Public Finance Department
804-697-2900

Post Office Box 85678
Richmond, Virginia 23285-5678

One James Center
901 East Cary Street
Richmond, Virginia 23219-4037

DAVENPORT & COMPANY
SINCE 1863

MEMORANDUM

Date: November 30, 2016

To: Mr. F. Wyatt Shields, *City Manager, City of Falls Church*

From: Mr. Joseph Mason, *Senior Vice President, Davenport Public Finance*

Re: Risk Analysis of CIP Funding Plan and Potential Mitigating Strategies

Cc: Ms. Melissa Ryman, *Acting CFO, City of Falls Church*
Mr. David Rose, *Senior Vice President and Manager, Davenport Public Finance*
Ms. Jennifer Diercksen, *First Vice President, Davenport Public Finance*
Mr. Peter Lind, *Analyst, Davenport Public Finance*

You have asked Davenport & Company LLC ("Davenport"), in our capacity as Financial Advisor to the City of Falls Church ("City"), to identify and assess the risks to the City of implementing its approximately $145 million Capital Improvement Plan ("CIP or CIP Funding Plan"), including the once-in-a generation GMHS replacement project. This memorandum is divided into two parts. First, potential risks to the program will be identified and explained. Second, possible strategies to mitigate (minimize) risk will be presented for consideration.

<u>Basis for Review and Scope of Analysis</u>

Davenport's review of the CIP Funding Plan is based on the models developed by senior staff of the City and provided to Davenport. The assumptions embedded within these models are those of the City and Davenport has not altered, tested, or otherwise recommended changes to these assumptions in preparing this analysis. Davenport also relied on the public financial documents we maintain on our network as part of our longstanding role as the City's Financial Advisor, including audits, budgets, and financial policies.

This memorandum was developed specifically from the standpoint of the risks presented to the City's general government and its future financial health. We recognize and acknowledge that the School Board, its constituencies, and the overall citizenry of Falls Church may identify other risks or potential mitigating factors. Further, the scope of this analysis should not be construed as exhaustive. This is a point in time analysis and is based on the facts and assumptions as presented to Davenport. As plans evolve and implementation begins, certain unforeseeable risks or mitigating strategies may emerge or factors identified herein may take on greater or lesser importance. Finally, unless otherwise noted, the risks and mitigating strategies do not appear in rank or priority order. Davenport does not presume to substitute its judgement for that of the City Council in determining which risks are more material than others. While not ranked as such, the City can assume that all of the mitigating strategies suggested by Davenport would be helpful in reducing risk to the program.

<u>Risk Analysis: Assumptions</u>

When deve1oping pro forma models of future budgets and debt service, it is necessary to make certain assumptions about changes in revenues and expenditures over time. The funding model prepared by the City includes three critical assumptions: 1) rate of assessed value growth, 2) borrowing (interest) rates, and 3) amount/timing of land sale proceeds. Each of these assumptions could positively or negatively affect the forecast output of the funding model.

Assessed Value Growth: The City's primary source of revenue is the property tax. At budget time, City staff estimates the new revenue avai1able for appropriation in the subsequent year based on changes in property assessment, new construction that will be added to the tax roll, the current tax rate, and the rate of timely tax collection. This is a fairly reliable predictor of revenue for the upcoming year and, in normal economic conditions, even one or two subsequent years can be estimated based on real estate market conditions and planning and permitting activity. However, property assessments do not rise, by whatever rate of growth assumed, in perpetuity, as evidenced following the recession only a few years ago. The City's location within the region and its excellent school system have contributed to a fairly steady trend of property appreciation over time, but there have been instances, such as during the last recession, where values either declined slightly or stagnated for several years. Therefore, in evaluating how much the tax rate might need to rise to meet the new debt service for the CIP, there is a risk to the City that property values might not rise by the 2.5% per year assumed in the City's funding model. Since the debt, once issued, is a fixed obligation, any shortfall in assumed tax base growth would result in the possible need for additional tax rate increases, other expenditure reductions, or both.

Interest Rates: One of the most critical drivers of future debt service expense is the interest rate at which capital funds are borrowed and repaid. In simple terms, the interest rate for a given bond issue is a function of the overall level of municipal interest rates, the credit rating of the issuer, the structure of the principal amortization of the bonds, and length of time to final maturity. The funding model assumes that interest rates will rise somewhat from current levels through 2021, that the major school projects will be financed over 30 years using a level annual payment structure, and that the $30 million in other general government projects will be repaid over the City's typical 20-year level principal structure. Interest rate assumptions made by the City include the three issuances of 30-year school bonds with a 4% interest rate and the other 20 year bonds having rates that range from 3.5% for the first issuance to 4.5% for the fiscal year 2021 sale.

The future direction of interest rates is inherently unknowable given the multitude of factors that affect the macro economy. Moreover, since the cost of capital (interest rate) on future borrowings is not locked in until the bonds are issued, the City faces exposure to fluctuations in future interest rates. This creates risk to the City's CIP Funding Plan because future borrowing rates might well exceed the estimates contained in the funding model, thereby increasing future debt service costs. Generally speaking, the longer the period of time of exposure and the more the borrowing is weighted toward the back end of such period, the greater the theoretical risk to the City. Davenport would be happy to run interest rate sensitivity cases, if asked, that would highlight the effects of higher rates.

Amount and Timing of Land Sales: The funding model assumes that some amount of land not needed for the GMHS/MEHMS projects could be sold off and turned into commercial development. If the policy of the City Council is to sell surplus assets, it is certainly reasonable to consider how such sale proceeds might assist in meeting the funding requirements of the CIP debt service. The funding model assumes $10 million will be received and deposited to the City's Capital Reserve in fiscal years 2022, 2024, and 2026.

The old saying goes “they aren’t making any more real estate”. This fact, coupled with the City's location inside the Capital Beltway, suggests that surplus real estate situated near major transportation routes would be particularly valuable and would likely appreciate over time. As a general premise this is true, although the local real estate market is not immune to the laws of supply and demand. Factors influencing the value of commercial real estate in Falls Church are too numerous to mention and beyond the scope of this memo, but it should be noted that there is a risk to the City that it might not receive the land sale proceeds in either the amount or timeline assumed in the funding model. Similar to a shortfall in real estate assessment growth, a shortfall in land proceeds or a delay in revenue realization may lead to the need for changes to the tax rate or other spending in order to accommodate fixed debt service costs.

Other Risks

Aside from the assumption risks discussed above, there are a few other categories of risk that are less quantifiable, although equally real in their ability to adversely affect the CIP Funding Plan.

Credit Downgrade: The City currently enjoys very strong credit ratings of Aa1/AAA/AAA from Moody's, Standard & Poor's, and Fitch Ratings, respectively. These ratings afford the City broad market access at among the most competitive interest rates available. Only Moody's has the City rated below the highest AAA rating available and then only by one rating notch. There is risk to the City that the increased borrowing and associated debt burden the City will take on as part of the CIP Funding Plan could result in an adverse change in Outlook, or an outright downgrade. A one-notch downgrade by each of the agencies would result in a modest uptick in the cost of capital since lower ratings tend to lead to higher cost. However, a one-notch downgrade across the board would not significantly impair the City's ability to come to market with its entire CIP Funding Plan.

A more significant downgrade, perhaps out of the AA category, while a remote possibility given the City's current operating practices, could impair the City's ability to fund the program at current levels on its own credit since the cost of capital would rise considerably. It should be noted that the City could potentially borrow through the Virginia Public School Authority (for schools) or the Virginia Resources Authority (general government projects) if there were a major downgrade to the City's ratings since both entities would presumably have higher ratings. The City currently has ratings equivalent to or better than VPSA and VRA and therefore has no need to pay the administrative fees associated with these programs.

The rating agencies are each aware of the City's plans to build a replacement high school as the CIP has contained a $100 million placeholder for several years. While the agencies factor the City's future borrowing plans into their ratings, they would be acting prematurely if they took an adverse action related to higher debt burden without hearing the details of the City's plans to pay the debt service. As will be discussed further in the mitigating strategies section, it is imperative that the City develop a thoughtful, conservative funding plan that is achievable in order to avoid a credit rating downgrade.

Cost Control: In light of significant amount of borrowing for the total CIP, there is little flexibility to accommodate major cost changes. If the City and School Board are not well coordinated about the scope of the school construction parameters, if major change orders are needed, or if construction bids come in higher than expected this could substantially increase the project cost and lead to unplanned borrowing. Similarly, if the CIP is revised upward in the near future after the initial rating reviews, the additional planned debt could lead to an adverse rating action.

City Council Turnover: In adopting the CIP Funding Plan, the current City Council may not bind future City Council's regarding the choices it makes in setting taxes/revenues to pay for the debt service. Future councils are bound to honor the City's general obligation, full faith and credit pledge to bondholders or risk default, but future councils can change the funding model by making different budgetary choices on taxes and spending. For example, the current City Council could make very conservative assumptions about proceeds of land sales and assessed value growth. A future council could make less conservative decisions, thereby increasing the risk that revenues might not be sufficient to fully fund debt service.

A related risk in this area is Virginia's constitutional post-default intercept of state aid to pay debt service. In the example cited above, a future council could make revenue choices that would lead to a shortfall and a possible default on the City's general obligation bonds. In that instance, the commonwealth would immediately withho1d state funds, including disbursements for education, and divert those funds to pay City debt service. Thus there is a risk that future councils, which have the ultimate taxing power, could put the City in a situation where not only the general government is in financial trouble, but that such problems cou1d affect the School Board's operations.

Mitigating Strategies

The CIP Funding Plan represents the largest set of investments in the City's history and will not be undertaken without risk to city government and to the citizens of Falls Church. Risk may not be eliminated entirely, but there are strategies that can be emp1oyed to partly mitigate risk and support the future financial health of the City.

Enhanced General Fund Reserves: The City's strategy of utilizing a Capital Reserve to smooth equivalent tax rate increases and make the CIP debt service more manageable/affordable is sound. However, it does not replace the importance of unassigned fund balance in supporting the City's high credit ratings. The City's current policy of 17% Unassigned General Fund Ba1ance-to-Revenues is solid and in keeping with its current credit ratings. However, because the City is introducing significantly higher fixed costs in the form of new debt service, the rating agencies may conclude that the City has a reduced margin for error in an economic downturn. Moreover, as the funding model identifies, the City will temporarily breach two of its Debt Policies -in particular the debt payout ratio of 50% within 10 years and the debt service-to-expenditures limit of 12%.

In order to partly offset the perception (and reality) that financia1 flexibility is reduced and that debt policies are out of compliance, the City may wish to consider increasing its Unassigned Fund Balance policy ratio. A strong fund balance is today the single most important credit factor for the rating agencies and therefore, enhancing the City's reserves is a strong way to offset to the higher risks identified by the agencies. A level of 20% (or higher if achievable) would provide an additional margin of safety and would support maintaining the ratings at the current level. Arriving at 20% from the current level of 17% entails policy choices by City Council, but in recent years the City has used the practice of temporarily dedicating pennies on the tax rate for certain purposes. For illustration purposes only, the City may want to consider dedicating two pennies to boosting the fund balance to the identified level and then transferring those pennies (plus others as needed) to the Capital Reserve as ongoing support for new debt service.

Comprehensive Plan of Finance: Protecting the City's credit ratings at the current level, or even a notch below, is critical to making CIP Funding Plan work in an affordable manner. Ratings are one of the most important factors in determining what the interest rates will be on future bond issues. It is therefore of utmost importance the rating agencies be presented with a plan of finance that clearly articulates thoughtful actions the City is taking to responsibly afford a large amount of new debt. Key elements of such a plan might include:

- Evidence of public support (referendum results);
- Clear and public discussion of the tax and revenue actions required to pay for CIP;
- Plan is not overly reliant on external risks such as land proceeds;
- The impact of revenue shortfalls tied to assumptions and higher costs tied to interest rates are well understood and needed re-balancing actions can be implemented quickly;
- Comparisons to similarly situated localities are made (e.g.; City of Fairfax); and
- Complete risk assessment has been thought through and mitigating strategies employed.

Davenport has been fortunate to have assisted many of our highly rated clients in managing large, complex capital programs that involve sizable new debt while maintaining, or even improving credit ratings. Our capabilities are only further enhanced by the newest member of our team, Ms. Jennifer Diercksen, who recently joined us from Moody's. Jennifer was the lead analyst for the City and other credits in the Washington metro area for several years and she has had input into this analysis, particularly with respect to fund balance reserves.

Strategic Debt Structuring: The City's funding model makes some basic assumptions about length of final maturity and debt structure (level debt service vs. level principal). These assumptions generate a varying number of tax equivalent pennies on the tax rate that would be needed to fund new debt service. As development of the Plan of Finance evolves over the next 12-18 months, Davenport would anticipate that we would model alternative debt structures that might be used to further smooth out tax rates, build Capital Reserve or General Fund balances, and otherwise bolster the City's ability to withstand the inevitable economic downturn while maintaining a healthy financial position. Examples of such structuring alternatives, all of which are routine in the Virginia public finance market include, amongst others:

- Interest-only periods;
- Funded (capitalized) interest;
- Use of bond anticipation notes to manage payout ratio; and
- Structured principal to wrap around existing declines in debt service

Investment of Proceeds: If implemented the CIP Funding Plan will entail borrowing in fairly large blocks, notably the two approximately $50 million borrowings for the school projects in fiscal years 2019 and 2020. Traditionally, the City has invested its bond proceeds in the State Non-Arbitrage Pool (“SNAP”) for purposes of efficiently complying with the arbitrage rebate rules of the Internal Revenue Service. The SNAP program is certainly one alternative to the investment of bond proceeds and it has historically met the City's needs. However, given the magnitude of funds to be invested, it may be worth exploring other alternatives that could generate a higher return of these funds, while still complying with the IRS yield restrictions. Once a construction contract is bid and a draw schedule can be properly defined, investments can be matched with draws to maximize the time funds are invested and with potentially higher yields. Alternatives such as guaranteed investment contracts and laddered portfolios can improve returns while maintaining safety of principal and IRS compliance. If interest rates rise as the market appears to be expecting, the City should seek to maximize returns. Dollars earned from investment are a natural hedge against increases to project costs or they can be used to enhance the interior fit-out of the school projects, for example.

In closing, Davenport is pleased to offer this analytical overview of challenges and opportunities facing Falls Church as it embarks on this historic CIP period. We stand ready to discuss and revise this memorandum as needed and would be pleased to present our thoughts to City Council directly if asked.