

RatingsDirect®

Summary:

Somerville, Massachusetts; General Obligation; Note

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Credit Profile

US\$64.203 mil GO BANs dtd 06/02/2023 due 05/30/2024

<i>Short Term Rating</i>	SP-1+	New
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US\$37.715 mil GO mun purp loan of 2023 bnds due 05/01/2053

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

<i>Long Term Rating</i>	AAA/Stable	Upgraded
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Somerville GO

<i>Long Term Rating</i>	AAA/Stable	Upgraded
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Credit Highlights

- S&P Global Rating raised its long-term rating to 'AAA' from 'AA+' on Somerville, Mass.'s general obligation (GO) debt.
- At the same time, we assigned our 'AAA' rating to the city's series 2023 \$37.7 million GO municipal purpose loan and our 'SP-1+' short-term rating to its roughly \$64.2 million GO bond anticipation notes (BANs).
- Finally, we affirmed our 'SP-1+' rating on the city's existing BANs.
- The upgrade reflects the city's ongoing economic development as well as a record of strong financial management and budgetary performance that has resulted in a very strong financial profile commensurate with that of other 'AAA' rated peers.
- The outlook is stable.

Security

Somerville's full-faith-and-credit pledge secures the GO debt and BANs. The city's debt is subject to Proposition 2 1/2 limitations, but we do not make a rating distinction because 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 criteria titled "Issue Credit Ratings Linked To U.S. Public Finance Obligors' Creditworthiness," published Nov. 20, 2019, on RatingsDirect.

The short-term rating reflects our high investment-grade, long-term rating on the city and its low market-risk profile. In our view, and pursuant to our BAN criteria, we have assessed the city's market risk as low due to Somerville's strong market access, information availability, and takeout authorization. Officials intend to use bond proceeds to fund various capital projects, while BAN proceeds will fund ongoing and newer capital projects.

Credit overview

Somerville's economy and tax base continue to strengthen, with public and private development throughout the city significantly improving its flexibility to invest in capital projects and manage long-term liabilities. Somerville's economic growth prospects and financial performance remain robust despite economic headwinds from inflation, rising mortgage interest rates (which could temper housing demand), and geopolitical uncertainty. As the city invests in capital projects and infrastructure, we will monitor the impact of its debt plans and related costs against budgetary performance and reserves. While we understand that the city has a large combined pension and other postemployment benefit (OPEB) liability, improved actuarial assumptions and funding discipline of its OPEB should help proactively address any future budgetary pressures relating to these liabilities.

The 'AAA' rating also reflects:

- A very strong local economy, anchored by a stable residential sector, with new growth driven by regional demand for life science space and housing in proximity to local employment centers and universities, evidencing its participation in the broad and diverse Boston metropolitan statistical area (MSA);
- Well-embedded financial management policies and practices that are reviewed on a consistent basis, a focus on long-term planning, and a strong institutional framework score;
- Consistently positive performance, with reserves higher than most comparably rated state peers and very strong liquidity; and
- Sizeable debt burden, driven by ongoing capital projects supporting development projects and growing service demands, and high pension and OPEB costs.

Environmental, social, and governance

Due to Somerville's location on the Mystic River, we view its physical risks as slightly elevated compared with those of its peers. However, we believe the city's multipronged approach to stormwater management as well as its reduction in carbon emissions and commitment to its climate change vulnerability assessment, as outlined in the management section, somewhat mitigate these risks. We have also evaluated social and governance risks relative to Somerville's economy, financial measures, management, and debt and long-term liability profile and view both as credit neutral in our analysis.

Outlook

The stable outlook reflects the city's stable performance and very strong reserves that we anticipate it will maintain over the outlook period.

Downside scenario

While this is not expected, we could lower the rating if growing fixed costs were to lead to budgetary pressure that causes operating performance to deteriorate and reserves to decrease.

Credit Opinion

Redevelopment continues throughout the city, with a focus on life sciences and bespoke office space

Somerville, located five miles north of Boston, is a key economic hub in the greater Boston MSA. It continues to see significant development and population growth, resulting in ongoing market value and income growth. We expect that development will likely continue because of the city's and commonwealth's funding of an extension to the Massachusetts Bay Transportation Authority (MBTA) light rail that adds five Green Line stops in Somerville that opened for service in December 2022. Development is ongoing throughout the city's neighborhoods, particularly in the Boynton Yards neighborhood, as the transit-oriented development continues. Management anticipates roughly \$14 million in new growth as projects come online in addition to continued tax base appreciation.

Updated long-range planning in concert with sustainability efforts inform policies and practices

In our opinion, management budgets conservatively and relies on historical data, forward-looking projections, and budget-to-actual results for revenue and expenditure assumptions. Management 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 five-year capital plan that identifies funding and a 10-year, long-term financial forecasting plan, and updates both annually. Management has formal debt-management, investment, and reserve policies and maintains stabilization reserves of at least 5% of expenditures.

The city is taking steps to mitigate its exposure to cyber security risks. Additionally, it has adopted Somerville Climate Forward, a priority-based climate-change plan that includes a timeline of actions it will undertake to reduce the overall effect of climate change on the community. Plan items include exploring the feasibility of a net-zero emissions-based performance standard, improving stormwater management, and creating a community leadership program. The plan is designed to be revisited every five years to reassess short-term (zero to three years) and medium-term (four to six years) metrics for each action item. More recently, the city led a regional grant, the Lower Mystic Vulnerability Assessment, that identified structural and social infrastructure vulnerabilities in a hypothetical super winter storm. The city has incorporated these findings into the recently updated hazard mitigation plan.

The institutional framework score for Massachusetts municipalities is strong.

New growth, other revenues fuel positive operating results

We have adjusted budgetary performance for transfers, one-time revenue, and capital expenses. Revenues came in \$23.6 million higher than budgeted, driven by \$20.8 million in department revenue and \$2.3 million in motor vehicle excise taxes. Expenditures were under budget, with turnbacks in general government, public safety, and public works. The city's main revenue source is property taxes at 61%, followed by intergovernmental aid at 16% and departmental income at 14%.

The 2023 general fund budget is \$307.5 million, an 8% increase from the previous year. Management reports that revenues continue to outperform budgeted levels, while expenses are trending below budget. Officials are currently in the middle of the fiscal 2024 budget process. The city anticipates \$14 million in new growth and looks to continue existing investments in cyber security, among other initiatives. It is projecting that the school budget will increase by approximately 5%. We note that as the city continues to grow, revenue, such as building permits, will also continue to

grow, as will property taxes; however, increasing service demands and hiring needs will likely partially offset this. We expect that management will likely adjust and maintain operations.

Our calculation includes about \$51 million in committed stabilization funds, which are available with council approval. We anticipate that the city will maintain this very strong level of reserves moving forward; however, it does have several expired labor contracts, which may affect the overall fund balance level. If negotiations end to the detriment of city finances, requiring the use of available reserves, we could change our opinion of the city's flexibility. Our liquidity calculation excludes restricted cash in the capital projects fund and nonmajor governmental funds. We believe that the city will likely maintain very strong liquidity due to total governmental fund cash and an ability to maintain stable operations and regenerate reserves.

Sizeable debt burden as Somerville ramps up infrastructure and school projects

Following these issuances, Somerville will have about \$398 million of total direct debt outstanding, including \$64.2 million in BANs. To be conservative, we have not included the BANs in our 10-year amortization calculation. The city has \$259 million in authorized, but unissued, debt remaining. We recognize that commonwealth grants will likely offset a portion of the total amount of unissued debt. We expect that debt will likely remain elevated.

Pensions and OPEB costs remain high and a source of ongoing credit pressure

- Somerville's annual retirement costs remain affordable; however, the pension's actuarially determined contribution (ADC) reflects what we view as weak assumptions and methodologies that we believe increase unexpected contribution escalation risk.
- The adopted pension funding schedule includes annual pension cost growth of more than 5% annually during the final 10 years. This could outpace overall budgetary growth if assumptions are not met.
- We note that, like other pension systems, the city anticipates an overall investment loss for its returns for December 2022 valuation; however, retirement board officials report that the current returns have outpaced losses, although it remains to be seen if this trend continues given market instability.
- Somerville expects to increase appropriations to the OPEB trust prior to projected full pension funding in fiscal 2033, with increased contributions thereafter. We note that the city has recently started to fully fund its OPEB ADC while also transferring money into its trust.
- We expect that costs will likely continue to increase. We recognize that weak pension assumptions could result in a delay in the city making material progress in funding the OPEB liability.

The city contributes to:

- Somerville Contributory Retirement System (SCRS): 85.91% funded, with a \$69.2 million proportionate share of the net pension liability; and
- Somerville's single-employer health care plan: 9.6% funded, with a \$155.5 million net OPEB liability.

SCRS recently revised its discount to 7.5% from 7.75%. We continue to view the discount rate as high relative to our 6% guideline, and we believe it could lead to volatile contributions if assumptions are not met. While Massachusetts requires all pension systems to achieve full funding no later than fiscal 2040, SCRS is planning to achieve it by fiscal 2033. We generally view closed, short amortization schedules as positive; however, for SCRS to meet this goal, costs

must increase, which market volatility could exacerbate.

Ratings above the sovereign

We rate Somerville above the sovereign because we think the town can maintain better credit characteristics than the nation in a stress scenario based on its predominantly locally derived revenue base and our view that pledged revenue supporting debt service on the bonds is at limited risk of negative sovereign intervention. Somerville has a predominantly locally derived revenue source, with 40% of general fund revenue coming from property taxes and independent taxing authority and treasury management from the federal government. (For further information, see our criteria, "Ratings Above The Sovereign: Corporate And Government Ratings—Methodology And Assumptions," published Nov. 19, 2013, on RatingsDirect.)

Somerville, Massachusetts -- Key credit metrics				
	Most recent	Historical information		
		2022	2021	2020
Very strong economy				
Projected per capita EBI % of U.S.	155.6			
Market value per capita (\$)	270,631			
Population			82,410	82,686
County unemployment rate (%)			4.6	
Market value (\$000)	22,302,696	20,853,026	19,297,892	
Ten largest taxpayers % of taxable value	9.0			
Strong budgetary performance				
Operating fund result % of expenditures		5.2	5.1	2.3
Total governmental fund result % of expenditures		12.8	7.7	1.4
Very strong budgetary flexibility				
Available reserves % of operating expenditures		35.5	30.3	25.7
Total available reserves (\$000)		102,792	83,981	68,412
Very strong liquidity				
Total government cash % of governmental fund expenditures		67	49	36
Total government cash % of governmental fund debt service		1,123.8	1,009.6	849.6
Very strong management				
Financial Management Assessment	Strong			
Very weak debt & long-term liabilities				
Debt service % of governmental fund expenditures		5.9	4.8	4.2
Net direct debt % of governmental fund revenue	103.3			
Overall net debt % of market value	3.3			
Direct debt 10-year amortization (%)	34.8			
Required pension contribution % of governmental fund expenditures		5.0		
OPEB actual contribution % of governmental fund expenditures		4.0		

Somerville, Massachusetts -- Key credit metrics (cont.)

	Most recent	Historical information		
		2022	2021	2020
Strong institutional framework				
EBI--Effective buying income. OPEB--Other postemployment benefits.				

Data points and ratios may reflect analytical adjustments.

Related Research

Through The ESG Lens 3.0: The Intersection Of ESG Credit Factors And U.S. Public Finance Credit Factors, March 2, 2022

Ratings Detail (As Of May 15, 2023)

Somerville note		
<i>Short Term Rating</i>	SP-1+	Affirmed
Somerville GO		
<i>Long Term Rating</i>	AAA/Stable	Upgraded

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