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Summary:

University Place, Washington; General Obligation

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Credit Profile

University Place ltd tax GO bnds

Long Term Rating

AA+/Stable

Upgraded

Rationale

S&P Global Ratings raised its long-term rating to 'AA+' from 'AA' on University Place, Wash.'s existing limited-tax general obligation (GO) bonds. The outlook is stable.

The rating action reflects our view of the city's easing debt burden after the city maximized what it could borrow a decade ago to push its town center development project forward in the face of the Great Recession. As limited-tax GO debt amortizes, the city is regaining statutory issuance flexibility virtually universally available to its state peers, which, coupled with a formal reserve policy, strengthens the city's ability to respond to a natural disaster.

Also factoring into the rating change is our view of the city's strong financial performance and rising reserves that, before our quantitative adjustments for analytical consistency, stand at 5x the level going into the Great Recession. Although this growth trend is likely partly cyclical in nature and we see increasing risk of a recession as a result of international tariff disputes, University Place's general fund net results have been particularly strong for a mostly built-out city. The city's available general fund balance inclusive of our adjustments for analytical consistency now exceeds 75% of expenditures, which is an important budgetary flexibility threshold under our criteria. Although the city's minimum reserve policy of 15% of expenditures is much lower and the city is working on a partly grant-funded main street redevelopment project that could require general fund resources, should we come to anticipate that the city will sustain reserves above this threshold in the face of less favorable revenue conditions, we see potential for raising the rating further.

The city will have about \$42 million in governmental debt outstanding at the end of 2019.

Security and use of proceeds

The bonds are secured by the city's full faith and credit, including the obligation to levy ad valorem taxes subject to statutory limitations that include a maximum levy rate of \$3.60 per \$1,000 of assessed value under current conditions (the city's levy rate in 2019 was \$1.04) and a limitation on property tax revenue growth to 1% per year, excluding new construction. The rating is equal to our view of the city's general creditworthiness, as obligor, because the limitations do not narrow the tax base or limit the fungibility of property tax revenue for different uses.

Proceeds of the city's GO debt have generally funded capital improvements, and the series 2016 proceeds enabled the city to refund prior issuances for interest expense savings.

Credit overview

The rating reflects our opinion of the city's:

- Very strong economy, with access to a broad and diverse metropolitan statistical area;
- Very strong management, with strong 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 81% of operating expenditures;
- Very strong liquidity, with total government available cash at 126% of total governmental fund expenditures and 7x governmental debt service, and access to external liquidity we consider strong;
- Weak debt and contingent liability position, with debt service carrying charges at 18% of expenditures and net direct debt that is 162% of total governmental fund revenue, but low overall net debt at less than 3% of market value; and
- Adequate institutional framework score.

Strong economy

The city serves an established nine-square-mile suburban area just southwest of Tacoma that was largely developed prior to its incorporation in 1995. Its 33,090 residents have access to employment centers in the broad and diverse Seattle-Tacoma-Bellevue metropolitan statistical area, including Seattle, which is 38 miles to the northwest. We project the city's per capita effective buying income at 112% of the national level in 2023, and per capita market value stands at \$128,100. The county unemployment rate in 2018 was 5.2%, which was slightly higher than the national level.

Overall, the city's market value grew by 12% over the past year to \$4.2 billion in 2019 following similarly strong 8% and 12% rates in the two prior years. The city, which is mostly built out, fronts Puget Sound and has a region-serving municipal golf course. This has, over the years, made it the location for many of south Puget Sound's higher-end homes, and we understand that tax base growth reflects a surging property market in the county rather than significant local construction, although the city's town center has seen additions in the past three years.

Very strong management

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

Key polices include:

- A budget formation process that incorporates internal and external analyses of historical revenue and expenditure trends to build assumptions;
- Budget-to-actual reports that include an analytical narrative of trends and deviations presented to the city council quarterly;
- Maintenance of a 10-year financial forecasting model that incorporates historical information and economic projections and details the city's various budgetary line items to help stakeholders understand long-term trends with

a goal of maintaining structural balance;

- Annually updated six-year capital improvement plan that details the timing and funding source of each project;
- Lack of formal investment policy but quarterly discussions between management and the chair of the city council financing committee and a practice of providing holdings and earnings reports in annual financial reports;
- Debt policy that lays out policy principles but does not include what we consider material quantitative constraints; and
- A formal fund balance policy to maintain a cash reserve of 5% to 15% of its operating budget, based on one month's operating expenses to manage economic uncertainty.

The city is managing cybersecurity risk through participation in a municipal insurance pool, monthly security awareness training, and a formal policy to respond to breaches.

Strong budgetary performance

University Place's budgetary performance is strong, in our opinion. The city had operating surpluses of 19% of expenditures in the general fund and of 26% across all governmental funds in fiscal 2018. These figures include quantitative adjustments for analytical consistency for both recurring transfers out that we have treated as expenditures and to remove \$2.6 million in transfers out from the general fund in 2018 for one-time spending on the city hall. (Without this latter adjustment, the city's net results would have been balanced.)

Although the city has been enjoying a now three-year streak of double-digit general fund net results as a percentage of expenditures inclusive of our adjustments, we understand from management that real estate transfer taxes have played a role in recent performance. We expect performance to moderate in the medium term, consistent with our expectation of slowing real GDP growth in the western U.S. states through 2021 that we think will moderate property sales activity and retail sales volumes. State data, which use a cash basis of accounting and a slightly different definition of the general fund, show property tax revenue, which generally can grow by only 1% per year excluding new construction, made up 22% of general fund revenue, followed by 20% for sales and use taxes and 12% for other taxes such as business gross receipts taxes.

We understand that the city has been tweaking fees to maintain structural balance with an increase in its transportation benefit district fee and sewer franchise fee to eliminate direct general fund support to the city's street fund, and management reports that the city's staffing levels have been largely stable with no plans for major changes through 2020.

Very strong budgetary flexibility

University Place's budgetary flexibility is very strong, in our view, with an available fund balance in fiscal 2018 of 81% of operating expenditures, or \$10.9 million, inclusive of our adjustments for recurring transfers out of the general fund. This ratio is one of the highest in the state among municipalities with debt that we rate, and should we come to view the city as likely to maintain its available general fund balance at at least 75% of expenditures, that would represent a material credit positive. For now, we think that a slowdown in revenue growth, coupled with the potential for using general fund resources to support the city's Main Street redevelopment project (which is linked to its town center) could lead to fluctuations in the city's budgetary flexibility. At this point the city is contemplating temporarily using

only about \$950,000 (7% of expenditures) for the project ahead of property sales; we understand that those sales will net about \$2.9 million by 2025 under the city's contract with a developer, and we anticipate that the city's financial position will continue to represent a significant credit strength for the foreseeable future.

Very strong liquidity

In our opinion, University Place's liquidity is very strong, with total government available cash at 126% of total governmental fund expenditures and 7x governmental debt service in 2018. In our view, the city has strong access to external liquidity if necessary based on its demonstrated ability to tap the capital markets during the past 15 years, including GO and sales tax revenue bond issuances.

Substantially all of city's investments are held with the state Local Government Investment Pool, which manages liquid assets for most local governments in the state and makes investment decisions using what we consider to be conservative guidelines.

Management has confirmed that the city has no alternative financing obligations, which we find can represent a source of contingent liquidity risk.

Very weak debt and contingent liability profile

In our view, University Place's debt and contingent liability profile is weak. Total governmental fund debt service is 18% of total governmental fund expenditures, and net direct debt is 162% of total governmental fund revenue. However, overall net debt is low at 2.6% of market value, which is, in our view, a positive credit factor. The city has one of the weaker debt profiles among peers in the state as a result of financing related to its Town Center project, which combined civic buildings with urban-scale commercial and residential buildings that the city had theretofore not had and was intended to give the city a focal point. With most of the original project site developed, the city has shifted its focus to improving infrastructure along Bridgeport Way, the city's main north-south street, to accommodate denser development in the city over time. We understand that property that the city already owns will provide much of the financing, and the city has no plans to issue additional debt.

As the city amortizes its debt outstanding, we expect its debt ratios to improve and its capacity to issue nonvoted GO debt to grow. As of the end of 2018, the city's debt portfolio and tax base size would allow it to issue \$24 million in nonvoted GO debt for general purposes, or \$67 million with a public vote.

The city participates in cost-sharing, multiple-employer public employee defined benefit retirement plans managed by the Washington State Department of Retirement Systems and must make its full annual required pension contribution each year. Using reporting standards in accordance with Governmental Accounting Standards Board Statement Nos. 67 and 68, the city's proportionate share of the collective net pension liability as of June 30, 2018 was \$1.4 million for Public Employees Retirement System (PERS) 1 and \$700,000 for PERS 2/3. As of June 30, 2018 PERS 1--its largest liability--maintained a funded level of 63.2%, using its fiduciary net position as a percentage of the total pension liability, and PERS 2/3 maintained a funded level of 95.8%. University Place's pension contributions in 2018 totaled 2.7% of total governmental fund expenditures, which is low relative to its state peers. This is partly a function of its young age (24 years), with less exposure to previous plans that had more favorable benefits. But it's also a function of not having a direct liability related to Law Enforcement Officers and Fire Fighters (LEOFF) plans. The city contracts with the county for law enforcement services (which is responsible for managing an LEOFF liability), and an

overlapping district, West Pierce Fire and Rescue, directly provides fire and emergency medical services.

The contribution amounts for the Department of Retirement Systems-administered pension plans are actuarially based. PERS 1 uses a 10-year, level-percent layered amortization approach; the city's other plans use an aggregate actuarial cost method that amortizes the unfunded actuarial accrued liabilities over the average remaining working lifetime of their employees, which effectively results in an open amortization period of approximately 15 years. We view open amortizations as more risky because they are not designed to fully pay off unfunded liability; however, with a short enough period (such as 15 years), significant funding progress can still be made. Mortality rates used to determine liabilities are projected on a generational basis, which, in our view, reduces the risk of significant upward revisions to liabilities following experience studies and thus provides more consistency to contribution rates. The liabilities used to calculate the funded levels discussed above are discounted at 7.5%, which is slightly above national averages, leading to an above-average likelihood of upward revisions to the net pension liability following years of poor investment performance. These actuarial methodologies and assumptions are generally comparable with those of other pension plans nationally.

The city does not offer other postemployment benefits.

Institutional framework

The institutional framework score for Washington municipalities is adequate, partly as a result of statutory discretion over the quality and timeliness of financial reporting.

Outlook

The stable outlook reflects our view that the city's operating performance is likely to moderate but that even if the city uses a portion of its reserves for capital spending related to its Main Street project, we think its budgetary flexibility going into what we think is a period of higher recession risk will remain a key credit strength. Moreover, strong assessed valuation growth, should it continue, and scheduled debt payments will continue to improve the city's statutory debt capacity, which we think can be important in an area with significant seismic risk exposure. We don't expect to change our rating during the next two years.

Upside scenario

Although we think the city's debt profile will remain a credit weakness during our two-year outlook horizon, we could raise the rating if the city continued to show strong-to-very-strong budgetary performance, if economic growth continued to fuel tax revenue growth, and if we thought the city were likely to sustain its available general fund balance in excess of 75% of expenditures.

Downside scenario

We could lower the rating if a recession scenario significantly depressed revenue performance that led to weak budgetary performance and the city concurrently upped its ambitions for capital investment that caused it to significantly draw on its reserves and debt capacity.

Related Research

- U.S. State And Local Government Credit Conditions Forecast, Oct. 24, 2018
- 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
- 2018 Update Of Institutional Framework For U.S. Local Governments

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 for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.

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