

Memorandum



CITY OF DALLAS

DATE September 25, 2020

TO Honorable Mayor and Members of the City Council

SUBJECT **S&P Global Ratings Affirmed 'AA-' Rating and Stable Outlook for City of Dallas
General Obligation Bonds – RATING ACTION**

Today, S&P Global Ratings (S&P) assigned its 'AA-' credit rating and stable outlook to the anticipated General Obligation Refunding and Improvement Bonds, Series 2020A, General Obligation Refunding Bonds, Taxable Series 2020B, and Equipment Acquisition Contractual Obligation Notes, Series 2020B, and affirmed the City's 'AA-' credit rating and stable outlook on outstanding general obligation bonds. S&P previously affirmed the City's rating on April 7, 2020.

With continued restrictions of the COVID-19 pandemic, S&P states that, "Dallas faces hurdles in fiscal 2021 as the COVID-19 pandemic remains a negative influence on the economy and some revenue streams," noting that despite unknown long-term effects of the pandemic and facing high fixed costs, the City's "stable financial performance, very strong reserve and liquidity position, and very strong fiscal management practices provide a cushion and counteract the negative effects of the pandemic."

According to S&P, the general obligation rating reflects, "the strength of Dallas' local economy and tax base, which are grounded in solid population growth and commercial and residential development in the past decade." The rating agency also continues to view the City's management as "very strong" with financial policies that are, "are strong, well embedded, and likely sustainable." The report also states that S&P views the City's liquidity and "budgetary flexibility" as "very strong," noting that in FY 2019, the City added to the year-end available reserve balance and has, "exceptional access to external liquidity if necessary."

The rating decision by S&P is a continued reflection of the prudent decision making and efforts of the City as we continue to provide equitable and sustainable services to the citizen and stakeholders of Dallas. Attached is the rating action report provided by S&P today.

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Please let me know if you need additional information.

Shei P. Kowalski
for

M. Elizabeth Reich
Chief Financial Officer

Attachment

cc: T.C. Broadnax, City Manager
Chris Caso, City Attorney
Mark Swann, City Auditor
Biliera Johnson, City Secretary
Preston Robinson, Administrative Judge
Kimberly Bizer Tolbert, Chief of Staff
Majed A. Al-Ghafry, Assistant City Manager

Jon Fortune, 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 Aleqresh, Chief Innovation Officer
M. Elizabeth (Liz) Cedillo-Pereira, Chief of Equity and Inclusion
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RatingsDirect®

Summary:

Dallas, Texas; General Obligation

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Dallas, Texas; General Obligation

Credit Profile

US\$190.07 mil GO rfdg & imp bn ds ser 2020A due 02/15/2041		
<i>Long Term Rating</i>	AA-/Stable	New
US\$77.63 mil GO rfdg bn ds ser 2020B due 02/15/2024		
<i>Long Term Rating</i>	AA-/Stable	New
US\$25.02 mil eqt acquisition contractual oblig ser 2020 due 02/15/2026		
<i>Long Term Rating</i>	AA-/Stable	New

Rating Action

S&P Global Ratings assigned its 'AA-' rating to the City of Dallas' anticipated \$190 million series 2020 general obligation (GO) refunding and improvement bonds, \$77.6 million series 2020 taxable GO refunding bonds, and \$25 million series 2020 equipment acquisition contractual obligations. At the same time, S&P Global Ratings affirmed its 'AA-' long-term and underlying ratings on Dallas' GO bonds outstanding. The outlook is stable.

The bonds and contractual obligations all constitute direct obligations of the city, payable from the proceeds of a continuing, direct annual ad valorem tax, within the limits prescribed by law, on all taxable property within the city. We view the limited-tax GO debt pledge on par with the city's general creditworthiness. The ad valorem taxes are not levied on a narrower or distinctly different tax base, and there are no limitations on the fungibility of resources available for the payment of debt service.

Proceeds from the sales will refund existing debt for net present value savings and finance projects throughout the city, including public works updates, and finance equipment purchases.

Credit overview

The long-term rating reflects the strength of Dallas' local economy and tax base, which are grounded in solid population growth and commercial and residential development in the past decade. In fiscal 2020, the city recorded a stable fiscal performance through cost-saving measures and cuts in discretionary spending to maintain budget stability in the face of a difficult revenue environment. Dallas faces hurdles in fiscal 2021 as the COVID-19 pandemic remains a negative influence on the economy and some revenue streams. While its stable financial performance, very strong reserve and liquidity position, and very strong fiscal management practices provide a cushion and counteract the negative effects of the pandemic, the city faces high fixed costs and a weak funded status of its pension plans. Long-term effects of the pandemic will depend on the severity of the impact. (For more information, see "U.S. Economic Update: A Recovery At Risk As COVID-19 Surges," published July 22, 2020, on RatingsDirect.) Future credit reviews will focus on what influence the current situation has on the city as well as its ability to respond in a timely and appropriate fashion to ensure maintenance of ample reserves.

The rating reflects our assessment of the city's:

- Strong economy, with access to a broad and diverse metropolitan statistical area (MSA);
- Very strong management, with strong financial policies and practices under our Financial Management Assessment (FMA) methodology;
- Weak budgetary performance, with an operating surplus in the general fund and break-even operating results at the total governmental fund level in fiscal 2019;
- Very strong budgetary flexibility, with an available fund balance in fiscal 2019 of 21% of operating expenditures;
- Very strong liquidity, with total government available cash at 59.5% of total governmental fund expenditures and 3.7x governmental debt service, and access to external liquidity we consider exceptional;
- Very weak debt and contingent liability profile, with debt service carrying charges at 16.0% of expenditures and net direct debt that is 167.5% of total governmental fund revenue, as well as a large pension and other postemployment benefit (OPEB) obligation and the lack of a plan to sufficiently address the obligation; and
- Strong institutional framework score.

Environmental, social, and governance factors

Our analysis of these risks encompasses our review of current environmental, social, and governance risks. We acknowledge the ongoing pandemic and potential negative impacts it might have on various aspects of the city's creditworthiness. Absent COVID-19, we believe the social risks to be in line with the sector standard. We have also analyzed the environmental risks and have determined that they are in line with our view of the sector standard. Despite a very strong management framework, we believe that the city's governance risks are elevated compared with the sector standard given the large and growing unfunded pension liabilities, persistent underfunding of annual contributions, and pension reforms must be enacted by the state legislature.

Stable Outlook

Downside scenario

If Dallas' debt service, pension, and OPEB carrying charge increase to a level we view as unsustainable and weaken the city's financial metrics or performance, we could lower the rating. In addition, if weakness or deterioration in budgetary flexibility, performance, or liquidity is realized due to the pandemic or otherwise, we could lower the rating.

Upside scenario

Should the city's debt profile improve significantly and the large and rising pension liabilities moderate, we could raise the rating.

Credit Opinion

Strong economy

We consider Dallas' economy strong. The city, with an estimated population of 1.3 million, is located in Collin, Dallas, and Denton counties in the Dallas-Fort Worth-Arlington, TX MSA, which we consider broad and diverse. The city has projected per capita effective buying income of 95.7% of the national level and per capita market value of \$104,148. Overall, the city's market value grew by 7.8% over the past year to \$140.2 billion in 2020. The weighted-average

unemployment rate of the counties was 3.5% in 2019.

Despite the ongoing pandemic, and its negative impacts on the economy, we believe steady growth in market value and population should support near-term stability.

Dallas is the hub of business in North Texas. The region is home to 42 Fortune 1000 companies, 16 of which are located in Dallas, including two Fortune 500 companies. The city is centrally located in the U.S. and is a draw for tourism and conventions alike. Sustained annual increases in market value, population growth, and in-migration, and positive employment metrics continue to bolster Dallas' local economy and further ground the city as a major economic hub in the country. Dallas and the greater metro area remain a desirable location for new business as well as for relocations of corporate headquarters. The strong economic expansion is represented in robust annual market value growth since 2011.

The pandemic has affected economic metrics, most notably unemployment. The estimated unemployment rate for Dallas County in July 2020 was 8.1%, more than double the 3.7% rate in July 2019, but down from peak unemployment of 13% in April 2020. The modest decline from April represents businesses slowly opening up after the state-mandated shutdown. However, data indicate travel and tourism will likely remain a pressured sector for an extended period.

Officials note major construction and development projects continue in the area. Amazon has announced it is expanding its corporate offices in Dallas with potentially 600 new technology jobs. Kehe Distributors LLC, a national food distributor, has announced a new 995,000-square-foot facility to be constructed in south Dallas. FedEx is also expanding operations with the leasing of a new distribution center, also in southern Dallas County.

Very strong management

We view the city's management as very strong, with strong financial policies and practices under our FMA methodology, indicating financial practices are strong, well embedded, and likely sustainable.

Dallas uses multiyear trends of certified property tax values, historical sales tax revenue trends, and other revenue stream data, as well as outside sources to formulate the budget. It uses a third party for sales tax projections and other economic forecasts to further inform budget preparation and planning. Management provides monthly reports to city council and produces a year-end report that reflects expenditures, concurrent with publishing a comprehensive annual financial report. City council can amend the budget at any time. City staff prepares and presents long-range financial forecasts for the general and debt service funds, which are presented to council during the budget development process or during bond program development. Council does not formally adopt these forecasts, but uses them as a financial planning tool in policy deliberations. The city maintains an inventory of capital needs that is updated annually. A formal facility condition assessment is conducted and presented to council. The assessment is being used to better plan for long-term maintenance and replacement needs. Dallas has historically used a multiyear capital bond program to fund infrastructure improvements. Management also reports investment results quarterly to council, and it reviews the investment policy annually. The city's financial management performance criteria (FMPC) establish guidelines and targets for operating programs and cash-and-debt management, including minimum reserves, debt ratios, and restrictions on debt use and issuance. The FMPC is part of the budget development process, at year-end, and is part of GO bond program development. The city adheres to a reserve policy of 40 days of expenditures. It has

also developed Dallas 365, which comprises 35 performance measures organized by six key strategic priorities that it tracks and reports on to better inform decision-making throughout the year.

Weak budgetary performance

Dallas' budgetary performance is weak in our opinion. The city had surplus operating results in the general fund of 2.7% of expenditures, and balanced results across all governmental funds of 0.3% in fiscal 2019. General fund operating results of the city have been stable over the past three years, with a result of 1.7% in 2018 and 3.3% in 2017. Weakening our view of budgetary performance is the city's deferral of significant expenditures, which we think inflates the budgetary result ratios.

Taken into consideration in the city's overall performance was the full cost of the actuarially determined contribution (ADC) for pension costs, as well as event risk associated with the pandemic.

Solid fiscal performance in 2019 was the result of increasing revenue streams. Dallas also benefits from producing a balanced budget for a two-year cycle and has historically benefitted from positive budget variances. Audited results of general fund revenues were primarily derived from property taxes (52% of total general fund revenues) and sales taxes (24%). Both revenue streams increased substantially in 2019, which aided stable performance. Before transfers, general fund revenues outpaced expenditures by \$30.2 million.

For fiscal 2020, the city anticipates generally stable results despite the negative impacts of the pandemic. Sales tax collections are projected to decline about 1.3% from 2019. Modest annual declines are, in part, offset by positive collections in the first half of the fiscal year. Cuts in expenditures, including a hiring freeze and discretionary spending cuts, resulted in a reduction in general fund expenditures for the year. Dallas benefitted from approximately \$234 million in CARES Act funding, which offset additional costs associated with the pandemic. For 2020, general fund revenues are forecast to be \$30.6 million higher than expenses, which indicates strong performance for the year.

The city has a balanced biennial budget (proposed for fiscal years 2021 and 2022) that focuses on long-term fiscal sustainability. The budget reflects austerity measures, given a great deal of uncertainty about the impacts of the pandemic. For 2021, Dallas projects a reduction in sales tax collections by 9% to \$296 million, and a reduction in new building permit counts. However, the property tax base rose 5% for fiscal 2021 and the city has budgeted for 3.5% annual growth in total market value in the near term. Future credit reviews will focus on the city's ability to manage difficult revenue situations and implement midyear course corrections to ensure it maintains budget performance stability.

Very strong budgetary flexibility

Dallas's budgetary flexibility is very strong, in our view, with an available fund balance in fiscal 2019 of 21% of operating expenditures, or \$271.3 million.

In fiscal 2019, the city added to year-end available reserve balance, which is what we consider very strong and exceeds the financial policy requirement of 40 days of general fund operating expenditures. The addition continues a trend of growth in available reserves on a dollar basis as well as on a percentage of expenditures basis. For fiscal 2020, the city expects general fund balance will increase, based on year-end projections, albeit modestly.

Very strong liquidity

In our opinion, Dallas's liquidity is very strong, with total government available cash at 59.5% of total governmental fund expenditures and 3.7x governmental debt service in 2019. In our view, the city has exceptional access to external liquidity if necessary.

Dallas' exceptional access to external liquidity is demonstrated by the city's frequent bond issuances, secured by various revenue streams, over the past 15 years. Given year-to-date budget performance trends, we do not expect deterioration in liquidity in the near term. We acknowledge the difficult revenue climate associated with the pandemic, and expect certain pledged revenues will be reduced. Future credit reviews will focus on the city's ability to maintain ample liquidity across funds.

Very weak debt and contingent liability profile

In our view, Dallas's debt and contingent liability profile is very weak. Total governmental fund debt service is 16.0% of total governmental fund expenditures, and net direct debt is 167.5% of total governmental fund revenue.

Dallas' fixed costs, including debt and pension costs, amounted to 29.7% of expenditures for fiscal 2019, which affects our overall view of the debt and liability profile. We expect the city will continue to issue bonds for general infrastructure improvements should assessed value growth support such issuances. Incorporated in the debt profile are the city's contingent liabilities to make up any shortfalls in debt service coverage for both the Dallas Convention Center Hotel revenue bonds and the Downtown Dallas Development Authority tax increment revenue bonds. The city also maintains a commercial paper program through JPMorgan Chase Bank N.A. The notes have a total program authorization of \$350 million. Liquidity support is provided by JPMorgan Chase Bank through a revolving credit agreement, which extends to Nov. 27, 2020.

Pension and other postemployment benefits

In our opinion, a credit weakness is Dallas' large pension and OPEB obligation, without a plan in place that we think will sufficiently address the obligation. The city's combined required pension and actual OPEB contributions totaled 13.6% of total governmental fund expenditures in 2019. Of that amount, 12.8% represented required contributions to pension obligations, and 0.8% represented OPEB payments. The city made 88% of its annual required pension contribution in 2019. The funded ratio of the largest pension plan (based on liability) is 45.4%.

We consider the high contributions, as well as continued contribution shortfalls when compared to the ADC, to be a credit weakness. Dallas' combined total pension and OPEB contributions for fiscal 2019 were 12.3% of governmental expenditures (11.5% for pension alone).

- Despite significant structural changes to the pension plans, we anticipate the city's pension obligations will remain a source of pressure for Dallas.
- Pension contribution rates fixed by statute are high and still insufficient.
- OPEB is small and closed to new participants, and thus, represents a comparatively small, and diminishing, problem for the city.

Dallas provides benefits to its employees primarily via the following defined-benefit retirement plans, as of fiscal 2019:

- Employees' Retirement Fund (ERF): 59% funded using a 5.98% discount rate, with a net pension liability of \$2.3 billion;
- Dallas Police and Fire Pension System (Combined Plan): 45% funded using a 7.25% discount rate, with a net pension liability of \$2.5 billion; and
- OPEB: 0% funded, with a net OPEB liability of \$0.6 billion.

We consider the funded levels of both pension plans to be poor. ERF assumed a 7.75% asset return and the Combined Plan assumed 7.25%, both of which we consider as acceptance of a very high level of market risk. We understand that this assumed return will be lowered to 7.25% for ERF and to 7.0% for the Combined Plan, which is comparatively less risk, though the change will lead to lower funded levels. The ERF discount rate is lower than the assumed return due to a projected asset depletion date under Governmental Accounting Standards Board calculations.

The relatively recent changes to Dallas' pension plans are an improvement to funding discipline, but we expect it will be several years until funding progress materially improves. Last year, the city paid 73% and 97% of the ADC for ERF and the Combined Plan. The 2019 ADC for both plans is calculated using an open period that we view negatively, a 30-year length that we view negatively, and a level percent of payroll basis (2.75% for ERF and 2.75% for the Combined Plan) that defers contributions to the future. These contributions were not only well below our minimum funding progress metric guideline, but also below static funding, which indicates increasing unfunded liabilities if all assumptions are met. Furthermore, the Combined Plan is expected to have supplemental contributions expire by fiscal 2025, though there is an actuarial review scheduled. This funding discipline is weak and is likely to be insufficient, leading to deteriorating funded levels for the foreseeable future.

The OPEB plan is funded on a pay-as-you-go basis and discontinued offering subsidized retiree health care for employees hired after Jan. 1, 2010.

Strong institutional framework

The institutional framework score for Texas municipalities is strong.

Related Research

- Through The ESG Lens 2.0: A Deeper Dive Into U.S. Public Finance Credit Factors, April 28, 2020

Ratings Detail (As Of September 25, 2020)		
Dallas GO		
<i>Long Term Rating</i>	AA-/Stable	Affirmed
Dallas comb tax and rev certs of oblig ser 2020 due 02/15/2030		
<i>Long Term Rating</i>	AA-/Stable	Affirmed
Dallas taxable GO (AGM) (SEC MKT)		
<i>Unenhanced Rating</i>	AA-(SPUR)/Stable	Affirmed
Dallas GO (AGM)		
<i>Unenhanced Rating</i>	AA-(SPUR)/Stable	Affirmed

Ratings Detail (As Of September 25, 2020) (cont.)

Dallas GO (BAM) (SECMKT)		
<i>Unenhanced Rating</i>	AA-(SPUR)/Stable	Affirmed
Dallas GO (BAM) (SECMKT)		
<i>Unenhanced Rating</i>	AA-(SPUR)/Stable	Affirmed
Dallas GO (BAM) (SECMKT)		
<i>Unenhanced Rating</i>	AA-(SPUR)/Stable	Affirmed
Dallas GO (BAM) (SECMKT)		
<i>Unenhanced Rating</i>	AA-(SPUR)/Stable	Affirmed
Dallas GO (BAM) (SECMKT)		
<i>Unenhanced Rating</i>	AA-(SPUR)/Stable	Affirmed
Dallas GO (BAM) (SECMKT)		
<i>Unenhanced Rating</i>	AA-(SPUR)/Stable	Affirmed
Dallas GO (BAM) (SEC MKT)		
<i>Unenhanced Rating</i>	AA-(SPUR)/Stable	Affirmed

Many issues are enhanced by bond insurance.

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.

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