



RATING ACTION COMMENTARY

Fitch Rates Virginia Beach, VA's \$92 Million Series 2021A GO Bonds 'AAA'; Outlook Stable

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Fitch Ratings - New York - 21 Jul 2021: Fitch Ratings has assigned an 'AAA' rating to the following city of Virginia Beach, VA's general obligation bonds:

--\$92,195,000 GO public improvement bonds, series 2021A.

The bonds will be sold via competitive sale on Aug. 4. The series 2021A bonds are being issued to support various city and school projects.

Fitch also affirmed the following ratings:

--City of Virginia Beach Issuer Default Rating (IDR) at 'AAA';

--Approximately \$524 million outstanding GO bonds issued by the city at 'AAA';

--Approximately \$384 million outstanding public facilities revenue bonds issued by the Virginia Beach Development Authority (VBDA) at 'AA+'.

The Rating Outlook is Stable.

SECURITY

The GO bonds are backed by the city's full faith and credit and unlimited taxing power. VBDA revenue bonds are backed by annual payments from the city to VBDA pursuant to a support agreement, subject to annual appropriation.

ANALYTICAL CONCLUSION

The 'AAA' IDR and GO bond rating reflects Fitch's view of the city's strong financial resilience to risks associated with periodic economic downturns, underpinned by an unlimited legal authority to adjust revenue, solid reserves and broad legal control over employee-related expenses. The rating also reflects management's demonstrated ability to control expenditures and achieve balanced results from operations. The 'AA+' rating on VBDA obligations reflects the slightly higher degree of optionality associated with appropriation payments to be made by the city compared to the GO bonds.

ECONOMIC RESOURCE BASE

Virginia Beach is located in the Hampton Roads region of Virginia along the Atlantic Ocean and the Chesapeake Bay. It is the most populous city in the Commonwealth with a 2020 census estimated population of roughly 451,000, up almost 3% since 2010. Economic activity is heavily influenced by the federal government owing to the presence of several U.S. naval installations in the region, in addition to a strong tourism component, real estate, agriculture, and trade and retail industry.

KEY RATING DRIVERS

Revenue Framework: 'aaa'

The city has complete legal control over key revenue streams and its revenue base is comprised mostly of property taxes, and supplemented by federal and state revenues, and to a lesser extent sales, utility and meals taxes. Revenue growth has strengthened the past six fiscal years and was not materially affected by the pandemic. Fitch expects future growth to trend more in line with recent activity due to projects underway and planned supporting new population and a return to growth in tourism.

Expenditure Framework: 'aa'

The largest expense is associated with education funding, followed by public safety. The city has solid control over spending, including the power to set terms of labor given the absence of collective bargaining. Fixed costs are a moderate proportion of overall spending and additional flexibility exists due to a strong history of budgeted pay-go capital spending.

Long-Term Liability Burden: 'aa'

Virginia Beach's overall governmental debt position coupled with its allocated portion of the net pension liabilities (NPLs) associated with state administered city and school pension plans is approximately 9% of residents' personal income. Fitch expects the city's liability burden could rise moderately based on based on future debt plans. However, the burden should not materially change based on a history of prudent debt management within established policies, continued growth in the economic resource base, and full actuarially determined contributions being made to the state pension plans.

Operating Performance: 'aaa'

Fitch expects the city to manage through periods of economic decline while maintaining a substantial financial cushion based on its history of sound financial management throughout the economic cycle, high reserves, and a superior level of inherent budget flexibility in the form of its unlimited taxing authority and solid expenditure flexibility.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to a positive rating action/upgrade:

--The 'AAA' GO bond rating is the highest rating in Fitch's rating scale. The 'AA+' lease revenue bond rating is the highest permissible under Fitch's tax-supported rating criteria.

Factors that could, individually or collectively, lead to a negative rating action/downgrade:

--A sustained increase in the city's long-term liability well in excess of 10% of personal income levels;

--A sustained pace of natural revenue growth below Fitch's expectations for growth to exceed inflation;

--A sustained decline in unrestricted general fund reserve fund balances to levels that provide weaker gap closing capacity with an expectation for slow recovery.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit <https://www.fitchratings.com/site/re/10111579>.

CURRENT DEVELOPMENTS

Virginia Beach emerged from the coronavirus pandemic in a stronger budget position than management had anticipated due to a strong recovery of local revenues and property tax collections, conservative budget assumptions and receipt of federal and state stimulus moneys.

Management was proactive in curtailing spending once the pandemic hit early last year and such actions combined with lower spending due to stay-at-home measures offset an approximate 10% decline in local revenues compared to budget and negated the need to use reserves. The city ended fiscal year 2020 (ending June 30) with a net operating surplus of \$75 million (6.7% of spending) increasing unrestricted fund balance (committed, assigned and unassigned) to \$293 million or 26% of spending. The positive results also

reflect school savings that resulted in unspent funding of approximately \$37 million that reverted back to the city's general fund.

The city's fiscal 2021 budget of \$1.3 billion was up modestly yoy and anticipated a use of general fund unassigned fund balance of \$55 million (4.6% of revenues); the budget also assumed approximately \$52 million for pay-go capital projects. Revenue assumptions were reduced by \$70 million from the originally proposed budget and a number of costs were reduced for personnel spending, new operating initiatives, and certain capital and vehicle replacement costs.

General fund revenues are projected to outperform budget slightly as consumer driven revenues (hotel, meals, sales tax) outperformed expectations. Positive sales tax activity reflects the capture of internet sales activity that began during mid fiscal 2021.

Management expects spending to come in moderately below budget. Fiscal 2021 projections show a use of \$52 million in unassigned fund balance and ending unassigned fund balance levels to remain within policy levels of a minimum unassigned general fund balance of 8%-12% of revenues. With the inclusion of committed and assigned balances, the level of unrestricted reserves is higher, and supports Fitch's view of the city's high financial resilience.

The fiscal 2022 budget reflects a 2.7% mill rate decrease and the city operating portion is up 4.2% yoy mostly reflecting the budget of revenues compared with the lower revenue assumptions in the prior year's budget due to the pandemic. Preliminary estimates of real property value growth are close to 4%, reflecting continued improvement. The budget includes a conservative increase in revenues and reflects a reduction in city funding to schools as the schools share in the tax decrease and supplement their budget with American Rescue Plan Act (ARPA) grants of \$84 million and state increases in aid. A portion of the general fund balance has been included to support capital projects.

The city was allocated \$136 million of ARPA moneys to be distributed half this year and the remaining half in 2022. The city's operating budget does not include the use of ARPA moneys. Preliminary plans for the use of the federal stimulus would support stormwater infrastructure improvements and economic relief assistance to residents and businesses; however, final approvals will be determined later in the fiscal year.

CREDIT PROFILE

The city is home to the Oceana Naval Air Station, the Navy's only East Coast master jet base, and the Joint Expeditionary Base Little Creek-Fort Story, the primary East Coast base supporting overseas contingency operations. According to the city and the Hampton Roads Planning District Commission, the Department of Defense supports between 35% and 40% of all regional employment and provides for a substantial level of financial and economic benefits to the region and city.

Tourism is also an economic mainstay of the region due to the city's beachfront location and year-round convention center events. Such activity translates into additional revenue for the city, primarily in the form of hotel room and meal tax receipts. Such taxes were affected only moderately due to the pandemic and have bounced back during fiscal 2021, but remain moderately below pre-pandemic levels. The city has traditionally experienced growth in these revenues and the rehabilitation of large hotel properties is expected to support continued growth. The city's general fund relies on a small portion of hotel tax revenues (less than 1% of total revenues) as a larger portion of hotel revenues are reported as special revenues in the city's tourism development-related funds.

The Port of Virginia, in nearby Portsmouth, supports a large trade component of the regional economy and has experienced increased volume following recent infrastructure investments and the widening of the Panama Canal. Offshore wind industry projects are in early stages but have begun to take traction due the city's coastline presence and support from the commonwealth and federal government. Significant infrastructure investments are planned for the region over the next several years including the Hampton Roads Transportation Accountability Commission's over \$3 billion I-64 Hampton Roads bridge and tunnel expansion project and Fitch expects such activity to support potential economic growth.

The city's tax base continues to see improvement, registering its sixth consecutive year of growth in fiscal 2020, an increase of 23% since fiscal 2014. Fiscal 2020 taxable assessed value figures of \$66.4 billion are up 3.8% compared with fiscal 2019 values. Fiscal years 2021 and 2022 real property values are up 3.5% and 3.8%, respectively. Improvement in the city's tax base reflects a combination of price appreciation and new construction activity. Resident per capita and median household income levels are similar to the Commonwealth's and exceed national levels.

REVENUE FRAMEWORK

Virginia Beach's general fund budget is largely supported by real and personal property taxes, which collectively account for a little over half the budget. The bulk of remaining general fund revenue sources are derived from federal and state revenues (16%), with sales taxes, charges for services, and utility and meals taxes, each representing between roughly 4%-6% of revenues.

Fitch expects future general fund revenue growth to range between the rate of inflation and GDP over time. In addition to a rebounding tax base, the long-term commitment of the federal government's naval operations in Virginia Beach and the increase in defense spending in the Hampton Roads region are expected to contribute to economic stability and solid revenue growth in the long term.

Revenues are also expected to benefit from moderate growth in population and the popularity of Virginia Beach as a tourist attraction along with recently completed and in-progress upgrades and additions to hotel facilities and other associated tourist amenities. Additional commercial, retail and residential projects planned or underway support the expectation for continued tax base growth. A history of low joblessness and high educational attainment further support Fitch's view on the city's long-term revenue outlook.

The 'aaa' key rating factor assessment for Virginia Beach's revenue framework is supported by the city's broad legal control as it is not subject to any cap or limit on its property tax rate or levy, nor is it subject to any restriction on its various non-property tax streams. The city has exercised its flexibility to adjust tax rates in response to shifts in the value of its tax base and currently maintains an affordable and competitive tax rate compared with other local governments in the Hampton Roads region.

EXPENDITURE FRAMEWORK

The city maintains solid expenditure flexibility supported by a moderate level of fixed spending associated with debt and retiree costs, a history of including capital pay-go in its budgets, and broad control over employee wages and other costs. Education is the largest single expenditure category in the general fund budget accounting for roughly 35% of spending in fiscal 2020. State law establishes a required local effort of funding for K-12

education for each municipality across the Commonwealth and the city has exceeded this minimum required level by a substantial margin. The bulk of other general fund spending is driven by salaries and benefits for city employees.

Fitch expects expenditure growth to be moderate and generally in line with to slightly above revenues without policy action. The Virginia Beach Public Schools, a component unit of the city, is largely funded by a mix of state and federal aid (50% of budget) and city contributions.

Fixed costs associated with debt service, pensions and other post-employment benefits (OPEB) contributions were moderate at 12% of fiscal 2020 total governmental spending. Fixed cost spending is expected to remain manageable even with future planned issuances as the city's debt amortizes very rapidly (76% of principal retired over ten years).

The city makes the full actuarially determined contribution to the state administered pension plan, the Virginia Retirement System (VRS). Pension payments have consumed about 3% to 4% of governmental spending in recent years. The city funds above the full actuarially-determined payment for OPEB, for which obligations are fairly modest.

According to Senate Bill 939 effective May 1, 2021 Virginia localities are permitted to engage in collective bargaining agreements with public employees. While some employees of the city are members of unions, the city has not adopted an ordinance to allow collective bargaining with its employees, and state law makes such an ordinance a condition precedent to collective bargaining. Restrictions on the ability to control labor spending pursuant to collectively bargained work rules and compensation could adversely impact Fitch's workforce evaluation and expenditure framework assessment. State laws also prohibit employees from striking.

LONG-TERM LIABILITY BURDEN

Long-term liabilities for debt and the Fitch-adjusted NPL are estimated by Fitch at 9% of personal income. Direct debt of the city accounts for roughly 40% of the metric. Management complies with a series of debt management policies that limit debt issuance to prudent levels compared to market value, population and personal income. The

remainder of the long-term liability burden represents the proportionate share of the Fitch-adjusted NPL (excluding for enterprise funds) of the cost-sharing multiple-employer retirement plan for teachers and separate cost-sharing pools within VRS for city employees and non-professional school employees. Fitch's NPL estimates are based on a 6% investment rate of return compared to the 6.75% VRS rate as of the June 30, 2019 measurement date.

Fitch expects the liability burden to remain around this level of personal income based on future borrowing plans and a rapid pace of principal amortization. However, the city and school NPLs (almost two-thirds of the liability metric) could experience increases if investment market returns fall short of the plans' assumed annual rates of return.

The capital improvement program (CIP) for the six-year fiscal period 2022-2027 totals roughly \$1.9 billion. The plan relies on an additional \$529 million in GO and public facility revenue bonds for funding (about half of current outstanding debt). Other funding sources for the plan include revenue bonds, state and federal funding, and pay-as-you go spending.

The city has been undertaking a comprehensive study on the impact of sea level rise (SLR) and has dedicated close to \$1 billion in the current CIP for improving flood control and protection via various storm water improvements, dredging and beach restoration. The CIP includes \$316 million in storm water revenue bonds to support these initiatives. The cost of the SLR program may be substantial but it is projected to be financed and developed over an extensive period of time, allowing the city the ability to balance this investment against other general governmental needs and its available economic resources. The city plans to have a voter referendum placed on the ballot in November to decide on the issuance of future debt of approximately \$567 million, mixed between enterprise funds and tax-supported, to support future flood control and sea level rise concerns.

OPERATING PERFORMANCE

The city's 'aaa' operating performance assessment is based on Fitch's view of the city's significant gap-closing capacity and superior inherent budget flexibility in the form of ample revenue raising authority and solid expenditure flexibility. The city ended fiscal 2020 with an unrestricted general fund balance of \$293 million or 26% of spending. Fitch expects fund balance levels to decline moderately during the upcoming fiscal year as assigned balances are drawn down, but Fitch believes the city will maintain a high level of fundamental financial flexibility to withstand an economic downturn and will be able to restore reserves during periods of economic growth.

Operating margins are consistently positive with reserve draw-downs in four of the last ten fiscal years driven by capital investments and other one-time outlays. The city has exercised a variety of budgetary actions in response to changing operating environments including spending cuts, tax and fee increases, and a reasonable use of reserves in support of non-recurring capital investment. Unrestricted general fund reserves have remained solid, ranging from 15% to 26% of spending (expenditures plus transfers out) from fiscal 2010-2020 and Fitch expects management to continue to maintain its high level of financial flexibility through future economic downturns.

In addition to the sources of information identified in Fitch's applicable criteria specified below, this action was informed by information from Lumesis.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

RATING ACTIONS

ENTITY/DEBT	RATING		PRIOR
Virginia Beach (VA) [General Government]	LT IDR	AAA Rating Outlook Stable	Affirmed AAA Rating Outlook Stable

ENTITY/DEBT	RATING			PRIOR
● Virginia Beach (VA) /Appropriation - CVBDA/1 LT	LT	AA+ Rating Outlook Stable	Affirmed	AA+ Rating Outlook Stable
● Virginia Beach (VA) /General Obligation - Unlimited Tax/1 LT	LT	AAA Rating Outlook Stable	Affirmed	AAA Rating Outlook Stable

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APPLICABLE CRITERIA

[U.S. Public Finance Tax-Supported Rating Criteria \(pub. 04 May 2021\) \(including rating assumption sensitivity\)](#)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

FAST Econometric API - Fitch Analytical Stress Test Model, v3.0.0 (1)

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Virginia Beach Development Authority

EU Endorsed, UK Endorsed

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