

RatingsDirect®

Summary:

Somerville, Massachusetts; General Obligation; Note

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Credit Profile

US\$72.921 mil GO BANs ser 2021 dtd 05/25/2021 due 06/03/2022		
<i>Short Term Rating</i>	SP-1+	New
US\$31.25 mil GO mun purp loan bnds ser 2021 due 06/01/2051		
<i>Long Term Rating</i>	AA+/Stable	New
Somerville GO BANs ser A due 06/04/2021		
<i>Short Term Rating</i>	SP-1+	Affirmed
Somerville GO BANs ser 2021 dtd 05/25/2021 due 06/03/2022		
<i>Short Term Rating</i>	SP-1+	Affirmed

Rating Action

S&P Global Ratings assigned its 'AA+' long-term rating, with a stable outlook, to the City of Somerville, Mass.' \$31.3 million series 2021 general obligation (GO) municipal-purpose loan bonds and assigned its 'SP-1+' short-term rating to the city's \$72.9 million GO bond anticipation notes (BANs). We also affirmed our 'AA+' long-term rating on the city's existing GO debt and our 'SP-1+' rating on its existing BANs.

Somerville's full-faith-and-credit pledge secures the GO debt. The town's debt is subject to Proposition 2 1/2 limitations, but we do not make a rating distinction, as we rate the limited obligation at the same level as our view of Somerville's general creditworthiness. We rate the limited-tax GO debt based on the application of our "Issue Credit Ratings Linked To U.S. Public Finance Obligors' Creditworthiness" criteria (published Nov. 20, 2019).

Officials intend to use proceeds from the 2021 bonds for various municipal capital projects, and proceeds from the 2021 BANs will rollover existing BANs and provide new money for water, sewer, and other municipal capital projects.

Credit overview

The rating reflects the city's continued strong budgetary performance, with a consecutive surplus for the year and growth in the available fund balance to approximately 26% of expenses. The tax base continues to see growth with the ongoing green line transit project, construction of Puma's new North American headquarters, and additional residential developments. However, we believe the rating is constrained by the combined retirement liabilities of over \$300 million as well as, in our opinion, potential for cost escalation in contributions to crowd out other obligations.

The rating further reflects our opinion of the city'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 an operating surplus in the general fund and a slight operating surplus at the total governmental fund level in fiscal 2020;
- Very strong budgetary flexibility, with an available fund balance in fiscal 2020 of 26% of operating expenditures;
- Very strong liquidity, with total government available cash at 35.7% of total governmental fund expenditures and 8.5x governmental debt service, and access to external liquidity we consider strong;
- Very weak debt and contingent liability profile--while debt service carrying charges at 4.2% of expenditures and net direct debt that is 94.8% of total governmental fund revenue are affordable, in our opinion the size of the combined pension and OPEB obligations and, in our opinion, the lack of a sufficient plan to address the obligation, constrains the rating; and
- Strong institutional framework score

Environmental, social, and governance factors

Given the city's location, we find Somerville's environmental risks slightly elevated compared with peers. However, we feel the risks are mitigated by the city's multipronged approach for stormwater management, reduction in carbon emissions, and commitment to the Climate Change Vulnerability Assessment, as outlined in our management section below. We also evaluated Somerville's social and governance risks relative to the city's economy, financial measures, and management, and debt and long-term liability profile. We find both factors to be in line with the sector standard.

Stable Outlook

Upside scenario

We could look to raise the rating if Somerville manages the costs associated with development and addresses the city's rising fixed costs associated with its pension and OPEB liabilities, while continuing to see economic growth.

Downside scenario

While not anticipated, 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.

Credit Opinion

Very strong economy

We consider Somerville's economy very strong. The city, with an estimated population of 81,360, is located in Middlesex County in the Boston-Cambridge-Newton, MA-NH MSA, which we consider to be broad and diverse. The city has a projected per capita effective buying income of 141% of the national level and per capita market value of \$221,195. Overall, the city's market value grew by 14.9% over the past year, to \$18.0 billion in 2020.

Somerville is located five miles north of Boston and is a key economic hub in the greater Boston MSA. The city continues to see significant development and population growth, resulting in ongoing growth in market value and income levels. We expect development will likely continue because of the city and commonwealth's plan to fund an extension to Massachusetts Bay Transportation Authority's light rail, adding five Green Line stops in Somerville. City officials report construction is underway, with passenger service expected to begin in 2021, increasing the number of

residents with access to rapid mass transit within a short walk to 85% from 15%. Union Square will benefit from this access. Therefore, extensive redevelopment plans will add 1.4 million square feet of commercial space and 900-1,000 housing units in the area in coming years.

Somerville's Assembly Row development has been a notable contributor to increased market value and the growing economy in the past few years. The large development has so far created more than 860,000 feet of office space; 500,000 square feet of retail, restaurant, and entertainment space; and more than 1,000 new high-end residential units. It also includes a 750,000-square-foot headquarters for Partners HealthCare, the commonwealth's largest medical group, which the company built to consolidate its Boston area operations. Despite headwinds from the pandemic, Puma is continuing progress on moving its North American headquarters to Assembly Row, and will occupy a 275,000-square-foot office building featuring a ground-floor company store and many amenities. There are also various residential and commercial developments occurring at the site, with others in the planning stages, including a 525,000-square-foot commercial office building with a research and lab component; ground-floor retail and restaurants at Assembly Edge; and a planned 1.4-million-square-foot, mixed-use development by XMBLY. The Assembly Row site also remains an attractive and desirable area due to its direct access to Boston and Cambridge, Interstate 93, and an onsite subway station serviced by the Massachusetts Bay Transportation Authority.

Other parts of Somerville continue to see growth and development, which the city markets and supports with infrastructure projects. Union Square has steadily become a center for more tech-focused development, with Greentown Labs Inc. and other startups moving into the area and expanding in the past few years. In our opinion, the Green Line extension's completion in 2021 should support continued area growth. We also expect other areas of the city--such as Boynton Yards, where a new 1,500,000-square-foot commercial, retail, and residential project is planned--to experience economic expansion.

Overall, with the city's numerous completed and ongoing developments and transportation projects, the tax base continues to increase, growing an average of 10.6% annually over the past five years. Although growth continues, the city notes they may see some softness in commercial property valuations as they go through assessments for the calendar year 2020. The city anticipates a spike in abatements as a result, but maintains cushion in its annual overlays, which should help mitigate the budgetary impact.

With the economic pressures from the pandemic, the county unemployment rate mirrored national trends, peaking during the pandemic to a high of 12.9% in April 2020, but since recovering to 5.2% as of March 2021. With the continued resumption of economic activity and continued access to Boston, we expect the city's economy will likely continue to grow and remain very strong.

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, management budgets conservatively 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 and a 10-year,

long-term financial plan; it updates both annually. Management has formal debt management and reserve policies, maintaining stabilization reserves of at least 5% of expenditures. Somerville's investment policy is rooted in Massachusetts statute. Management internally updates holdings and earnings monthly and reports the results to the board of aldermen annually as part of the budget process. Management discloses policies and practices as part of budget documents, which are publicly available on its website, and complies with all policies.

Furthermore, Somerville has taken steps to mitigate exposure to cyber-related risks, and has been addressing concerns related to climate change that could directly affect taxable properties. In particular, in 2016 the city released a robust Climate Change Vulnerability Assessment to further understand how climate change can affect the community and inform its decision-making process. This assessment led to the creation of Somerville Climate Forward, the city's priority-based climate change plan. It includes a timeline of implementable actions Somerville will undertake to reduce the overall impact of climate change on the community. Items in the plan include exploring feasibility of a net-zero emissions-based performance standard, improving storm water management, and creating a community leadership program to educate the public and increase participation in climate programs. The plan extends out six years, after which the city will select new priority actions. In fiscal 2020, Somerville contributed \$400,000 for climate-resiliency efforts.

Strong budgetary performance

Somerville's budgetary performance is strong, in our opinion. The city had surplus operating results in the general fund of 2.3% of expenditures and slight surplus results across all governmental funds of 1.4% in fiscal 2020. General fund operating results have been stable, at 1.8% in 2019 and 1.5% in 2018.

For analytical consistency, we adjusted fiscal 2020 general fund and total governmental fund results to account for recurring transfers and capital costs funded from bond proceeds. Despite headwinds, the city ended the year with a surplus, continuing the trend of favorable performance over the past four years. Revenues came in approximately \$248,000 favorable to budget, driven by strong investment income. Property tax collections at the end of the fiscal year were down slightly, to 97%, below historical levels of around 99%. State legislative changes allowed cities to extend the due date for tax collections. Because of the adopted legislation, there was a delay in collections. The 97% collection rate does not reflect the \$1 million in collections between July and August 2020 bringing the collections in line with previous years. With respect to expenses, the city initiated a spending freeze, including holding capital projects. The city realized COVID-19-related expenses of approximately \$1.7 million, and set up a separate fund to capture expenses to ensure efficient reimbursement. A portion of the COVID-19 relief funding was used to support school technology costs.

For fiscal 2021, the city remained conservative in its budgeting practices, proposing a \$288.4 million budget, approximately 2.9% higher than fiscal 2020. The city reduced revenues associated with economically sensitive sources, including a 25% reduction in state aid estimates and 45% reduction in meals tax estimates. Revenues continue to remain strong: through April 2021, the city noted it has received 88% of its budgeted revenues and about 81% of expenses. As a result, the city anticipates at least balanced performance for the year.

The city is continuing to work through its fiscal 2022 budget, but anticipates remaining conservative with meals and hotel taxes as well as other revenue sources; however, strong continued growth in the property tax base, with nearly

\$9.5 million in new growth, should help provide stability. The city does not anticipate a use of free cash in the budget, in line with previous years.

Over the long term, we believe pension and OPEB costs could become a budgetary stress, given below-average funding ratios, limited local control, and somewhat aggressive assumptions. As long-term liability expenses increase, management is making budgetary adjustments to absorb them. Somerville funds its actuarially determined contribution (ADC) for pension costs, and is funding an OPEB trust. While we expect costs associated with pensions and OPEB to continue to rise, we expect the city will maintain stable operations despite these challenges.

Very strong budgetary flexibility

Somerville's budgetary flexibility is very strong, in our view, with an available fund balance in fiscal 2020 of 26% of operating expenditures, or \$68.4 million.

Our calculation includes about \$28 million in committed stabilization funds, which are available with board approval. In fiscal 2020, Somerville established a COVID-19 stabilization fund with a \$3 million appropriation of free cash and did not need to materially draw down its reserves during the year. With no anticipated inclusion of fund balance use in the city's fiscal 2022 budget and balanced performance expected for fiscal 2021, we anticipate budgetary flexibility will likely remain very strong.

Very strong liquidity

In our opinion, Somerville's liquidity is very strong, with total government available cash at 35.7% of total governmental fund expenditures and 8.5x governmental debt service in 2020. 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 nonmajor governmental funds. In our opinion, the city's frequent debt issuance, including GO bonds and BANs, supports its strong access to external markets. Somerville does not invest aggressively, and does not have any variable-rate or privately placed debt exposure. Despite the use of free cash and stabilization reserves in the budget, we expect the city will likely maintain very strong liquidity due to its total governmental-fund cash and ability to maintain stable operations and regenerate reserves.

Very weak debt and contingent liability profile

In our view, Somerville's debt and contingent liability profile is very weak. Total governmental fund debt service is 4.2% of total governmental fund expenditures and net direct debt is 81.0% of total governmental fund revenue.

With this issuance, the city will have about \$360 million of total direct debt, including \$72.9 million in BANs. Currently, the city does not have any finalized plans to issue debt in the next two to three years.

Pension and other postemployment benefits:

- In our opinion, a credit weakness is Somerville's large pension and OPEB obligation without a plan in place that we think sufficiently addresses the obligation, particularly given the pension system and OPEB trust's low funded ratios. The city will continue to escalate appropriations to the OPEB trust before 2033.
- While the use of an ADC is a positive, we believe some of the assumptions used to build the pension ADC reflect

what we view as slightly weak assumptions and methodologies that we believe increase the risk of unexpected contribution escalations. However, investment returns have remained strong, averaging 8.58% over the past five years.

- Although OPEB liabilities are funded on a pay-as-you-go basis, costs remain low despite the large liability, and we expect the city will continue adding to its OPEB trust fund.

As of June 30, 2020, the city participates in the following pension plan:

- Somerville Contributory Retirement System (SCRS): 66.18% funded, with a \$161.8 million proportionate share of the net pension liability.

Somerville's combined required pension and actual OPEB contributions totaled 7.2% of total governmental fund expenditures in 2020. Of that amount, 4.7% represented required contributions to pension obligations and 2.6% represented OPEB payments. The city made its full annual required pension contribution in 2020. While the system revised its discount rate downward, to 7.75% from 8.00%, we believe this discount rate is high for municipal systems and remains elevated above our 6.0% guideline, and could lead to volatile contributions should market performance not meet expectations. While Massachusetts requires all pension systems to achieve full funding no later than 2040, SCRS has planned to achieve full funding by 2033. We generally view closed, short amortization schedules as positive, but for SCRS to meet its adopted funding schedule to achieve full funding in 2033, costs must rise, given the low funded ratio and 4.5% payroll growth assumption. Furthermore, while the system met our static funding metric in the most recent year, indicating that the system is addressing current costs, it did not meet our minimum funding progress calculation, indicating that the system is not making headway in addressing its unfunded liabilities. Somerville is also a member of Massachusetts Teachers' Retirement System, a cost-sharing, multiple-employer, defined-benefit plan. The city does not make an annual plan contribution because the commonwealth is responsible for contributions and future benefit payments to the system.

Somerville also provides postemployment benefits in the form of health care and life insurance for qualifying retirees, but the city has set up an OPEB trust to prefund the liability. The city's actuary adjusted the discount rate to 7.5% from 3.75%, which was the main driver of the OPEB liability falling from \$278.5 million in 2019 to a \$147.6 million net OPEB liability. The city has traditionally funded OPEB through pay-as-you-go financing. As of June 30, 2020, the city maintained \$10.4 million in its OPEB trust, supporting a 6.58% funded ratio for the plan. The city has added its annual contribution, raising the trust to an estimated \$13.1 million. Officials indicate that by the end of fiscal 2021 they will have contributed \$1 million to the OPEB trust, and they plan to continue adding about \$1.2 million toward it annually.

Strong institutional framework

The institutional framework score for Massachusetts municipalities is strong.

Related Research

- S&P Public Finance Local GO Criteria: How We Adjust Data For Analytic Consistency, Sept. 12, 2013
- Criteria Guidance: Assessing U.S. Public Finance Pension And Other Postemployment Obligations For GO Debt, Local Government GO Ratings, And State Ratings, Oct. 7, 2019

- Through The ESG Lens 2.0: A Deeper Dive Into U.S. Public Finance Credit Factors, April 28, 2020

Ratings Detail (As Of May 19, 2021)		
Somerville GO muni purp loan ser 2020 due 10/15/2050		
<i>Long Term Rating</i>	AA+/Stable	Affirmed
Somerville GO mun purp loan bnds		
<i>Long Term Rating</i>	AA+/Stable	Affirmed

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