

## CREDIT OPINION

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### Update

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## Somerville (City of) MA

Update - Moody's upgrades Somerville, MA's GO to Aa1

### Summary Rating Rationale

Moody's Investors Service has upgraded to Aa1 from Aa2 the rating on the City of Somerville, MA's outstanding general obligation debt. Concurrently, we have removed the positive outlook.

The upgrade to Aa1 reflects the healthy financial position and the sizeable tax base that has experienced significant growth in recent years due to ongoing redevelopment. The rating also incorporates a manageable debt burden that is expected to increase over the near to medium term given a significant amount of debt coming online over the next 10 years. Finally, the rating reflects the large but manageable pension and OPEB liabilities.

### Credit Strengths

- » Sizeable and diverse tax base
- » Strong and growing economy in Boston-metro area
- » Healthy reserve levels
- » City maintains and adheres to formal financial policies

### Credit Challenges

- » Rising costs for education and debt service
- » Income levels trail the state median
- » Large pension and OPEB liabilities

### Rating Outlook

Outlooks are usually not assigned to local government credits with this amount of debt outstanding.

### Factors that Could Lead to an Upgrade

- » Material improvement in available reserves
- » Eliminated reliance on annual free cash appropriations
- » Significant improvement in resident income levels
- » Decline in the debt burden

## Factors that Could Lead to a Downgrade

- » Trend of operating deficits resulting in a material decline in reserves or liquidity
- » Weakening of local economy
- » Deterioration of tax base or demographic profile
- » Growth in debt burden or long term liabilities beyond expectations

## Key Indicators

Exhibit 1

<b>Somerville (City of) MA</b>	<b>2012</b>	<b>2013</b>	<b>2014</b>	<b>2015</b>	<b>2016</b>
<b>Economy/Tax Base</b>					
Total Full Value (\$000)	\$ 9,139,060	\$ 9,237,328	\$ 9,237,328	\$ 10,446,575	\$ 10,446,575
Full Value Per Capita	\$ 120,292	\$ 120,051	\$ 119,099	\$ 132,917	\$ 130,065
Median Family Income (% of USMedian)	112.0%	112.8%	114.6%	120.1%	120.1%
<b>Finances</b>					
Operating Revenue (\$000)	\$ 195,805	\$ 202,363	\$ 207,573	\$ 213,653	\$ 218,847
Fund Balance as a % of Revenues	21.3%	23.3%	22.4%	23.5%	25.0%
Cash Balance as a % of Revenues	24.3%	26.2%	25.3%	26.9%	28.2%
<b>Debt/Pensions</b>					
Net Direct Debt (\$000)	\$ 85,304	\$ 92,950	\$ 108,702	\$ 115,971	\$ 120,177
Net Direct Debt / Operating Revenues (x)	0.4x	0.5x	0.5x	0.5x	0.5x
Net Direct Debt / Full Value (%)	0.9%	1.0%	1.2%	1.1%	1.2%
Moody's - adjusted Net Pension Liability (3-yr average) to Revenues (x)	1.1x	1.2x	1.4x	1.4x	1.5x
Moody's - adjusted Net Pension Liability (3-yr average) to Full Value (%)	2.4%	2.7%	3.1%	2.9%	3.1%

As of June 30 fiscal year-end

Source: Moody's Investors Service; city's audited financial statements

## Detailed Rating Considerations

### Economy and Tax Base: Strong New Development Will Continue for Sizeable Tax Base in Metro Boston

The sizeable and diverse tax base is a notable strength of the city's credit profile. New growth will continue to be healthy over the near term, given the city's favorable location in the Greater Boston (Aaa stable) area and management's ongoing commitment to redevelopment activity, which is supported by the approval of the Green line extension project. The tax base is primarily residential (85% of 2017 assessed value) with a moderate commercial and industrial presence (13%). The city experienced seven consecutive years of assessed value growth including a strong 13.1% in fiscal 2017, which is the third largest increase of any municipality in the commonwealth and reflects large scale developments added to the tax rolls and appreciation of the residential market. The positive trend increases the five-year average annual growth rate in AV to 8.6%. Additionally, the 2017 two year equalized value increased a substantial 19.1% from 2015, which is stronger than most municipalities in the commonwealth.

One of the drivers of the city's recent growth has been the 145-acre Assembly Square Project, which includes two million square feet of office space, over 2,000 housing units, and 1.2 million square feet of retail space which includes shopping, dining, and entertainment. Partners Healthcare System, MA (Aa3 negative) recently constructed its new 875,000 square foot headquarters on this site with approximately 4,000 employees. Projects currently under construction include ground floor retail with 447 apartments, 122 condos, and a hotel. Another project with 500 apartments, retail and a restaurant was recently approved, and a 258,000 square feet office space is going through the permitting stages.

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In addition to the Assembly Square project, significant redevelopment continues in the city's Union Square neighborhood, including a 2.3 million mixed use project, which is in the early stages of planning. The Massachusetts Department of Transportation is moving forward with its Green Line extension, which will add a total of six new subway stops in the city and one in neighboring Medford (Aa3) by 2021. The extension of public transportation in the city will continue to spur ongoing development in the adjacent areas.

Portions of Tufts University (Aa2 stable) lie within the city and the university's presence provides economic stability as well as significant employment opportunities. The city's sizeable student population, drawn from Tufts, as well as nearby Harvard University (Aaa stable) and Massachusetts Institute of Technology (Aaa stable), partially depresses the city's income levels. Median family income is 91% of the commonwealth and 120.1% of the US (2015 ACS data), which is below the median for the rating category. The city's unemployment levels (2.8% May 2017) remain below the commonwealth and US.

### **Financial Operations and Reserves: Well Managed Financial Position with Healthy Reserves**

Somerville's financial position will remain stable in the near term given management's conservative budgeting, and new property tax revenue from the ongoing development will help to finance growing debt service and education costs. The city annually appropriates a moderate amount of reserves to balance the operating budget, but the city has historically generated surpluses to replenish the appropriations and General Fund balance has increased in five out of the past six years.

Audited fiscal 2016 results reflect a \$4.1 million surplus (net of bond premium), which increased available General Fund balance (committed, assigned and unassigned) to \$54.7 million or a healthy 25% of revenues, which is stronger than the commonwealth median for the rating category. Of this amount, \$15.5 million (71%) is unassigned and the city remains in compliance with its policy to maintain unassigned fund balance at a minimum of 5% of the current budget. The positive operations were due to strong meals and motor vehicles excise taxes, building permits, and turnbacks in most departments.

The fiscal 2017 budget was balanced with \$2.5 million of reserves (compared to \$3.5 million in 2016) and management reports that positive variances in both revenues and expenditures will allow the reserves to be replenished and fund balance should be relatively flat from 2016. The adopted 2018 budget increased 4.6% and education, which has increased 4.5% to 5% annually for the past few years, continues to be a main budget driver. The reliance on reserves to balance the budget continues to decrease, with a \$2 million appropriation in 2018.

The 10 year long range forecast shows budgetary surpluses that average 4.4% of annual revenues, which is in line with the city's goal to generate a surplus that is approximately 5% of revenues. The assumptions are fairly conservative and include a 4.6% average annual increase in revenue, driven by strong property tax receipts related to new development. State aid is assumed to increase 1.5% annually. The average annual increase in total expenditures is 3.3%, driven by education (4% annual growth), employee benefits (4.2%), and debt service (7.2%, excluding the exempted high school debt).

Future reviews will focus on management's ability to at least maintain fund balance at current levels to offset our expectation of a rising debt burden.

Somerville derives the majority of its revenues from property taxes (58.2% in fiscal 2016) and state aid, including aid for education (26.2%). The largest expenditure is education (28.9%), followed by employee benefits (1.9%), public safety (17.6%), and public works (10.6%).

### **LIQUIDITY**

Year-end General Fund cash has been stable and was \$61.7 million, or a healthy 28.2% of revenues, in fiscal 2016.

### **Debt and Pensions: Large Capital Plan Will Increase Debt Burden; Large But Manageable Pension and OPEB Liabilities**

The debt burden will increase due to a large 10 year capital plan and recently approved high school project, but the debt burden will remain manageable given self-supporting water and sewer funds, debt exclusion for the high school, and expected tax base growth that will generate new tax revenue to support debt service. The direct debt burden is currently an average 1.2% of equalized value (full value), and the overall debt burden increases to 4.2% when incorporating overlapping debt from the Massachusetts Water Resources Authority (Aa1 stable) and the Massachusetts Bay Transportation Authority (Aa2 stable).

The 10 year capital plan totals \$358 million for city, water and sewer needs. Of this amount, the water and sewer debt (\$167 million total) is expected to be self-supporting with user fees.

In addition to the CIP, voters recently approved the construction of a \$257 million new high school. The state's MSBA program will cover \$120 million, leaving the local share at \$137 million. Positively, the majority of the local share (\$130.3 million) is excluded from the levy limits of Proposition 2 ½. The high school project is the city's only excluded debt. The city issued \$15 million of bond anticipation notes (BANs) in June and will continue to issue BANs over the next seven years. Long term bonds will be issued in tranches beginning in fiscal 2019 through 2026.

Additionally, the city has agreed to finance \$50 million towards the Green Line extension project. Long term bonds will be issued in five \$10 million tranches beginning in fiscal 2018, and the city expects developer fees to cover roughly half of its commitment.

The city has various stabilization reserves held as committed General Fund balance that it has been adding to every year and will draw down over time to partially cover the rising debt service costs.

#### **DEBT STRUCTURE**

All debt is fixed rate and amortization of outstanding principal is below average, with 61% repaid within ten years. Debt service costs of \$10 million in fiscal 2016 comprised 4.6% of expenditures. The city remains in compliance with its policy to maintain debt service (that falls under the limits of Proposition 2 ½) under 6% of annual expenditures.

#### **DEBT-RELATED DERIVATIVES**

The city is not party to any interest rate swaps or other derivative agreements.

#### **PENSIONS AND OPEB**

Somerville maintains a single employer defined benefit pension plan for substantially all city employees, with the exception of teachers and qualified staff who are covered under the state plan. The city contributed the required \$14.2 million in fiscal 2016, equal to a manageable 6.6% of General Fund expenditures. The fiscal 2016 three-year average adjusted net pension liability (ANPL), under Moody's methodology for adjusting reported pension data, is \$99.6 million, or an average 1.5 times General Fund revenues and an above average 3.1% of equalized value. Moody's uses the adjusted net pension liability to improve comparability of reported pension liabilities. The adjustments are not intended to replace the city's reported liability information, but to improve comparability with other rated entities.

In February of 2012, the city established a trust fund for its OPEB liability, which has been funded by annual appropriations and has a current balance of \$1.8 million. The city funded 41% of the OPEB cost in fiscal 2016, representing \$8.5 million or 4% of General Fund expenditures. The total Unfunded Actuarially Accrued Liability (UAAL) is \$301.8 million as of June 30, 2016.

Total fixed costs for fiscal 2017, including debt service, required pension contributions and retiree healthcare payments, represented \$32.7 million, or 15.2% of expenditures. When including the additional General Fund supported debt issuances over the next several years, total fixed costs will increase to approximately 20% of expenditures, a level that is slightly elevated for the rating category but still manageable.

#### **Management and Governance**

Management is strong, as evidenced by a growing and healthy fund balance, adherence to formal fiscal policies, and multi-year budget forecasting and capital planning.

Massachusetts cities have an Institutional Framework score of Aa, which is high compared to the nation. Institutional Framework scores measure a sector's legal ability to increase revenues and decrease expenditures. Massachusetts cities major revenue source, property taxes, are subject to the Proposition 2 1/2 cap which can be overridden with voter approval only. However, the cap of 2.5% still allows for moderate revenue-raising ability. Unpredictable revenue fluctuations tend to be minor, or under 5% annually. Across the sector, fixed and mandated costs are generally greater than 25% of expenditures. However, Massachusetts has public sector unions, which can limit the ability to cut expenditures. Unpredictable expenditure fluctuations tend to be minor, under 5% annually.

**Legal Security**

The outstanding rated debt is secured by the city's general obligation limited tax pledge as debt service is subject to the levy limitations of Proposition 2 ½.

**Use of Proceeds**

Not applicable.

**Obligor Profile**

The City of Somerville has a population of 78,500 and is located in eastern Massachusetts, approximately 3 miles northwest of Boston (Aaa stable).

**Methodology**

The principal methodology used in this rating was US Local Government General Obligation Debt published in December 2016. Please see the Rating Methodologies page on [www.moodys.com](http://www.moodys.com) for a copy of this methodology.

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