

## Rationale

S&P Global Ratings has assigned its 'AA+' rating to Somerville, Mass.' series 2017 general obligation (GO) refunding bonds. At the same time, S&P Global Ratings affirmed its 'AA+' rating on the city's GO debt outstanding. The outlook is stable.

Somerville's full-faith-and-credit GO pledge, subject to Proposition 2 1/2 limitations, secures the bonds. Despite the limitations from the state levy limit law, we do not make a rating distinction for the limited-tax GO pledge given the city's reserves and budgetary flexibility under the levy cap. Bond proceeds will refund portions of the series 2006, series 2009, and series 2010 bonds for present value savings.

The rating reflects our opinion of the following factors for Somerville:

- Very strong economy, with access to a broad and diverse metropolitan statistical area (MSA);
- Very strong management, with strong financial policies and practices under our Financial Management Assessment (FMA) methodology;
- Strong budgetary performance, with operating surpluses in the general fund and at the total governmental fund level in fiscal 2016;
- Very strong budgetary flexibility, with an available fund balance in fiscal 2016 of 18% of operating expenditures;
- Very strong liquidity, with total government available cash at 30.9% of total governmental fund expenditures and 7.4x governmental debt service, and access to external liquidity that we consider strong;
- Weak debt and contingent liability profile, with debt service carrying charges at 4.2% of expenditures and net direct debt that is 59.5% of total governmental fund revenue, and significant medium-term debt plans, as well as a large pension and other postemployment benefits (OPEB) obligation and the lack of a plan to sufficiently address it, but low overall net debt at less than 3% of market value; and
- Strong institutional framework score.

### *Very strong economy*

We consider Somerville's economy very strong. The city, with an estimated population of 79,743, is located in Middlesex County in the Boston-Cambridge-Newton MSA, which we consider to be broad and diverse. The city has a projected per capita effective buying income of 132% of the national level and per capita market value of \$158,767. Overall, the city's market value grew by 13.1% over the past year to \$12.7 billion in 2017. The county unemployment rate was 3.0% in 2016.

Somerville continues to see significant new development and population growth, leading to increased market values and incomes. Market values have risen more than 20% in the past three years, to about \$13 billion in 2017. We expect development to continue as the city and state plan to fund an extension to the Massachusetts Bay Transportation Authority's light rail that will add four Green Line stops in Somerville. City officials report the contract was recently awarded and construction is to begin in 2018. Officials also report extensive redevelopment plans that will add 1.4 million square feet of commercial space and 900-1,000 housing units in the Union Square area, which will have light rail service to downtown Boston with the Green Line extension.

Development continues in the Assembly Square area, with projects including new residential and commercial properties, as well as a new hotel. Officials also note that a project in neighboring Cambridge will be partially in Somerville, with a 300-square-foot office and lab building that will add to the city's ratable base. Services and road access will be provided by Cambridge, which Somerville expects will limit the effect on the city's finances. Overall, given the positive development trends, we expect Somerville's economy to strengthen.

#### *Very strong management*

We view the city's management as very strong, with strong financial policies and practices under our FMA methodology, indicating financial practices are strong, well embedded, and likely sustainable.

In our opinion, Somerville management is conservative in its budgeting approach, and relies on historical data, forward-looking projections, and budget-to-actual results for revenue and expenditure assumptions. The management team has biweekly meetings to monitor budget performance, and uses SomerStat, a real-time monitoring program that provides current budget-to-actual comparisons. The city maintains a 10-year capital plan that identifies funding sources, and a 10-year long-term financial plan. It updates both annually. Management has a formal debt management policy, and a formal reserve policy of maintaining stabilization reserves of at least 5% of expenditures. Somerville's investment policy is rooted in Massachusetts statute. Holdings and earnings are updated monthly internally and reported to the Board of Aldermen annually as part of the budget process. The city discloses policies and practices as part of its budget documents, which are publically available on its website, and complies with all of its policies.

#### *Strong budgetary performance*

Somerville's budgetary performance is strong in our opinion. The city had operating surpluses of 1.9% of expenditures in the general fund and of 3.1% across all governmental funds in fiscal 2016.

After adjusting for recurring transfers into the general fund from enterprise funds as well as capital projects funded with bond proceeds, Somerville's performance continues to be strong, in our view. Management

attributes recent surpluses to revenues exceeding budgeted estimates, particularly for meals, hotel, and motor-vehicle taxes. Unaudited fiscal 2017 results indicate another strong year. Management reports revenues exceeded expectations, and expenditures were about 3% below budgeted. Somerville plans to deposit about \$5 million of the expected fiscal 2017 surplus into the city's stabilization funds.

The fiscal 2018 budget continues the trend of decreasing the amount of reserves appropriated into the budget; the city used \$2 million of free cash, down from \$3 million in fiscal 2017. So far in fiscal 2018, revenues are exceeding expectations, partially from strong meals taxes. Expenditures are in line with expectations.

Somerville's leading revenues sources include property taxes, state aid, and excise taxes at 59%, 27%, and 4% of general fund revenues, respectively. Property tax collections are strong, in our opinion, averaging more than 99% of the levy in the past five fiscal years. The city's leading revenue sources are stable and management has historically adjusted the budget as needed to align recurring revenues with recurring expenditures. Overall, given the economic growth in Somerville and management's conservative budgeting practices, we expect the city's budgetary performance to remain strong.

#### *Very strong budgetary flexibility*

Somerville's budgetary flexibility is very strong, in our view, with an available fund balance in fiscal 2016 of 18% of operating expenditures, or \$38.5 million.

Our calculation includes \$17.1 million in committed stabilization funds, which are available with Board of Aldermen approval. Fiscal 2017 preliminary results indicate the city fully regenerated reserves used in the budget and will add about \$5 million to its fund balances. Management is committed to reducing the amount of free cash used to balance the budget, with the goal of no longer relying on free cash in 2020. Given management's proven ability to replenish appropriated reserves and commitment to maintaining fund balances, we expect the city's budgetary flexibility to remain very strong.

#### *Very strong liquidity*

In our opinion, Somerville's liquidity is very strong, with total government available cash at 30.9% of total governmental fund expenditures and 7.4x governmental debt service in 2016. In our view, the city has strong access to external liquidity if necessary.

Our calculation excludes restricted cash in Somerville's capital projects fund and non-major governmental funds. We believe the city's frequent debt issuances, including GO bonds and bond appreciation notes, supports its strong access to external markets. Somerville does not invest aggressively and is not exposed to variable-rate or

privately placed debt. Despite the use of free cash and stabilization reserves in fiscal 2017, we expect the city will maintain its very strong liquidity metrics given its total governmental fund cash position.

*Weak debt and contingent liability profile*

In our view, Somerville's debt and contingent liability profile is weak. Total governmental fund debt service is 4.2% of total governmental fund expenditures, and net direct debt is 59.5% of total governmental fund revenue. Negatively affecting our view of the city's debt profile is its significant medium-term debt plans. Overall net debt is low at 1.2% of market value, which is in our view a positive credit factor.

In accordance with the capital improvement plan and approved debt exclusions, Somerville will issue about \$122 million of additional debt over the next two years. This includes bonding for the Green Line extension project and for a new high school. The issuance would bring total direct debt to about \$240 million by 2019, depending on the timing of issuances and any changes to amortization schedules. The city's 10-year amortization rate on long-term debt outstanding is 60%. We have factored these plans into our overall assessment of Somerville's debt profile.

In our opinion, a credit weakness is Somerville's large pension and OPEB obligation, without a plan in place that we believe sufficiently addresses it. The combined required pension and actual OPEB contributions totaled 9.1% of total governmental fund expenditures in 2016. Of that amount, 5.6% represented required contributions to pension obligations, and 3.6% represented OPEB payments. The city made its full annual required pension contribution in 2016. The funded ratio of the largest pension plan is 62.5%.

The city participates in the Somerville Contributory Retirement System, a cost-sharing, multiple-employer defined-benefit pension plan. As of June 30, 2016, the city reported a liability of \$134.3 million for its proportionate share of the net pension liability. As of the most recent valuation on Dec. 31, 2015, the plan fiduciary net position as a percent of the total pension liability, as defined in Governmental Accounting Standard Board (GASB) Statement No. 67, was 62.56%, down from 65.52% the previous year. While Somerville is paying its full actuarially determined contribution annually with the intention to fully fund the plan by 2033, success is contingent upon aggressive assumptions and methods, such as a discount rate of 8.25% and a deferral of contributions assuming annual increases based on 4% payroll growth.

Somerville is also a member of the Massachusetts Teachers' Retirement System (MTRS), a cost-sharing multiple employer defined benefit plan. The city does not make an annual contribution, as the commonwealth is responsible for the contributions and future benefits payments for MTRS.

Somerville provides postemployment health-care and life-insurance benefits for qualifying retirees. The city finances benefits on a pay-as-you-go basis, although it does have an OPEB trust with a balance of \$814,000 as of June 30, 2016. This leaves the city with an unfunded actuarial accrued liability of \$301.8 million as of its most recent valuation of June 30, 2016.

The city is managing these costs in its budget and is seeking ways to better address these liabilities, including moving a portion of the \$13 million in Somerville's health-care trust into its OPEB trust fund. However, given that these plans are not yet in place and have not been proven to significantly reduce these long-term liabilities, we believe the costs associated with Somerville's long-term liabilities will continue to rise in the medium term, given the pension system's funding level and the unfunded OPEB liability's size.

#### *Strong institutional framework*

The institutional framework score for Massachusetts municipalities is strong.

## **Outlook**

The stable outlook reflects our view of Somerville's very strong local economy and ongoing economic growth, which we believe will continue to benefit the local tax base. Access to the broad and diverse Boston MSA and the city's strong management lends additional stability to the rating. Therefore, we do not expect to raise or lower the rating over our two-year outlook horizon.

#### *Upside scenario*

Beyond that time, holding all other credit factors equal, we could raise the rating if Somerville reduces its overall debt burden and addresses the city's rising fixed costs associated with its pension and OPEB liabilities, while continuing to see economic growth.

#### *Downside scenario*

If Somerville's rising fixed costs lead to budgetary pressure that causes operating performance to deteriorate and reserves to decline, we could lower the rating.