S&P Global
Ratings

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Summary:

Detroit, Michigan; General Obligation

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Long Term Rating	BB+/Positive	Upgraded

Credit Highlights

- S&P Global Ratings raised its long-term rating to 'BB+' from 'BB' on Detroit's unlimited-tax general obligation (GO) bonds and issuer credit rating.
- The outlook is positive.
- The rating action reflects our view of Detroit's ongoing efforts toward building financial resiliency, evident in another year of positive financial results and improvements to reserves and liquidity as well as its commitment to robust financial planning and budgetary management. The rating action also reflects our view of Detroit's strong revenue growth and enormous federal stimulus allocation, supporting its extensive capital needs.

Credit overview

The rating reflects our view of Detroit's strengthened financial position, but also incorporates near-term uncertainties pertaining to slowing economic and tax base growth, cost pressures, and additional pension costs that could increase should plans realize negative experience compared to assumptions.

Ten years on from its bankruptcy filing, Detroit's financial position and economic condition are the strongest they've been in decades. Liquidity and reserves are at record levels, the debt burden is manageable, population decline is flattening, the stock of blighted and vacant properties is down considerably thanks to extensive city-managed programs, assessed property values have increased in five consecutive years (which hasn't occurred since the 1997-2002 tax years), and taxable wages continue to grow. These positive developments were facilitated, in part, by the restructuring process, including the plan of adjustment (POA) and the pension "grand bargain" included therein. However, in our view, concerted management action and institutional support to not only recover from bankruptcy, but to revitalize Detroit's economy and finances, enabled the city to capitalize on its situation. The post-financial-crisis economic recovery aided the city, but city policies (such as increasing public safety responsiveness and revamping public lighting) and new economic development initiatives expanded opportunities and buttressed the city's reputation, accelerating credit improvements. These improvements are significant compared with forecasts in the POA.

As the 10-year pension holiday concludes, the city begins making actuarially based pension contributions in fiscal 2024. These costs will add $130.2 million to general fund expenditures, an increase of 11.4% over the original fiscal 2023 budget. The city will offset the budgetary impact by drawing from reserves in its retiree protection fund (RPF), which has grown to $473.4 million. The city will appropriate $57.2 million in RPF funds in fiscal 2024, bringing the net

budgetary impact to $73.0 million. This alone is still a 6.4% increase over the 2023 budget, but is more manageable and within fiscal 2024 budgeted revenue growth of 9.3%.

While credit conditions have improved, the city remains exposed to a variety of credit challenges, in our view, including:

- Ability to maintain balanced operating results, given rising costs generally, the return of pension contributions, and significant general fund financial support of transportation fund operations;
- Plans to draw down unassigned general fund reserves in the near term;
- An economically sensitive revenue mix, with more than 50% coming from income and wagering taxes;
- Slowing payroll growth and uncertain long-term effects on remote working trends and nonresident income taxes, which could affect income tax revenue;
- A local economy with outsized exposure to economic downturns given low income metrics as well as comparatively elevated poverty and unemployment rates; and
- Relative employment concentration in cyclical industries, such as auto manufacturing and the mortgage industry.

We believe the city has the capability and fiscal discipline to respond to these challenges over the near term. Our view of Detroit's ability to attain long-term structural balance will depend on revenue performance in the face of the predicted economic slowdown compared with expenditure trajectories and potential volatility in pension costs over the next several years.

Environmental, social, and governance

We view Detroit as facing elevated social risks, specifically social capital risks. Commuting patterns changed significantly through the pandemic and more than 30% of nonresidents continue to work remotely. This translates to revenue losses directly from income tax refunds, but also slowed recovery of jobs that rely on a regular course of business and leisure activity in the city. Detroit's population trends and high poverty levels remain risks, as they can limit revenue-raising abilities and increase service needs. The city's leadership views building up its residential tax base as fundamental to its future and invests significant resources in these efforts. Successes to date are reflected in increasing property values, improved public safety metrics, and reduced poverty rates, and substantial new job creation within the city likely reflects the private sector's recognition of an increasingly skilled labor force. Detroit's poverty rate fell to 30% in 2021, a decline of 12 percentage points since 2012.

We see governance as a strength, with strong fiscal controls, formal long-term forecasting, well-framed policies that are consistently met, and commitment to long-term goals that keeps the city's rebound moving forward. We do not see high environmental risk. Detroit is building a sustainability plan and continues to seek solutions to fight flooding of the Detroit River in certain pockets of the city. It also anticipates that federal infrastructure act funding will yield substantial investment in lead pipe removal, road repair, and broadband expansion.

Outlook

The positive outlook reflects our view of Detroit's recent revenue growth and forecasts showing that it can follow through with its financial plan, at least in the near term. The positive outlook signifies at least a one-in-three likelihood that we could raise the rating over a one- to two-year outlook horizon.

Downside scenario

We could revise the outlook to stable if revenue growth slows and the city is unable to adjust its budget to limit draws on reserves. A stable outlook could also result if a predicted economic slowdown is worse than anticipated or if pension experience disrupts budgetary plans or leads to accelerated draws from the RPF.

Upside scenario

All else equal, we could raise the rating if it becomes apparent that RPF draws will not accelerate over the next several years, increasing the certainty that pension contributions can be absorbed within the operating budget. Ongoing revenue growth and improvements in macroeconomic conditions could also contribute to a higher rating.

Credit Opinion

Recovering employment and population trends, though low socioeconomic metrics remain a limiting credit factor

Detroit anchors the Detroit-Warren-Dearborn metropolitan statistical area, which we consider broad and diverse, and supports about half of the payrolls and population in the state. The city's projected per capita effective buying income is at 50% of the national level. Per capita market value has risen to more than $45,000 amid consecutive years of price appreciation. Detroit's estimated 2021 population was 654,188, essentially flat over the past five years, marking an improvement over historical declines. Somewhat tempering these weak fundamentals is a revenue profile reaching beyond city boundaries, with substantial operating revenue coming from statewide sales taxes, nonresident commuter income taxes, and visitors to casinos (and, more recently, anyone in the state partaking in internet gambling).

The pandemic had an outsized effect on lower-wage earners, and the leisure and entertainment industry continues to have a slow recovery. Employment has recovered to pre-pandemic levels, powered by growth in "blue collar" and manufacturing employment. Forecasts through 2027 from the University of Michigan and S&P Global Ratings show employment rising but growth rates slowing across the metro area, particularly among positions requiring advanced degrees. City unemployment remained above 8% as of the latest reading, though this is down compared with the 20-year average. Labor force participation rates remain well below pre-pandemic and historical levels, presenting labor availability challenges that could hinder economic development efforts.

General Motors, Ford, and Stellantis recently embarked on more than $5.4 billion in investments that could create more than 11,000 jobs within the city, and several other major investments are taking place in plants just outside the city that could employ residents. In total, more than 20,000 new jobs are expected to be created in Detroit over the next few years. Many of these jobs reflect automakers' increasing shift to electric vehicles (EVs), from which this region is strategically positioned to benefit. However, a variety of emerging factors could disrupt Detroit's auto sector,

including international competition and uncertainty as to how traditional market dynamics will fare during the mass transition to EVs, labor availability and skill sets required for modern vehicles, disruption in the auto component manufacturing industry and new supply chain dynamics, and the comparatively high retail price for EVs.

Prolonged weakness in Detroit's commercial real estate could become a pressure, particularly in office space, as Detroit has an above-average reliance on commercial property (50%) and its 10 largest payers, mostly commercial, make up 24% of the base. Rocket Cos., the parent company to Rocket Mortgage, is the largest employer in the city (around 18,000 employees) and owns significant real estate. District Detroit, a $1.5 billion mixed-use development project, continues to move forward and could accelerate the resurgence of the core downtown area. A newly announced $1.8 billion investment by Henry Ford Health for a hospital and research center includes plans to anchor a broader $2.5 billion mixed-use development, and could further support the local economy.

Detroit continues to prioritize investing in its residents, and around $800 million in American Rescue Plan Act funds will accelerate this. The focus is on continued blight and abandoned building removal, streetscaping, and beautification projects, all of which have proven to increase home values and public safety, along with people projects such as paying for job training and degree attainment, improving internet access, and facilitating record expungements, which help better position residents for jobs. Detroit Public Schools should also benefit greatly from nearly $800 million in stimulus funds. Confidence in the school district is likely to remain a key factor in reinvigorating the city's economy.

Well-managed budgetary position and growing ability to absorb pension payments, though legacy challenges continue to pose long-term credit risks

Fiscal 2022 marked the 10th consecutive year that Detroit had positive results in its general fund. Detroit increased its available fund balance position to $572 million (55% of 2022 expenditures) and built its RPF, a restricted balance, to $473.4 million with additional deposits made in fiscal 2023. RPF balances will help the city offset actuarially-based pension contributions starting in fiscal 2024. Solid revenue growth, strong fiscal controls, and a fixed-cost environment benefiting from the post-bankruptcy POA supported these results. We believe Detroit's financial controls, robust planning efforts, and robust cash and reserve and position provide the city high resiliency to near-term financial challenges. However, we believe the city's reserve and liquidity positions may have peaked following the receipt of federal stimulus funds and plans to spend down unassigned reserves through fiscal 2024. In addition, we believe Detroit faces a variety of challenges that could lead to the rapid deterioration of reserves if budgetary and pension-related assumptions do not hold up for the next several years.

Per our methodology, Detroit continues to exhibit signs of structural imbalance. This determination largely stems from our view of actuarially based pension contributions beginning in fiscal 2024 that will require material support from accumulated reserves. Detroit's 10-year pension holiday, as stipulated by the POA, allowed it to forgo contributions to its bankruptcy-adjusted legacy pension plans. To prepare for fiscal 2024, Detroit made regular deposits to the RPF. However, historical deposits to the RPF and 2024 legacy pension contributions made from recurring revenue are significantly below actuarial amounts. Actuarially based legacy pension contributions for fiscal 2024 are equal to $148.9 million, or 11.4% of budgeted recurring expenditures. The city will utilize $57.2 million in RPF draws and $18.7 million in bankruptcy-related external revenue to help meet this amount, leaving net contributions of approximately $73.0 million from recurring revenue. Given plan demographics and assumptions, contributions may exhibit volatility. In addition, supplemental 2023 appropriations call for the near-complete spend-down of unassigned reserves, although

these plans are for one-time uses, with a minority component increasing more dedicated reserves, such as recapitalizing the risk management fund (the city is self-insured for most types of liability) and increasing the budget reserve to $150 million.

The fiscal 2024 budget and four-year financial plan is balanced only with the use of the RPF to meet pension contributions. The budget and four-year financial plan includes conservative revenue assumptions, with most major revenue sources budgeted in line with or below actual revenue received in fiscal 2022. This is material, considering revenue is estimated up 5.3% in fiscal 2023 over fiscal 2022 actual results. Revenue forecasts incorporate the likelihood of a mild recession in 2023 or 2024, in line with our own forecasts.

The city's revenue is well diversified, in our opinion. Income taxes constitute 30% of 2024 general fund revenue, followed by wagering taxes at 21%, state shared revenue at 18%, and property taxes at 11%. However, overall economic sensitivity has increased along with wagering taxes, growing by $100 million in fiscal 2022 (74% increase). All online wagering must go through one of the city's three casinos or a tribal casino, allowing the city to collect from users across the state. Nonresident income taxes are a large share of total income taxes, highlighting that Detroit's tax base is partly diversified beyond the city itself, which we view positively. The city estimates income tax losses from remote work at around $26 million annually, though the long-term impact of remote work remains a credit risk. We note that the operating budget does not include the use of federal stimulus funds.

Detroit consistently has very strong liquidity, closing fiscal 2022 with nearly $1.4 billion in total government cash. It collects most major revenue streams either monthly or bimonthly, supporting steady cash flow throughout the year.

Expenditures in the 2024 budget and financial plan include scheduled increases in fixed costs and labor costs as well as a return to full general fund subsidies of the transportation fund. Total general fund spending for fiscal 2024 is up 14% over the 2023 original budget, with new nonpension costs making up most of the increase. Growing wages and tight labor market conditions represent a long-term budgetary pressure. This is particularly acute given competition from neighboring communities for public safety staff. However, in September 2022 the city reached an agreement with its police union through 2027, offering predictability for a historically sensitive and significant component of the budget, at approximately 30% of general expenditures.

Estimated average annual revenue growth from 2025 through 2027 is at 1.9% compared with 1.6% for expenditures following the pension-related jump in fiscal 2024. The city's 10-year financial plan shows balance through 2032 (including RPF draws), an improvement from last year's long-term forecasts that highlighted an imbalance beginning in 2027. Changes in macroeconomic conditions, online wagering market dynamics, auto manufacturing, and pension contributions (as a result of negative experience or changes to assumptions) are some of the key uncertainties in achieving long-term balance. The forecast also excludes the use of fund balance for one-time projects, which presents a key area of uncertainty regarding longer-term reserves and liquidity. The forecast and the city's financial plan do not include revenue from planned economic development, and we view the overall assumptions and projections as fairly conservative. Per city policy, Detroit plans to maintain at least 5% of expenditures in its budgetary reserve fund ("rainy day" fund, designated as "assigned" in its audits), and the balance is about 11% of 2024 budgeted expenditures. In addition, we believe the city's financial management practices provide strong budgetary controls and adaptability that was not necessarily present in the city's pre-bankruptcy environment.

With the city's socioeconomic challenges extending to its tax base, we view the city's ability to raise new revenue as somewhat limited. Comparatively low current-year property tax collections (though they have improved to 85% from 80% five years ago) and a rapidly rising allowance for doubtful accounts among utilities highlight some of these challenges. Nonresident wage growth compared with resident wages also highlight some of these challenges. Furthermore, despite management financial strengths, expenditure levels and service provision are highly political and may face resistance to cuts. For example, transportation fund operations are highly dependent on general subsidies and the city has no plans to scale back services. Thus, while the prospects for Detroit's finances are brighter than they've been in decades, the city remains exposed to nuanced challenges that could be difficult for it to manage.

Supportive financial management practices with an institutionalized goal of sustaining long-term resiliency

We consider Detroit to have good financial policies and practices under our financial management assessment methodology, although the management assessment remains weak as it is constrained by our view of the budget gap that would exist without the pension holiday and the RPF reserves.

Detroit performs a formal historical trend analysis--encompassing both revenue and expenditures--that is updated annually and has a biannual revenue-estimating conference to help it stay on track with projections and remain disciplined in budgeting. Budget-to-actual results are provided to the Financial Review Commission (FRC) and city council monthly, and a new investment policy requires quarterly reporting to the city council on investment holdings. The city has a comprehensive debt policy that provides parameters for the issuance and use of debt, as well as limitations/ranges to limit debt burdens on the budget and residents' tax bills. Also, the city must keep a budget reserve of at least 5% of appropriations to remain in compliance with the requirements of the Home Rule City Act.

Detroit annually updates a four-year financial projection in accordance with the Home Rule City Act, and also has a five-year capital plan that it must update biennially. By administrative order, the city reviews policies annually unless the CFO determines a review is not necessary.

Financial Review Commission and the Home Rule City Act

The FRC continues to waive oversight, and we do not anticipate it reversing course. If it determines that Detroit is in a deficit or at increased financial risk, it could rescind its waiver and return to full oversight (for a minimum of three years). This would create additional layers of budget and contract approval and more reporting, though officials would maintain control and run day-to-day operations. Regardless of the presence of the FRC, Detroit is subject to provisions of the Home Rule City Act (amended in 2014).

The commission was put in place after the city's December 2014 exit from Chapter 9 to monitor compliance with POA requirements, such as the maintenance of balanced budgets. The city will seek a sixth one-year waiver from direct state oversight in late spring/early summer.

Large legacy pension liabilities remain a negative credit factor, though no pressure from post-bankruptcy hybrid plans and no other postemployment benefit pressures

The significant liabilities associated with Detroit's legacy pension plans remain extremely high, though the amortization of the unfunded component will finally begin in fiscal 2024. New actuarially based costs are elevated compared with the general fund budget at 11.4% of expenditures, but long-standing plans to utilize RPF balances will

support these costs during the transition toward full responsibility from recurring revenue. Under level-dollar amortization, these costs will decline as the budget grows--assuming actuarial assumptions are met, on average.

The city has the following pension plans (as of a June 30, 2022, valuation date, on an actuarial basis):

- General Retirement System (GRS) Component II (single-employer defined benefit legacy plan), 62.7% funded with an unfunded liability of $909 million
- Police and Fire Retirement System (PFRS) Component II (single-employer defined benefit legacy plan), 74.9% funded with an unfunded liability of $820 million
- GRS Component I (hybrid), 105.2% funded with a net asset of $12 million
- PFRS Component I (hybrid), 104.7% funded with a net asset of $12 million

Detroit froze both its plans effective July 1, 2014. Active and retired employees continue to receive benefits, but at a reduced level, accrued up until this date under the old plan (legacy plan), and the new hybrid GRS and PFRS plans dictate benefits accrued thereafter. The POA outlined funding methods for the two legacy plans, including contributions from the library fund, Great Lakes Water Authority, Foundation for Detroit's Future, and Detroit Institute of Arts, and bond proceeds in escrow.

The POA dictates actuarial assumptions through fiscal 2024, including a level-dollar, 30-year amortization and a 6.75% discount rate, at which point the pension boards will determine a funding policy. The POA also set the hybrid plan contributions, which will be actuarially determined starting with fiscal 2024. Hybrid plan contributions are nominal in fiscal 2024 given the lack of an unfunded liability to amortize. We consider this plan to have many financially sound aspects, namely that it eliminates cost-of-living adjustments, increases employee contributions, and reduces benefits if certain funded ratios are not met.

Although we consider actuarially based contributions favorable to alternative methods, the assumptions that the POA and pension board set are permissive, in our opinion, and could lead to a rapid deterioration in plan funded status and untenable contributions if assumptions are not met. As the plans are closed and frozen, most members are retired (both plans have active-to-retiree ratios of less than 20%) and active members are near retirement. Considering these demographics, a discount rate of 6.75% could lead to contribution volatility, especially considering that investment objectives shift toward asset preservation as members age. In addition, despite level-dollar contributions, negative amortization is possible under both plans because amortization lengths (20 years for PFRS and 30 years for GRS) are significantly shorter than the average remaining age to retirement. In this scenario, investment returns and city contributions must "catch up" to benefit payments. If updated demographic studies reveal beneficiaries are living longer than in past studies, the risk of negative amortization and rising contributions increases. These outcomes may be tenable in the near term, as the city has the flexibility to offset higher contributions with RPF draws, but this could accelerate planned RPF draws and lead to general fund pressures should multiple years of negative experience occur. These dynamics make meeting actuarial assumptions particularly important over the next several years. A higher rating could depend partly on our understanding of how the city adjusts its budget and RPF draws as pension contributions change from year to year.

The PFRS pension board adopted a 20-year amortization in contrast to the POA, and this decision is being litigated.

We understand the GRS may take the same approach depending on the outcome. This would increase legacy GRS contributions by around $11 million but would improve the plan's long-term funding prospects compared to the 30-year amortization.

As part of the bankruptcy and POA, the city effectively eliminated its entire other postemployment benefit liability, leaving only a minimal supplemental death benefit plan. Not having such a liability is a strength among most large cities.

Moderately elevated debt burden and carrying charges relative to the budget

Detroit retains approximately $146.3 million in authorized but unissued debt capacity outstanding, but, considering unspent federal stimulus funds, the city is unlikely to issue additional debt over the next several years. Declining unlimited tax GO debt service and rising taxable values have led to plans to reduce the debt millage rate to seven mills from nine by 2025. Debt carrying charges are slightly above the city's target of 10% or less, yet below its 15% cap, as defined in the city's formal debt affordability metrics. All debt is fixed-rate, the city has no direct-purchase debt, and we see no contingent liability risks. However, high overall net debt (above 12% of market value, including overlapping debt) and our view of the city's large pension obligation ultimately weaken the debt assessment. As the city's debt amortizes and if additional debt plans remain muted, our view of its debt position could improve within the next several years.

The city issued GO debt in 2020 and 2021 at competitive rates and with no additional enhancements, signaling strong market access, if need be. During and after the bankruptcy, most debt was issued through the Michigan Finance Authority and carried added revenue pledges with intercept features.

Detroit, Michigan -- Key credit metrics

	Most recent	Historical information		
		2022	2021	2020
Very weak economy				
Projected per capita EBI % of U.S.	50.0			
Market value per capita ($)	45,083			
Population			654,188	655,610
County unemployment rate (%)			8.0	
Market value ($000)	29,492,806	23,909,798		
Ten largest taxpayers % of taxable value	24.0			
Adequate budgetary performance				
Operating fund result % of expenditures		10.1	(2.3)	1.1
Total governmental fund result % of expenditures		5.6	(8.8)	(11.8)
Strong budgetary flexibility				
Available reserves % of operating expenditures		54.8	53.3	45.1
Total available reserves ($000)		569,054	509,121	433,363
Very strong liquidity				
Total government cash % of governmental fund expenditures		65.4	63.3	61.1
Total government cash % of governmental fund debt service		543.8	531.1	602.3

Detroit, Michigan -- Key credit metrics (cont.)				
	Most recent	**Historical information**		
		2022	**2021**	**2020**
Weak management				
Financial Management Assessment	Strong			
Very weak debt & long-term liabilities				
Debt service % of governmental fund expenditures		12.0	11.9	10.1
Net direct debt % of governmental fund revenue	133.9			
Overall net debt % of market value	12.5			
Direct debt 10-year amortization (%)	46.6			
Required pension contribution % of governmental fund expenditures		6.8		
OPEB actual contribution % of governmental fund expenditures		0.0		
Strong institutional framework				
EBI--Effective buying income. OPEB--Other postemployment benefits.				

Data points and ratios may reflect analytical adjustments.

Related Research

Through The ESG Lens 3.0: The Intersection Of ESG Credit Factors And U.S. Public Finance Credit Factors, March 2, 2022

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