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Ratings

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Summary:

Butler, Pennsylvania; General Obligation

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Many issues are enhanced by bond insurance.

Rationale

S&P Global Ratings has lowered its underlying rating (SPUR) on Butler, Pa. series 2015A and 2015B general obligation (GO) bonds four notches to 'B' from 'BB+' and placed it on CreditWatch with negative implications.

The downgrade reflects our continued concern over the city's lack of management and its plan to fund a line of credit with PNC bank, which it guaranteed for the redevelopment authority and which is due Dec. 6, 2017. If the bank decides to exercise its right for payment of the line of credit, it could pressure the city's already thin liquidity and affect its ability to meet its other debt obligations.

Butler entered into an agreement with its redevelopment authority to guarantee a $2 million line of credit for the authority's construction of a hotel. Originally, the plan had been to pay the line of credit from a grant from the commonwealth once the construction was complete. There have been construction delays and the line of credit has been extended by the bank twice because of them. After reaching out to management and the bank, we understand the loan will not be paid by the due date as the project is once again delayed and there is no plan to pay the line of credit at this time. The authority and bank have discussed the potential for a sale of the project or waiting until the project is completed. The bank has noted that currently, it does not intend to exercise its right to request repayment, but reserves the right to do so. While the bank does not expect to receive the payment from either the city or the development authority by the Dec. 6 maturity date, it is currently anticipating payment on Jan, 5, 2018. If this happens, the city will be relieved of this obligation. Neither party has requested an extension.

The rating reflects our concern of the contingent liquidity risk that remains with the line of credit outstanding and the potential for the bank to request payment at any time after Dec. 6. In our opinion, Butler's guarantee of the line of credit is considered a nonremote contingent liability and it represents about 27% of the city's 2016 general fund revenues. Furthermore, we believe that the city could face unexpected liquidity pressures since it has no plan in place for how it would address the payment of the line of credit which has a short maturity. In our opinion, given the magnitude of the loan, the city's current liquidity position is already thin and will diminish if it has to make payment of the line of credit. Its cash declined significantly and stood at only $183,000 in fiscal 2016.

Adding to our concern regarding the line of credit is that the city has missed previous payments without a timely extension due to the lack of oversight and has not included any appropriation since inception of the guarantee. City management has indicated that there are no plans to do so at this time. We believe that if the grant revenues, which also secure the loan, are not received, the city would have to make the payment and it has not expressed any intention of making any payment on the loan, which we view as a lack of willingness to support a debt obligation.

Somewhat mitigating our concerns about potential financial stress is the fact that the bank did not express concerns about the nonpayment and it did not request payment from the city.

The CreditWatch Negative placement reflects our view that the line of credit is due on Dec. 6, 2017, after which point the city could be called on to provide payment of $2 million. It is possible the city and the bank could resolve the payment situation through sale of the hotel within the 90-day CreditWatch horizon, which would alleviate our contingent liquidity concerns, though concerns regarding management's oversight and very weak liquidity would likely persist.

A pledge of the city's full faith, credit, and taxing power, including unlimited ad valorem property taxes, secures the GO bonds.

The 'B' rating also reflects our assessment of Butler's:

- Very weak management, with "vulnerable" financial policies and practices under our Financial Management Assessment (FMA) methodology;
- Very weak liquidity that is likely to remain constrained once the line of credit remains outstanding;
- Very weak debt and contingent liability position, with debt service carrying charges at 8.9% of expenditures and net direct debt that is 77.2% of total governmental fund revenue;
- Weak budgetary performance, with operating deficits in the general fund and at the total governmental fund level in fiscal 2016;
- Very weak budgetary flexibility, with an available cash reserve in fiscal 2016 of 2.3% of operating expenditures that is also low on a nominal basis at $183,000, as well as limited capacity to reduce expenditures;
- Weak economy, with projected per capita effective buying income (EBI) at 70.0% and market value per capita of $28,423, that benefits from access to a broad and diverse metropolitan statistical area (MSA); and
- Strong institutional framework score.

Very weak management

In addition to a lack of a plan to address its guaranteed debt obligation, Butler has been experiencing ongoing structural imbalances which have persisted at least within the past three years and is also a contributing factor for the very weak management.

The city's management practices include monthly budget-to-actual reports to the council. However, it is also our opinion that, though the board receives such monthly reports, given past results, it has not demonstrated an ability to make the necessary budgetary adjustments to address revenue shortfalls through expenditure reductions. Furthermore, the city also lacks multiyear long-term financial and capital plans. Nor are there debt management or reserve policies in place. Therefore, we view the city's management as weak, with "vulnerable" financial policies and practices under our FMA methodology, indicating it lacks policies in many of the areas we believe are most critical to supporting credit quality.

Officials follow state-mandated investment policies and invest the city's cash in FDIC-insured bank accounts.

Very weak liquidity

We believe that, the city's ability to continue accessing in the market and meeting its obligation could be questionable. While Butler had demonstrated in prior years that it has access to external liquidity supported by its frequent note issuances and GO bonds within the past ten years, we believe that it may not have such access in the future due to its very weak liquidity. Therefore, this generates concerns regarding its ability to continue meeting its financial obligation.

We believe that with the timely completion and payment of the line of credit that the city will no longer be exposed to a nonremote contingent liability. It is our understanding that the grant funding has already been secured and is not likely to be affected by the current budget stalemate. Nonetheless, if the project delays continue, the revenues will not be released and the city's liquidity will remain at risk.

Very weak debt and contingent liability profile

We have included in the city's outstanding debt the loan it guarantees for the redevelopment authority. To date, we understand that Butler has not had to act on the guarantee and is not anticipating that it will have to pay. Nonetheless, given the city's contractual obligation, it has a requirement to make the payment. Therefore, it is our opinion that this also poses a speculative contingent liability risk as the city's debt service payments would increase above 20% of total governmental expenditures. We do not believe that the debt profile would improve if the guarantee debt is no longer considered its debt. Total governmental fund debt service is 8.9% of total governmental fund expenditures, and net direct debt is 118.1% of total governmental fund revenue. Net of the guarantee debt, the net direct debt as a percent of total governmental fund revenue would only reduce to 95.2%.

We believe that the city's debt and contingent liability is likely to remain very weak if its outstanding debt does not moderate and it continues to guarantee the line of credit.

Though the city's debt and contingent liability is weak, we believe that the absence of pension and other postemployment benefit (OPEB) pressures provides credit strength. Butler's pension contributions totaled 4.7% of total governmental fund expenditures in 2016. Despite its ongoing structural imbalances, the city has been able to consistently fund its pension obligation. It has contributed 100% of the annual required contribution in each of the past three years. The city provides pension benefits for its employees through three fully funded single-employer defined-benefit pension plans by the Municipal Pension Plan Funding Standard Recovery Act (Act 205 of 1984): the police, firemen, and general employees retirement systems (the plans). In spite of the financial challenges, the plans were at least 100% funded as of Jan. 1, 2015, the latest actuarial valuation date; the police plan is funded at 102.8%, the firefighters at 109.3%, and the general at 114.6%. The city has no OPEB liabilities.

Weak budgetary performance

The city's ongoing structural imbalances reflect its lack of revenue-raising flexibility since it has reached its maximum 30 mills for the real estate tax levy. This is coupled with increases in expenditures that have outpaced revenues; expenditures have been growing at a rate of about 5% over the past three years, while revenues have been flat. Based on the past three audited years, both the general fund and all governmental funds have operated with deficit operating results. This is net of adjustments that we have made to account for note proceeds and transfers from the parking fund for reimbursing the general fund for payroll and other expenses.

The fiscal 2017 budget totals $8.9 million, a 3.4% increase year over year. The budget includes $1 million of tax anticipation notes, which accounts for 11% of revenues and has increased from $750,000. Based on year-to-date results, management is expecting the general fund could end with an operating surplus of about $150,000 due to curtailing of its expenditures. However, we believe that given past results, if the city does not take steps to curb expenditures in the face of its limited revenue-raising flexibility, the year could end with another shortfall. Therefore, we believe that the city's ability to achieve structural balance could be hampered since there is no plan in place to correct the situation.

The city is also anticipating that the parking fund is likely to continue to generate additional revenues given the increase in the number of customers. We believe, however, that this may not be a sustainable source of revenue and it's unlikely that the city will achieve structural balance in the near term.

We understand that management has the ability to levy a recreation, library, and street lighting tax and is doing so. Also, according to officials, Butler was expecting to generate an additional $109,000 in revenues after the completion of the hotel. Given the delay, the city has revised its assumptions to account for lower revenues. However, we do not believe that this is enough to address its structural imbalance. In addition, the city's three collective bargaining unit contracts expire Dec. 31, 2017, which could hinder its attempts at achieving structural balance and prevent improvements to its budgetary performance. Management has indicated that negotiations are ongoing.

Very weak budgetary flexibility

Further fiscal stress involves the city's budgetary flexibility with a nominally low available cash reserve in fiscal 2016 of only $183,000, or 2.3% of operating expenditures, which we view as vulnerably low and a negative credit factor. The cash reserve includes $45,000 (0.6% of expenditures) in the general fund and $138,000 (1.8%) that is outside the general fund but legally available for operations. This dropped from $1.2 million (including $729,000 from the parking fund), or 15.3% of operating expenditures in 2014. In addition, while the general fund had positive cash reserves in 2016, it was at a deficit of $3,000 in 2015, and only improved due to the one-time transfer from the parking fund. Impairing budgetary flexibility, in our view, is the use of cash accounting, which reduces clarity about the amount of funds that are truly available.

The city's budgetary flexibility was bolstered by the stronger balances maintained in the parking authority funds but they, too, have declined. Management attributes the decline to higher-than-anticipated expenditures associated with the dissolution of the authority. It's been over a year since Butler dissolved its parking authority and has taken over the operations by establishing a parking enterprise fund. Officials believe that with the city assuming the day-to-day operations, that it will be better managed.

We believe that the city's budgetary flexibility could remain very weak if it can't achieve structural balance and ultimately rebuild its reserves.

The city does not have a plan in place to rebuild its cash reserves but with the anticipated surplus in fiscal 2017, it expects that they could grow.

Weak economy

We consider Butler's economy weak. The city, with an estimated population of 13,371, is in Butler County in the Pittsburgh MSA, which we consider to be broad and diverse. It has a projected per capita EBI of 70.1% of the national level and a low per capita market value of $28,423 in 2016, which, in our view, indicates a limited tax base supporting the debt and is a negative credit factor. Overall, market value grew by 2.5% over the past year to $380.0 million in 2016. The county unemployment rate was 5.1% in 2016.

The area has benefited in recent years from the relocation of Westinghouse Electric Co.'s headquarters to the county, which brought in about 3,400 jobs. Other large employers in the area include the federal government (2,212 employees), Butler Health Systems (2,013), and the Pennsylvania State System of Higher Education (1,500). There is no concentration in the tax base as the top 10 taxpayers make up 9.7% of total assessed value.

We believe that the limitations of the economy are likely to continue to constrain the rating.

Strong institutional framework

The institutional framework score for Pennsylvania nonhome-rule cities and all boroughs and townships is strong.

Related Research

- S&P Public Finance Local GO Criteria: How We Adjust Data For Analytic Consistency, Sept. 12, 2013
- Alternative Financing: Disclosure Is Critical To Credit Analysis In Public Finance, Feb. 18, 2014
- Incorporating GASB 67 And 68: Evaluating Pension/OPEB Obligations Under Standard & Poor's U.S. Local Government GO Criteria, Sept. 2, 2015