

Summary:

**Somerville, Massachusetts; General
Obligation; Note**

Primary Credit Analyst:

Anthony Polanco, Boston + 1 (617) 530 8234; anthony.polanco@spglobal.com

Secondary Contact:

Victor M Medeiros, Boston (1) 617-530-8305; victor.medeiros@spglobal.com

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Credit Profile

US\$63.151 mil BANs ser A due 06/05/2020		
<i>Short Term Rating</i>	SP-1+	New
US\$55.0 mil BANs ser B due 10/25/2019		
<i>Short Term Rating</i>	SP-1+	New
US\$26.92 mil GO muni purpose loans ser 2019 due 06/01/2047		
<i>Long Term Rating</i>	AA+/Stable	New
Somerville GO mun purp loan bnds		
<i>Long Term Rating</i>	AA+/Stable	Affirmed
Somerville GO BANs		
<i>Short Term Rating</i>	SP-1+	Affirmed

Rationale

S&P Global Ratings has assigned its 'AA+' long-term rating to Somerville, Mass.' series 2019 general obligation (GO) bonds, and affirmed its 'AA+' rating on the city's GO debt outstanding. At the same, time, S&P Global Ratings assigned its 'SP-1+' short-term rating to Somerville's series 2019A and B GO bond anticipation notes (BANs), and affirmed its 'SP-1+' rating on the city's existing short-term debt. The outlook on the long-term ratings is stable.

The long-term rating reflects our view of the city's stable and growing economy that continues to experience significant economic and transportation developments while maintaining access to the Boston metropolitan statistical area (MSA). In our view, the city's economic growth and conservative budgeting practices, with strong financial management policies and planning have led to continued positive financial operations and maintenance of its very strong budgetary flexibility and liquidity profile, with available reserves reaching 21% as of fiscal 2018. While Somerville's fixed costs remain manageable, we believe the city's retirement liabilities will remain a long-term credit risk.

The short-term BAN rating reflects our high investment-grade long-term rating and low market risk profile. In our view, and in accordance with our BAN criteria, we have assessed the city's market risk as low due to its strong market access, information availability, and takeout authorization.

The city's full-faith-and-credit pledge secures the bonds, subject to limitations of Proposition 2 1/2. We rate the limited-tax GO debt on par with our view of Somerville's general creditworthiness, since the ad valorem tax is not derived from a measurably narrower tax base and there are no limitations on the fungibility of resources, which supports our view of the town's overall ability and willingness to pay debt service.

Officials plan to use series 2019 bond proceeds to permanently finance a portion of the city's existing BANs and provide funding for various capital improvement projects (CIPs). City plans to use the series A BAN proceeds to renew a portion of the city's existing BANs and provide funding for various CIPs. Series B BAN proceeds will be used to renew \$55 million in existing BANS related to the high school project.

The city's general creditworthiness reflects our view of its:

- Very strong economy, with access to a broad and diverse MSA;
- Very strong management, with strong financial policies and practices under our Financial Management Assessment (FMA) methodology;
- Strong budgetary performance, with a slight operating surplus in the general fund and an operating surplus at the total governmental fund level in fiscal 2018;
- Very strong budgetary flexibility, with an available fund balance in fiscal 2018 of 21% of operating expenditures;
- Very strong liquidity, with total government available cash at 39.0% of total governmental fund expenditures and 10.0x governmental debt service, and access to external liquidity that we consider strong;
- Weak debt and contingent liability profile, with debt service carrying charges at 3.9% of expenditures and net direct debt that is 79.8% of total governmental fund revenue, and a large pension and other postemployment benefits (OPEB) obligation and the lack of a plan to sufficiently address the obligation, but low overall net debt at less than 3.0% 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 80,288, 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 133% of the national level and per capita market value of \$195,004. Overall, the city's market value grew by 13.5% over the past year to \$15.7 billion in 2019. The county unemployment rate was 3.0% in 2017.

Somerville continues to see significant development and population growth, leading to increased market values and incomes. Market values have risen more than 22% in the past three years, to nearly \$13.8 billion in 2018. We expect development to continue as the city and state plan to fund an extension to the Massachusetts Bay Transportation Authority (MBTA)'s light rail that will add four Green Line stops in Somerville. City officials report construction is underway and expect to begin passenger service in 2021, increasing the number of residents with rapid mass transit access within a short walk to 85% from 15%. Areas that will benefit from this access include Union Square. As a result, extensive redevelopment plans will add 1.4 million square feet of commercial space and 900-1,000 housing units in the area over the coming years.

A notable contributor to the city's increase in market values and growing economy is the development at Assembly Row over 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. This also includes a 750,000-square-foot headquarters for Partners Healthcare, the state's largest medical group, which

the company built in order to consolidate its operations around the Boston area under one roof. Puma also announced it is moving its North American headquarters to Assembly Row and will occupy a 275,000-square-foot office building, which will feature many amenities and a ground-floor company store. There are also various other residential and commercial developments occurring at the site with others at the planning stage, including a new 180-room hotel and 210 unit residential building by 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 given its close proximity to the cities of Boston and Cambridge, Interstate 93, and on-site subway station serviced by the MBTA.

Other parts of the city continue to see growth and development, which the city continues to market and support with infrastructure projects. The city's Union Square has steadily become a center for more tech-focused development Greentown Labs and other startups moving into the area and expanding over the past few years. The area is expected to see further growth with the completion of the Green Line extension in 2021. Other areas of the city such as Boynton Yards, where a new 900,000-square-foot commercial, retail, and residential project is being planned, are also expected to see economic expansion.

Overall, due to the city's numerous completed and ongoing developments and transportation projects which has led to continued growth in market values, a stable regional real estate market, and continued access to the Boston, we expect the city's economy to 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, 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 CIP 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 slight surplus operating results in the general fund of 1.5% of expenditures, and surplus results across all governmental funds of 3.0% in fiscal 2018. General fund operating results have been stable over the past three years, with a result of 2.2% in 2017 and a result of 1.9% in 2016.

After adjusting for recurring transfers as well as capital projects funded with bond proceeds, Somerville's performance continues to be strong, in our view. According to management, the fiscal 2018 general fund surplus was primarily due to revenues exceeding the budget and the city realizing savings in expenditures. Specifically, building permit revenue, real estate taxes, investment income, and department incomes were the notable revenue items that exceeded the

budget. On the expenditure side, officials indicate the city realized savings in health insurance as a result of changing its health plans to the state's Group Insurance Commission, lower-than-budgeted energy, public works, and salary costs, as well as the closing out of some purchase orders.

For fiscal 2019, officials indicate budget to actuals are currently tracking favorably with expenses about \$4.5 million under budget and revenues such as hotel/motel taxes and building permits amongst others are exceeding revenue projections. As a result, the city currently expects to end the year with a \$6.2 million general fund surplus. The proposed fiscal 2020 budget, which currently totals \$263 million, is expected to be balanced and include a \$1.25 million fund balance appropriation. The city has settled most of its outstanding labor contracts and will budget to any additional salary costs in its fiscal 2020 budget. Management also plans to include a 5% increase in school department costs and 3%-4% increase in health insurance expenses.

As a result, given the city's historically positive financial operations, projected general fund surplus in fiscal 2019, conservative budgeting practices, and no major changes to its upcoming fiscal 2020 budget, we expect its budgetary performance to remain strong. We also expect the city's ongoing developments will translate to increasing new growth figures on its property tax levy and higher local receipts going forward. Over the long term, however, we believe the city's retirement costs will continue to escalate given the large liabilities that could pressure the budget, especially if pension and OPEB plan assumptions are not met or market conditions worsen.

Somerville's leading revenues sources include property taxes, state aid, and excise taxes at 58%, 26%, 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.

Very strong budgetary flexibility

Somerville's budgetary flexibility is very strong, in our view, with an available fund balance in fiscal 2018 of 21% of operating expenditures, or \$52.8 million.

Our calculation includes about \$27 million in committed stabilization funds, which are available with Board of Aldermen approval. The city has an additional \$11.5 million in a health claims stabilization fund in fiscal 2018 that we have not included in our analysis, because it is considering moving these into its OPEB trust. Officials expect the city to end fiscal 2019 with another increase in available reserves as a result of positive financial operations. 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 39% of total governmental fund expenditures and 10x governmental debt service in 2018. 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 BANs, 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 its budget, we expect the city will maintain its very strong liquidity metrics given its total governmental fund cash position given its ability to maintain stable operations and regenerate its reserves.

Weak debt and contingent liability profile

In our view, Somerville's debt and contingent liability profile is weak. Total governmental fund debt service is 3.9% of total governmental fund expenditures, and net direct debt is 79.8% of total governmental fund revenue. Overall net debt is low at 1.5% of market value, which is in our view a positive credit factor.

With this issuance, the city will have about \$248 million in total direct debt outstanding including \$113 in BANs outstanding. Somerville plans to issue more than \$100 million over the next two-to-three years for various CIPs and the new high school. A portion of the high school project is excluded from the limitations of Proposition 2 1/2. Therefore, we expect the city could raise additional revenues to support this debt service. However, given the amount of total debt authorized, depending on timing of issuances and growth of revenues, our view of the city's debt profile could weaken following future issuance.

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 7.6% of total governmental fund expenditures in 2018. Of that amount, 4.8% represented required contributions to pension obligations, and 2.8% represented OPEB payments. The city made its full annual required pension contribution in 2018. The funded ratio of the largest pension plan is 69.4%.

The city participates in the Somerville Contributory Retirement System, a cost-sharing, multiple-employer defined-benefit pension plan. The plan fiduciary net position as a percent of the total pension liability, as defined in Governmental Accounting Standards Board Statement No. 67, was 69.41% as of Dec. 31, 2017, using an assumed discount rate of 8.0%. We believe many of the plans assumptions, including the revised discount rate and a deferral of contributions assuming annual increases based on 4.5% payroll growth, are aggressive. Although Somerville is paying its full actuarially determined contribution annually with the intention to fully fund the plan by 2033, we believe it could face rapidly escalating contributions should plan assumptions and methods not be met.

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 \$7.7 million as of fiscal 2019 according to management. The city plans to add about \$1 million towards the trust annually and will continue to slowly shift funds from its health claim stabilization account towards its OPEB trust fund going forward. Its unfunded liability totaled \$268.6 million as of June 30, 2018, which represents a \$34 million decrease as a result of changes in the city's health insurance plans.

The city is managing these costs in its budget and is seeking ways to better address these liabilities, including moving a portion of its health care stabilization funds into its OPEB trust fund. However, given that these plans have not yet fully

materialized 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 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

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.

Related Research

- S&P Public Finance Local GO Criteria: How We Adjust Data For Analytic Consistency, Sept. 12, 2013
- Incorporating GASB 67 And 68: Evaluating Pension/OPEB Obligations Under Standard & Poor's U.S. Local Government GO Criteria, Sept. 2, 2015
- Local Government Pension And Other Postemployment Benefits Analysis: A Closer Look
- 2018 Update Of Institutional Framework For U.S. Local Governments

Ratings Detail (As Of May 24, 2019)		
Somerville BANs ser A due 06/05/2020		
<i>Short Term Rating</i>	SP-1+	Affirmed
Somerville BANs ser B due 10/25/2019		
<i>Short Term Rating</i>	SP-1+	Affirmed

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