

ISSUER IN-DEPTH

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Contacts

Tiphany Lee-Allen 212-553-4772
AVP-Analyst
 tiphany.lee-allen@moodys.com

Pisei Chea 212-553-0344
Analyst
 pisei.chea@moodys.com

Gregory W. Lipitz 212-553-7782
*VP-Sr Credit Officer/
 Manager*
 gregory.lipitz@moodys.com

Leonard Jones 212-553-3806
MD-Public Finance
 leonard.jones@moodys.com

Naomi Richman 212-553-0014
Senior Vice President
 naomi.richman@moodys.com

Petersburg (City of) VA

Prudent Management Key to Turnaround Even With State Intervention

The city of Petersburg, VA's (unrated) continuing fiscal distress increases the probability of default on its general obligation (GO) debt. While state help is a possibility, there is no explicit legal mechanism for the commonwealth of [Virginia](#) (Aaa stable) to step in and repair the city's finances. The state General Assembly recently passed a budget bill that would add new monitoring and oversight procedures for localities. Still, even with robust state support, Petersburg will need stronger management to restore fiscal stability, a questionable outcome given a history of poor budgetary and fiscal choices leading to the city's credit weakness.

- » **Years of mismanagement have led to lingering fiscal distress.** A lack of internal controls and expense monitoring, combined with missed revenue estimates, have led to a structural imbalance since 2009 and annual declines in reserves. The city's financial condition looks to worsen with a negative net cash position and state auditors projecting a \$12 million budget gap for fiscal 2016 on a total budget of nearly \$85 million.
- » **The city's ability to change course is contingent on new, stronger management.** A permanent management team will need to take aggressive steps to put the city on a path to recovery. Many options were put forward in a recovery plan developed by a team of consultants last year, including staff reductions, tax cuts and a restructuring of approximately \$18.6 million in debt. The debt restructuring would give the city \$8.9 million of cash flow relief over the next five years.
- » **Virginia has a limited history of intervention to help distressed municipalities, though new legislation provides a clearer framework for state involvement.** Petersburg would receive some help if the governor signs a budget bill passed by the General Assembly, which includes provisions for emergency aid and a stronger monitoring system for distressed local governments. But even with extensive state assistance, the city is mostly on its own for a recovery. In the event the city faces imminent default, its options would be limited because Virginia is one of 22 states that does not authorize its local governments to file for Chapter 9 bankruptcy.

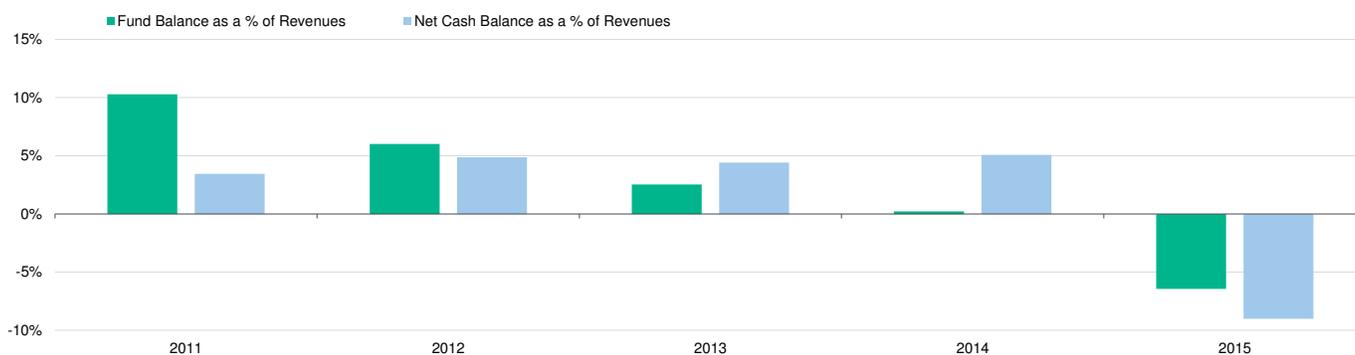
Years of mismanagement lead to lingering fiscal distress

Years of budgetary and fiscal mismanagement have led to a significant deterioration in the city's financial position and credit quality. A lack of internal controls and expense monitoring, combined with poor revenue estimates, have contributed to a structural budgetary imbalance and annual declines in reserves. Fiscal 2008 was the last year of a true budgetary surplus for the city. And Petersburg's financial position will likely worsen with fiscal 2016 audited results (expected in May).

The city's reserves, measured by unassigned fund balance, were a negative \$5 million in fiscal 2015 or -6.5% of revenues (see Exhibit 1). The city continues to rely heavily on revenue anticipation notes (RANs) to cover increasing revenue shortfalls and a negative net cash position (\$7 million as of fiscal 2015). State auditors found that Petersburg faces a \$12 million gap on an \$85 million fiscal 2016 budget while dealing with nearly \$19 million in unpaid obligations as of June 30, 2016. The city projects an estimated \$8.7 million in outstanding unpaid invoices at fiscal year end June 30, 2017 in addition to the outstanding \$6.5 million RAN (maturing October 2017).

Exhibit 1

Severe Declines in Reserves Exemplify Petersburg's Fiscal Distress

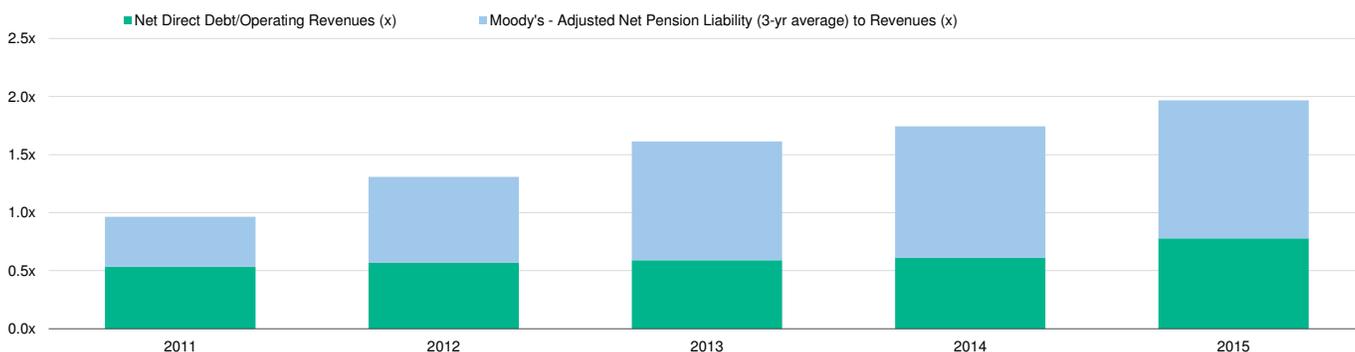


Source: Moody's Investors Service

Petersburg also faces challenges related to fixed costs largely driven by a growing pension burden over the last four years (see Exhibit 2). Moody's adjusted net pension liabilities (ANPLs) were \$81.2 million in fiscal 2015 (1.05 times operating revenues), an increase from \$33.7 million in fiscal 2011. Still, despite an escalating pension burden and an above-average debt burden, total fixed costs remain manageable at 10.44% of 2015 expenditures.

Exhibit 2

Pension and Debt Burdens Continue to Grow, Posing a Fiscal Challenge



Moody's ANPL reflects certain adjustments we make to improve comparability of reported pension liabilities. The adjustments are not intended to replace Petersburg's reported liability information but to improve comparability with other rated entities.

Source: Moody's Investors Service; city of Petersburg, VA

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Additionally, starting in fiscal 2009, the city's mass transit and golf enterprises began to experience deficits. Expenditures in the enterprise funds increased annually to \$4.1 million in fiscal 2015 from \$3.4 million in fiscal 2009 with no corresponding revenue growth.

City's ability to change course is contingent on new, stronger management

A turnaround will require significant changes in budgeting practices and ultimately depend on a new management team. The city's previous team historically failed to implement internal controls and take advice from financial consultants. An executive search is currently underway for key permanent management positions.

The city's first action towards recovery was to hire an Emergency Management Team consisting of an outside consulting firm in October 2016 (fiscal 2017). The firm has helped the city revise its 2017 budget and draft a structurally balanced fiscal 2018 budget, which would take effect in July. The city is implementing sound fiscal policies, including making quarterly reports to the City Council on cash flow and budget-to-actual variances. It is also creating a list of all vendors that it owes with a plan for repayment and reduced city staff by 14%.

Petersburg's recovery plan also includes a proposal to restructure debt to provide annual debt service payment relief. As of March 14, 2016, the city had \$50.5 million of outstanding general fund and golf fund debt with an annual debt service payment of \$5.3 million. The plan proposes a restructuring of \$18.6 million of debt to reduce annual debt service to approximately \$3.7 million annually over the next 10 years with gradual declines thereafter.

Virginia local governments' strong credit quality (Aa2 is the median rating for cities and counties) has roots in a strong legal ability to match revenues with expenditures and generally strong management. Virginia cities typically rely heavily on property taxes to fund operations, which are a generally reliable revenue source that provide for high revenue-raising flexibility since increases are not limited by law. Expenditures, which are largely predictable in nature, can be cut if necessary.

Additionally, Virginia local governments are not exposed to collective bargaining units, providing for greater flexibility in managing expenditures. Despite a strong institutional framework among Virginia local governments, Petersburg has historically been unable to match recurring revenues with recurring expenditures. The new management's adherence to conservative fiscal policies and practices will be vital to a successful turnaround of Petersburg's financial condition.

Virginia has a limited history of intervention to help distressed municipalities, though new legislation provides a clearer framework for state involvement

A budget bill passed by the state General Assembly and awaiting the governor's signature would usher in a new monitoring system and oversight procedures for financially troubled local governments. Currently, there is no mechanism that would allow the commonwealth to intervene effectively, by, for example, imposing a control board, appointing an emergency manager or providing emergency aid. Additionally, there is no provision in state law allowing a local government to file for bankruptcy, limiting Petersburg's options for an orderly restructuring of debt if the city should default. While new oversight procedures would likely help Petersburg, the city will still have to engineer a turnaround mostly on its own.

In the summer of 2016, the state's Technical Assistance Team undertook a review of the city's financial operations at Petersburg's request. State officials then provided the city with assistance, including cataloging liabilities and obligations, researching problems and reviewing city funds. But this form of state involvement is typically limited to advice and can only occur if a city invites the state to look into its affairs. Consequently, it is a weaker level of oversight that some states have put into place to address deteriorating credit conditions in their local governments.

Under the monitoring system included in pending legislation, if a municipality is deemed fiscally distressed, the commonwealth could provide assistance, intervention or targeted oversight to help remediate or stabilize the situation, although the scope of the intervention is unclear. The legislation would directly help Petersburg through a \$500,000 appropriation. City management has not included any funds provided for by the legislation in its fiscal 2018 budget or in any projections.

Benefitting investors, Petersburg is a participant in the [Virginia Resources Authority \(VRA\) Pooled Financing Program](#) (infrastructure revenue bonds rated Aaa stable; state moral obligation revenue bonds rated Aa2 stable), representing 1% of the pool. VRA closely monitors its participants and has a history of working with the state to enact solutions for troubled local governments to ensure the

flow of funds for payment of debt service on its bonds is not impacted. Petersburg's loans in the VRA pool are further enhanced by the [VRA State Aid Intercept Program](#) (Aa1 stable), a pre-default intercept program, which adds an additional layer of security for a large number of VRA's borrowers.

The Virginia Localities Intercept Program, which is a post-default intercept program, benefits Petersburg's GO bondholders. Petersburg also borrows through the Virginia Public School Authority, and its loans are enhanced by a pre-default intercept.

Strong state oversight can provide a credit lift

Many states have strong oversight and support programs for distressed local governments, which we generally view as a credit positive. In many cases, state oversight has mitigated significant credit stress. For example, a number of financially distressed cities and counties in [New York](#) (Aa1 stable), a state with a long history of intervention and support, have maintained their credit quality for an extended period of time, compared to other states with a history of failing to prevent default and bankruptcy for similar credits. Historical examples of effective state intervention in New York include [New York City](#) (Aa2 stable), [Buffalo](#) (A1 positive), [Troy](#) (A2), [Erie County](#) (A2 stable) and [Nassau County](#) (A2 stable).

Still, strong oversight at the state level does not guarantee protection from credit distress if the underlying financial conditions are exceedingly dire. In [Michigan](#) (Aa1 stable), state intervention failed to prevent the [Detroit](#) (B2) bankruptcy, for example.

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Contacts

Tiphany Lee-Allen
AVP-Analyst
 tiphany.lee-allen@moodys.com

212-553-4772

Naomi Richman
Senior Vice President
 naomi.richman@moodys.com

212-553-0014

Gregory W. Lipitz
*VP-Sr Credit Officer/
 Manager*
 gregory.lipitz@moodys.com

212-553-7782

Pisei Chea
Analyst
 pisei.chea@moodys.com

212-553-0344

CLIENT SERVICES

Americas 1-212-553-1653

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