

RatingsDirect®

Summary:

Somerville, Massachusetts; General Obligation

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Summary:

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Credit Profile

US\$8.602 mil GO mun purp loan bnds ser 2015 due 10/15/2040

<i>Long Term Rating</i>	AA+/Stable	New
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Somerville GO

<i>Unenhanced Rating</i>	AA+(SPUR)/Stable	Affirmed
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Many issues are enhanced by bond insurance.

Rationale

Standard & Poor's Ratings Services has assigned its 'AA+' long-term rating and stable outlook to Somerville, Mass.' series 2015 general obligation (GO) municipal purpose loan bonds. At the same time, Standard & Poor's affirmed its 'AA+' long-term rating, with a stable outlook, on the city's existing GO debt.

Somerville's full-faith-and-credit GO pledge, subject to the limitations of Proposition 2 1/2, secures the bonds. We understand bond proceeds will permanently finance bond anticipation notes (BANs) maturing Oct. 16, 2015, which were originally issued to fund various capital projects throughout the city.

The rating reflects our assessment of Somerville's:

- Very strong economy, with access to a broad and diverse metropolitan statistical area (MSA);
- Strong management, with "good" financial policies and practices under our financial management assessment (FMA) methodology;
- Strong budgetary performance, with balanced operating results in the general fund and an operating surplus at the total governmental fund level;
- Strong budgetary flexibility, with an available fund balance in fiscal 2014 of 14.6% of operating expenditures;
- Very strong liquidity, with total government available cash of 29.8% of total governmental fund expenditures and 7.0x governmental debt service, and access to external liquidity we consider strong;
- Adequate debt and contingent liability position, with debt service carrying charges of 4.2% of expenditures and net direct debt that is 41.0% of total governmental fund revenue, and low overall net debt at less than 3.0% of market value, but a large pension and other postemployment benefit (OPEB) liability and the lack of a plan to sufficiently address the obligation; and
- Strong institutional framework score.

Very strong economy

We consider Somerville's economy very strong. The city, with an estimated population of 78,357, is located in Middlesex County in the Boston-Cambridge-Newton, Mass. MSA, which we consider to be broad and diverse. The city has a projected per capita effective buying income of 127% of the national level and per capita market value of \$133,903. Overall, the city's market value grew by 11.1% over the past year to \$10.5 billion in 2015. The county unemployment rate was 4.6% in 2014.

Somerville is a fully developed 4-square-mile city adjacent to Boston and Cambridge. The city continues to sustain ongoing economic development within Assembly Square and Union Square driven by residential and commercial construction. These developments have led to continued new growth in the city's tax base, which management projects to be \$3.2 million in fiscal 2016, \$300,000 greater than the \$2.9 million initially budgeted. In addition, a new subway station is scheduled to open by 2018, which would provide additional access to the city limits of Boston.

Leading employers within the city include:

- Tufts University (2,193 employees);
- ABM Industries (2,000);
- Somerville School Department (1,100); and
- Cambridge Health Alliance (1,014).

Strong management

We view the city's management as strong, with "good" financial policies and practices under our FMA methodology, indicating financial practices exist in most areas, but that governance officials might not formalize or monitor all of them on a regular basis.

City management is conservative in its budgeting approach, and relies on historical data, as well as budget-to-actual results for revenue and expenditure assumptions. The management team also has biweekly meetings to monitor budget performance, and uses "SomerStat," a real-time monitoring program that provides current budget-to-actuals. The city maintains a five-year capital plan that identifies funding sources, and is currently being updated. Management has historically maintained a debt policy limiting debt service to 5% of budget and a formal reserve policy of maintaining stabilization reserves of at least 5% of expenditures. The city's investment policy is rooted in state statute, and holdings, as well as earnings are updated monthly internally and to the council as part of the budget update. We understand the city does not maintain a long-term revenue and expenditure forecast at present.

Strong budgetary performance

Somerville's budgetary performance is strong in our opinion. The city had balanced operating results in the general fund of negative 0.3% of expenditures, and surplus results across all governmental funds of 1.8% in fiscal 2014.

The city's budgetary performance is adequate in our opinion. Somerville had balanced operating results in the general fund of negative 0.3% of expenditures, and surplus results across all governmental funds of 1.8% in fiscal 2014.

Our total governmental fund calculation includes an \$8.7 million adjustment for one-time capital outlay financed by bond proceeds in the city's capital projects fund. The slight deficit in the general fund was primarily driven by transferring funds to the OPEB Trust and Community Preservation Fund.

Somerville's fiscal 2015 budget totaled \$220 million, and included a free cash appropriation of \$3.5 million. Although management indicates the fiscal year generated \$10.6 million in free cash, the city experienced a snow and ice shortfall of \$8.5 million due to the harsh winter. Consequently, management used \$3 million of the generated free cash, \$629,300 in operating transfers, and \$2 million in rainy-day stabilization funds to alleviate the shortfall, which still leaves a \$2.8 million deficit that management will be carrying over the next three fiscal years in order to raise the requisite tax revenue to close the gap. We understand the city will also be receiving about \$1.7 million in Federal

Emergency Management Agency aid within the next two years. For fiscal 2016, Somerville's budget totals \$228 million, and again includes a \$3.5 million free cash appropriation, which is in line with historical practice. The city's leading revenues sources include property taxes, state aid, and excise taxes at 55%, 32%, and 4% of general fund revenues, respectively. Current property tax collections are strong, in our opinion, averaging greater than 99% of the levy in the past five fiscal years.

Overall, we expect the city's budgetary performance will remain strong despite the significant snow and ice shortfall in fiscal 2015. The city's \$10.6 million generation of free cash, departmental turnbacks, and ability to carry the shortfall over three budget cycles alleviates our concern of significant deterioration in budgetary performance. At the same time, the city's leading revenue sources are stable and management has historically demonstrated an ability to make the necessary budget adjustments to align recurring revenues with recurring expenditures; therefore, we do not expect further deterioration in budgetary performance over the next two fiscal years.

Strong budgetary flexibility

Somerville's budgetary flexibility is strong, in our view, with an available fund balance in fiscal 2014 of 14.6% of operating expenditures, or \$30.4 million.

Our calculation includes adding \$8.9 million in committed stabilization funds, which are available with council approval. Somerville closed fiscal 2014 with \$30.4 million in available reserves, including an unassigned, assigned, and committed fund balance. While management used about \$3 million in free cash generated and \$2 million in stabilization funds to cover part of the snow and ice shortfall in 2015, the city's budgetary flexibility will remain strong, in our opinion. Furthermore, we believe the \$3.5 million in free cash appropriated to balance the 2016 general fund budget will be regenerated, as management has historically not drawn on this appropriation and uses it as part of its budgetary practices.

Very strong liquidity

In our opinion, Somerville's liquidity is very strong, with total government available cash of 29.8% of total governmental fund expenditures and 7x governmental debt service in 2014. In our view, the city has strong access to external liquidity if necessary.

Our calculation includes a \$29 million adjustment for bond proceeds and restricted cash in the city's capital projects fund and nonmajor governmental funds. We believe the city's strong access to external liquidity is supported by its frequent debt issuances including GO bonds and BANs. Despite the use of free cash and stabilization reserves in fiscal 2015, we expect the city will maintain its very strong liquidity metrics given its total governmental fund cash position.

Adequate debt and contingent liability profile

In our view, Somerville's debt and contingent liability profile is adequate. Total governmental fund debt service is 4.2% of total governmental fund expenditures, and net direct debt is 41.0% of total governmental fund revenue. Overall net debt is low at 0.9% of market value, which is in our view a positive credit factor.

After this issue, the city will have \$117.4 million in total direct debt outstanding, of which \$32 million is BANs. Management indicates it does not have significant debt plans in the next two years outside of the long-term financing of this issue of BANs.

In our opinion, a credit weakness is Somerville's large pension and OPEB liability, without a plan in place that we think will sufficiently address the obligation. The city's combined pension and OPEB contributions totaled 9.2% of total governmental fund expenditures in 2015. Of that amount, 5.3% represented contributions to pension obligations and 3.9% represented OPEB payments. The city made its full annual required pension contribution in 2015. The pension funded ratio is 57%.

We believe the costs associated with the city's long-term liabilities will continue to rise in the medium term given the pension system's current funding level, and the size of the unfunded liability. At the same time, we note that the city's efforts to reduce the OPEB liability has resulted in declines in each of the last four actuarial valuations. In addition, Somerville has established an irrevocable trust fund to begin funding its OPEB liability. The projected balance as of June 30, 2015, is \$806,323. Although we believe the establishment of the trust is a proactive step in addressing the liability, we do not view the current annual funding of \$200,000 to be a material amount relative to the unfunded liability, which is \$285.3 million as of June 30, 2014.

Strong institutional framework

The institutional framework score for Massachusetts municipalities is strong.

Outlook

The stable outlook reflects our view of Somerville's access to the Boston MSA and ongoing economic growth, which will continue to benefit the local tax base. We believe the city's strong management conditions and improving economic outlook should provide an environment for a consistent and balanced budgetary performance, as well as maintenance of strong budgetary flexibility. For these reasons we do not expect to change the rating within the two-year parameter outlook of the outlook horizon.

Upside scenario

All else remaining equal, over time we could raise the rating if underlying fundamentals improve to levels commensurate with higher rated peer credits, and management demonstrates an ability to maintain a strong budgetary performance, and sustained growth in available reserves while instituting a credible plan to mitigate the rising fixed costs associated with its pension and OPEB liabilities.

Downside scenario

Although not likely within the two-year parameter of the outlook period, if Somerville's high pension and OPEB costs materially affect its operating profile resulting in a trend of weak budgetary performance and a significant decline in available reserves, we could lower the rating.

Related Criteria And Research

Related Criteria

- USPF Criteria: Assigning Issue Credit Ratings Of Operating Entities, May 20, 2015
- USPF Criteria: Local Government GO Ratings Methodology And Assumptions, Sept. 12, 2013
- Criteria: Use of CreditWatch And Outlooks, Sept. 14, 2009

- USPF Criteria: Debt Statement Analysis, Aug. 22, 2006
- USPF Criteria: Financial Management Assessment, June 27, 2006
- USPF Criteria: Limited-Tax GO Debt, Jan. 10, 2002

Related Research

- Institutional Framework Overview: Massachusetts Local Governments

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