Memorandum

CITY OF DALLAS

DATE April 3, 2020

TO Honorable Mayor and Members of the City Council

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

I am pleased to report that today, Fitch Ratings (Fitch) affirmed the City's 'AA' credit rating and stable outlook for General Obligation debt. Amid the current economic downturn and ensuing conditions, Fitch states that the affirmed rating and outlook for the General Obligation debt reflects the City's continued, "strong revenue growth prospects, conservative budgeting practices, and solid reserve levels." Echoing the City's rating in April 2019, Fitch reiterates that the "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 again assigns 'aaa' grades to two Key Rating Drivers, Revenue Framework and Operating Performance, citing "expectations for continued economic expansion," and noting that the City's "healthy reserves position it to maintain financial resilience through an economic downturn." While the report underlines the rating agency's expectation of the City's Fiscal Year 2020 budget to be "significantly affected by the current public health crisis," Fitch also states that the "city historically demonstrated positive budget-management practices, and the recent positive operating results, which included sharply higher pension contribution amounts, continued that trend and enabled the city to maintain a strong financial cushion."

According to Fitch, with "continued positive operating performance" and prudent "budget balancing measures" that will be needed through current global economic uncertainty, "the city's revenue growth prospects remain strong longer term," and "each of the city's revenue streams will likely rebound in a different way in the eventual recovery." The affirmed rating today reflects Dallas' position as a strong, strategic, and resilient City.

Please let me know if you need additional information.

M. Elizabeth Reich

M. Elizabeth Reich
Chief Financial Officer

[Attachment]

c: T.C. Broadnax, City Manager
Chris Caso, Interim City Attorney
Mark Swann, City Auditor
Bilierae Johnson, City Secretary
Preston Robinson, Administrative Judge
Kimberly Bizor Tolbert, Chief of Staff to the City Manager
Jon Fortune, Assistant City Manager
Majed A. Al-Ghafry, Assistant City Manager
Joey Zapata, Assistant City Manager
Nadia Chandler Hardy, Assistant City Manager
Dr. Eric A. Johnson, Chief of Economic Development and Neighborhood Services
Laila Alequresh, Chief Innovation Officer
M. Elizabeth (Liz) Cedillo-Pereira, Chief of Equity and Inclusion
Directors and Assistant Directors

FitchRatings

RATING ACTION COMMENTARY

Fitch Rates Dallas, TX $276 Million GOs, COs 'AA'; Outlook Stable

Thu 02 Apr, 2020 - 4:36 PM ET

Fitch Ratings - Austin - 02 Apr 2020: Fitch Ratings has assigned an 'AA' rating to the following City of Dallas, TX obligations:

--$233.2 Million General Obligation (GO) Refunding and Improvement Bonds, Series 2020;

--$14.25 Million Combination Tax and Revenue Certificates of Obligation, Series 2020;

--$29.0 Million Equipment Acquisition Contractual Obligations, Series 2020.

All three series of bonds are scheduled for a competitive sale on April 15. GO bond proceeds will finance infrastructure improvements and refund outstanding tax-supported debt; certificate proceeds will finance the construction of two new fire stations; contractual obligation proceeds will finance the acquisition of various departmental equipment.

Fitch has also affirmed the following ratings:

--Issuer Default Rating (IDR) at 'AA';

--$1.6 billion of outstanding limited tax debt at 'AA'.

The Rating Outlook is Stable.

SECURITY

The GOs, certificates and contractual obligations are payable from a limited ad valorem tax levied against all taxable property in the city. The certificates are further backed by a limited pledge of the city's drainage utility system, not to exceed $1,000.

ANALYTICAL CONCLUSION

The city's 'AA' IDR and long-term 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 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 and continues increasing pension contributions; these pressures will be exacerbated by the current economic downturn.

KEY RATING DRIVERS

Revenue Framework: 'aaa'

Strong revenue growth prospects are based on expectations for continued economic expansion. The assessment also reflects the city's diminished, but still high, independent legal ability to increase ad valorem tax revenues as a result of recently approved state legislation effective in fiscal 2021.

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 represents a moderate 12% of personal income. Recent pension reforms to both the civilian and uniform plans 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 an economic downturn. Elevated debt and retiree benefit outlays will maintain a certain amount of pressure on the city's budget-management practices.

RATING SENSITIVITIES

Developments that May, Individually or Collectively, Lead to Positive Rating Action:

--Operational Strength: Continued positive operating performance and successful absorption of additional public safety-related spending.

--Greater Spending Flexibility: An improvement in Fitch's assessment of the city's expenditure flexibility, due to moderation in fixed-debt service and retiree benefit costs as a percentage of spending.

Developments that May, Individually or Collectively, Lead to Negative Rating Action:

--Pension Funding: Failure to consistently fund annual pension contributions at the actuarially determined levels.

--Erosion of Reserves: A material decline in operating reserves that weakens the current financial-resilience assessment.

BEST/WORST CASE RATING SCENARIO

Best/Worst Case Rating Scenarios - Public Finance:

Ratings of Public Finance issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings https://www.fitchratings.com/site/re/10111579.

CREDIT PROFILE

Sectorwide Coronavirus Implications

The recent outbreak of coronavirus and related government containment measures worldwide creates an uncertain global environment for U.S. state and local governments and related entities in the near term. As severe limitations on economic activity only began recently, most local governments' fiscal and economic data do not reflect any credit impairment. However, material changes in revenues and expenditures are occurring across the country and likely to worsen in the coming weeks and months as economic activity suffers and public health spending increases. Fitch's ratings are forward looking, and Fitch will monitor developments in state and local governments as a result of the virus outbreak as it relates to severity and duration, and incorporate revised expectations for future performance and assessment of key risks.

As is the case with other cities, Dallas is already experiencing effects from the spread of the coronavirus. Given federal travel restrictions and local officials' recently announced shelter-in-place requirements, tourism declined sharply; conventions, large meetings and sporting events were cancelled; non-essential businesses are closed or operating with remote workforces; and all area school districts switched to remote learning.

Fitch expects the city's current fiscal 2020 budget to be significantly affected by the current public health crisis due to near-term revenue impacts and possible increased expenditures on containment measures. Economically sensitive revenue streams, primarily sales tax receipts (25% of fiscal 2018 general fund revenues) and hotel occupancy taxes will see the most immediate declines, while licenses, fees and fines, permits and other revenues will shrink if the economic downturn is prolonged.

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 Inc.; Southwest Airlines Co.; Texas Instruments Incorporated; 7-Eleven, Inc.; HollyFrontier Corp.; Pizza Hut, Inc.; and other large corporate concerns. The city reported new construction permit activity in 2019 of more than $2.5 billion, continuing a recent trend of strong economic expansion. 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 provides major employers easy access to a highly skilled workforce to support the growing technology, finance, business and medical service sectors. Top taxpayers represent the utility, air transportation, developers, real estate, manufacturing and retail industries, and the tax base has no significant concentration. Fitch expects the underlying strength, size and diversity of Dallas' economy will support the city in its recovery from the current economic downturn.

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 accelerated over the past several years after sluggish post-recession gains; annual increases averaged more than 5% over the past five years.

Near-term revenue growth prospects weakened sharply due to the economic downturn triggered by the coronavirus pandemic. The impact on hotel occupancy and sales tax revenues will be felt swiftly. If the economic downturn is sustained and adversely affects property values, the impact on property tax revenues, which are the largest source of general fund revenues, will not be seen for some time, giving the city a chance to make the necessary budgetary adjustments. The city's revenue growth prospects remain strong longer term. Each of the city's revenue streams will likely rebound in a different way in the eventual recovery, depending on pent-up demand during the decline and the size of residents' discretionary incomes.

The city's total tax rate of $0.7766 per $100 of taxable assessed valuation in fiscal 2020 was reduced for four consecutive years and is well below the constitutional and city charter caps of $2.50 per $100. However, the recently enacted Texas Senate Bill 2 (SB 2) makes a number of changes to local governments' property tax rate setting process. Most notably, SB 2 will reduce the rollback tax rate (the voter approval tax rate) from 8.0% to 3.5% for most local taxing units and require a ratification election, replacing the current petition process, if any local taxing unit exceeds its voter approval rate, effective fiscal 2021.

The tax rate limitation in SB 2 excludes new additions to tax rolls and allows for banking of unused margin for up to three years. Dallas' remaining control over property taxes and other local revenues such as fines, fees and charges for services is still sufficient to maintain high revenue-raising flexibility, a credit strength that will likely be critical in the current environment.

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.

Longer term, 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. Management will be forced to make spending adjustments for the remainder of fiscal 2020 given the sharply weaker general fund revenue picture.

The recent pension reforms reduced required contribution amounts, but the city's annual carrying costs -- debt service, actuarially determined pension contributions, actual other post-employment benefit outlays -- remain elevated at 27% of fiscal 2018 governmental spending. Fitch expects 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 carrying costs are vulnerable to future increases.

The new bond program is heavily weighted towards streets (53%) and parks and recreation (26%). The current carrying costs also reflect a rapid 68% debt-amortization rate over the next 10 years, which will somewhat lessen 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 12% of personal income, with roughly 46% of the total attributable to unfunded pension liabilities. Fitch adjusts the liability calculation 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 has roughly $2.3 billion in GO debt outstanding (including these offerings), about 21% of the total long-term liability burden. Overlapping debt of $3.35 billion comprises the remainder of the liability (33% of the total).

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

As reported in the city's fiscal 2018 annual report, the ERF plan under GASB statement 68 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 years to 40 years, elimination of the health benefit supplement, and a reduction in the benefit multiplier from 2.75% to 2.50%. These changes are expected to boost to the long-term viability of the plan.

In response to a steady weakening of the combined 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 combined 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 cost of living adjustment 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 combined plan reported an NPL for the combined and supplemental plans of $2.4 billion and $16 million. 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 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.

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. Preliminary fiscal 2019 results indicate a roughly $13 million net surplus after transfers, primarily the result of sales taxes totaling more than $317 million and outperforming budget by nearly 2% ($5.7 million).

The city historically demonstrated positive budget-management practices, and the recent positive operating results, which included sharply higher pension contribution amounts, continued that trend and enabled the city to maintain a strong financial cushion. However, increased annual pension contributions and public safety salary outlays will maintain a degree of pressure on the city's budget-management practices for the foreseeable future. Expected revenue challenges for the remainder of fiscal 2020 are expected to make budget balancing measures even more difficult.

The city in fiscal 2018 initiated a biennial budget process for the first time. The fiscal 2020 adopted general fund budget is balanced and includes a 5.5% spending increase to $1.44 billion -- due largely to increased public safety spending for both salaries and pensions. The city and public safety employees agreed on a new three-year meet-and-confer agreement in September 2019 that includes a market-based pay schedule. The cumulative cost of salary increases through fiscal 2023 is projected to be nearly $100 million.

Management is hopeful the new pay structure, along with previous salary adjustments, will stem a recent police employee attrition issue, which likely reflects both rank-and-file departures during the pension crisis and police recruiting challenges nationwide. Fiscal 2019 reportedly ended with 3,130 sworn officers, 33 more than budgeted. While that total remains below prior years' budgeted positions, the city reports it has engaged an external consultant to help determine the appropriate officer count and confirms that additional officers will be hired over the near term.

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

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

ESG issues are credit neutral or have only a minimal credit impact on the entity(ies), either due to their nature or the way in which they are being managed by the entity(ies). For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

RATING ACTIONS

ENTITY/DEBT	RATING

ENTITY/DEBT	RATING		
Dallas (TX) [General Government]	LT IDR	AA	Affirmed
• Dallas (TX) /General Obligation - Limited Tax/1 LT	LT	AA	Affirmed

VIEW ADDITIONAL RATING DETAILS

Additional information is available on www.fitchratings.com

APPLICABLE CRITERIA

U.S. Public Finance Tax-Supported Rating Criteria (pub. 27 Mar 2020) (including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

FAST States & Locals - Fitch Analytical Stress Test Model, v2.4.0 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Dallas (TX)	EU Endorsed

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