FitchRatings

One State Street Plaza
New York, NY 10004

T 212 908 0500 / 800 75 FITCH
www.fitchratings.com

February 14, 2003

Mr. Michael W. Hill
Director of Financial Planning
City of Lynchburg, VA
P.O. Box 60
Lynchburg, VA 24505

Re: City of Lynchburg, VA
$16,745,000
General Obligation Public Improvement Bonds, Series 2003A
$24,120,000
General Obligation Public Improvement Refunding Bonds, Series 2003B

Dear Mr. Hill:

Fitch Ratings has assigned a rating of "AA" to the above referenced issues.

Ratings assigned by Fitch are based on the documents and information provided to us by the City of Lynchburg, VA its experts and agents and are subject to receipt of the final closing documents. Fitch does not audit or verify the truth or accuracy of such information.

It is important that Fitch be provided with all information that may be material to the ratings so that they continue to accurately reflect the condition of the issues. Ratings may be changed, withdrawn, suspended or placed on Rating Watch due to changes in, additions to or the inadequacy of information.

Ratings are not recommendations to buy, sell or hold securities. Ratings do not comment on the adequacy of market price, the suitability of any security for a particular investor, or the tax-exempt nature or taxability of payments made in respect of any security.

The assignment of a rating by Fitch shall not constitute a consent by Fitch to use its name as an expert in connection with any registration statement or other filing under U.S., U.K., or any other relevant securities laws.

We are pleased to have had the opportunity to be of service to you. If we can be of further assistance, please feel free to contact us at any time.

Sincerely,

Daniel C. Champeau
Managing Director
Public Finance

DCC/em
cc: W. Frank Williams, III – BB&T Capital Markets
Donald G. Gurney – Hawkins, Delafield & Wood

Tax Supported
New Issue

Lynchburg, Virginia

Ratings

New Issues

General Obligation Public Improvement Bonds, Series 2003A .... AA
General Obligation Public Improvement Refunding Bonds, Series 2003B .... AA

Outstanding Debt

General Obligation Bonds .... AA

Analysts

Nelsie L. Smith
1 312 368-3143
nelsie.smith@fitchratings.com

Amy R. Laskey
1 212 908-0568
amy.laskey@fitchratings.com

Joseph D. Mason
1 703 245-3068
joseph.mason@fitchratings.com

Issuer Contact

Michael W. Hill
Director of Finance
1 434 847-1307

New Issue Details

$16,745,000 General Obligation Public Improvement Bonds, Series 2003A, and $24,120,000 General Obligation Public Improvement Refunding Bonds, Series 2003B, are scheduled to sell competitively on Feb. 19. The series 2003A bonds will mature serially Feb. 1, 2004–2033. Bonds maturing on or after Feb. 1, 2014 are subject to optional redemption at par beginning Feb. 1, 2013. The series 2003B bonds mature serially April 1, 2004–2014 and are not subject to optional redemption prior to maturity.

Security: Both series of bonds are general obligations of the city for which its full faith and credit are irrevocably pledged.

Purpose: The series 2003A bonds will finance various public improvements, including school renovations and water and sewer improvements. The series 2003B bonds will refund a portion of the city's outstanding series 1993 and series 1994 general obligation bonds.

■ Outlook

The 'AA' rating reflects the City of Lynchburg's strong financial management, moderate debt levels, and mature economy, with an above-average presence of manufacturing. The city achieved some success in attracting higher paying manufacturing jobs, although income levels remain below average. Future debt needs for the sewer system and the remediation of combined sewer overflow (CSO) are manageable, yet sewer system operations will remain pressured until the CSO program is completed.

■ Rating Considerations

Located east of Roanoke in the geographic center of Virginia, Lynchburg has effectively dealt with many of the challenges that face most economies historically focused on manufacturing while maintaining its role as a retail center for the large surrounding area. Lynchburg also serves as a regional provider of higher education and health care services. Unemployment increased to 5.0% as of November 2002 as a reflection of the shrinking technology and communication sector but consistently tracks below the national average. Income levels are below average, equaling 76.2% of the state and 84.6% of the national levels.

Financial management is strong, with consistent operating surpluses and prudent reserve levels. The city has formalized policies regarding fund balance reserves and debt affordability, better ensuring stable financial operations in the future. The city has also implemented several other new financial management practices in recent years, including quarterly reporting, revenue tracking, and mid-year budget reviews. As of June 30, 2002, the city's undesignated general fund balance equaled $18 million, or 15.7% of expenditures and transfers out, which is up from $10.3 million, or 9.2%, at the end of fiscal 2000.

Capital needs outside of the sewer system upgrades are minimal due to the absence of population growth and the presence of an established infrastructure. The six-year capital improvement program (CIP) addresses capital needs related to transportation, schools, and the water and sewer utility system. Approximately 16% of the $169 million fiscal years 2003–2008 capital program is related to the sewer system and compliance with a consent order regarding the CSO issue, which is down from 36% of the fiscal years 2002–2007 CIP. Virginia has given the city some flexibility in timing, as well as state grants and low-interest loans to aid in the separation of the storm sewer and sanitary sewer systems. Debt levels are moderate, and amortization is rapid. All general obligation bonds issued for use by city enterprise funds, excluding the airport, are self-supporting by the user fees charged by the respective operations.

Strengths

- Strong financial performance and management, with institution of formal policies.
- Increasingly diversified economy concentrated on manufacturing that also serves as the retail center for the surrounding area.
- Moderate debt levels, with manageable future capital plans.

Risks

- Limited flexibility in sewer operations with CSO consent order requirements.
- Below-average income levels.

Debt

Debt levels are moderate, with overall debt representing $1,490 per capita and 2.8% of market value. General obligation debt represents the majority of the city's total direct debt, representing close to 74% of all debt outstanding. General obligations issued for the water, sewer, and solid waste enterprise funds have been fully supported by fees charged by the respective systems. The new bond issue will finance school renovations, as well as capital projects within the sewer and water enterprise funds that will be supported by the respective system revenue.

Amortization of the city's total direct debt is above average, with 69.6% retired within the next 10 years. Debt amortization has slowed in recent years as the city has tried to better match debt repayments with the expected life of certain assets, such as water and sewer financed projects.

Approximately $125 million of the $169 million six-year CIP for fiscal years 2003–2008 is expected to be bond financed ($114.5 million general obligation bonds and $10.5 million revenue bonds), with the remaining portion consisting of pay-as-you-go financing and grant moneys. Capital needs related to schools and other general governmental requirements (including building, transportation, and parks and recreations improvements) will require larger direct investments from the city, estimated to total $104.7 million over the six-year period. Due to the city's maturity and population trends, the $45.6 million capital needs in the school system are focused on renovation and updating older school facilities. The city projects issuing general obligation bonds in amounts ranging between $19 million and $24 million annually between fiscal years 2004 and 2008. Self-supporting water and sewer systems and the improvements related to CSO projects comprise approximately $45.6 million of the total CIP. The city continues to adjust sewer rates and control spending to maintain the self-supporting nature of the enterprise fund.

The city council adheres to several debt affordability policies that guide capital planning and better ensure maintenance of manageable debt levels. These policies include restricting the use of short-term borrowing for current operations, limiting debt service expenditures to 10% of government expenditures, and maintaining tax-supported debt below 5% of assessed value and $2,000 per capita.

Debt Statistics

($000)

This Issue	40,865
Outstanding Debt	56,418
Total Direct Debt*	97,283
Overlapping Debt	0
Total Overall Debt*	97,283

Debt Ratios

Direct Debt Per Capita ($)**	1,490
As % of Market Value†	2.8
Overall Debt Per Capita ($)**	1,490
As % of Market Value†	2.8

*Excludes self-supporting water, sewer, and solid waste debt.
**Population: 65,300 (2001). †Market value: $3,466,111,000 (2002).

Combined Sewer Overflow

To comply with a special consent order issued in 1994, the city is working to separate the storm sewer and sanitary sewer systems, an operation that originally was expected to cost about $200 million. City officials, along with independent counsel, estimate that 89 of the 132 originally identified overflow points have been eliminated. Approximately $126 million of the original projected cost has been authorized and appropriated, yet revised cost projections in 2000 estimate an additional $199 million will be needed over the next 15–20 years to fully eliminate overflows.

Commonwealth and federal grants historically have decreased the financial burden of the CSO project on the city. Since 1998, the city has received federal grants for the CSO project, with matching grants from the commonwealth. Due to Virginia's current financial position, the city has not received its 2001 grant moneys to match those of the federal government, which will slow the progress of the CSO program. However, the commonwealth's environmental protection agency allows local governments to utilize low-interest loans through the state revolving funds (SRFs) to match federal grants, which means the city may issue the $10.5 million of revenue bonds through fiscal 2007 through the SRF program.

While the more costly and time-consuming components of the project remain outstanding, the special order sets three compliance guidelines based on financial capability, as opposed to fixed dates for completion. As of Dec. 3, 2002, the city was in compliance with the stipulations outlined in the order. Rates are adjusted annually to meet the maintenance of effort stipulation that the sewer bill be at least equal to 1.25% of median household income. In addition, the debt service coverage of 1.2 times (x) at the end of fiscal 2002 is consistent with the stipulated 1.1x–1.5x, and the sewer operating fund balance equaled the required 25% of the subsequent year's expenses.

Because of these restrictions and the uncertainty of future Virginia Department of Environmental Quality compliance orders, sewer fund operations will have limited financial flexibility until the completion of the project in an estimated 15–20 years. In addition, the loss of several large industrial users in fiscal 2001 resulted in a 10% increase in sewer rates on July 1, 2002 and the implementation of expenditure controls within the fund. The closing of Mrs. Giles Country Kitchen, a subsidiary of Bob Evans Farms Inc., and the temporary shutdown of a paper mill resulted in $650,000 of lost revenue in fiscal 2001.

Finances

The city's financial position is sound. The undesignated general fund balance at the end of fiscal 2002 improved to $18 million, or 15.7% of expenditures, from $10.3 million, or 9.2%, in 2000. The undesignated fund balance surpasses the city's target 10% level and is well above the 7% minimum requirement pursuant to city policy. Six months into fiscal 2003, the city was slightly behind budget. However, at the end of calendar 2002, the city implemented a hiring freeze and other cost control measures that should lead to balanced operations by the end of the fiscal year.

Due to the condition of the commonwealth's budget, the city is anticipating a decline of state-shared revenue of approximately $2 million throughout fiscal years 2003 and 2004. The cuts will be absorbed in social services and funding for constitutional officers and the regional jail. The city is managing its vacancies in each of these areas, as well as restructuring positions and pursuing grant moneys to fully absorb the anticipated loss in revenues.

The city designates 15% of annual revenue growth for strategic initiatives or emerging issues. Two-thirds of the 15% is being used to offset the city's increased obligations to the recently renovated Blue Ridge Regional Jail. The jail is operated by a regional jail authority from payments made by member jurisdictions. The remaining one-third of revenue was initially designated to fund the city's economic incentive program. However, officials report that the current budget climate requires a partial shift of these resources to other priorities. The city's business incentives require certain levels of investment within

Financial Summary — General Fund

($000, Audited Fiscal Years Ended June 30)

	2000	2001	2002
Revenues	108,283	112,954	115,524
Expenditures	79,422	77,364	78,647
Net Change	28,861	35,590	36,877
Transfers In	3,704	823	730
Transfers Out	0	(10,768)	(4,799)
Other Uses	(32,785)	(30,635)	(31,462)
Net Income	(220)	(4,990)	1,347
Total Fund Balance	27,377	21,235	22,582
As % of Expenditures, Transfers Out, and Other Uses	24.4	17.9	19.7
Unreserved Fund Balance	10,345	16,942	18,042
As % of Expenditures, Transfers Out, and Other Uses	9.2	14.3	15.7
Undesignated Fund Balance	10,345	16,942	18,042
As % of Expenditures, Transfers Out, and Other Uses	9.2	14.3	15.7

Note: Numbers may not add due to rounding.

set time frames, or the benefiting private entity is required to reimburse the city. All the businesses that have received economic incentives to date have fulfilled their investment obligations and often exceeded performance benchmarks.

Funding of the school budget is the largest single expenditure item of the city's general fund. School funding is a shared responsibility between the city and Virginia. Although the city annually allocates a contribution to the school budget, the city has no control over the use of funds. The school board is appointed by the city council, yielding the council greater control over school operations than school boards in other cities in Virginia that are separately elected. Enrollment trends have mirrored population stagnation, remaining flat to slightly declining over the past 10 years.

The solid waste fund, which is a city enterprise fund, experienced a slight operating deficit in fiscal years 2001 and 2002 due to revenue shortfalls attributable to private hauler contracts negotiated in 2001. During fiscal 2002, the city council authorized a comprehensive rate study to maintain the self-supporting nature of the system. As a result, in January 2003, the city implemented a $5 per month per household service charge, increased the private hauler tipping fee to $35 per ton from $32 per ton, and increased the tire disposal fee to $2.00 from $1.00. With these additional changes, Fitch Ratings anticipates the fund will resume positive operating activities over the next two fiscal years.

■ Economy

Manufacturing in Lynchburg is still important but has diversified as the city focuses on the attraction of industry with technologically advanced processes. The city's development of fiber-optic infrastructure is a key component in the economic strategy.

Ericsson, which was once the world's leading supplier in telecommunications and the city's second largest employer, recently reorganized its Lynchburg operations, spinning off into Sanmina-SCI and M/A-Com, with a net loss of approximately 1,400 employees. With M/A-Com planning to retain approximately 500 employees from the Ericsson layoffs and other leading employers (including NorCraft and Frito-Lay) in the process of expanding and creating additional jobs, the city should maintain the majority of its employment base. Other leading city employers include Central Health (3,800 employees), BWX Technologies, Inc. (1,940), GE Financial Assurance (1,607), Central Virginia Training Center (1,600), Lynchburg City Schools (1,554), and Framatome ANP, Inc. (1,400). Growth in the service sector continues, as Lynchburg maintains its position as a retail hub for the region. The proximity to numerous higher education institutions provides area employers with significant training opportunities and access to a more skilled work force.

Unemployment figures increased to 5.0% as of November 2002, representing the shrinking technology and communications sector, but remains below the 5.7% national average. The city adopted a proactive approach to economic development in response to the current environment. With increasingly limited human resources available, economic development has focused more on the retention and expansion of existing businesses. This allows the city to best utilize its mature employment base. The city population, approximating 65,300 in 2001, declined by 1% during the 1990s.

Recent relocations should have only modest effects on the overall economic environment. Mrs. Giles Country Kitchen, which employed approximately 150, moved out of the city. While the move is anticipated to have little impact on the city's employment base, the company, which produces refrigerated salads, was a large water and sewer customer. The lost water and sewer system revenue will likely be recovered from increased rates on residential customers, who have already experienced significant rate increases during the past five years to fund the remediation of the CSO problem.

Strong per capita retail sales reflect Lynchburg's established position as a retail center. Retail sales per capita in 2000 were 189% and 181% of state and national levels, respectively. Income levels are below average, with median household effective buying income equal to 76.2% and 84.6% of state and national averages, respectively. These numbers are a product of an economy concentrated on the manufacturing and service sectors and reflect the lower cost of living in areas of central Virginia.