmee, FL revenue bonds:

--$42,480,000 capital improvement revenue bonds, series 2016.

Fitch also affirms the 'AA' rating on the Kissimmee's Issuer Default Rating (IDR).

SECURITY
The capital improvement revenue bonds are a limited obligation of the city backed by a pledge of the following: (i) local government half-cent sales tax (LGST) revenues, (ii) public utilities and services taxes (PST) imposed on the sale of electricity, metered or bottled gas and water services in the city, and (iii) communication services taxes (CST) imposed on certain communication service sales in the city. The city has also covenanted to budget and appropriate sufficient non-ad valorem (NAV) revenue, in addition to such revenues specifically pledged to the bonds, to pay debt service on the bonds in the event the pledged funds are insufficient to do so.

KEY RATING DRIVERS

The affirmation of the 'AA' IDR reflects the combination of Kissimmee's strong financial resilience evidenced in high reserves and revenue raising authority relative to potential revenue declines in a moderate economic downturn. Spending controls are satisfactory and the budgetary burden related to fixed debt and retiree benefits is moderate. Kissimmee's economic base has historically supported a relatively low level of natural revenue growth and high volatility which is a key credit negative. The city is not overly burdened by debt and retiree benefit liabilities which account for a moderate percentage of resident's personal income.

The affirmation of the 'AA' rating on the capital improvement revenue bonds is based on the significant coverage cushion from current pledged revenues in excess of 20x Fitch-modeled revenue declines and 6x historical losses based on existing leverage levels. Fitch believes the coverage cushion would remain consistent with the 'AA' rating in the unlikely event the city issues debt to the maximum amount permitted under the 1.35x additional bonds test (ABT). Fitch's rating on the bonds is capped by the city's IDR rating of 'AA' as Fitch does not assume the pledged revenues are 'special revenues' under Chapter 9 of the U.S. Bankruptcy Code.

Economic Resource Base
Kissimmee is a suburban community in central Florida approximately 20 miles south of Orlando and 10 miles southeast of Walt Disney World Resort. Tourism-related retail and service activity are the key drivers of the local economy. Income, housing, and employment metrics tend to register below regional and state norms.

Revenue Framework: 'aa' factor assessment
General fund revenue sources exhibit slow growth absent policy action related to utility transfers. The strength of the surrounding economy and prospects for development in the city could improve revenue performance over time. The city's millage rate is well within statutory limits resulting in considerable revenue raising capacity relative to expected volatility in a moderate economic downturn.

Expenditure Framework: 'aa' factor assessment
The city's spending profile has risen sharply in conjunction with growth in population and service demands. The city has fairly strong legal control over employee wages which is the key driver of spending, and additional flexibility is evident in a moderate cost for servicing debt and retiree benefits.

Long-Term Liability Burden: 'aa' factor assessment
Debt and retiree benefits are expected to remain a moderate burden relative to the city's personal income. Reported capital needs are manageable and pension liabilities have been relatively stable reflecting recent benefit reforms and consistent funding of actuarial determined contributions.

Operating Performance: 'aaa' factor assessment
The city's budgetary tools and high reserves are expected to minimize risk to cyclical budgetary pressures. Management has demonstrated the ability to achieve favorable financial results through changing environments.

RATING SENSITIVITIES

Dedicated Tax Bonds: The 'AA' rating on the capital improvement revenue bonds is sensitive to changes in pledged revenue performance and leverage. Fitch believes the current risk to a material shift in either of these factors is low. The rating is capped by the city IDR and thus sensitive to changes in the city's long-term credit quality. Conversely, the rating will be no lower than one notch below the IDR based on the city's NAV covenant to cover any shortfall in pledged revenue.

IDR Sensitivities: Kissimmee's IDR is sensitive to changes in its financial and operating flexibility and its continued capacity to manage risks associated with potential volatility in its economy and tax base. Improved revenue stability and growth expectations would be viewed as a positive rating factor.

CREDIT PROFILE

Kissimmee is a predominantly residential community with a growing population estimated at 69,150 in 2015 compared to 59,682 in 2010. Many of the city's residents are employed in a tourism-related capacity. Income and educational attainment measures are subpar relative to regional and state norms and the city has a low property wealth estimated at $40,000 per capita. Home values are recovering very slowly from significant losses incurred during the Great Recession and currently measure roughly 80% of the state norm according to Zillow Group. The tourism industry is important to local employment and continues to expand with major investments in theme parks and hotel properties contributing to solid gains in local employment. Expansion of SunRail from Orange County through major population centers in Osceola County (including Kissimmee and Poinciana) could stimulate more diverse private sector investment and also stabilize home prices in areas previously underserved by transit.

Revenue Bonds Demonstrate Very Strong Resilience to Potential Revenue

Stresses

Current pledged revenues provide a solid cushion against potential revenue downturns supporting the current 'AA' rating. Unaudited fiscal 2016 pledged revenues total near $11.5 million or almost 4x maximum annual debt service (MADS) of $3 million. Fitch estimates pledged revenues would need to decline by roughly 75% before MADS coverage is less than 100% or more than 20x the revenue sensitivity results produced by Fitch's Analytical Sensitivity Tool (FAST) in a -1% U.S. GDP scenario and 6x the largest actual cumulative decline dating back to fiscal 2000 - an 11% loss from fiscal 2008-2011.

The ABT for the capital improvement revenue bonds is based on a 1.35x MADS coverage requirement. Issuance near the ABT level would most likely not impact the rating, all other factors remaining stable. That said, the city has stated it does not expect to issue new money parity debt and reported capital needs are modest. Additional leverage would also serve to diminish general fund budgetary resources as surplus pledged revenues after the payment of debt service are available to fund general government operations.

Solid Growth Subject to Periodic Volatility and CST Risk

Pledged revenues have increased at a compound annual growth rate (CAGR) of roughly 2.7% from fiscal 2000-2015. The PST and LGST components are roughly equivalent and combine to account for more than 80% of total pledged revenue. The PST component of pledged revenue has risen at more than 5% per year since fiscal 2000 but its growth captures various increases in utility rate schedules. The LGST has expanded at a more moderate pace of about 2% per year. Both revenue streams have exhibited a fairly high level of volatility with annual losses of 10% or more recorded recently. Absent a significant shift in resident incomes and economic breadth, Fitch would expect similar periods of volatility going forward tempering growth expectations. Additional growth pressures are evident in the performance of the CST revenue which declined for a ninth consecutive year in fiscal 2015. The CST history is emblematic of a trend statewide that appears to be caused by changes in consumer preference and competition, among other factors.

As additional security, the city covenants in the bond resolution to budget and appropriate non-ad valorem (NAV) revenues in order to cure a debt service funding deficiency, if any. The NAV covenant represents a continuing obligation, not subject to termination or appropriation. The NAV covenant does not create a lien on any revenue and the NAV covenant may be subject to the prior payment of debt secured by a lien on such revenue. The NAV covenant is further subject to prior payment of services and programs which are for essential public purposes affecting the health, welfare and safety of the inhabitants of the city. Lastly, the NAV covenant does not create requirement to generate non-ad valorem revenue.

Revenue Framework

The fiscal 2017 general fund budget approximates $62 million or an increase of roughly 40% from a decade ago due to the growing nature of the community and service provision. The city has a revenue structure that is more heavily dependent on various forms of utility consumption compared to other Fitch-rated local governments. About 60% of the budget is linked to utility taxes or transfer payments with the remainder coming from ad valorem taxes, sales taxes, and service charges.

Utility transfer payments from Kissimmee Utility Authority (KUA) and Toho Water Authority (TWA) represent about 30% and 10% of the general fund budget, respectively. The KUA and TWA utility payments are recorded as an operating expense of the respective utility paid prior to debt service on outstanding revenue bonds. Fitch rates KUA and TWA's revenue bonds 'AA-' and 'AA+', respectively. For more information see 'Fitch Affirms Kissimmee Utility Authority, FL's Electric System Revs at 'AA-'; Outlook Stable' dated March 2015 and 'Fitch Rates Tohopekaliga Water Authority, FL's Utility Revs 'AA+'; Outlook Positive' dated March 2016 on www.fitchratings.com.

General fund revenues have increased at a solid 10-year CAGR of 2.5% through fiscal 2015; however, growth has largely been influenced by policy action and increases to the annual utility payment from KUA. KUA had existed as a department of the city until 1985 when voters approved an amendment to the city charter establishing the KUA as a separate unit of local government with independent budget authority. The city still appoints the KUA governing body and the charter establishes a minimum utility payment to be made by the KUA to the city on the basis of gross electric retail sales. The city may request a higher utility payment subject to KUA approval; two such increases have been requested and approved in recent history, the most recent occurring in fiscal 2014 resulting in a $5 million increase in the KUA utility payment contributing to an increase in total general fund revenue of almost 13% on the year. Absent this adjustment and others, Fitch believes the city's revenue performance has been weaker than the 10-year CAGR implies.

Property taxes are the second largest source of general fund revenue at about 20%. Property taxes have increased at a pace of roughly 1% consistent with changes in the city's tax base over the 10-year period. The tax base is showing positive signs after five consecutive years of decline aggregating a 44% loss in taxable assessed value (TAV) from fiscal 2008-2013. From fiscal 2014-2017, annual growth in TAV has ranged from 4%-8%. Home prices are up 14% over the past 12 months to almost $160,000 according to Zillow Group but remain almost 30% below pre-recession highs. Sales tax revenues have demonstrated similarly slow growth over the prior decade in line with changes in inflation. The impact of population growth on sales tax and other consumption-driven revenue streams is expected to be somewhat muted from continued sluggish improvement in resident personal incomes.

The city has ample legal revenue raising authority. General fund revenues are diverse in their sources but the city's levy of ad valorem property taxes, which fund roughly 20% of the general fund budget, offer the greatest opportunity for revenue increases, if needed. Florida local governments are subject to a statutory ad valorem tax cap of 10 mills. Fiscal 2017 marks the sixth consecutive year the city's tax rate was set at 4.63 mills. Fitch estimates the city could generate roughly $14 million in additional revenue through an increase in the property tax rate to the maximum legal rate, which is the equivalent of roughly 20% of the total general fund budget.

Annual changes in the property tax rate are determined using a roll-back or revenue neutral rate, which is then adjusted for changes in the Florida per capita personal income. However, this limitation may be overridden by vote of the city governing body. The city's ability to increase various service charges, licenses and permits augment its notable legal authority to increase revenues.

Expenditure Framework

Kissimmee's general fund spending responsibilities are largely related to police and fire service provision which collectively consume about 55% of the fiscal 2017 budget, parks and recreation 10%, and public works 8%.

General fund expenditures have largely risen in lockstep with revenues. Fitch would expect this trend to continue as growth-driven demands on spending are countered by commensurate growth in the tax base and other economically sensitive revenues. Debt and pension-related expenditures are expected to remain both manageable and fairly stable.

Fitch views the city's expenditure flexibility as solid. The cost of funding debt and retiree health and pension obligations are estimated by Fitch at a moderate 15% of governmental spending. The remainder of the budget is largely driven by personnel costs. Wages and benefits are collectively bargained for police and fire, which account for approximately one-third of the citywide full-time workforce. Police and fire contracts are in place through Sept. 30, 2018. Under Florida law a bargaining impasse is ultimately resolved by action of the governing body of the local government following the conclusion of a non-binding mediation process.

A hiring freeze was in effect from fiscal 2008-2013 but since then the city has increased its full-time staff by more than 10% government-wide with the largest departmental gains in parks and recreation which has added 19 positions or a near 40% increase. The budget for parks and recreation and economic development initiatives, which Fitch views as an important but non-critical service, consumes more than $7 million or about 11% of spending. The city also consistently funds contributions to pay-go capital of approximately $2 million annually which could be deferred in the event of a short-term stress on the budget.

Long-Term Liability Burden
Fitch estimates the city's long-term liability burden at 12% of personal income which is comfortably within the 20% ceiling established for a 'aa' assessment. The series 2016 capital improvement revenue bonds roughly doubled the city's direct debt but funded the bulk of its reported capital needs over the next several years. The city administers two single-employer defined benefit pension plans for police and fire and is a participant in a multiple-employer

with the Toho Water Authority for general employees. The city's Fitch-adjusted aggregate ratio of assets to liabilities for all three pension plans was 73% and the net pension liability (NPL) $51 million or 3% of personal income. The city and its labor unions agreed to various pension modifications several years ago that should help control the pace of liability growth going forward. Fitch also expects the city will continue to fund the full actuarially-determined pension contribution on an annual basis.

Operating Performance

Fitch views the city's financial resilience relative to FAST-generated revenue declines in a -1% U.S. GDP scenario as exceptionally strong. The city's ability to increase property tax revenue within statutory limits covers by a wide margin the 5% scenario-estimated revenue decline. The city has broad legal control over staffing levels and has demonstrated its ability to effectively cut spending in certain non-critical areas in response to prior revenue stresses. The city could also tap into a portion of its reserves, if necessary, without impairing credit quality. In fiscal 2015, unrestricted general fund reserves exceed $24 million or 42% of spending.

The city's budget management is also considered a positive rating factor. The city has diligently adhered to a fairly conservative fund balance policy set at 20% of spending and in the past seven fiscal years (2009-2015) has only recorded two operating deficits less than $400,000 or 1% of spending in the aggregate. The recent strong run of financial results reflects an improvement in the economic and revenue environment but also the city's careful budgeting practices. Revenues tend to be conservatively estimated which is prudent given the city's high dependency on more economically sensitive utility-based taxes and transfer payments. Expenditure savings are typically achieved from workforce turnover and vacancies.

Financial statements for fiscal 2016 are not yet available for review; however, the city indicated there were no major deviations from the budget and expects to generate another operating surplus. The adopted fiscal 2017 general fund budget represents an almost $2 million or 3% annual increase mostly driven by salary increases following a formal compensation study to ensure comparability with surrounding communities. The budget forecast a roughly $2 million use of reserves on the year consistent with recent practice.

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

Applicable Criteria

U.S. Tax-Supported Rating Criteria (pub. 18 Apr 2016)
(https://www.fitchratings.com/site/re/879478)

Additional Disclosures

Dodd-Frank Rating Information Disclosure Form
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