S&P Global Ratings

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Summary:

Arlington, Massachusetts; General Obligation

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Credit Profile		
US$83.36 mil GO mun purp loan bnds ser 2021 due 09/15/2050		
Long Term Rating	AAA/Stable	New
Arlington GO		
Long Term Rating	AAA/Stable	Affirmed

Rating Action

S&P Global Ratings assigned its 'AAA' rating to the Town of Arlington, Mass.' $83.36 million series 2021 general obligation (GO) municipal purpose loan. At the same time, S&P Global Ratings affirmed its 'AAA' rating on the town's existing GO bonds. The outlook on all ratings is stable.

The series 2021 bonds and parity GO bonds are secured by the town's full faith and credit, subject to Proposition 2 1/2 limitations. We rate the limited-tax GO debt on par with our view of Arlington's general creditworthiness because the ad valorem tax is not derived from a measurably narrower property tax base and there are no resource-fungibility limitations supporting our view of the town's overall ability and willingness to pay debt service.

Under our criteria, titled "Ratings Above The Sovereign: Corporate And Government Ratings—Methodology And Assumptions," published Nov. 19, 2013, we rate Arlington higher than the sovereign because we think the town can maintain better credit characteristics than the nation in a stress scenario due to its predominantly locally derived revenue base and our view that pledged revenue supporting bond debt service is at limited risk of negative sovereign intervention. In 2020, local property taxes generated 72% of general fund revenue, demonstrating a lack of dependence on central government revenue.

Credit overview

The rating reflects our opinion of Arlington's extremely strong tax base, which continues to grow within the Boston metropolitan statistical area (MSA), supporting continued positive budgetary performance that has led to improved reserves. The town's primary revenue streams are relatively stable, with property taxes making up the majority of revenue and, due to the COVID-19 pandemic, the town has pulled back assumptions for more sensitive revenue streams such as meals and hotel taxes for the 2021 budget for which actual revenues are outpacing assumptions year to date. We view these assumptions as more conservative than our economic forecast pertaining to growth and consumer spending. For more information on the pandemic's effect on the U.S. public finance sector, see "Potholes On The Road To Recovery," Sept. 29, 2020, and "Staying Home For The Holidays," Dec. 2, 2020, both published on RatingsDirect.

The town's debt is manageable, in our view, with significant debt plans for a new high school. In our opinion, long-term liabilities will likely remain a credit risk due to low funded pensions and other postemployment benefits

(OPEB). However, we expect Arlington's favorable tax rate, very strong budgetary flexibility with additional support from a taxpayer-approved operating override of the commonwealth levy limit, very strong economy, and conservative budgeting somewhat mitigate long-term liability risk.

Additional rating factors include our opinion of Arlington's:

- Very strong economy, with access to a broad and diverse metropolitan statistical area (MSA);
- Strong management, with good financial policies and practices under our Financial Management Assessment (FMA) methodology;
- Adequate budgetary performance, with operating surpluses in the general fund and at the total governmental fund level in fiscal 2020;
- Very strong budgetary flexibility, with an available fund balance in fiscal 2020 of 30% of operating expenditures;
- Very strong liquidity, with total government available cash at 52.9% of total governmental fund expenditures and 7.0x governmental debt service, and access to external liquidity we consider strong;
- Very weak debt and contingent liability profile, with debt service carrying charges at 7.5% of expenditures and net direct debt that is 111.3% of total governmental fund revenue, and significant medium-term debt plans and a large pension and 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.

Environmental, social, and governance factors

We analyzed Arlington's environmental, social, and governance risks relative to the town's economy, management, financial measures, and debt and liability profile. The town has some exposure to environmental risks such as flooding and severe weather events; however, we view its exposure as in line with the sector standard. Arlington approved its five-year hazard mitigation plan in 2020, which includes identified risks, targeted projects with funding sources, and time frame targets to address them. Our rating also incorporates our view regarding the indirect risks posed by the COVID-19 pandemic. Absent the implications of COVID-19, we consider the town's social risks in line with those of the sector. We believe Arlington's governance risks are in line with our view of the sector standard.

Stable Outlook

Downside scenario

We could lower the rating should the town's fixed costs (both debt service and pension and OPEB) rise to a level such that budgetary performance or flexibility weakens given Arlington's plans for additional debt needs combined with an intent to shore up funding for long-term liabilities by 2035.

Credit Opinion

Very strong economy

We consider Arlington's economy very strong. The town, with an estimated population of 46,173, is in Middlesex County in the Boston-Cambridge-Newton MSA, which we consider to be broad and diverse. The town has a projected per capita effective buying income of 206% of the national level and per capita market value of $263,940. Overall, the town's market value grew by 1.1% over the past year to $12.2 billion in 2021. The county unemployment rate was 2.3% in 2019.

Arlington is a wealthy, primarily residential community about eight miles north of Boston. Its favorable location in the Boston MSA contributes to the area's desirability, leading to strong tax base appreciation and low unemployment. About 95% of assessed value (AV) is residential and 4% is commercial.

The town continues to experience modest AV growth. The AV increased by 26% from fiscal years 2018 to 2021, to $12.2 billion, reflecting 1% growth in 2021. Management reports permitting for mixed-use development along Arlington's commercial corridor and additional interest for residential development is underway. The town has not experienced any slowdown in the housing market or property tax collections to date despite the pandemic. Currently, management is projecting 1% growth in the taxable value for the next year, which is a more normalized expectation of growth subsequent a revaluation, which last occurred in 2019.

In light of the pandemic, Middlesex County's monthly unemployment rate peaked in June 2020 at 15.0% but has moderated since then to 5.4% for November 2020. The county's unemployment rate has trended in line with Massachusetts' unemployment rate and is just below the nation's rate. With a growing tax base and steadily improving employment base, we anticipate the economic profile will remain very strong.

Strong management

We view the town's management as strong, with good financial policies and practices under our FMA methodology, indicating financial practices exist in most areas, but that governance officials might not formalize or monitor all of them on a regular basis.

Arlington creates its annual budget based on a multiyear analysis and intentionally conservative revenue and expenditure assumptions; this typically yields positive operating results. Management monitors the budget monthly to identify and address any intrayear budget variances with formal quarterly reports to the finance committee. Arlington appoints oversight committees under its town charter that serve as checks and balances, including a finance committee and three trust commissions--the boards of library trustees, trust fund commissioners, and cemetery--each of which continually reviews the performance of town funds.

The town's long-term financial plan is updated annually and used as a planning tool to identify future budget gaps and identify the need for potential overrides. Arlington also annually maintains a comprehensive five-year capital improvement program that identifies capital projects and funding. Its formal investment-management policy calls for regular holdings-and-earnings reports to the finance committee. Arlington's basic debt management policy does not cap capacity. The town's reserve policy mandates a minimum unassigned general fund balance at 5% of expenditures.

Adequate budgetary performance

Arlington's budgetary performance is adequate in our opinion. The town had operating surpluses of 2.8% of expenditures in the general fund and of 41.3% across all governmental funds in fiscal 2020. However, we account for the potential for general fund and governmental performance could weaken to adequate within the next two years due to unknown budgetary impacts from the continuing pandemic.

We adjusted general fund results to account for recurring transfers into nonmajor governmental funds and the water and sewer enterprise fund from the general fund. We also adjusted total governmental-fund results to account for capital fund expenditures using previously received bond proceeds.

Property taxes generated 71% of fiscal 2020 general fund revenue while intergovernmental aid accounted for 12%, which we view as a stable revenue mix. The fiscal 2020 budget included a $5.5 million fund balance appropriation, as it has done historically; however, revenues trended $1.2 million better than assumed and expenditures trended $3.6 million under budget. The budget included allocation of $4.7 million toward the fiscal stabilization fund and about $1.0 million toward the OPEB trust fund. Officials also approved a $5.5 million operating override of the commonwealth levy limit in June 2019, beginning with the fiscal 2020 budget.

The fiscal 2021 budget assumes 3.5% growth in property taxes, an 89% decline in hotel and meals tax revenues due to the pandemic, and 6.0% decline in state aid revenue. Total expenditures for the budget increased 3.6% compared with the previous year and include a $5.9 million use of free cash and $2.0 million in override stabilization funds. Management indicates budget-to-actual results are on target, and it does not currently expect any negative financial performance by fiscal year-end 2021. Due to our view of the town's stable revenue profile, very strong collections at more than 99%, and active management with strong budgetary oversight, we expect budgetary performance will likely remain at least adequate through the two-year outlook period. However, we believe pension and OPEB costs could become a budgetary pressure. As long-term liability expenses increase, management is actively making budgetary adjustments to absorb growing expenses. We note that Arlington is funding the actuarially determined contribution and that it maintains a trust fund to prefund OPEB. We also think adjustments to more conservative assumptions could materially affect annual contributions, pressuring the bottom line, particularly if economic or business conditions weaken.

Very strong budgetary flexibility

Arlington's budgetary flexibility is very strong, in our view, with an available fund balance in fiscal 2020 of 30% of operating expenditures, or $54.5 million. Over the past three years, the total available fund balance has remained at a consistent level overall, totaling 29% of expenditures in 2019 and 30% in 2018.

The town has maintained very strong budgetary flexibility during the past three fiscal years. Year to date, the fiscal 2021 budget is trending as budgeted and therefore we anticipate Arlington will maintain very strong reserves. The town also approved an operating override of the commonwealth levy limit, totaling about $5.5 million, which we think provides additional flexibility. Therefore, we expect budgetary flexibility will likely remain very strong. While the town's policy is to maintain a minimum available fund balance equivalent to 5% of the annual operating budget, reserves have remained well in excess of this level, and we do not anticipate any material deterioration in reserves in the near term.

Very strong liquidity

In our opinion, Arlington's liquidity is very strong, with total government available cash at 52.9% of total governmental fund expenditures and 7.0x governmental debt service in 2020. In our view, the town has strong access to external liquidity if necessary.

The town is a regular market participant that has issued debt frequently over the past several years. Arlington has no variable-rate or direct-purchase debt, and investments are limited to highly liquid, conservative investment vehicles. We expect the liquidity profile to remain very strong.

Very weak debt and contingent liability profile

In our view, Arlington's debt and contingent liability profile is very weak. Total governmental fund debt service is 7.5% of total governmental fund expenditures, and net direct debt is 111.3% of total governmental fund revenue. Negatively affecting our view of the town's debt profile is Arlington's significant medium-term debt plans. Overall net debt is low at 2.1% of market value, which is in our view a positive credit factor.

Following this issuance, Arlington has about $236.6 million in total direct debt. Officials currently expect to issue an additional $100 million during the next two years, some of which will be allocated toward high school construction and a portion will fund construction of the town's department of public works site. We estimate that the additional debt plans will negatively affect debt metrics; however, we believe that this debt will likely remain affordable due to a wealthy tax base and that it will likely not materially affect finances due to its commonwealth levy limit exclusion. However, if increased debt service were to pressure finances, leading to negative financial performance, we could lower the rating.

In our opinion, a credit weakness is Arlington's large pension and OPEB obligation, without a plan in place that we think will sufficiently address the obligation. The town's combined required pension and actual OPEB contributions totaled 13.5% of total governmental fund expenditures in 2020. Of that amount, 8.6% represented required contributions to pension obligations, and 4.8% represented OPEB payments. The town made 100% of its annual required pension contribution in 2020. The funded ratio of the largest pension plan is 56.5%.

Pension and other postemployment benefits highlights

- While the town is managing these costs, we think pension and OPEB liabilities will likely remain a long-term credit concern due to lower funding and our expectation that costs will likely increase.
- Because the town's actuarially determined pension contribution reflects what we view as weak assumptions and methodologies, we believe the risk of unexpected contribution escalations will likely increase. However, we expect higher contributions will likely remain affordable, at least during the next few fiscal years, due to the strength of the town's revenue base, very strong reserves, and conservative budgeting.
- Arlington funds OPEB on a pay-as-you-go basis, which, due to claims volatility and medical cost and demographic trends, is likely to lead to escalating costs. Management, however, also contributes to an OPEB trust fund, which has a current balance of $15.9 million for fiscal 2020, according to the audit, or a 6.3% funded ratio.

As of June 30, 2020, the town participates in:

- Arlington Contributory Retirement System, which is 56.5% funded with a proportionate share of the town's net pension liability at $128 million, assuming a 7.00% discount rate as of fiscal 2020; and

- Arlington's defined-benefit, postretirement health care plan, which is 6.3% funded, with an OPEB liability of about $236.2 million.

The Arlington Contributory Retirement System is currently on track for full funding by 2035, five years ahead of the commonwealth-mandated deadline of 2040. We attribute this low funding to numerous years of underfunding, aggressive assumptions, and weak market performance. Currently, the plan assumptions are meeting static funding progress but not minimum funding progress. While the town is currently managing these elevated costs with a structurally balanced budget, we speculate it has a limited ability to control pension-liability growth.

Management's OPEB policy is to contribute about $1 million annually toward the trust. Arlington has maintained a very strong financial position and at least adequate performance during the past three fiscal years despite these elevated fixed costs. In addition, management's willingness and ability to support very strong budgetary flexibility and approve the commonwealth levy limit operating override, coupled with very strong economic indicators and strong management, will likely help Arlington withstand notable retirement cost increases during the next few fiscal years. In our opinion, however, these costs will likely create long-term budgetary pressure, potentially weakening budgetary performance and reserves.

Strong institutional framework

The institutional framework score for Massachusetts municipalities is strong.

Related Research

- Through The ESG Lens 2.0: A Deeper Dive Into U.S. Public Finance Credit Factors, April 28, 2020
- 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
- 2020 Update Of Institutional Framework For U.S. Local Governments