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CREDIT OPINION
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Contacts

Benjamin J VanMetre +1.312.706.9951
AVP-Analyst
ben.vanmetre@moodys.com

Tatiana Killen +1.212.553.2895
VP-Senior Analyst
tatiana.killen@moodys.com

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Lakeville (City of) MN

Update to credit analysis

Summary

The City of Lakeville (Aa1) benefits from a large tax base located in the Twin Cities (Minneapolis; Aa1 stable; St. Paul, Aa1 stable) 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.

We regard the coronavirus outbreak as a social risk under our ESG framework, given the substantial implications for public health and safety. We do not see any material immediate credit risks for the city. However, the situation surrounding coronavirus is rapidly evolving and the longer term impact will depend on both the severity and duration of the crisis. If our view of the credit quality of the city changes, we will update our opinion at that time.

Credit strengths

» Large and affluent tax base near the Twin Cities

» Very strong financial profile

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 burdens

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

Lakeville (City of) MN	2015	2016	2017	2018	2019
Economy/Tax Base					
Total Full Value ($000)	$6,157,266	$6,520,717	$6,921,610	$7,472,127	$8,160,104
Population	58,592	59,786	61,056	62,489	62,489
Full Value Per Capita	$105,087	$109,068	$113,365	$119,575	$130,585
Median Family Income (% of US Median)	158.7%	161.1%	161.0%	163.4%	163.4%
Finances					
Operating Revenue ($000)	$35,704	$37,269	$39,818	$40,784	$44,566
Fund Balance ($000)	$24,918	$28,536	$31,892	$33,442	$37,314
Cash Balance ($000)	$39,041	$40,163	$33,625	$34,043	$44,662
Fund Balance as a % of Revenues	69.8%	76.6%	80.1%	82.0%	83.7%
Cash Balance as a % of Revenues	109.3%	107.8%	84.4%	83.5%	100.2%
Debt/Pensions					
Net Direct Debt ($000)	$108,220	$115,545	$109,802	$110,212	$107,737
3-Year Average of Moody's ANPL ($000)	$49,467	$57,795	$60,853	$63,612	$63,324
Net Direct Debt / Full Value (%)	1.8%	1.8%	1.6%	1.5%	1.3%
Net Direct Debt / Operating Revenues (x)	3.0x	3.1x	2.8x	2.7x	2.4x
Moody's - adjusted Net Pension Liability (3-yr average) to Full Value (%)	0.8%	0.9%	0.9%	0.9%	0.8%
Moody's - adjusted Net Pension Liability (3-yr average) to Revenues (x)	1.4x	1.6x	1.5x	1.6x	1.4x

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

Profile

The City of Lakeville is located about 20 miles south of downtown Minneapolis and encompasses nearly 40 square miles in Dakota County (Aaa stable). The city serves more than 62,000 residents.

Detailed credit considerations

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

The coronavirus is driving an unprecedented economic slowdown. We currently forecast US GDP to decline significantly during 2020 with a gradual recovery commencing toward the end of the year. Local governments with the highest exposure to tourism, hospitality, healthcare, retail, and oil and gas could suffer particularly severe impacts. Going into the current economic slowdown, a combination of appreciating home values and robust residential construction drove seven consecutive years of tax base growth in the city. The tax base now exceeds $8 billion, as measured by economic market value. 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. Despite the coronavirus pandemic, officials report generally stable operations and collections among larger employers and taxpayers as well as continued residential development underway within the city. Management expects residential development to continue, with 350 new single family home building permits annually. About 30% of the city is available to accommodate future development.

The city's economic ties to the Twin Cities metropolitan area supports the strong resident income indices and favorable demographic trends. Median family income is estimated at 163% of the national median. The unprecedented economic slowdown, however, is causing a sharp spike in unemployment rates across the nation. As of April 2020, the city's unemployment rate (8.4%) was on par with the state's rate (8.6%) and well below the national rate (14.4%).

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

The city's financial profile is likely to remain very strong because of sizable reserves, conservative budgeting practices and limited financial pressure related to the coronavirus pandemic. Current fiscal 2020 projections reflect a modest operating surplus. The city reports that unbudgeted expenditures related to the coronavirus pandemic have been modest and that positive revenue variances and recently implemented expenditure controls will help mitigate the financial impact. Looking forward to fiscal 2021, the city plans to adopt a balanced budget that will include a decrease in the property tax collection rate and will also continue focusing on expenditure controls including holding non-personnel budgets at 2020 levels, prioritizing capital projects and deferring non-major projects as needed.

The city had several years of operating surpluses before the current economic slowdown. The city closed fiscal 2019 with a combined available fund balance of about $37 million, equal to a very strong 84% of operating revenue across the general fund and debt service fund.

Property taxes are the city's primary revenue source, comprising about 64% of revenue, which provides the city with a great degree of flexibility because 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 revenue.

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 2019 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 2019 operating cash at $45 million, or 100% of operating revenue. Unrestricted cash and investments in the city's liquor enterprise and utility enterprise funds exceeded $13.6 million at the close of fiscal 2019.

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 2020 bonds, the city has a net debt burden equals about $110 million, or 1.4% of full value and 2.5x fiscal 2019 revenue.

The city's adjusted net pension liability (ANPL), based on a 3.5% discount rate, totals about $71 million while the three year average totals $63 million, equal to 0.8% of full value and 1.4x operating revenue. In comparison, the city's reported net pension liability, based on a 7.5% discount rate, totals about $10 million.

The city's total fixed costs, consisting of debt service and retirement contributions, are high, typically hovering around 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. 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 also 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. The 2019 employer contribution rates were set at 7.5% of payroll for GERF and at 16.95% of payroll for PEPFF. The city's total fiscal 2019 pension contribution was equal to about 4% of operating revenue.

Statutory contribution levels have historically not kept pace with growing unfunded liabilities in statewide pension plans. Contributions to both PEPFF and GERF from all participating governments in aggregate, however, exceeded 100% of each plan's "tread water" indicator in 2019.[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 previous rate of 16.2% in 2018. 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 healthcare plan, creating an implicit rate subsidy. Both the city's reported net OPEB liability and our adjusted net OPEB liability for the city, based on the use of a different discount rate, total about $1 million. .

ESG considerations

ENVIRONMENTAL

Environmental factors have not had a material impact on the city's credit profile. According to data of Moody's affiliate, Four Twenty Seven, Dakota County has notable exposure to water stress and has a relatively limited exposure to other various environmental risks going forward.

SOCIAL

Social factors are a key consideration for the city. Resident income levels are above average. The median age of Lakeville residents is slightly below state and national figures.

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GOVERNANCE

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.

Lakeville (City of) MN

Scorecard Factors	Measure	Score
Economy/Tax Base (30%) [1]		
Tax Base Size: Full Value (in 000s)	$8,160,104	Aa
Full Value Per Capita	$130,585	Aa
Median Family Income (% of US Median)	163.4%	Aaa
Finances (30%)		
Fund Balance as a % of Revenues	83.7%	Aaa
5-Year Dollar Change in Fund Balance as % of Revenues	27.7%	Aaa
Cash Balance as a % of Revenues	100.2%	Aaa
5-Year Dollar Change in Cash Balance as % of Revenues	-13.3%	Ba
Management (20%)		
Institutional Framework	Aa	Aa
Operating History: 5-Year Average of Operating Revenues / Operating Expenditures (x)	1.0x	Aa
Debt and Pensions (20%)		
Net Direct Debt / Full Value (%)	1.4%	Aa
Net Direct Debt / Operating Revenues (x)	2.5x	A
3-Year Average of Moody's Adjusted Net Pension Liability / Full Value (%)	0.8%	Aaa
3-Year Average of Moody's Adjusted Net Pension Liability / Operating Revenues (x)	1.4x	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.
[3] Standardized adjustments are outlined in the GO Methodology Scorecard Inputs.
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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Contacts

Benjamin J VanMetre +1.312.706.9951
AVP-Analyst
ben.vanmetre@moodys.com

Tatiana Killen +1.212.553.2895
VP-Senior Analyst
tatiana.killen@moodys.com

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