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INVESTORS SERVICE

New Issue: MOODY'S DOWNGRADES TO Aa3 FROM Aa1 THE CITY OF ANNAPOLIS' (MD) LONG-TERM

Global Credit Research - 04 Mar 2011

ASSIGNS Aa3 RATING WITH NEGATIVE OUTLOOK TO THE CITY'S $38 MILLION GENERAL OBLIGATION BONDS PUBLIC IMPROVEMENTS AND REFUNDINGS BONDS, 2011 SERIES

Municipality
MD

Moody's Rating

ISSUE	RATING
General Obligation Public Improvements and Refunding Bonds, 2011 Series	Aa3

Sale Amount	$36,145,000
Expected Sale Date	03/10/11
Rating Description	General Obligation

Opinion

NEW YORK, Mar 4, 2011 -- Moody's has assigned a Aa3 rating with a negative outlook to the City of Annapolis' (MD) $38 million General Obligation Bonds Public Improvements and Refundings Bonds, 2011 Series. At this time, Moody's Investors Service has also downgraded to Aa3 from Aa1 the long-term General Obligation rating of the City of Annapolis (MD), affecting approximately $86 million of outstanding debt, and assigned a negative outlook.

SUMMARY RATINGS RATIONALE

The bonds are secured by the city's unlimited ad valorem tax pledge. Approximately $6 million of bond proceeds will provide new money financing for various capital projects. The remaining $32 million will be used to refund all or a portion of the city's Series 1998, 2002, 2005, 2007 and 2009 Public Improvements Bonds. The refunding will extend overall maturity by 11 years and will provide approximately $17.8 million of cash flow savings through 2018, with the majority of savings taken during fiscal 2011, 2012, and 2013. The downgrade to Aa3 rating from Aa1 rating reflects the city's rapid financial deterioration and weakened liquidity position driven by insufficient budget adjustments to offset revenue shortfalls throughout multiple funds and growing expenditures. Moody's anticipates the city will be challenged to grow reserves and return to its formally strong liquidity position over the near-term. The rating is balanced against a manageable debt position and a sizeable and diverse tax base.

The negative outlook reflects Moody's expectation that the city will continue to face difficulties in the implementation of budget adjustments, including revenue enhancements, that will result in a stabilization of the city's declining financial position. In addition, the liquidity position may continue to face pressure over the near-term as the city attempts to return to structural balance and surplus operations.

STRENGTHS:

-Large tax base anchored by public sector presence

-Manageable debt burden

CHALLENGES:

-Inadequate liquidity position

-Significantly weakened financial position

DETAILED CREDIT DISCUSSION

SIGNIFICANTLY WEAKENED FINANCIAL POSITION; NEW MANAGEMENT TEAM EXPECTED TO STABILIZE DECLINE

The city's reserve and liquidity position began its rapid deterioration during fiscal 2009, largely driven by ineffective budget management across city funds as the economic downturn eroded the city's ability to maintain structural balance. Fiscal 2009 ended with a $4.48 million decline in the General Fund reserve position, although a portion was due to a capital outlay; the city's structural imbalance was approximately $3.6 million. The General Fund experienced a $2.5 million revenue shortfall despite property tax revenues coming in above the original budget ($1.5 million). The shortfall largely represented negative variances from the original budget in license and permits ($1 million) and current services ($755,000), partially reflecting the economic downturn. The city was unable to control expenditures to offset the revenue decline and experienced a significant $4.3 million expenditure variance from the original budget. The largest variances were in police ($1.2 million) and fire ($1.23 million) line items, and insufficient budget management affected most of the city's financial operations.

The city ended Fiscal 2010 with a smaller $1.3 million decline in reserves, although operations reflected a $3.8 million structural imbalance as the Capital Project Fund transferred approximately $4 million to the General Fund to support operations. A new management team put in place expenditure controls throughout city funds by implementing a hiring freeze ($600,000 savings), overtime management ($1.2 million) and approximately 86 layoffs ($1 million in 2010 and $4 million in 2011). These measures proved insufficient to fully offset the original structural imbalance and budgetary variances partially related to state aid cuts and declines in economically sensitive revenues. Overall, the General Fund performed relatively close to the original budget, with revenues underperforming by $793,000 and various expenditures exceeding the

original budget for a total negative variance of $765,000. The city's General Fund ended fiscal 2010 with a Total General Fund balance of $3.8 million (6.3% of General Fund revenues) and did not maintain a balance in the Unreserved Undesignated General Fund.

The city's fiscal 2011 General Fund budget declined by 6.8%, before factoring in $5 million of expenditures allocated to enterprise funds to offset associated costs. and is structured to improve General Fund reserves by approximately $2.5 million. Management reports that operations are running close to budget, and reserves may improve by $1.4 to $2.4 million. Management is currently structuring the Fiscal 2012 budget and anticipates that expenditures will decline by 4.9% and will result in improvement to the General Fund balance of $2.58 million; the majority of the budget contraction reflects debt service savings related the current sale. The fiscal 2012 budget is expected to include a return to funding the city's annual pension and OPEB contributions, which have not been budgeted over the last several years. Positively, the city's police and fire pension funds remain funded at 97% as of July 1, 2009. In addition, the city is currently working on assembling a multi-year financial plan to return to compliance with the city's fund balance policy by 2014. By policy, the General Fund is required to maintain unreserved fund balance equal to a minimum 10% and a targeted 15% of annual revenues; any fund balance available in excess of the policy target may be directed to pay-go capital projects and other non-recurring uses, consistent with historical practice. Approximately 58.8% of the city's revenues are derived from property taxes.

GENERAL FUND LIQUIDITY POSITION PRESSURED AS ENTERPRISE FUNDS OPERATIONS NARROW

The city's liquidity position has deteriorated significantly since 2009 as the financial position of the city's General Fund, as well as many of its Enterprise Funds, have weakened. The General Fund year-end cash position has declined by approximately 154% since 2006, and fiscal 2010 cash balance, net of cash flow borrowing proceeds ($7 million), ended at -8.6% of General Fund receipts. The city's liquidity position is significantly weaker than the US city median of 25.2%. The decline is partially driven by the weakened General Fund financial operations, but is also related to an increase in the reliance of Enterprise Funds on the General Fund to support cash needs. During fiscal 2010, the city relied on access to a line of credit that provided them the flexibility to maintain operations. Going forward, the city plans on implementing significant rate increases in several enterprise funds including its Water and Sewer Funds and Moody's anticipates that this action will help to replenish the city's liquidity position over the medium-term. Moody's will continue to monitor the impact of the city's narrow liquidity position on its ability to maintain operations, including its ability to maintain access to cash flow borrowing.

ECONOMIC STABILITY PROVIDED BY LARGE PUBLIC SECTOR PRESENCE

The City of Annapolis continues to derive economic stability from a significant governmental presence, including the state capital of Maryland (G.O. rated Aaa/stable), the U.S. Naval Academy, and the seat of Anne Arundel County (G.O. limited tax rated Aa1/negative outlook). These institutions account for nearly 15,700 jobs in the local area and, together with the county school system, serve as the city's largest employers. The State Capitol Building and the Naval Academy also contribute to a robust tourism sector that includes the city's historic district and 17 miles of waterfront; officials estimate that more than five million tourists visited the city during 2010, more than half of which visited the Naval Academy campus. In addition to government and tourism, the city experienced significant growth in its commercial sector over the last decade. Commercial development was spurred in part by redevelopment projects throughout the city, including the $250 million Park Place Annapolis project. The city reports several large development projects are in the review process and could yield a significant increase in the city's assessable value.

The assessed valuation of the tax base has increased by an average 11.2% annually since fiscal 2005, growing to $6.6 billion as of fiscal 2011. Notwithstanding the economic growth associated with redevelopment initiatives, leading up to 2008, annexation activity also served as a principal driver of tax base expansion in the city's 7.3 square-mile land area. Going forward, tax base expansion is expected to moderate as a result of the economic downturn, as evidenced by estimated 4.6% growth in fiscal 2010 and 3.8% growth in fiscal 2011 (projected). New residential construction has been impacted by the market downturn, as reflected in the significantly lower residential construction permits, down to $15 million from a high $60 million in 2006. Management anticipates that economic development projects that include both commercial and residential properties will drive tax base growth over the next several years.

The city's daytime population of 120,000 is more than three times the residential population of 38,400, confirming the city's role as a regional job center. Although city unemployment of 6.2% in December 2010 was above historical levels, it is below state and national norms for the same period, signaling a shift from recent years when the local jobless rate was above state and national levels. Wealth levels in the city approximate the relatively high state averages.

DEBT BURDEN EXPECTED TO REMAIN MANAGEABLE

The city's debt burden is expected to remain manageable given projected rate increases in Enterprise Funds that should help offset potential new debt related to the city's water system. The city's direct debt burden increases to 1.3% of full valuation with the current offering and the overall debt burden of 1.9% includes the overlapping debt of the county. Following the current refunding, principal amortization will be below average, with 47% of debt retired within 10 years, and debt service accounted for 9.7% of fiscal 2010 General Fund operating expenditures. Historically, the city's water and sewer enterprise operations have been self-supporting, with related debt service fully supported by net revenues of both systems. As discussed earlier, these funds have experienced declining financial flexibility which has pressured their ability to continue to pay for related debt service through system operations. Moody's anticipates these funds will return to previous strength over the medium-term. The city anticipates issuing approximately $50 million of bonds over the next two years for a new water treatment facility. All of the city's debt is in a fixed-rate mode and the city is not party to any derivative agreements.

Outlook

The negative outlook reflects Moody's expectation that the city will be challenged to implement adequate budget adjustments, including revenue enhancements, that will result in a stabilization of the city's declining financial position. In addition, the liquidity position may continue to face pressure over the near-term as the city attempts to return to structural balance and surplus operations.

WHAT COULD CHANGE THE RATING - UP (REMOVAL OF NEGATIVE OUTLOOK)

- Establishment of a trend of GAAP basis operating surpluses

- Demonstration of significant progress toward structural balance

- Improved liquidity as reflected in increased year-end net cash balance

WHAT COULD CHANGE THE RATING - DOWN

- Fiscal 2011 financial results significantly worse than current projections

- Further narrowing liquidity trend as reflected in decreased year-end net cash balances/increased cash flow borrowing beyond that currently anticipated

KEY STATISTICS

2008 population: 38,900 (8.5% increase since 2000)

FY 2010 full valuation: $6.56 billion

Full valuation per capita: $168,533

1999 Per Capita Income: $27,180 (106% of state and 126% of nation)

1999 Median Family Income: $56,984 (92% of state and 114% of nation)

December 2010 unemployment rate: 6.2%

Debt burden: 1.9%

Payout of principal (10 years): 47%

Fiscal 2008 General Fund balance: $9.6 million (18% of revenues)

Fiscal 2009 General Fund balance: $5.1 million (9% of revenues)

Fiscal 2010 General Fund balance: $3.8 million (6.3% of revenues)

Fiscal 2010 General Fund cash balance (net of line of credit proceeds): -$5.2 million (-8.6% of revenues)

Post sale parity debt outstanding: $91.5 million

The principal methodology used in this rating was General Obligation Bonds Issued by U.S. Local Governments published in October 2009.

REGULATORY DISCLOSURES

Information sources used to prepare the credit rating are the following: parties involved in the ratings, public information, and confidential and proprietary Moody's Investors Service information.

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