

# RatingsDirect®

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## Summary:

# Farmington, Minnesota; General Obligation

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## Summary:

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### Credit Profile

US\$1.83 mil GO bnds ser 2019A due 02/01/2029

<i>Long Term Rating</i>	AA+/Stable	New
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Farmington GO imp rfdg bnds ser 2011A dtd: 08/25/2011 due 02/01/2012-2019

<i>Long Term Rating</i>	AA+/Stable	Upgraded
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## Rationale

S&P Global Ratings raised its long-term rating to 'AA+' from 'AA' on Farmington, Minn.'s series general obligation (GO) debt. At the same time, we assigned our 'AA+' rating on the city's series 2019A GO bonds. The outlook is stable.

The upgrade reflects the city's growing economic base, very strong financial management, and lower debt burden. The city adopted a detailed financial management plan in 2017 with the goals of lowering its debt burden, cash-financing future projects, and managing the growth in its tax levy. The plan provides detailed forecasting for both operations and capital improvements, which is necessary as the city grows. Management has also focused on retiring debt early for costs savings by using internal financing, with minimal effects on the city's liquidity. As a result, our view of the city's economy, financial management, and debt burden has improved.

The bonds are secured by the city's GO, full faith and credit pledge, which benefits from an unlimited ad valorem tax. The series 2019A bonds are also payable from net revenue of the city's water utility, but we rate to the GO pledge. Several of the city's bonds have additional revenue pledged, but we rate them all to the GO pledge.

The series 2019A bonds will finance a street reconstruction project and refurbishment of the city's water tower.

The rating reflects our assessment of the following factors, including Farmington's:

- Strong economy, with access to a broad and diverse metropolitan statistical area (MSA);
- Very strong management, with strong financial policies and practices under our Financial Management Assessment (FMA) methodology;
- Strong budgetary performance, with operating surpluses in the general fund and at the total governmental fund level in fiscal 2017;
- Very strong budgetary flexibility, with an available fund balance in fiscal 2017 of 58% of operating expenditures;
- Very strong liquidity, with total government available cash at 1.6x total governmental fund expenditures and 7.6x governmental debt service, and access to external liquidity we consider strong;
- Adequate debt and contingent liability position, with debt service carrying charges at 20.7% of expenditures and net direct debt that is 59.5% of total governmental fund revenue, as well as rapid amortization, with 96.3% of debt scheduled to be retired in 10 years; and

- Strong institutional framework score.

### **Strong economy**

We consider Farmington's economy strong. The city, with an estimated population of 24,082 over roughly 14.8 miles, is in Dakota County, roughly 25 miles south of the Twin Cities. It is in the Minneapolis-St. Paul-Bloomington MSA, which we consider to be broad and diverse. The city has a projected per capita effective buying income of 115% of the national level and per capita market value of \$85,524. Overall, market value grew by 6.1% over the past year to \$2.1 billion in 2018. The county unemployment rate was 3.0% in 2017.

Farmington is primarily residential (82% of tax capacity) with smaller commercial/industrial (10%) component. Since the recession, it has seen steady valuation growth resulting from both the appreciation of properties as well as new residential development. The city has ample room for additional growth, and management reports that it expects two new residential plats to be approved this spring, which would bring 300 more single-family homes. Officials expect taxable and market values to continue to increase at similar rates over the next few years. Based on the recent trend and upcoming developments in the city, we view this growth as likely.

### **Very strong management**

We view the city's management as very strong, with strong financial policies and practices under our FMA methodology, indicating financial practices are strong, well embedded, and likely sustainable.

Our view of the city's management has improved following the adoption and implementation of a long-term financial plan in 2017. The plan goes out to 2030, but has detailed schedules that project forward the next five years. The five-year forecast schedules are updated by management throughout the year, but are reviewed by the council annually. Some other management highlights include:

- Use of at least three years of historical information in the formulation of the upcoming years revenue and expenditure assumptions with the help of outside sources and a line-by-line approach to budgeting;
- Monthly reporting of budget-to-actual performance to the council, with the ability to make amendments to the budget as needed;
- A five-year capital improvement plan that addresses capital needs, along with sources and uses of funds that is updated annually;
- An investment management policy with monthly reporting of investments and holdings to the city manager and annual reports to council;
- A debt management policy containing provisions limiting the city from issuing variable-rate debt and will not use derivative-based debt; and
- A fund balance policy to maintain 40% to 50% of operating expenditures for cash-flow needs, which the city meets.

### **Strong budgetary performance**

Farmington's budgetary performance is strong, in our opinion. The city had surplus operating results in the general fund of 5.4% of expenditures and 13.9% across all governmental funds in fiscal 2017. General fund operating results of the city have been stable over the last three years, with results of 4.3% in 2016 and 6.2% in 2015.

We have adjusted revenue and expenditures to account for recurring transfers into and out of the general fund as well as total governmental funds. We also removed one-time transfers and expenditures related to the early retirement of debt.

Over the last three fiscal years, the city has achieved strong general fund results, with surpluses ranging between 4% and 6% of expenditures. Management attributes the strong results to its conservative budgeting of revenue, for items such as building permits, as well as expenditures. Across total governmental funds, the city has had some use of reserves related to capital projects.

The fiscal 2018 audit is not yet available, but management reports the year closed with roughly a \$600,000 general fund surplus, but the city will transfer the surplus to capital projects funds or reclassify the fund balance for future projects to remain at its policy level of 40% of expenditures in reserve. Across total governmental funds, there was a reduction in fund balance related to three bond issues that were optionally redeemed (2010A, 2010B, and 2011A), but management is not expecting any other significant use of reserves.

The 2019 budget is balanced for the general fund and across total governmental funds. Year-to-date, the city reports that revenue and expenditures are tracking to budget. Based on the city's historical performance and budgeting practices, we believe it will likely maintain a strong budgetary performance as it has consistently been able to outperform the budget.

### **Very strong budgetary flexibility**

Farmington's budgetary flexibility is very strong, in our view, with an available fund balance in fiscal 2017 of 58% of operating expenditures, or \$6.8 million. We expect the available fund balance to remain above 30% of expenditures for the current and next fiscal years, which we view as a positive credit factor. The available fund balance includes \$5.7 million (48.2% of expenditures) in the general fund and \$1.1 million (9.5%) that is outside the general fund but legally available for operations.

Additional liquidity is provided by the cash and cash equivalents in the liquor fund which can be used for general operations with no repayment provisions. Based on fiscal 2018 projections and the 2019 budget, we believe the city's available fund balance as a percentage of expenditures will remain very strong.

### **Very strong liquidity**

In our opinion, Farmington's liquidity is very strong, with total government available cash at 1.6x total governmental fund expenditures and 7.6x governmental debt service in 2017. In our view, the city has strong access to external liquidity if necessary.

We believe that the city has strong access to external liquidity, having issued GO debt, which demonstrates access to capital markets. The city's governmental cash may decline slightly in 2018 as it used \$3.2 million of cash on hand in its Storm Water Trunk Fund to optionally redeem its 2010A-B and 2011A GO debt for cost savings. The Storm Water Trunk Fund will be repaid with the annual tax levy on a schedule that runs through 2024. We do not expect this use of cash to materially affect the city's overall liquidity, which we expect to remain very strong. Additionally, the city does not have any potential contingent liabilities that could have an adverse effect on its cash position, and we do not view its investment practices as aggressive as the majority are in U.S. agencies and securities, highly rated municipal bonds,

CDs, and mutual funds.

### **Adequate debt and contingent liability profile**

In our view, Farmington's debt and contingent liability profile is adequate. Total governmental fund debt service is 20.7% of total governmental fund expenditures, and net direct debt is 59.5% of total governmental fund revenue. Approximately 96.3% of the direct debt is scheduled to be repaid within 10 years, which, in our view, is a positive credit factor.

We have adjusted the city's debt service costs in 2017 to remove debt payments associated with the early redemption of debt. The city does not have any plans to issue additional debt in the next two years. In 2020, it expects to finance a water tower project that will cost roughly \$2.2 million with cash on hand in its enterprise funds. In 2022, it will likely have another street reconstruction project for which it may issue debt.

Farmington's combined required pension and actual other postemployment benefit (OPEB) contributions totaled 3.7% of total governmental fund expenditures in 2017. The city made its full annual required pension contribution in 2017. It participates in two cost-sharing multiple-employer pension plans, including the General Employees Retirement Fund (GERF) and the Public Employees Police and Fire Fund (PEPFF), which are administered by the Public Employees Retirement Association of Minnesota (PERA). Required pension contributions to these plans are determined by state statute. Statutory contributions rates have generally not kept pace with actuarially determined contribution (ADC) rates, indicating potential for future payment acceleration. In June 2018, the state passed pension legislation that will marginally increase contributions (for PEPFF only), reduce the investment rate of return to 7.5% (from 8%), and reduce some employee benefits (primarily cost-of-living adjustments). While we view these as positive changes for future plan funding levels, the lack of an actuarial funding policy remains a weakness in these plans. For more information about the reforms included in the 2018 omnibus retirement bill and the potential for future cost increases see our article "Minnesota's New Pension Bill Is A Positive Step Toward Sustainable Funding," published on June 7, 2018, on RatingsDirect.

The GERF and PEPFF were 79.5% and 88.8% funded, respectively, in fiscal 2018. The city's proportionate share of the net pension liability for these plans totaled \$7 million in fiscal 2017, the most recent year in which data are available. We consider historical plan funding levels somewhat weak, and we believe that the history of pension contributions below ADC increases the risk of payment acceleration. Additionally, in our view, the plan's investment portfolio is exposed to significant market risk, with only 22% of its investments allocated to fixed income and cash, which increases the risk for volatility in plan funding levels. Despite these weaknesses, we believe the city has sufficient taxing and operational flexibility to manage future increases in pension contributions. However, in the future, if pension contributions absorb a larger share of the city's budget, our view of its debt and contingent liability profile could weaken.

The city also participates in the Farmington Fire Relief Association, a single-employer pension plan. In fiscal 2017, the plan was over 100% funded with a net pension asset of \$778,000. It funds OPEBs on a pay-as-you-go basis. As of Jan. 1, 2016, the most recent actuarial valuation, its unfunded actuarial accrued liability was \$976,000.

### Strong institutional framework

The institutional framework score for Minnesota cities with a population greater than 2,500 is strong.

### Outlook

The stable outlook reflects our view that Farmington will maintain its very strong reserves supported by strong financial performance and management, so we do not expect to revise the ratings within the two-year outlook period.

### Upside scenario

A higher rating is possible if the city's economic metrics were to improve to levels commensurate with those of its higher rated peers.

### Downside scenario

A lower rating is possible if the city's budgetary performance were to weaken, causing a significant deterioration in its reserves.

### Related Research

- S&P Public Finance Local GO Criteria: How We Adjust Data For Analytic Consistency, Sept. 12, 2013
- Incorporating GASB 67 And 68: Evaluating Pension/OPEB Obligations Under Standard & Poor's U.S. Local Government GO Criteria, Sept. 2, 2015

#### Ratings Detail (As Of April 4, 2019)

Farmington GO		
<i>Long Term Rating</i>	AA+/Stable	Upgraded
<i>Unenhanced Rating</i>	NR(SPUR)	
Farmington GO imp rfdg bnds ser 2013A dtd 01/15/2013 due 02/01/2015-2022		
<i>Long Term Rating</i>	AA+/Stable	Upgraded
Farmington GO street reconstruction bnds ser 2015A dtd 10/15/2015 due 02/01/2030		
<i>Long Term Rating</i>	AA+/Stable	Upgraded

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at [www.standardandpoors.com](http://www.standardandpoors.com) for further information. Complete ratings information is available to subscribers of RatingsDirect at [www.capitaliq.com](http://www.capitaliq.com). All ratings affected by this rating action can be found on S&P Global Ratings' public website at [www.standardandpoors.com](http://www.standardandpoors.com). Use the Ratings search box located in the left column.

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