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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 rapidly growing tax base located in the Twin Cities (Minneapolis; Aa1 negative; St. Paul, Aa1 negative) metropolitan area, above average resident income indices and a very strong financial profile. The credit attributes are balanced by above average leverage related to long-term debt and pension burdens, both of which contribute to high fixed costs.

Credit strengths

» Wealthy and rapidly growing tax base near the Twin Cities

» Very strong reserves

Credit challenges

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

» 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

» Significant narrowing of operating reserves or liquidity

» Growth in leverage or fixed costs

Key indicators

Exhibit 1

Lakeville (City of) MN	2014	2015	2016	2017	2018
Economy/Tax Base					
Total Full Value ($000)	$5,694,638	$6,157,266	$6,520,717	$6,921,610	$7,473,143
Population	57,715	58,592	59,786	61,056	64,334
Full Value Per Capita	$98,668	$105,087	$109,068	$113,365	$116,162
Median Family Income (% of US Median)	160.6%	158.7%	161.1%	161.0%	161.0%
Finances					
Operating Revenue ($000)	$36,278	$35,704	$37,269	$39,818	$40,784
Fund Balance ($000)	$24,990	$24,918	$28,536	$31,892	$33,442
Cash Balance ($000)	$50,605	$39,041	$40,163	$33,625	$34,043
Fund Balance as a % of Revenues	68.9%	69.8%	76.6%	80.1%	82.0%
Cash Balance as a % of Revenues	139.5%	109.3%	107.8%	84.4%	83.5%
Debt/Pensions					
Net Direct Debt ($000)	$114,590	$108,220	$115,545	$109,802	$108,212
3-Year Average of Moody's ANPL ($000)	N/A	$49,467	$57,795	$60,853	$63,612
Net Direct Debt / Full Value (%)	2.0%	1.8%	1.8%	1.6%	1.4%
Net Direct Debt / Operating Revenues (x)	3.2x	3.0x	3.1x	2.8x	2.7x
Moody's - adjusted Net Pension Liability (3-yr average) to Full Value (%)	N/A	0.8%	0.9%	0.9%	0.9%
Moody's - adjusted Net Pension Liability (3-yr average) to Revenues (x)	N/A	1.4x	1.6x	1.5x	1.6x

Source: US Census Bureau; 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 serves more than 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, which supports the city's strong resident income indices and favorable demographic trends. Fully valued at $7.5 billion, as measured by economic market value, the city's rapidly growing tax base increased by more than 40% since 2012 and well exceeds its pre-recession peak of $6.4 billion in 2009. The growth in the city's tax base has largely been driven by the residential development needed to support the city's growing population. Between 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. Management expects residential development to continue, with 350 to 400 new single family home building permits annually.

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 and low unemployment. As of April 2019, the city's unemployment rate (2.6%) was below the state's rate (3.2%) and the national rate (3.3%).

Financial operations and reserves: very strong financial profile supported by ample reserves

The city's financial profile is expected to remain very strong due to sizeable operating fund reserves and conservative budgeting practices. The city closed fiscal 2018 with a combined available fund balance of more than $33 million, equal to 82% of operating revenue across the General Fund and Debt Service Fund. Fiscal 2019 is tracking better than budget with higher than budgeted building permit revenue driving the positive variance.

Property taxes are the city's primary revenue source, comprising about 63% of revenue and state levy limits are not currently in place for cities. 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 2018 with very healthy liquidity and strong debt service coverage. Neither enterprise has relied on General Fund support.

LIQUIDITY

The city's liquidity is strong with fiscal 2018 operating cash at $34 million, or 84% of operating revenue. Unrestricted cash and investments in the city's liquor and utility enterprise funds exceeded $12.6 million.

Debt and pensions: elevated leverage; high fixed costs

The city's leverage related to long-term debt and pension liabilities is elevated. Inclusive of the 2019 bonds, the city has a net debt burden equals about $108 million, or 1.5% of full value and 2.7x fiscal 2018 operating revenue. The city's adjusted net pension liability (ANPL), which we calculate using a market-based interest rate, totaled $64 million in fiscal 2018, equal to 0.9% of full value and 1.6x operating revenue. In comparison, the city's reported net pension liability, based on the use of higher discount rates, was $11 million.

The city's total fixed costs, consisting of debt service and retirement contributions, are high, totaling more than 30% of operating revenue. The city's debt burden is the primary driver of the high fixed costs, most of which is supported by an unlimited tax levy.

DEBT STRUCTURE

All of the city's debt is fixed rate and long term with about 74% of outstanding principal retired within 10 years.

The city's GOULT bonds are secured by the city's full faith and credit pledge and the authority to levy a dedicated property tax unlimited as to rate and amount. The security benefits from a statutory lien.

The city's lease revenue debt is secured by its pledge to make annual lease payments, which are subject to annual appropriation, per the lease-purchase agreements.

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. Employer contribution rates are currently set at 7.5% of payroll for GERF and at 16.2% of payroll for PEPFF. The city's total fiscal 2018 pension contribution was equal to about 4% of operating revenue.

Statutory contribution levels have not kept pace with growing unfunded liabilities in state-wide pension plans. Contributions to PEPFF from all participating governments in aggregate amounted to 90% of the plan's "tread water" indicator in 2018.[1] The state of Minnesota approved legislation in 2018 that will modify benefits and modestly increase contributions for some pension plans. Employer contributions from cities to the police and fire plan, for example, will modestly increase to 17.7% by 2020 from the current rate of 16.2%. Because employer contributions will not rise significantly, cities are unlikely to contend with material budget strain from the increases.

Other post-employment benefits (OPEB) obligations 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 paygo cost in fiscal 2018 was only $28,000 while the net OPEB liability is approximately $1.1 million.

Management and governance: strong institutional framework

Minnesota cities have an Institutional Framework score of "Aa", which is strong. 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 currently in place for cities. Across the sector, fixed and mandated costs are relatively high. Expenditures mostly consist of personnel costs, which are highly predictable.

Rating methodology and scorecard factors

The US Local Government General Obligation Debt methodology includes a scorecard, a tool providing a composite score of a local government's credit profile based on the weighted factors we consider most important, universal and measurable, as well as possible notching factors dependent on individual credit strengths and weaknesses. Its purpose is not to determine the final rating, but rather to provide a standard platform from which to analyze and compare local government credits.

Exhibit 2

Lakeville (City of), MN

Lakeville (City of) MN

Rating Factors	Measure	Score
Economy/Tax Base (30%) [1]		
Tax Base Size: Full Value (in 000s)	$7,473,143	Aa
Full Value Per Capita	$116,162	Aa
Median Family Income (% of US Median)	161.0%	Aaa
Finances (30%)		
Fund Balance as a % of Revenues	82.0%	Aaa
5-Year Dollar Change in Fund Balance as % of Revenues	33.2%	Aaa
Cash Balance as a % of Revenues	83.5%	Aaa
5-Year Dollar Change in Cash Balance as % of Revenues	-19.1%	B & Below
Management (20%)		
Institutional Framework	Aa	Aa
Operating History: 5-Year Average of Operating Revenues / Operating Expenditures	1.1x	Aaa
Debt and Pensions (20%)		
Net Direct Debt / Full Value (%)	1.4%	Aa
Net Direct Debt / Operating Revenues (x)	2.7x	A
3-Year Average of Moody's Adjusted Net Pension Liability / Full Value (%)	0.9%	Aaa
3-Year Average of Moody's Adjusted Net Pension Liability / Operating Revenues (x)	1.6x	A
Notching Factors:[2]		
Standardized Adjustments [3]: Unusually strong or weak security features: Secured by statute		Up
	Scorecard-Indicated Outcome	Aa1
	Assigned Rating	Aa1

Note: The negative trend in the city's liquidity reflected in the above table is driven by the timing of various cross-over refundings. Net of these refundings, and similar to the trend fund balance, the liquidity trend has been positive.

[1] Economy measures are based on data from the most recent year available.

[2] Notching Factors are specifically defined in the US Local Government General Obligation Debt methodology dated December 16, 2016.

[3] Standardized adjustments are outlined in the GO Methodology Scorecard Inputs Updated for 2019 publication.

Source: US Census Bureau, audited financial statements

Endnotes

1 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.

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