Summary:

Somerville, Massachusetts; General Obligation

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Many issues are enhanced by bond insurance.

Rationale

S&P Global Ratings has assigned its 'AA+' long-term rating and stable outlook to the City of Somerville, Mass.' series 2016 bonds. At the same time, S&P Global Ratings affirmed its 'AA+' long-term rating on the city's general obligation (GO) debt outstanding.

Somerville's full-faith-and-credit pledge, subject to the limits of Proposition 2 ½, secures the bonds. We understand bond proceeds will be used to provide district improvement financing for Assembly Square and Union Square, finance school and street repairs, and pay for upgrades at a playground, among other capital projects.

The rating reflects our assessment of Somerville's:

- 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 2015;
- Very strong budgetary flexibility, with an available fund balance in fiscal 2015 of 16% of operating expenditures;
- Very strong liquidity, with total government available cash at 31.7% of total governmental fund expenditures and 6.8x governmental debt service, and access to external liquidity we consider strong;
- Weak debt and contingent liability position, with debt service carrying charges at 4.7% of expenditures and net direct debt that is 45.3% of total governmental fund revenue, and significant medium-term debt plans and a large pension and other postemployment benefit (OPEB) obligation and the lack of a plan to sufficiently address the obligation, 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 79,143, 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 127% of the national level and per capita market value of $141,500.
Overall, the city's market value grew by 6.7% over the past year to $11.2 billion in 2016. The county unemployment rate was 4.0% in 2015.

Somerville is a densely packed residential city adjacent to Boston and Cambridge. It has long served a middleclass and immigrant demographic, but is seeing a shift toward young professionals and high income individuals. Leading employers within the city include Tufts University (2,193 employees); ABM Industries (2,000); Somerville School Dept. (1,100); and Cambridge Health Alliance (1,014). Partners Healthcare Health Care, the state's largest healthcare system and biggest employer, just recently completed a 13-story, 825,000-square-foot administrative office in Assembly Square, which will eventually employ 4,200. The development complements other construction in Assembly Square, including the pending construction of a hotel, a condominium building, and a 450-unit rental apartment.

In the fall of 2015, the state halted progress on a subway extension project to bring the Green Line seven stops through Somerville, Cambridge, and Medford due to escalating costs. Owing, in part, to a strong pushback from local communities and an additional $75 million pledged by Somerville and Cambridge to the project, Massachusetts transportation officials agreed to move forward with a scaled-down version of the extension. The completion date is currently targeted for the spring of 2022, although several stations may come online before then.

Given the pending impact of the Green Line extension and continued development in Assembly Square, we expect Somerville's economy, which is already very strong, to improve in the coming years with higher market values and improved income levels. This, combined with the city's efforts to increase its commercial tax base, will contribute to an even stronger underlying economy.

**Very strong management**

We revised our assessment of the city's management to "very strong' from "strong" based on the presentation of a long-term financial plan, which we believe demonstrates that the city is forward-thinking in budgeting for revenues and expenditures. Under our FMA methodology, an assessment of very strong indicates that financial practices are strong, well embedded, and likely sustainable.

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 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 long-term financial plan, both of which are updated annually. Management has historically maintained a debt policy limiting debt service to 6% 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 internally on a monthly basis and reported to the Board of Aldermen as part of the budget update.

**Strong budgetary performance**

Somerville's budgetary performance is strong in our opinion. The city had operating surpluses of 1.8% of expenditures in the general fund and of 3.3% across all governmental funds in fiscal 2015.

Our total governmental fund calculation includes a $12.5 million adjustment for one-time capital outlay financed by bond proceeds in the city's capital projects fund.
Somerville officials report an $8 million surplus on a budgetary basis in 2016 owing to high collections on economically sensitive revenues (such as motel, meal, and motor vehicle taxes) and strong budget oversight. For fiscal 2017's budget, management anticipates a 4.9% increase and a $2.5 million free cash appropriation, which is in line with historical practice.

In the future, the city will use less free cash to balance the budget and by 2020 will no longer need to appropriate free cash into the budget. Somerville's leading revenues sources include property taxes, state aid, and excise taxes at 57%, 26%, and 4% of general fund revenues, respectively. Current 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 demonstrated an ability to make the necessary budget adjustments to align recurring revenues with recurring expenditures; therefore, we anticipate the city's budgetary performance will remain strong.

**Very strong budgetary flexibility**

Somerville's budgetary flexibility is very strong, in our view, with an available fund balance in fiscal 2015 of 16% of operating expenditures, or $34.1 million.

Our calculation includes $13.9 million in committed stabilization funds, which are available with Board of Aldermen approval. While management used about $3 million in free cash and $2 million in stabilization funds to cover part of the snow and ice shortfall in 2015, Somerville's budgetary flexibility is improved. We believe the $2.5 million in free cash appropriated to balance the 2017 general fund budget will be regenerated, as management has historically not drawn on this appropriation. Over the next two fiscal years, we expect the city's budgetary flexibility will remain at least strong as management does not have plans to draw on reserves.

**Very strong liquidity**

In our opinion, Somerville's liquidity is very strong, with total government available cash at 31.7% of total governmental fund expenditures and 6.8x governmental debt service in 2015. In our view, the city has strong access to external liquidity if necessary.

Our calculation includes a $32.9 million adjustment for bond proceeds and restricted cash in the city's capital projects fund and nonmajor governmental funds. We believe Somerville's strong access to external liquidity is supported by its frequent debt issuances, including GO bonds and bond anticipation notes (BANs). Despite the use of free cash and stabilization reserves in fiscal 2015, we anticipate 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 4.7% of total governmental fund expenditures, and net direct debt is 45.3% 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 1.0% of market value, which is in our view a positive credit factor.

Our analysis factors in $50 million in bonding for the Green Line extension project and $130 million for a new high school. Although we recognize the proposal for a new high school has not been presented to voters, we chose to
include the additional debt into our analysis, to be conservative. After this issue, the city will have $129.3 million in total direct debt outstanding, of which $26.8 million is BANs.

In our opinion, a credit weakness is Somerville's large pension and OPEB obligation, without a plan in place that we think will sufficiently address the obligation. Somerville's combined required pension and actual OPEB contributions totaled 9.3% of total governmental fund expenditures in 2015. Of that amount, 5.2% represented required contributions to pension obligations, and 4.1% represented OPEB payments. The city made its full actuarial determined contribution in 2015. The funded ratio of the largest pension plan is 65.5%.

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. Using updated reporting standards in accordance with Governmental Accounting Standards Board Statement Nos. 67 and 68, the city's share of the net pension liability was about $127.9 million. The system was 65.5% funded as of June 30, 2015. At the same time, we note that the city's efforts to reduce the OPEB liability has resulted in declines in each of the past 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, 2016, is about $1 million. While we believe the establishment of the trust is a proactive step in addressing the liability, which was $285.3 million as of June 30, 2014, we also note the city has executed reforms on the liability side to manage its exposure. In future, OPEB funding will be made available from a health care trust that is estimated to be overfunded by $13 million. The city will continue with these transfers until the health care trust is no longer viewed as overfunded.

**Strong institutional framework**
The institutional framework score for Massachusetts 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 very strong management conditions and improving economic outlook should provide an environment for a consistent and balanced budgetary performance, as well as maintenance of very strong budgetary flexibility. For these reasons we do not expect to change the rating in the next two years.

**Upside scenario**
Over time we could raise the rating if economic indicators and underlying fundamentals improve to levels commensurate with higher-rated credits, and management demonstrates an ability to maintain a strong budgetary performance and sustain growth in available reserves while instituting a credible plan to mitigate the rising fixed costs associated with its pension and OPEB liabilities.

**Downside scenario**
While unlikely during our outlook period, if Somerville's operating performance were to become unbalanced, and cause a significant decline in available reserves, we could lower the rating.
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