FitchRatings

Fitch Upgrades Cape Coral, FL Special Obs to 'AA-' and Affirms Gas Tax Bonds at 'A-'; Outlook Stable

Fitch Ratings-New York-20 March 2017: Fitch Ratings has taken the following rating actions on the City of Cape Coral, FL's outstanding obligations:

--$96.7 million special obligation revenue bonds, series 2007, 2011 and 2015, upgraded to 'AA-' from 'A+';
--$41.1 million gas tax revenue bonds, series 2010A and 2010B (Federally Taxable Build America Bonds-Direct Payment), affirmed at 'A-';
--Issuer Default Rating (IDR) upgraded to 'AA' from 'AA-'.

The Rating Outlook is Stable.

SECURITY
Special Obligation Bonds: The city has covenanted and agrees to appropriate in its annual budget legally available non-ad valorem revenues in an amount sufficient to pay debt service on the special obligation revenue bonds. The obligation shall be cumulative to the extent not paid. Such covenant to budget and appropriate non-ad valorem revenue is subject to the availability of non-ad valorem revenues after satisfying obligations with a specific lien on such revenue and the funding of essential government services.

Gas Tax Bonds: The gas tax revenue bonds are payable from a first lien on the revenues from the 5- and 6-cent local option gas tax imposed by the county and received by the city pursuant to state law and interlocal agreement. The county ordinances authorizing collection of the gas tax revenues do not extend to the scheduled final maturity date of the bonds; therefore, the city has a covenant to budget and appropriate legally available non-ad valorem revenues only in the event the city's receipt of gas tax revenues terminates as a result of the county's determination not to extend the levy of either of the local option gas taxes.

KEY RATING DRIVERS

The upgrade of the city's IDR to 'AA' from 'AA-' is based on application of Fitch's revised criteria for U.S. state and local governments, released on April 18, 2016, in particular with respect to the strength of the city's revenue system and solid financial resilience. Such resilience is evidenced in high reserves and revenue raising authority relative to potential revenue declines in a moderate economic downturn. Fixed costs for debt service, pension and other post-employment benefits (OPEB) represent a large percentage of overall spending but Fitch does not expect these levels to grow materially from current levels.

The rating on the special obligation revenue bonds is one notch below the city's IDR to reflect the slightly higher degree of optionality associated with payments subject to appropriation.

The rating on the city's gas tax revenue bonds reflects the solid resilience during economic downturns and modest growth prospects. The city does not currently have plans to issue additional debt backed by these revenues.

Economic Resource Base
Cape Coral is located in Lee County on the southwest coast of Florida about 10 miles south of Fort Myers and 125 miles south of Tampa. The city is principally a residential, recreational and vacation community and its population is a mix of retirees and young families. Population growth has been strong since 2000 and the current 2015 census estimate is 175,229, up almost 14% since 2010.

Revenue Framework: 'aaa' factor assessment
General fund revenue growth has outpaced inflation and GDP over the 10 year period through 2015, representative of tax base and population growth and a diversification of revenues. Fitch expects future growth to remain above inflation levels reflective of the strong economy and prospects for new development. The city retains strong revenue raising flexibility.

Expenditure Framework: 'a' factor assessment
Spending has kept in line with revenue growth and Fitch expects this trend to continue. The city has fairly strong legal control over employee wages and

staffing levels which is a key driver of spending, as labor-related contracts are not overly restrictive. However, spending for debt service and retiree benefits represents a large 31% of total governmental spending.

Long-Term Liability Burden: 'aaa' factor assessment
The city's long-term liability burden is relatively low when compared to personal income. Fitch expects levels to remain low due to the absence of significant future borrowing plans and scheduled 10-year amortization of principal.

Operating Performance: 'aaa' factor assessment
Management effectively responded to revenue declines during the Great Recession by reducing staff, using reserves and budgeting conservatively. Since that time management has diversified its revenue base, implemented pension reform measures and re-built reserves to high levels supporting its financial resilience. Fitch expects similar actions would be taken during a future economic decline.

RATING SENSITIVITIES
IDR: While not expected, a material change in long-term liabilities, associated with either additional debt beyond levels projected or a significant weakening of pension funded levels, could negatively affect the rating.

Special Obligation Bonds: The rating on the special obligation revenue bonds is one notch below the city's IDR based on the city's covenant to budget and appropriate and is thus sensitive to changes in the city's long-term credit quality.

Gas Tax Bonds: The 'A' rating on the city's gas tax bonds is sensitive to changes in expectations for pledged revenue performance and future leverage. Fitch believes the current risk to a material shift in either of these factors is low.

CREDIT PROFILE

Cape Coral has experienced significant recovery from the economic downturn that began in 2008.

Cape Coral was among the communities hardest hit by the housing downturn and recession. Taxable assessed value (TAV) of $21 billion in fiscal 2008 dropped by more than $12 billion or about 59% through fiscal 2012. Since then TAV has experienced average annual growth rates of 8% and stands at $12 billion for fiscal 2017. Management has made a concerted effort to attract new businesses to its city and expand its commercial tax base, lowering the reliance on residential property taxes. The city reports an increase to 12% from 8% of the commercial component of the tax base over the past two years. Growth in manufacturing, medical related jobs, and the retail and service industries has supported improved employment levels as well.

Population in the city has almost doubled since 1990 and the growth continues to occur as commercial expansion occurs and new housing is developed. The city has more than 65 square miles of unimproved commercial and residential land within its total 120 square mile city limit, providing for additional growth capacity.

Unemployment rates spiked during the recession but have since returned to more normal levels and stand at slightly below state and national averages. Median household income levels exceed state levels but are below national averages.

Revenue Framework

The city's revenue base is comprised of a diverse mix of property, sales and excise taxes and assessments. These revenues are subject to volatility due to economic cycles. General fund revenues have rebounded reflective of an improving economy and, beginning in fiscal 2014, the addition of a new public services utility tax (PST) and a new fire assessment fee. The implementation of new revenues sources and efforts to expand the city's commercial tax base component have helped lower the dependence on residential property taxes and the tax rate has been adjusted downward in three of the past four fiscal years to reflect this change.

General fund revenue growth has outpaced inflation and GDP for the 10 year period through 2015. The new PST and fire services assessment revenues accounted for 13% and 14% growth in total revenues for fiscal 2014 and 2015, respectively. Even without these two new revenue sources revenues outpaced inflation for the period. Fitch expects natural revenue growth to remain robust reflective of the strong economy and prospects for new development.

The city maintains significant revenue raising capacity. The city's tax rate of 6.75 mills for fiscal 2017 provides for sufficient capacity within the maximum statutory 10 mill limit. Additional revenue raising capacity is available with respect to higher PST and fire assessment rates; as such rates are currently below the legal maximums.

Expenditure Framework
The city's expenses are primarily related to personnel costs with public safety representing close to 50% of general fund spending.

Annual general fund expenditures have varied year over year but Fitch expects expenses to be in line with natural revenue growth 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 manageable.

Fitch views the city's expenditure flexibility as adequate. The budget is largely driven by personnel costs. The city has the ability to reduce staff as necessary as bargaining agreements are not overly restrictive. Fixed costs for debt service, pension contributions (net of enterprise fund contributions) and OPEB are high at 31% of total fiscal 2015 governmental spending. Fitch does not expect these levels to change materially based on limited future debt plans and pension reform measures instituted in 2013 that are expected to control growth in the city's unfunded pension liabilities. Management expects to fund capital and maintenance needs through pay-as-you go funding.

Long-Term Liability Burden
Liability levels are low at 8% of the city's estimated personal income levels.

The city maintains three defined benefit single-employer pension plans, including a general plan for non-public safety employees and separate plans for police and fire fighters. As of Oct. 1, 2016, the combined funded ratio of the three plans was estimated by Fitch to be 71% assuming a 7% investment rate of return.

In fiscal 2013, the city began implementing reform measures to control pension related costs that had essentially doubled since 2008. These included revisions to labor contracts that increased retirement age and length of service for new employees and certain caps on final retirement and changes in vesting requirements for all employees.

The city's unfunded OPEB liability as of Oct. 1, 2014 was $249 million, or a slightly high 3.7% of personal income.

Operating Performance

Fitch expects Cape Coral to maintain superior financial resilience throughout the economic cycle. The city has built a high reserve cushion through a combination of expenditure reductions and revenue increases and is committed to maintaining reserves at a level equal to at least two months of operations (approximately 17% of spending). Current levels handily exceed this policy. While reserves may be pressured downward in a moderate recession scenario (1% decline in national GDP), Fitch expects that management would address the shortfall through an increase in revenues and expenditure management as it has done in the past.

Fitch views the city's budget management as a positive rating factor. The recent strong operating results reflect the implementation of new revenue sources, the city's historical practice to budget conservatively and its adherence to a three-year rolling budget plan that helps control growth in expenses. During the last downturn, when the city experienced significant declines in housing values and high foreclosure rates, management took efforts to reduce staff, cut expenses and ultimately increased revenues to restore reserve levels. Fitch would expect management to reduce capital spending, drawdown excess reserves and make staffing cuts if necessary during a future downturn.

Fiscal 2015 ended with a general fund operating surplus of $18.5 million reflective of positive revenue variances due to higher than anticipated building permit fees, property tax collections and budgeted sales taxes. Unrestricted general fund balance improved to $54 million or a strong 39% of spending.

Projected fiscal 2016 results show net-operating deficit of approximately $4.3 million after transfers reflecting a planned drawdown for capital needs.

Two new revenue sources were implemented by management beginning in fiscal 2014. A PST on electric services was effective Oct. 1, 2013 and is levied at 7% (the state limit is 10%), and accounted for $7.2 million in revenues in fiscal 2015 (5% of general fund revenues).

A fire services assessment (FSA) was approved by the city council with rates gradually increased through fiscal 2016 accounting for approximately $22 million in revenues. These revenues will help support significant city capital needs which had been deferred since the downturn.

Fitch expects economic growth to continue, albeit at lower annual rates, contributing to future growth in the non-ad valorem revenues that support the city's outstanding special obligation bonds.

Gas Tax Bonds

Current pledged gas tax revenues provide an adequate cushion against potential revenue downturns. Fitch believes that additional population growth and economic expansion provide the basis for modest growth prospects in the tax revenues despite the inherent weakness of what is essentially a consumption based tax.

Unaudited fiscal 2016 pledged revenues total around $8.7 million from both the fifth cents and sixth cents gas taxes providing 1.7x coverage of maximum annual debt service (MADS; occurring in 2030). The improved coverage levels reflect a decline in debt service due to a recent bond refunding and higher consumption levels. Debt service coverage on MADS, when the federal subsidy for BABs is included, is slightly higher. Fitch estimates pledged revenue would need to decline by roughly 39% before MADS coverage is less than 100%. This is more than 9x the revenue sensitivity results in a -1% U.S. GDP scenario produced by Fitch's Analytical Sensitivity Tool (FAST) based on historical performance and more than 2x the largest actual cumulative decline of 16% dating back to fiscal 2008-2012.

The additional bonds test (ABT) for the gas tax bonds is based on a 1.25x

MADS coverage requirement. While issuance near the ABT level could have a negative impact on the rating, the city has stated it does not currently have plans for new debt. Fitch views the pledged gas tax revenues as special revenues under section 902(2)(B) of the bankruptcy code so the rating is not capped by the city's IDR.

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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)

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