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CREDIT OPINION
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Lakeville (City of) MN

Update to credit analysis

Summary

The City of Lakeville (Aa1) benefits from a large and growing tax base located in the Twin Cities metropolitan area, above average resident income indices and a healthy financial profile. The credit attributes are balanced by above average leverage related to long-term debt and pension liabilities, both of which contribute to high fixed costs.

Credit strengths

» Wealthy and growing tax base near the Twin Cities

» Very healthy reserves

Credit challenges

» Above average leverage related to long-term debt and pension liabilities

» High fixed costs

Rating outlook

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

Factors that could lead to an upgrade

» Reduced leverage and fixed cost burden

Factors that could lead to a downgrade

» Substantial tax base contraction or weakening of resident income indices

» Narrowing of operating fund balance or liquidity

» Growth in leverage or fixed costs

Key indicators

Exhibit 1

Lakeville (City of) MN	2013	2014	2015	2016	2017
Economy/Tax Base					
Total Full Value ($000)	$5,387,471	$5,694,638	$6,157,266	$6,520,717	$6,921,610
Population	-	57,715	58,592	59,786	61,993
Full Value Per Capita	$94,920	$98,668	$105,087	$109,068	$111,651
Median Family Income (% of US Median)	158.9%	160.6%	158.7%	161.1%	161.1%
Finances					
Operating Revenue ($000)	$29,727	$36,278	$35,704	$37,269	$39,818
Fund Balance ($000)	$19,916	$24,990	$24,918	$28,536	$34,238
Cash Balance ($000)	$41,849	$50,605	$39,041	$40,163	$33,625
Fund Balance as a % of Revenues	67.0%	68.9%	69.8%	76.6%	86.0%
Cash Balance as a % of Revenues	140.8%	139.5%	109.3%	107.8%	84.4%
Debt/Pensions					
Net Direct Debt ($000)	$109,605	$114,590	$108,220	$115,545	$109,802
3-Year Average of Moody's ANPL ($000)	$49,152	$52,766	$49,467	$57,795	$60,853
Net Direct Debt / Full Value (%)	2.0%	2.0%	1.8%	1.8%	1.6%
Net Direct Debt / Operating Revenues (x)	3.7x	3.2x	3.0x	3.1x	2.8x
Moody's - adjusted Net Pension Liability (3-yr average) to Full Value (%)	0.9%	0.9%	0.8%	0.9%	0.9%
Moody's - adjusted Net Pension Liability (3-yr average) to Revenues (x)	1.7x	1.5x	1.4x	1.6x	1.5x

Source: Moody's Investors Service, US Census Bureau, the city's audited financial statements

Profile

The City of Lakeville is located 25 miles south of downtown Minneapolis and encompasses nearly 40 square miles in Dakota County (Aaa stable). The city has 60,000 residents.

Detailed credit considerations

Economy and tax Base: large, affluent tax base near Twin Cities

The city's large tax base is expected to remain healthy due to its economic ties to the Twin Cities metropolitan area (Minneapolis, Aa1 negative; St. Paul Aa1 negative), which supports the city's strong resident income indices and favorable demographic trends. Fully valued at $6.9 billion, as measured by economic market value, the city's tax base grew at an average of 5.3% annually during the last five years and currently exceeds its pre-recession peak of $6.4 billion in 2009. The growth in the city's tax base has largely been driven by residential development to support the city's growing population. From 1990 to 2010, the city's population more than doubled to nearly 56,000 residents and has shown continued growth in recent years. The city notes that approximately 30% of the city is available to accommodate future development.

Median family income is estimated at 161% of the national median. Underscoring the health of the Twin Cites regional economy are the city's strong employment trends, with March 2018 employment levels nearly 20% above the pre-recession peak and a low 2.4% unemployment rate.

Financial operations and reserves: healthy financial operations supported by ample reserves

The city's financial profile is expected to remain sound due to sizeable operating fund reserves and conservative budgeting practices. The city's fiscal 2017 budget included a more than $2 million use of fund balance though positive revenue variances coupled with expenditure reductions allowed the city to close the year balanced. The city closed fiscal 2017 with an available operating fund balance of $34 million, or more than 85% of revenue across the General Fund and Debt Service Fund. Fiscal 2018 is tracking better than budget and current projections reflect a $350,000 surplus driven by higher than budgeted building permit revenue.

Property taxes are the city's primary revenue source, comprising 62% of fiscal 2017 revenue. State levy limits are not in place for municipalities for the 2017-2019 biennium. The city receives limited state and federal aid and does not have significant reliance on economically sensitive revenues.

The city's two major enterprise funds include its Liquor Fund and the Utility Fund. The Liquor Fund accounts for operations of the city's three liquor stores, while the Utility Fund accounts for water and sanitary sewer activities. Both funds ended fiscal 2017 with healthy liquidity. Net income from the operations of the city's three liquor stores totaled $1.2 million while net revenue for the Utility Fund totaled $3 million. Total debt service coverage across all bonds supported by enterprise revenues exceeded 4x in fiscal 2017. Neither enterprise has relied on General Fund support.

LIQUIDITY

The city's liquidity is strong with fiscal 2017 operating cash at $34 million, or 85% of operating revenue. Across the city's liquor and utility enterprise funds, unrestricted cash and investments totaled $9.7 million, or nearly 300 days cash on hand.

Debt and pensions: high and growing leverage

The city's leverage related to long-term debt and pension liabilities is elevated. Inclusive of the 2018 bonds, the city has a net debt burden equal to $109 million, or 1.6% of full value and 2.7x fiscal 2017 operating revenue. The city's adjusted net pension liability (ANPL), which we calculate using a market-based interest rate, totaled $61 million in fiscal 2017, equal to 0.9% of full value and 1.5x operating revenue. In comparison, the city's reported net pension liability, based on the use of higher discount rates, was $12 million.

The city's total fixed costs, consisting of debt service and retirement contributions, are high, totaling more than 30% of operating revenue. While we view this as a credit challenge, the high ratio is mitigated by the very high share of fixed costs consisting of debt service. Most of the city's debt service is supported by the authorization to levy taxes unlimited by rate or amount.

DEBT STRUCTURE

All of the city's debt is fixed rate and long term with almost 70% of outstanding principal retired within 10 years.

The city's GO bonds are secured by the city's pledge and authorization to levy a dedicated property tax unlimited as to rate and amount. The security benefits from a statutory lien, but there is no lockbox structure.

The city's lease revenue debt is secured by its pledge to pay lease payments, subject to annual appropriation.

DEBT-RELATED DERIVATIVES

The city has no debt-related derivatives.

PENSIONS AND OPEB

The city participates in two multiple-employer cost-sharing plans, the General Employees Retirement Fund (GERF) and the Public Employees Police and Fire Fund (PEPFF). Minnesota statutes establish local government retirement contributions as a share of annual payroll. The fiscal 2017 employer contribution rates were set at 7.5% of payroll for GERF and at 16.2% of payroll for PEPFF. Lakeville's fiscal 2017 pension contribution totaled approximately 4% of operating revenue.

Contributions to PEPFF from all participating governments in aggregate amounted to only 90% of the plan's "tread water" indicator in 2017. Employer contributions that tread water equal the sum of current year service cost and interest on reported net pension liabilities at the start of the year, using reported assumptions. If plan assumptions are met exactly, contributions equal to the tread water indicator will prevent the reported net pension liabilities from growing.

Other post-employment benefits (OPEB) do not represent a material credit risk for the city. The city does not offer explicit OPEB benefits, but allows retired employees to stay on its health care plan, creating an implicit rate subsidy. The city's most recent unfunded actuarial accrued liability was $530,000.

Management and governance: strong institutional framework reflects ability to easily adjust revenues and expenditures

Minnesota cities have an Institutional Framework score of Aa, which is high. Institutional Framework scores measure a sector's legal ability to increase revenues and decrease expenditures. The sector has one or more major revenue sources that are not subject to any caps. Revenues tend to be predictable, as cities rely primarily on property taxes and state Local Government Aid (LGA), which is distributed based on demographic and tax base factors. Revenue-raising flexibility is moderate as cities generally benefit from unlimited levying authority, except during years in which the state has imposed limits. Levy limits are not in place for the 2017-2018 biennium. Across the sector, fixed and mandated costs are relatively high. Minnesota has public sector unions, which can limit the ability to cut expenditures. Expenditures mostly consist of personnel costs, which are highly predictable.

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