Memorandum

CITY OF DALLAS

DATE April 19, 2019

TO Honorable Mayor and Council Members

SUBJECT **Fitch Ratings Affirmed 'AA' Rating and Stable Outlook for City of Dallas Outstanding General Obligation - INFORMATION**

As previously communicated, I am pleased to report that on April 16, Fitch Ratings (Fitch) affirmed the City's 'AA' credit rating and stable outlook for General Obligation debt. Fitch states the affirmed rating and outlook for the General Obligation debt reflects the City's "strong revenue growth prospects, conservative budgeting practices, and solid reserve levels." Additionally, "reforms to both the city's civilian and public safety plans have had a positive effect on the city's long-term liability burden, and recent operating performance has been positive despite increased spending on both pensions and public safety salaries."

In the analysis, Fitch assigned 'aaa' grades to two Key Rating Drivers, Revenue Framework and Operating Performance, for "expectations for continued gains in taxable value and sales tax revenues due to ongoing economic expansion," and that the City's "gap-closing capabilities and healthy reserves position it to maintain financial resilience through a typical economic downturn." The report also highlights the City's history of positive budget management practices and pension reform.

With sustained growth in revenue and prudent management practices, the City of Dallas continues to be economically strong, fiscally stable, and a solid investment. As we continue to meet with rating agencies and prepare for upcoming bond issues, I look forward to sharing the successes the City has achieved.

Please let me know if you need additional information.

M. Elizabeth Reich

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Chief Financial Officer

Attachment

c: T.C. Broadnax, City Manager
Chris Caso, City Attorney (Interim)
Bilierae Johnson, City Secretary
Preston Robinson, Administrative Judge
Kimberly Bizor Tolbert, Chief of Staff to the City Manager
Majed A. Al-Ghafry, Assistant City Manager
Jon Fortune, Assistant City Manager
Joey Zapata, Assistant City Manager
Nadia Chandler Hardy, Assistant City Manager and Chief Resilience Officer
Michael Mendoza, Chief of Economic Development and Neighborhood Services
Laila Alequresh, Chief Innovation Officer
Directors and Assistant Directors

FitchRatings

Fitch Rates Dallas, TX $378MM GO Bonds 'AA'; Outlook Stable

Fitch Ratings-Austin-16 April 2019: Fitch Ratings has assigned an 'AA' rating to the following City of Dallas, TX obligations:

--$228.6 million general obligation (GO) refunding and improvement bonds, series 2019A;
--$149.3 million GO refunding bonds, series 2019B.

Both series of bonds are scheduled for a competitive sale on April 30. Series 2019A proceeds will finance infrastructure improvements and refund outstanding commercial paper; series 2019B proceeds will finance a legal settlement.

Fitch has also affirmed the following ratings:

--Issuer Default Rating (IDR) at 'AA';
--$1.8 billion of outstanding limited tax debt at 'AA'.

The Rating Outlook is Stable.

SECURITY
GO bonds are payable from the city's ad valorem tax levy, limited to $2.50 per $100 of taxable assessed valuation (TAV).

ANALYTICAL CONCLUSION

The city's 'AA' IDR and limited tax bond rating reflect strong revenue growth prospects, conservative budgeting practices, and solid reserve levels. Reforms to both the city's civilian and public safety plans have had a positive effect on the city's long-term liability burden, and recent operating performance has been positive despite increased spending on both pensions and public safety salaries. Budgeting pressure is likely to continue as the city attempts to build up police staffing levels and continues with increasing pension contributions.

Economic Resource Base
Dallas is the anchor of the large and diverse Dallas-Fort Worth regional economy. The city is a center for technology, trade, finance and healthcare; it also ranks among the top visitor and leisure destinations in the state.

KEY RATING DRIVERS

Revenue Framework: 'aaa'
Strong revenue growth prospects are based on expectations for continued gains in taxable value and sales tax revenues due to ongoing economic expansion. The assessment also reflects the city's ample independent revenue raising capacity.

Expenditure Framework: 'a'
The city's pace of spending is expected to be generally in line with revenue growth given its mature residential base. Increased pension contributions will keep carrying costs at an elevated level; a rapid debt amortization rate also contributes to the elevated carrying costs.

Long-Term Liability Burden: 'aa'
The long-term liability burden currently represents a moderate 14% of personal income. Recent pension reforms to both the civilian and uniform plans have reduced the combined total liability by roughly 40%. These reforms, in conjunction with continued economic growth, are expected to keep the long-term liability burden within the current range.

Operating Performance: 'aaa'
The city of Dallas' gap-closing capabilities and healthy reserves position it to maintain financial resilience through a typical economic downturn. Elevated debt and retiree benefit outlays will maintain a certain amount of pressure on the city's budget management practices.

RATING SENSITIVITIES

Maintenance of Operating Flexibility: Recent strong revenue performance has enabled management to both successfully absorb larger annual pension contributions and boost public safety salaries without affecting overall general fund performance. Any economic weakness would likely shrink revenue gains and could amplify budgetary pressures. Conversely, continued positive operating performance and successful absorption of additional public safety spending could lead to positive rating action.

CREDIT PROFILE

Dallas is located in north central Texas and with a population of 1.34 million ranks among the top 10 U.S. cities by population. The city serves as corporate headquarters for AT&T, Southwest Airlines, Texas Instruments, 7-Eleven, Inc., HollyFrontier Corp., Pizza Hut, Inc. and other large corporate concerns. Nokia, Vistaprint, Amazon Services and Home Depot lead the list of recent or planned relocations and expansions. Large employers in the education, government and health services sectors lend stability to the city's employment base.

The city's role as a wholesale and retail trade center is enabled by a strong transportation network of airports, rail and interstate highways. Dallas Area Rapid Transit (DART) provides major employers easy access to a highly skilled work force to support growing technology, finance, business and medical service sectors. Driven by professional service, construction, mining and trade sector growth, the city's employment base continues to expand. Top taxpayers represent utility, air transportation, developers, real estate, manufacturing and retail industries, and the tax base has no significant concentration.

Revenue Framework
General fund operations are supported by a diverse mix of revenues led by ad valorem tax revenues (49% of the fiscal 2018 total), sales tax revenues (25%), and franchise fees (12%). General fund revenue growth has accelerated the past several years after sluggish post-recession gains; annual increases have averaged more than 5% over the past five years.

Near term revenue growth prospects are strong based on the overall strength of the local and regional economies, including expansion in the trade/transportation, professional business services and leisure/hospitality sectors. New development continues, as indicated by ongoing growth in the city's residential and commercial building permit activity, including $2.4 billion in new permit activity in fiscal 2018. This activity is also reflected in recent tax base gains. Annual TAV gains have averaged nearly 9% the past four years, including a 10% increase in fiscal 2019 to $130.1 billion. The city expects another 6% gain in TAV for fiscal 2020.

The city's fiscal 2019 total tax rate of $0.7767 per $100 of TAV has been reduced for three consecutive years and provides ample legal revenue-raising capacity below the constitutional and city charter caps of $2.50. If a proposed tax rate results in an 8% or higher year-over-year levy increase (based on the prior year's values), the rate increase may be subject to election if petitioned by voters.

Expenditure Framework
As is typical with U.S. cities, public safety is Dallas' largest operating spending category (60% of fiscal 2018 general fund outlays), followed by general government and culture and recreation (both at 12%). General fund spending growth has generally kept pace with revenue gains in recent years.

Fitch expects the pace of spending growth to generally track what is projected to be a positive trajectory in revenues, as future service demands from a relatively mature residential base and increasing public safety and pension outlays should align with increasing operating receipts over the near to medium term.

The recent pension reforms have reduced required contribution amounts but the city's annual carrying costs (debt service, actuarially determined pension contributions, actual other post-employment benefit [OPEB] outlays) remain elevated -- 27% of fiscal 2018 governmental spending. Fitch expects actual carrying costs to remain high, the result of both increased pension contributions to the police and fire plan and debt service associated with a $1.05 billion GO bond authorization approved by voters in 2017. Fitch's supplemental pension metric, which estimates the annual pension cost based on a level dollar payment for 20 years with a 5% interest rate, indicates that carrying costs are vulnerable to future increases.

The new bond program is heavily weighted toward streets (53%) and parks and recreation (26%). The current carrying costs also reflect a rapid 70% debt amortization rate over the next 10 years, which will lessen somewhat the burden associated with new debt. The city's ability to control headcount and salary costs is strong, providing operational flexibility.

Long-Term Liability Burden
Dallas' long-term liability burden is moderate at 13.6% of personal income, with roughly 45% of the Dec. 31, 2017 total attributable to unfunded pension liabilities; the liability calculation is adjusted by Fitch to assume a more conservative 6% investment return. The burden is down from roughly

19% of personal income recently as a result of the various pension reforms. The city currently has roughly $2.2 billion in GO debt outstanding (including these offerings), about 20% of the total long-term liability burden. Overlapping debt of $3.7 billion comprises the remainder of the liability (35% of the total).

Dallas participates in three single employer defined benefit pension plans. The ERF covers non-uniformed employees. The DPFP (combined plan) and the smaller Supplemental Police and Fire Pension Plan of the city of Dallas (supplemental plan) cover police and firefighters.

Under GASB Statement 68, the ERF plan at Dec. 31, 2017 reported a net pension liability (NPL) of roughly $766 million, with fiduciary assets covering 83% of total pension liabilities at the plan's 7.75% investment return assumption. Changes to the benefit plan were approved by the ERF board, city council and voters in 2016. They apply to employees hired on or after Jan. 1, 2017 and include an increase in the normal retirement age from 60 to 65, an increase in service retirement from 30 to 40 years, elimination of the health benefit supplement, and a reduction in the benefit multiplier from 2.75% to 2.5%. These changes are expected to boost to the long-term viability of the plan.

In response to a steady weakening of the DPFP plan--attributable primarily to issues associated with the deferred retirement option program (DROP) feature--the Texas Legislature in its 2017 regular session approved legislation that made a number of noteworthy changes to the DPFP plan. The modifications included increases in retirement ages for the various tiers of employees, a reduction in the benefit multiplier for most employees and elimination of the current COLA benefit. The legislation also made changes to the troubled DROP, including a 10-year limitation on participation, elimination of interest on DROP accounts after Sept. 1, 2017, and modifications to DROP account distribution options. The legislation also called for increased plan contributions from both the city and employees. These reforms should stabilize the city's obligations to the plan and reduce the risks presented by the DROP feature of the retirement plan, and should enhance the plan's long-term viability.

Under GASB Statement 68, the DPFP plan reported an NPL for the combined and supplemental plans of $2.4 billion and $16 million, respectively as of Dec. 31, 2017. The $2.4 billion combined plan NPL is down from $6.3 billion in the prior reporting period. Fiduciary assets of the combined plan covered 47% of liabilities based on a 7.25% rate of return assumption. Fiduciary assets covered 53% of the liabilities of the supplemental plan. The Dec. 31, 2017 NPL for all three plans totaled $3.18 billion, with assets covering 64% of liabilities. The NPL increases to $4.77 billion and the ratio of assets to liabilities declines to 55% when a 6% investment return assumption is used.

The city has addressed another sizeable potential financial liability, namely several back pay disputes with city public safety employees. The city settled four suits (the Collin County lawsuits) in 2017 for $61.7 million, and funding was provided through a 2018 GO bond financing. Negotiations on the remaining two class-action back-pay lawsuits (the Rockwall County suits) concluded successfully in 2018, and the city council authorized a $173 million settlement. The settlement figures, while not immaterial, are substantially less than the potential figures originally cited. The series 2019B GO refunding bonds will finance the Rockwall County suits' settlement.

Operating Performance
Fitch expects Dallas to demonstrate strong financial resilience during economic downturns, as demonstrated by a history of the highest gap-closing capacity and sizable reserves. Audited fiscal 2018 general fund results included a net surplus after transfers of $21 million and unrestricted reserves of nearly $235 million (18% of spending), as both revenues and expenditures outperformed budget.

The city has demonstrated positive budget management practices historically, and the positive fiscal 2018 results (that included sharply higher pension contribution amounts) continued that trend and enabled the city to maintain a strong financial cushion. However, the increased annual pension contributions will maintain a degree of pressure on the city's budget management practices for the foreseeable future.

The fiscal 2018 budget was year one of a biennial budget process adopted by the city for the first time. The fiscal 2019 adopted general fund budget was balanced and included a 6.5% spending increase to $1.366 billion -- due in part to increased public safety spending (both salaries and pensions). The fiscal 2019 DPFP contribution from the city is scheduled at roughly $157 million and includes a $13 million supplemental contribution that is scheduled to occur annually until 2024.

Dallas continues to contend with attracting and retaining police officers. The fiscal 2019 budget includes funding for 3,050 officers, down from 3,613 budgeted positions in fiscal 2017. Management is hopeful the recent salary adjustments (increase in starting pay, salary increase for current officers, additional salary step) will stem the recent attrition, which likely reflects both rank and file departures during the pension crisis and police recruiting challenges nationwide. The current projection for fiscal 2019 general fund results suggest another operating surplus of nearly $13 million, the result reportedly of both revenues and spending again outperforming budget. Sales taxes are projected to total more than $315 million, a more than 3% increase from the prior year and $3.6 million above budget.

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Additional information is available on www.fitchratings.com
Applicable Criteria
U.S. Public Finance Tax-Supported Rating Criteria (pub. 03 Apr 2018)

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