

## **MOODY'S ASSIGNS Aa2 RATING TO THE CITY OF SOMERVILLE'S (MA) \$6.7 MILLION GENERAL OBLIGATION BONDS**

### **Aa2 RATING AFFECTS \$90.6 MILLION OF OUTSTANDING G.O. DEBT, INCLUDING CURRENT ISSUE**

Moody's Investors Service has assigned a Aa2 rating to the City of Somerville's (MA) \$6.7 million General Obligation Municipal Purpose Loan of 2011 Bonds. Concurrently, Moody's has affirmed the Aa2 long-term rating on approximately \$83.9 million of outstanding general obligation debt. The bonds are secured by the city's limited tax pledge as debt service has not been voted exempt from the levy limitations of Proposition 2 ½. Bond proceeds will be used to redeem outstanding BANs (\$6.7 million) for water meter upgrades and various capital improvement projects.

### **RATING RATIONALE**

The Aa2 rating reflects the city's sizeable tax base within the greater Boston (GO rated Aaa/stable outlook) economy and a sound financial position with healthy reserve levels. Also, incorporated in the rating is a resident wealth profile which lags commonwealth medians as well as an above-average overall debt position.

### **STRENGTHS**

- Conservative budgetary practices
- Sizable tax base

### **CHALLENGES**

- Declining assessed value growth

### **DETAILED CREDIT DISCUSSION**

#### **REDEVELOPMENT ACTIVITY CONTINUES; HOUSING MARKET BEGINNING TO RECOVER**

After experiencing two consecutive declines, modest property value reductions have begun to reverse. The \$9.1 billion equalized value base is expected to benefit from ongoing commercial redevelopment activity related to Somerville's favorable location and management's commitment to attracting new business. Consequently, while residential values continue to contract, particularly in the multi-family sector, several new commercial development projects are expected to soften the overall assessment declines. Recent assessed valuations show relatively flat to modest growth of 0.4% for fiscal 2011, contrary to regional and national trends and reversing local declines of 2.1% and 1.8% in fiscal 2009 and 2010, respectively. Long-term, we believe the city's convenient location, economic stability provided by higher education institutions and planned transit improvements favorably position the city for growth. Equalized values grew an average of 3.8% annually over the last five years incorporating both significant market appreciation and new growth, partially offset by the national economic slowdown over the last two fiscal years. Consequently, the city's equalized value has more than tripled to over \$9.6 billion from \$3.17 billion in 1998 primarily driven by condominium conversions of rental units, new commercial development and market value appreciation in the first three quarters of the decade.

To capitalize on Somerville's desirable location and to facilitate future growth, city management has embarked on an ambitious economic development plan, including commissioning various feasibility studies to identify potential projects, rezoning initiatives to facilitate investment and pursuit of state and federal grant funds. The principal driver for future growth is the 145-acre Assembly Square Project, including two million square feet of office space, over 2,000 housing units, and a 500,000-square-foot IKEA retail store. Previously delayed due to zoning litigation, construction is expected to begin after the commonwealth completes construction of a \$15 million ARRA-funded roadway which is currently under construction. The city is also pursuing several new hotels and is working to rezone areas of the city to allow for greater density in areas served by mass transit. Longer term plans to add two subway stops within city limits would unlock additional land for redevelopment. The city has secured \$15 million in developer support and \$25 million of federal earmarks for one of these projects; however construction remains several years out.

Portions of Tufts University (revenue bonds rated Aa2/stable outlook) lie within the city and the university's presence provides economic stability as well as significant employment opportunities. Although a tax-exempt entity, the city benefits from annual payments-in-lieu of taxes of \$125,000 and affordable rental rates of university-owned property utilized for city operations. The city's sizeable student population (about 14% of total population according to the 2000 census), drawn from Tufts, as well as nearby Harvard (rated Aaa/stable outlook) and MIT (rated Aaa/stable outlook), partially depresses the city's income indices, expressed by median family income and per capita income at 83% and 91%, respectively, of commonwealth medians. Unemployment typically trends lower than state and national averages and in October 2010 stood at 5.9%, comfortably below the state and national jobless rates of 7.7% and 9%, respectively. Equalized value per capital is a solid \$120,643, which is also somewhat understated given the significant \$1.17 billion estimated valuation of tax-exempt property in Somerville.

#### STABLE FINANCIAL OPERATIONS DESPITE DECLINES IN STATE AID REVENUE

Moody's believes Somerville's conservative budgeting approach and strong financial management will be integral to the city's financial stability over the next several years given slowing revenues and continued reductions in state aid. Audited fiscal 2009 results indicate a seventh consecutive operating surplus, although a significant \$4 million transfer to the city's capital and general stabilization funds resulted in a general fund decrease to \$26.7 million, a still-sound 14.8% of general fund revenues. The undesignated general fund balance also dropped to \$8.7 million, a slim 4.7% of revenues. The total general fund balance includes a \$6.7 million reserve for employee benefits as Somerville maintains employee contributions for its self-funded health insurance program within the general fund. As these balances are not available for general operations, Moody's views Somerville's unreserved fund balance as more accurately reflecting the city's financial position. As planned, certified free cash balances fell by roughly \$4 million to \$6.3 million, after transferring \$1 million to capital stabilization and \$4 million to establish a revenue stabilization fund or "rainy day" fund, providing a financial bridge during this economic downturn. Available reserves (consisting of unreserved General Fund balance plus Stabilization Funds) in fiscal 2009 total \$25 million, a solid 14% of general fund revenues, and more than triple the fiscal 2002 available reserve balance of \$7.8 million, a slim 4.87% of revenues. Operations in fiscal 2010 (unaudited) are projected to end with another modest operating surplus, replenishing the \$3.5 million in appropriated free cash. Conservative budgeting and close expenditure management are the main drivers of the favorable revenue and expenditure variances, relative to budget.

The fiscal 2011 budget includes a 3.2% expenditure increase over fiscal 2010 which is balanced by \$2.2 million of free cash as revenue. Also, an appropriation of roughly \$2 million from Somerville's rainy day stabilization fund is planned. To offset a \$916,000 additional state aid reduction and generally flat growth in local revenue streams, management has imposed 18 layoffs in city departments and continues to aggressively pursue opportunities to improve operating efficiency and reduce costs. Going forward, we expect the weaker economy will continue to cause budgetary tightening; however management's commitment to conservative revenue budgeting and demonstrated willingness to reduce expenditures will likely allow the city to weather the economic downturn without significant detriment to reserve levels. To the extent that the city continues to rely on its rainy day fund over the next few years, we will monitor the city's active management of overall reserve levels and the ability to maintain sufficient financial flexibility.

#### MANAGEABLE DEBT BURDEN

The city's debt position is expected remain manageable given anticipated school construction assistance and rapid retirement of outstanding debt. Somerville's direct debt burden is a modest 1% of equalized valuation, however overall debt burden is above average at 5% due to significant overlapping obligations attributable to the Massachusetts Water Resources Authority (senior lien revenue debt rated Aaa/negative outlook) and the Massachusetts Bay Transportation Authority (assessment debt rated Aa1/stable outlook). After adjusting for 90% commonwealth school construction reimbursement, this number falls to an affordable 4.6%. Debt service payments accounted for a manageable 4% of general fund expenditures in fiscal 2009. Amortization of outstanding debt is rapid with 81.5% of principal repaid within 10 years. Future capital plans consist of routine building maintenance projects and replacement or extensive renovation of a fire-damaged school. The extent of the school construction or reconstruction will certainly drive the total cost, currently estimated at \$25 million, however \$9 million of received insurance payments and Massachusetts School Building Authority grants of roughly 80% of project cost (MSBA revenue bonds rated Aa1/stable outlook) are expected to partially mitigate the effect on the city's debt burden. The city solely issues fixed rate debt and has no exposure to derivative products.

What could make the rating change – UP:

-- Trend of operating surpluses that result in increased financial flexibility

-- Significant tax base expansion

What could make the rating change – DOWN:

-- Decline in financial flexibility resulting in General Fund balance reduction

-- Deterioration of the city's tax base and demographic profile

-- Significant increase in debt burden

KEY STATISTICS:

2008 population (estimate): 75,662 (-2.3% since 2000 census)

2011 Equalized Valuation: \$9.1 billion

Average Annual Equalized Value growth (2006-2011): 3.8%

2011 Equalized Value per capita: \$120,643

Per Capita Income: \$23,628 (91% of commonwealth median, 110% of nation)

Median Family Income: \$51,243 (83% of commonwealth median, 102% of nation)

FY09 General Fund balance: \$26.6 million (14.8% of pro-forma General Fund revenues)

FY09 Unreserved undesignated General Fund balance: \$8.4 million (4.7% of pro-forma General Fund revenues)

FY09 Stabilization Fund balance: \$13.1 million (7.4% of pro-forma General Fund revenues)

Overall debt burden: 5% (4.6% adjusted for state building aid)

Payout of principal (10 years): 81.5%

Post-Sale Long-term debt outstanding: \$90.6 million