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Ratings

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Summary:
Fraser, Michigan; General Obligation

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Summary:

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Credit Profile		
Fraser GO (AGM)		
Unenhanced Rating	AA(SPUR)/Stable	Affirmed
Fraser GO		
Long Term Rating	AA/Stable	Affirmed

Many issues are enhanced by bond insurance.

Rationale

S&P Global Ratings affirmed its 'AA' long-term rating and underlying rating on Fraser, Mich.'s series 2015 general obligation (GO) bonds and series 2010 GO refunding bonds. The outlook is stable.

The rating reflects our view of the city's proactive approach to stabilizing its operating budget through expenditure reductions and revenue enhancements in fiscal 2018, following a period in which a misalignment resulted in an operating deficit and reduction in reserves. Furthermore, although shoring up long-term liabilities will remain challenging and may lead to budgetary pressure, we believe funding the contributions is manageable.

The debt service on the bonds outstanding is secured by the city's full faith and credit, including the levy and collection of property taxes on all taxable property within the city without limitation as to rate or amount.

The rating further reflects our view of the city's:

- Adequate economy, with access to a broad and diverse metropolitan statistical area;
- Adequate management, with standard financial policies and practices under our financial management assessment methodology;
- Strong budgetary performance, with operating surpluses in the general fund and at the total governmental fund level in fiscal 2018;
- Very strong budgetary flexibility, with an available fund balance in fiscal 2018 of 28% of operating expenditures;
- Very strong liquidity, with total government available cash at 76.9% of total governmental fund expenditures and 7.9x governmental debt service, and access to external liquidity we consider strong;
- Adequate debt and contingent liability position, with debt service carrying charges at 9.7% of expenditures and net direct debt that is 21.1% of total governmental fund revenue, as well as rapid amortization, with 69.7% of debt scheduled to be retired in 10 years, but a large pension and other postemployment benefit (OPEB) obligation and the lack of a plan to sufficiently address future escalation in OPEB; and
- Strong institutional framework score.

Adequate economy

We consider Fraser's economy adequate. The city, with an estimated population of 14,602, is located in Macomb County in the Detroit-Warren-Dearborn metropolitan statistical area, which we consider broad and diverse. The city has a projected per capita effective buying income of 100.7% of the national level and per capita market value of $74,503. Overall, the city's market value grew by 2.1% to $1.1 billion in 2018. The county unemployment rate was 4.3% in 2017.

Encompassing about four square miles and located five miles north of Detroit, the city serves primarily as a bedroom community. The city's tax base is approximately 50% residential property, while facilitation of commercial and industrial development occurs through the use of industrial development districts. Property owners within the districts pay an industrial facilities tax in lieu of property taxes, and the city has succeeded in encouraging development with three industrial facilities tax parcels approved. Furthermore, health care facilities supplier Healthmark Industries recently announced a three-year, $12 million expansion to its headquarters in Fraser. With the expansion, the company will also nearly double its existing workforce (to about 340 from 200). We believe the city's economy will remain stable and gradually expand as incremental development continues over the long term.

Adequate management

We view the city's management as adequate, with standard financial policies and practices under our financial management assessment methodology, indicating our view that the finance department maintains adequate policies in some but not all key areas.

During fiscal 2018 the city hired a new city manager and director of finance, who together implemented revenue and expenditure modifications that complement existing policies and procedures. We believe these changes support the rating.

Management's practices include use of two years of historical information to formulate the upcoming budget while providing monthly budget-to-actual reports to the city council to ensure that revenue and expenditure trends remain consistent with budgeted expectations. We believe the city's use of long-term financial and capital planning is prudent to identify out-year budget gaps and required infrastructure investment, as the council must determine annually whether to levy the nine-mill public safety special assessment. Although the city lacks a debt policy, investments are governed by state statute and an informal reserve policy targets maintenance of the fund balance at 16% to 25% of expenditures to ensure cash flow is sufficient to cover 60 to 90 days of operations.

Strong budgetary performance

Fraser's budgetary performance is strong, in our opinion. The city had operating surpluses of 13.5% of expenditures in the general fund and of 19.2% across all governmental funds in fiscal 2018. Our assessment accounts for our expectation that budgetary results will not result in a surplus of the same magnitude in fiscal 2019.

Our analysis incorporates adjustments to audited results to remove one-time capital expenditures in fiscal years 2016 through 2018. The city's budget consists primarily of property tax revenue (65%) and intergovernmental revenue (about 19%). Given the city's stable economy and modest tax base growth, we believe property tax collections will remain a consistent source of revenue to fund the budget.

Following an operating deficit (5.2% of expenditures) in 2017, which management attributes to public safety expenditures outpacing revenue, the management team implemented various expenditure adjustments in fiscal 2018. City departments determined how to eliminate $1 million in expenditures, which led to a reduction of eight public safety positions and contracting of dispatch services. In addition, the city council voted to implement two mills of a nine-mill public safety levy, generating approximately $800,000 in additional revenue. Following these modifications, audited results substantially improved in fiscal 2018, with the general fund showing a nearly $1.8 million operating surplus (13.5% of expenditures).

The fiscal 2019 budget continued the expenditure reductions, and the city council voted to implement the full nine-mill levy to support public safety expenditures. (The full mill levy generates approximately $3.5 million in revenue.) Furthermore, management is closely controlling other departmental expenditures in an effort to ensure the budget remains balanced. A combination of these factors show that operations are positive year to date and will likely generate a subsequent operating surplus at year end.

The management team quickly rectified the city's unsustainable spending plan, which we believe will lead to strong budgetary performance over the outlook period. Although the expenditure reductions alleviated some pressure, the council must determine annually whether to levy the public safety assessment. Should the council determine in future years not to levy the public safety assessment, management may be required to further reduce expenditures to ensure budgetary balance.

Very strong budgetary flexibility

Fraser's budgetary flexibility is very strong, in our view, with an available fund balance in fiscal 2018 of 28% of operating expenditures, or $3.7 million.

As a result of the expenditure controls and revenue enhancements implemented in fiscal 2018, the city's fund balance increased to a very strong level and brought the fund balance back in compliance with the city's informal reserve target. The fiscal 2019 budget included a $600,000 appropriation to fund balance, upon which the reserve will increase to approximately $4.3 million, or about 32% of expenditures. We believe management's plan to bolster reserves, which is consistent with year-to-date operating results, will ensure maintenance of very strong financial flexibility in the near term.

Very strong liquidity

In our opinion, Fraser's liquidity is very strong, with total government available cash at 76.9% of total governmental fund expenditures and 7.9x governmental debt service in 2018. In our view, the city has strong access to external liquidity, if necessary, as demonstrated by various issuances of debt over the past 20 years.

The city's cash balances are primarily invested in interest-bearing bank accounts, which we do not consider aggressive. Furthermore, the city's debt position contains no derivative or variable-rate obligations that could be considered a contingent liquidity risk. As a result, we believe the city's liquidity will remain very strong.

Adequate debt and contingent liability profile

In our view, Fraser's debt and contingent liability profile is strong. Total governmental fund debt service is 9.7% of total governmental fund expenditures, and net direct debt is 21.1% of total governmental fund revenue. Approximately

69.7% of the direct debt is scheduled to be repaid within 10 years, which is, in our view, a positive credit factor.

The city has about $23 million in debt outstanding, of which about $19 million is revenue debt secured by water and sewer enterprise funds. Officials report that over the next five years they may issue as much as $12.6 million for water and sewer capital projects, but that they have applied to the state revolving loan program as an alternative mechanism to secure funding. As a result of the city's modest debt requirements and rapid amortization of principal of 70% in 10 years, we do not believe the debt profile will deteriorate over the two-year outlook period.

In our opinion, a credit weakness is Fraser's large pension and OPEB obligation, without a plan in place that we think will sufficiently address future escalation in the OPEB obligation. Fraser's required pension and actual OPEB contributions totaled 16.8% of total governmental fund expenditures in 2018, with 8.2% representing required contributions to pension obligations and 8.6% representing OPEB payments. The city made 156% of its annual required pension contribution in 2018. The funded ratio of the largest pension plan is 54%.

The city provides pension benefits through the Municipal Employees Retirement System (MERS) of Michigan, an agent multiple-employer, statewide plan, and covers some employees with a defined contribution plan. The city council can modify pension benefits when new labor agreements are negotiated. Officials have changed benefits for those employees hired after July 1, 2016, including reducing termination pay, increasing vesting requirements, and requiring employee contributions to the plan. Despite benefit modifications, we continue to view the plan's discount rate of 8.0% as high relative to the nationwide average of 7.3%, and should investment returns not meet this threshold, we believe increased contributions could result. Somewhat offsetting our view of the discount rate is the city's decision to overfund the actuarially determined contribution in fiscal years 2016 through 2018. Over that timeframe, actuarially determined contributions totaled approximately $5.5 million, while total contributions were $6.9 million. We believe this funding discipline had led to a manageable net pension liability ($26.8 million) despite the lower funded ratio of 54%. The decision to contribute amounts in excess of the ADC is annually determined and appropriated in the budget. As a result, the city's funding discipline could change should the city council modify its approach.

OPEB presented a larger liability than pension at $53.4 million at the end of fiscal 2018 (based on a discount rate of 3.62%). Benefits are also identified in labor agreements and consist of retiree health care benefits to eligible employees and their spouses. In fiscal 2018, the actuarially determined contribution was $3.6 million, whereas the amount contributed was $1.4 million (38.6%). Over the long term, we believe that funding of the city's combined long-term liabilities could create fiscal stress but that it is manageable with the additional levy of the public safety special assessment.

Strong institutional framework

The institutional framework score for Michigan municipalities with a population of 4,000 to 600,000 is strong.

Outlook

The stable outlook reflects our view that Fraser's management team and the city council will continue evaluating revenue measures and expenditure adjustments to ensure budgetary balance and maintenance of very strong reserves. Furthermore, we believe the city's decision to overfund its pension contributions is prudent given the plan's funded ratio. The city's economic stability also supports the rating. As a result, we do not expect to change the ratings within the two-year outlook horizon.

Downside scenario

We could lower the rating if the city were challenged to maintain structural balance--particularly related to an increase in public safety costs without an identifiable revenue source to cover expenditures, resulting in a material reduction in reserves or a change in the pension funding discipline--and encountered substantial growth in the long-term liability profile.

Upside scenario

All else equal, we could raise the ratings should the city's economic indicators improve to levels commensurate with those of higher-rated peers and management codified additional policies and procedures.

Related Research

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