Detroit GO Rating Raised To 'BB-' As Finances Stabilize; Priority-Lien Ratings Lowered To 'BB+' On Criteria Application

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CHICAGO (S&P Global Ratings) Feb. 7, 2019--S&P Global Ratings raised its issuer credit rating (ICR) on Detroit to 'BB-' from 'B+'. At the same time, we raised our long-term rating to 'BB-' from 'B+' on Detroit's series 2018 unlimited-tax general obligation (GO) bonds. The outlook for the 'BB-' ratings is stable. The series 2018 bonds are secured by Detroit's full faith and credit unlimited-tax GO pledge.

We also lowered our ratings on the city's income tax- and user utility tax (UUT) supported debt to 'BB+' from 'A' and 'A-', respectively, based on application of our "Priority Lien" criteria (published Oct. 22, 2018, on RatingsDirect).

More specifically, we lowered our rating to 'BB+' from 'A' on the Michigan Finance Authority's Local Government Loan Program bonds (City of Detroit Financial Recovery Income Tax Revenue and Refunding Local Project bonds), series 2014F-1 and F-2. The bonds were issued on behalf of the city of Detroit and are secured by a first lien on the city's municipal income taxes.

In addition we lowered our rating on the Authority's Local Government Loan Program bonds (Public Lighting Authority Local Project bonds), series 2014B, to 'BB+' from 'A-'. The bonds were issued for the Detroit Public Lighting Authority (PLA) and are secured by Detroit's UUT.

Our Priority Lien criteria factors in both the strength and stability of the pledged revenues, as well as the general credit quality of the municipality where taxes are distributed and/ or collected (the obligor's creditworthiness [OC]). The priority-lien rating on both the income tax-and UUT-secured debt is limited by our view of the Detroit's creditworthiness (BB-/Stable).

"In both cases, the two-notch distinction between the 'BB+' and 'BB-' ratings reflects our view that the pledged revenues and the flow of funds (under both state law and bond documents) are sufficiently removed from the city's control, so as to substantially, but not entirely, mitigate operating risk," said S&P Global Ratings credit analyst John Sauter.

Neither the income taxes nor UUT revenues are collected by the city of Detroit. Pledged income tax revenues are currently collected by the Michigan Department of Treasury, and pledged UUT revenues are collected by private utility companies. In both cases, the pledged revenues are collected and transferred directly to independent trustees to meet monthly deposit requirements, before being released to the city to be used for operations. Pursuant to the different applicable state laws, liens are created in favor of the trustees on all pledged revenues collected or to be collected; and all pledged revenues are held in respective trust for the benefit of the bondholders. However, we believe that dependence and linkage cannot be entirely overcome through the overlay of a legal structure supporting the bonds. Therefore, despite strong annual coverages and legal provisions in each case, Detroit's general creditworthiness will continue to weigh down the ratings.

"The one-notch upgrade to Detroit's GO rating reflects our view of the city's stabilizing financial position, whereby we feel it is well situated to absorb increasing pension commitments and scheduled increases in debt service in the coming years, as well as possible revenue setbacks, while still sustaining year-to-year budget balance and very strong reserves," said Mr. Sauter. In our view, Detroit's recent unlimited-tax GO issuance, its first post-bankruptcy financing backed solely by its GO pledge, demonstrated its ability to access capital markets at competitive borrowing rates. Market access is a significant stabilizing factor for the city's financial trajectory. This type of access can help the city more effectively generate funds for needed public investment, while also helping alleviate some burden on the operating budget, which is still funding pay-as-you-go capital. The rating movement to the 'BB' category from the 'B' category reflects our view that exposure to adverse business, financial, or economic conditions could impair the city's ability to meet financial commitments, but is not likely to.

Detroit is demonstrating ability to meet its budget demands, while also providing a strong reserve cushion against unexpected events or stagnating revenues. The city is experiencing good economic growth (though mostly centered in the downtown area) and population declines are moderating. At the same time, it continues to post budget surpluses, grow reserves, and meet objectives as defined in the Plan of Adjustment (POA) and subsequent planning documents.

The city still faces substantial credit pressures, both in the near and longer term. It operates within a very limited revenue-raising framework that is intricately tied to economic activity. Therefore, continued stabilization of the population and tax base will be key to future budgetary performance and long-term viability. To support this stabilization, the city must continue investing in public infrastructure and economic development initiatives, while also managing increasing annual pension and debt service burdens. Though beyond the two-year outlook horizon, the city's very large unfunded pension obligation will continue to grow, and there remains risk that projected funding requirements, starting in fiscal 2024, could be larger than anticipated.

Factors for further GO rating improvement will include ongoing access to capital markets, tax base stabilization, maintenance of very strong reserves, and remaining on track to meet both near- and medium-term increasing budget obligations. The latter factor will be particularly key as the fiscal 2024 actuarial determined pension requirements inch closer and become clearer, especially if the projected costs rise significantly.

"The stable outlook on the 'BB-' GO rating reflects our view of Detroit's demonstrated improvements to operations since bankruptcy, which have led to better capacity to meet both operating needs and debt obligations," added Mr. Sauter. In our view, the city has positioned the budget to be able to absorb increasing pension and debt service costs in the near term, while relying on conservative revenues estimates, and still remain balanced. It has built up a very strong reserve and recently demonstrated an ability to access capital markets at competitive rates, both of which are significant stabilizing factors that we expect will continue. Although a structural imbalance persists due to the pension funding gap, in our view, Detroit's current budget and reserve position provide it cushion against possible near-term revenue volatility or other unexpected events. This cushion will decrease, however, as pension contributions and debt service costs ramp up, or if revenue growth falls short of projections.

The stable outlook on the 'BB+' priority-lien ratings primarily reflects the outlook on the GO rating.

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.