

RatingsDirect®

Summary:

Arlington, Massachusetts; General Obligation

Primary Credit Analyst:

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

Secondary Contact:

Lauren B Carter, Boston + 1 (212) 438 0376; lauren.carter@spglobal.com

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Credit Profile

US\$70.115 mil GO mun purp loan of 2019 bnds due 09/01/2049

<i>Long Term Rating</i>	AAA/Stable	New
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Arlington GO

<i>Long Term Rating</i>	AAA/Stable	Affirmed
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Arlington GO

<i>Unenhanced Rating</i>	AAA(SPUR)/Stable	Affirmed
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Many issues are enhanced by bond insurance.

Rationale

S&P Global Ratings assigned its 'AAA' rating and stable outlook to Arlington, Mass.' series 2019 general obligation (GO) bonds and affirmed its 'AAA' rating, with a stable outlook, on the town's existing GO debt.

Security and use of bond proceeds

Under our criteria, titled "Ratings Above The Sovereign: Corporate And Government Ratings—Methodology And Assumptions," published Nov. 19, 2013, on RatingsDirect, 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 2018, local property taxes generated 71% of general fund revenue, demonstrating a lack of dependence on central government revenue.

Officials intend to use series 2019 bond proceeds to refund existing bond anticipation notes, totaling \$3 million, permanently and finance various projects townwide, including the construction of a new high school.

The town's full-faith-and-credit pledge, subject to Proposition 2 1/2 limitations, secures the bonds. However, we note a large portion of the series 2019 issuance, totaling \$56.7 million for the high-school project, is exempt from 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.

Credit summary

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 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 pensions and other postemployment benefits (OPEB). However, we expect the town'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 MSA;
- Strong financial management, with good 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 available fund balance in fiscal 2018 at 30% of operating expenditures;
- Very strong liquidity, with total government available cash at 38.2% of total governmental-fund expenditures and 6x governmental debt service, and access to external liquidity we consider strong;
- Very weak debt-and-contingent-liability position, with debt service carrying charges at 6.3% of expenditures and net direct debt that is 87.9% 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 liability, at least, during the next few fiscal years, but low overall net debt at less than 3% of market value; and
- Strong institutional framework score.

Very strong economy

We consider Arlington's economy very strong. The town, with an estimated population of 44,695, is in Middlesex County in the Boston-Cambridge-Newton MSA, which we consider broad and diverse. The town has a projected per capita effective buying income at 208% of the national level and per capita market value of \$246,413. Overall, market value grew by 13.9% during the past year to \$11 billion in fiscal 2019. County unemployment was 2.7% in 2018.

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 94% of assessed value (AV) is residential and 4.4% is commercial.

Arlington continues to experience modest AV growth. AV increased by 23.6% since fiscal 2014 to \$9.6 billion in fiscal 2018. Management reports the completion of several mixed-use developments during the past two years have led to continued local economic growth, coupled with a healthy real estate market and strong regional economic growth, including the Boston and Cambridge areas. We expect the town's economy, with very strong wealth and income and access to the broad and diverse MSA, will likely remain very strong throughout the two-year outlook period.

Strong management

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

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 review the performance of town funds.

Arlington's long-term financial plan forecasts budget pressure and potential overrides; the plan has links to the town's comprehensive, annually updated, 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.

Strong budgetary performance

Arlington's budgetary performance is strong, in our opinion. The town had slight surplus operating results in the general fund at 0.7% of expenditures and surplus results across all governmental funds at 4.4% in fiscal 2018.

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.

Officials attribute the fiscal 2018 general fund surplus to overall conservative budgeting, which led to higher-than-budgeted local receipts, including motor-vehicle-excise and hotel-and-motel taxes and departmental income, and intergovernmental revenue and commonwealth grants. The town also realized budget savings, including salaries, encumbrances, and health insurance. For fiscal 2019, officials indicate the town ended with balanced financial performance, resulting in increasing free cash. Management, however, elected to draw down about \$2.8 million in its fiscal-stabilization fund, within the general fund, as part of a planned drawdown.

The fiscal 2020, \$179.5 million budget is an 8.6% increase over fiscal 2019, including a \$5.5 million fund-balance appropriation it has done historically. The budget also adds about \$4.7 million toward the fiscal-stabilization fund and roughly \$1 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. Management indicates budget-to-actual results are currently on target, and it does not currently expect any negative financial performance by fiscal year-end 2020.

Property taxes generated 71% of fiscal 2018 general fund revenue while intergovernmental aid accounted for 13%, which we view as a stable revenue mix. 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 strong through the two-year outlook period. However, we posit 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 available fund balance in fiscal 2018 at 30% of operating expenditures, or \$48.9 million. During the past three fiscal years, total available fund balance has remained consistent overall at 31% of expenditures in fiscal 2017 and 30% in fiscal 2016.

Management has maintained very strong budgetary flexibility during the past three fiscal years. For fiscal 2019, although the town experienced positive financial operations, officials indicate they drew down about \$2.8 million in the fiscal-stabilization fund, which is part of unassigned fund balance, as part of a planned drawdown; however, the town's fiscal 2020 budget includes the replenishment of this fund by more than \$4.7 million, according to officials.

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, it has far surpassed that recently.

Very strong liquidity

In our opinion, Arlington's liquidity is very strong, with total government available cash at 38.2% of total governmental-fund expenditures and 6x governmental debt service in fiscal 2018. 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 during the past several years, demonstrating its strong access to the market. Arlington does not have any variable-rate or direct-purchase debt. Its limited investments are in highly liquid, conservative vehicles. We expect liquidity will likely 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 6.3% of total governmental-fund expenditures, and net direct debt is 87.9% of total governmental-fund revenue. Arlington's significant medium-term debt plans negatively affect our view of its debt profile. Overall net debt is low at 1.5% of market value, which is, in our view, a positive credit factor.

Following this issuance, Arlington has roughly \$167 million in total direct debt. Officials currently expect to issue an additional \$130 million during the next two years to three years, including about \$100 million toward a high-school-construction project the town's electorate has approved for Proposition 2 1/2 exclusion. While we recognize this large debt proposal would increase debt and negatively affect debt metrics, we theorize 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, Arlington's large pension and OPEB obligation, without a plan in place to address the liability sufficiently during, at least, the next few fiscal years, is a credit weakness. Arlington's combined required pension and actual OPEB contribution totaled 10.2% of total governmental-fund expenditures in fiscal 2018: 6.2% represented required contributions to pension obligations and 4% represented OPEB payments. The town made 100% of its annual required pension contribution in fiscal 2018. The largest pension plan is 55.4% funded.

Pension and OPEB highlights include:

- 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 imagine the risk of unexpected contribution escalations will likely increase. We, however, 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 \$15.5 million for fiscal 2020, according to the town, or an 8.4% funded ratio.

As of June 30, 2018, Arlington participates in:

- Arlington Contributory Retirement System, which is 55.4% funded with a proportionate share of the town's net pension liability at \$127 million, assuming a 7.25% discount rate as of fiscal 2018; and
- Arlington's defined-benefit postretirement health-care plan, which is 7.9% funded with an OPEB liability of about \$183.7 million.

The 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. While the town is currently managing these costs, 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. While we view retirement costs as high, we note the town has managed them. It has maintained stable financial performance during the past three fiscal years. 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 it 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.

Outlook

The stable outlook reflects S&P Global Ratings' opinion Arlington will likely maintain very strong reserves, supported by good financial management practices. In our view, the town's participation in the broad and diverse Boston MSA provides additional rating stability. Therefore, we do not expect to change the rating within the outlook's two-year period.

Downside scenario

However, due to pension and OPEB liabilities and the potential for large future debt issuances, if budgetary performance or flexibility were to weaken, we could lower the rating.

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
- 2019 Update Of Institutional Framework For U.S. Local Governments

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