MOODY'S
INVESTORS SERVICE

# Rating Update: Moody's upgrades City of Bainbridge Island, WA's, Unlimited G.O. Bonds to Aa2

Global Credit Research - 08 Jul 2014

**Approximately $21.1M in debt affected**

BAINBRIDGE ISLAND (CITY OF) WA
Cities (including Towns, Villages and Townships)
WA

**Opinion**

NEW YORK, July 08, 2014 --Moody's Investors Service has upgraded to Aa2 from Aa3 the City of Bainbridge Island, WA's, Unlimited General Obligation bonds. The rating action affects $5 million in outstanding debt. Concurrently, Moody's has upgraded the city's limited tax bonds to Aa3 from A1, affecting $16.1 million in outstanding debt. All debt outstanding is rated by Moody's.

SUMMARY RATING RATIONALE

The rating upgrade reflects the stabilizing tax base, and consistent four-year operating surpluses, restoring the General Fund balance to healthy levels. The rating further reflects the city's modest debt and pension burdens, affluent demographic profile and strong management practices.

STRENGTHS

-Moderately-sized tax base, which returned to growth in 2014

-Strong socioeconomic profile

-Healthy fund balances and reserves supported by strong fiscal policies

CHALLENGES

-Tax base slow to recover from recession

-Near-term projected decline in reserves for capital outlay

DETAILED CREDIT DISCUSSION

STRONG FINANCIAL PERFORMANCE; DRAWS ON RESERVES EXPECTED NEAR-TERM

Since instituting conservative budgetary policies in fiscal 2010, the city has reported sizeable surpluses for three consecutive periods, growing General Fund reserves to $8.3 million, or a strong 54.4% of revenues. The city continues the positive trend, reporting a $2 million surplus in fiscal 2013, increasing General Fund balance to $10.4 million, or a healthy 65.8% of revenues (unaudited). Officials report that sales tax collections, permit and inspection revenues and franchise fees were better than expected in fiscal 2013.

In fiscal 2014, the city is projecting a draw on reserves of approximately $2.7 million for capital outlay, reducing the General Fund balance to $7.7 million, or a still-adequate 51.1% of revenues. The city is spending $2 million in Washington State Ferries settlement monies, received in fiscal 2010, on a waterfront park and city park. The city has held this money in the General Fund for several years, planning to spend the money in fiscal 2014. Additional expenditures include cash-funding IT updates and equipment purchases. Moving forward, Moody's notes that the city has several on-going capital improvement projects that are funded, in part, by transfers out of the General Fund. While these projects are considered one-time expenditures, they represent a long-term burden on the General Fund. Future reviews will focus on the city's ability to manage capital requirements with corresponding revenues.

The city relies heavily on property tax revenues and other taxes, such as sales tax collections, to fund operations.

While the city's revenue sources are diverse, sales taxes are volatile, subject to changes in the economy, and if the city is unable to properly mitigate revenue fluctuations, this would place downward pressure on the rating. Positively, the city has made an effort to explore new revenue streams: in fiscal 2013, the city created a transportation benefit district, generating approximately $330,000 per year in vehicle licensing fees. The fees are used to support qualifying transportation projects, thereby not burdening the General Fund with future expenses. Officials are committed to maintaining a General Fund balance of at least 30% of reoccurring revenues, including a stability reserve ($3 million), emergency reserve ($1 million) and contingency reserve at ($800,000), all held within the General Fund. Currently, all reserve funds are fully-funded.

MODERATELY-SIZED TAX BASE SLOW TO RECOVER FROM RECESSION

The city is located ten miles directly west of Seattle (Aaa/STA) in the Puget Sound. The city's tax base is sizeable compared to medians; however, the city has been slow to recover from the economic downturn, losing over 25% in assessed value (AV) from 2010 to 2013. The 2014 AV showed signs of stabilization at $5.2 billion, or an increase of 0.1% over prior year. Positively, officials report residential and commercial development in progress. Projects include an assisted living facility, "built green" community (90 units), retail shopping center, urgent care facility and community swimming pool. Additionally, the city was a recipient of Google's eCity award for having the strongest online business presence in the state. The city's economic recovery is supported by strong wealth indices, with per capita income and median family income reported at 188.2% and 185.5% of US, respectively, per the 2011 American Community Survey. Unemployment rates are low at 5.5% compared to the state's 5.6% as of April 2014. The city's tax base is not concentrated, with top ten taxpayers comprising a modest 1.9% of 2014 AV. Full value per capita is $224,923, which is above-average compared to similarly rated credits.

MODEST DEBT BURDEN

The city's direct debt burden is manageable at 0.3% of 2014 assessed value, net of self-supporting debt, with average principal payout of 82.5% in 10 years. All of the city's debt is fixed rate, and the city is not party to any derivative agreements. Officials report the city does not have firm plans to issue debt in the near- to medium-term; however, the city is considering available revenue options to finance construction of a new public safety facility.

The city has an elevated fixed cost burden: the city has $16.1 million in non-voted debt, and the debt service payments represent 9.5% of fiscal 2013 operating expenditures. In addition, officials report that $4.7 million of debt is covered by net revenues of the sewer system, subordinate to any sewer revenue bonds, although none are currently outstanding. Moody's believes this fixed cost pressure to be somewhat mitigated given the city's strong financial position, but inability to effectively manage the fixed cost burden would place pressure on the rating.

The city's pension liability is manageable. The city participates in the Washington State Department of Retirement Systems (DRS), a cost-sharing multiple-employer, defined benefit retirement plan sponsored by the state. The city's combined annual required contribution (ARC) for the plans was $575,637 in fiscal 2012, or 4.0% of total operating expenditures. Moody's adjusted net pension liability (ANPL) for the city is $11.6 million, or 0.71 times operating revenues for fiscal 2012. The adjustments are not intended to replace the city's reported liability information, but to improve comparability with other rated entities. We determined the city's share of liability in proportion to its contributions to the statewide plan.

WHAT COULD MAKE THE RATING GO UP

-Significant tax base growth

-Maintenance of structural balance

-Rebuilding reserves after near-term draw

WHAT COULD MAKE THE RATING GO DOWN

-Tax base contraction

-Significant deterioration of financial position

KEY STATISTICS

Full value, 2014: $5.2 billion

Full value per capita, 2014: $224,923

Median family income: 185.5% of U.S.

Available fund balance, FY 2013: 64.7% of operating revenues

5-year change in fund balance: 46.84% of operating revenues

Net cash, FY 2013: 71.1% of operating revenues

5-year change in net cash: 47.22% of operating revenues

Institutional framework: Aa

5-year average of operating revenues / expenditures: 1.10x

Net direct debt burden % of full value: 0.3%

Net direct debt burden / operating revenues: 0.57x

3-year average Moody's adjusted net pension liability % of full value: 0.21%

3-year average Moody's adjusted net pension liability / operating revenues: 0.71x

RATING METHODOLOGY

The principal methodology used in this rating was US Local Government General Obligation Debt published in January 2014. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

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