

CREDIT OPINION

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New Issue

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Naugatuck (Borough of) CT

New Issue - Moody's Downgrades Naugatuck, CT's GO Debt to Aa3; Assigns Negative Outlook

Summary Rating Rationale

Moody's Investors Service has downgraded to Aa3 from Aa2 the rating on the Borough of Naugatuck, CT's \$56.6 million of outstanding general obligation debt. Concurrently, we have downgraded to A1 from Aa3 the rating on \$9.6 million of outstanding certificates of participation (COPs). We have also assigned a Aa3 rating to the \$8.2 million General Obligation Bonds, Issue of 2017 consisting of \$6.5 million Series A (AMT) and \$1.7 million Series B (Federally Taxable). The outlook on all debt is negative.

The general obligation rating downgrade to Aa3 reflects the satisfactory but weakened financial position coupled with a high debt burden that has been increasing over the past several years. The rating further incorporates the moderately sized tax base with average wealth levels and large pension and OPEB liabilities.

The A1 rating assigned to the COPs reflects satisfactory legal provisions, appropriation risk, and the essential nature of the projects financed. The rating also incorporates the fundamental characteristics of the borough's general obligation rating.

Credit Strengths

- » Stabilizing tax base with new commercial development

Credit Challenges

- » High debt burden
- » Weakened financial position due to use of reserves to balance budgets

Rating Outlook

The negative outlook reflects the possibility that fiscal 2017 could result in another deficit, further reducing reserves to levels not in line with the Aa3 rating category. Further, the combined leverage of debt, pension and OPEB is high, and maintaining structurally balanced operations with sound reserves, as the borough had done historically, is an important credit factor. Despite the recent negative financial trend, the borough plans to increase the amount of budgeted contingency over the next five years, and if unused, the contingency would flow to General Fund balance and increase reserves. Going forward, increased reserves and decreasing leverage could lead to the removal of the negative outlook.

Factors that Could Lead to an Upgrade

- » Material growth of reserve levels
- » Trend of positive operating performance without the use of reserves
- » Significant tax base expansion and improvement in income levels
- » Material decline in the debt burden

Factors that Could Lead to a Downgrade

- » Further decline in reserves or liquidity
- » Failure to eliminate fund balance appropriations to balance budgets
- » Material declines in tax base or income levels
- » Significant growth in debt burden or debt service as percentage of operating expenditures

Key Indicators

Exhibit 1

Naugatuck (Borough of) CT	2012	2013	2014	2015	2016
Economy/Tax Base					
Total Full Value (\$000)	\$ 2,503,022	\$ 2,353,970	\$ 2,254,140	\$ 2,267,948	\$ 2,248,545
Full Value Per Capita	\$ 78,724	\$ 74,057	\$ 70,907	\$ 71,494	\$ 70,916
Median Family Income (% of USMedian)	119.0%	117.8%	118.2%	117.5%	117.5%
Finances					
Operating Revenue (\$000)	\$ 111,502	\$ 114,122	\$ 118,259	\$ 114,581	\$ 114,647
Fund Balance as a % of Revenues	11.2%	15.1%	15.0%	15.1%	12.0%
Cash Balance as a % of Revenues	23.9%	23.1%	28.9%	29.7%	9.5%
Debt/Pensions					
Net Direct Debt (\$000)	\$ 78,870	\$ 88,547	\$ 105,757	\$ 99,960	\$ 101,571
Net Direct Debt / Operating Revenues (x)	0.7x	0.8x	0.9x	0.9x	0.9x
Net Direct Debt / Full Value (%)	3.2%	3.8%	4.7%	4.4%	4.5%
Moody's - adjusted Net Pension Liability (3-yr average) to Revenues (x)	0.4x	0.6x	0.7x	0.8x	1.0x
Moody's - adjusted Net Pension Liability (3-yr average) to Full Value (%)	1.9%	3.1%	3.7%	4.3%	4.8%

As of June 30 fiscal year-end

Fund and cash balances include General Fund and Debt Service Fund

Source: Moody's Investors Service; borough's audited financial statements

Recent Developments

Since our most recent report in October 2016, the borough released its audited fiscal 2016 financial statements which reflect a \$3 million General Fund deficit, slightly worse than the \$2.6 million projection made in October. Available General Fund balance declined to 10.5% of revenues (as expected), but unassigned General Fund balance declined even further to 7.6%. Management reports that fiscal 2017 operations are trending positively year to date, but it is unclear at this time if the borough will be able to replenish the entire \$3.4 million of reserves used in the budget. In addition, the fiscal 2018 Net Taxable Grand List (assessed value) increased a modest 0.5%. The fiscal 2016 Equalized Net Grand List (full value) declined 0.9%, after increasing 0.6% the previous year.

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on www.moody's.com for the most updated credit rating action information and rating history.

Detailed Rating Considerations

Economy and Tax Base: New Commercial Development Should Lead to Modest Growth Over the Medium Term

Naugatuck's moderately sized \$2.2 billion Equalized Net Grand List (ENGL) is beginning to stabilize following six years of significant declines. The ENGL declined 30% from fiscal 2009-2014, and increased a modest 0.6% in fiscal 2015. Fiscal 2016 ENGL reflects a 0.9% decline, but modest growth is expected going forward from new development. The tax base includes a healthy commercial and industrial component (15% of fiscal 2017 Taxable Grand List), and future growth will come from new commercial (and some residential) development. Large-scale projects in the borough's downtown include a \$7 million 30,000 square foot medical facility which will be occupied by one for-profit hospital; a 320,000 square foot office and retail space with a parking garage; and, over the longer term, planned transit-oriented development (TOD). The medical facility is expected to break ground this year, and the office and retail projects are in the design stage.

With a median family income of \$77,538 (2015 American Community Survey), income levels are above average compared to the US (117.5%) but trail the state (87.1%). ENGL per capita of \$70,916 is below both the state and national medians. Naugatuck's unemployment (6.6% February 2017) remains slightly higher than the state (5.5%) and US (4.9%).

Financial Operations and Reserves: Weakened but Adequate Financial Position; Eliminating Reserve Appropriations Will be Key Focus of Future Reviews

The borough relies on reserves to balance budgets (both for operating and capital expenses), but conservative budgeting has historically allowed the appropriations to be replenished and fund balance has increased modestly over the past six years (2010-2015). However, the borough incurred a deficit in 2016 and the reserve appropriations increased in the 2017 budget. Future reviews will focus on the ability to add to fund balance in order to keep up with budgetary growth. Further declines from current levels could result in negative credit pressure. Positively, management plans to increase the amount of budgeted contingency over the next five years, with a goal of 1% of budgeted expenditures (roughly \$1.2 million). If unused, contingency would flow to General Fund balance and increase reserves.

The fiscal 2016 General Fund balance declined by \$3 million - the borough used \$1.4 million of fund balance in the budget that was not replenished, \$1.2 million was due to delayed rent payments from the incinerator operator, and the remaining was largely due to a decline in tax collections. Available General Fund balance declined to \$12.2 million or 10.5% of revenue. Unassigned fund balance declined to \$8.9 million or 7.6%, which represents a material decline from prior years when this balance has averaged 11% of revenues. The borough maintains a formal policy to keep unassigned fund balance between 8% and 12% of budgeted revenues, and at 8.1%, the borough was still in compliance in 2016.

When including the Debt Service Fund, which will be used for future wastewater debt service payments, the 2016 available operating fund balance increases to \$13.8 million or 12% of revenues.

Management reports that fiscal 2017 operations are trending positively year to date (June 30 year-end), but it is unclear at this time if the borough will be able to replenish the entire \$3.4 million of reserves used in the budget and maintain fund balance at 2016 levels. The borough is developing the 2018 budget and the amount of mill rate increase and fund balance appropriation is still being determined. The governor's proposed 2018 budget, if adopted as proposed, would give Naugatuck an additional \$1 million in state aid, though the borough has prudently not budgeted for this additional aid and instead assumes flat funding from 2017 levels (including mid-year cuts).

The primary revenue sources are property taxes (61.6% of fiscal 2016 revenues) and state aid (32%), including education aid. Property tax collections remain adequate with roughly 95% collected in the current fiscal year. Education remains the largest expenditure (55.9%).

LIQUIDITY

Total operating cash (General and Debt Service Funds) at the close of fiscal 2015 totaled \$10.9 million, or 9.5% of revenues

Debt and Pensions: Debt Burden Will Remain High; Large but Manageable Pension and OPEB Liabilities

The debt burden will remain elevated but manageable given below average principal amortization and no near-term borrowing plans. The direct debt burden is 4.8% of ENGL (including the current issue), well above the 1.3% state median. The above average debt burden is partially due to \$34.1 million of outstanding pension obligation bonds issued in 2003 (32% of total outstanding debt).

The borough has no near term borrowing plans. Over the longer term (6+ years), the borough is considering borrowing for a new elementary or middle school and would apply to the state for partial reimbursement. Additionally, the borough may need to borrow for wastewater treatment plant improvements to comply with new US EPA regulations, but the cost is not known at this time. Given the already elevated debt burden, an increase in this metric would further increase fixed costs and reduce financial flexibility, resulting in negative credit pressure.

DEBT STRUCTURE

All debt is fixed rate and amortization of principal is below average, with 56.4% repaid within ten years. Debt service costs have been accounting for a growing percentage of annual expenditures, and were \$10 million or 8.4% in fiscal 2016, compared to 5.7% in fiscal 2012. Future debt service projections show debt service will begin to decline starting in fiscal 2019.

DEBT-RELATED DERIVATIVES

Naugatuck is not party to any interest rate swaps or other derivative agreements.

PENSIONS AND OPEB

Pensions and OPEB

Naugatuck maintains two single-employer defined benefit pension plans: the Borough of Naugatuck Employee Pension Plan and the Borough of Naugatuck Fire Plan. The borough contributed \$5.2 million (4.3% of expenditures) to the plans in fiscal 2016, equal to 94% of the combined actuarially determined contribution. The fiscal 2016 three-year average adjusted net pension liability (ANPL), under Moody's methodology for adjusting reported pension data, is \$108.9 million, equal to 0.95 times operating revenues and 4.9% of ENGL. Moody's uses the adjusted net pension liability to improve comparability of reported pension liabilities. The adjustments are not intended to replace the borough's reported liability information, but to improve comparability with other rated entities. In an effort to lower the long-term liability, the borough has transitioned all new employees to defined-contribution retirement plans.

Naugatuck contributed \$8.5 million (7.1% of expenditures) for OPEB in fiscal 2016, which represents 68% of the annual OPEB cost. Positively, the borough established an OPEB reserve fund, which has a current balance of \$7.8 million. The total unfunded liability is \$142.8 million as of July 1, 2014.

Total fixed costs for fiscal 2016, including debt service, required pension contributions and retiree healthcare payments, represented \$23.7 million, or an elevated 19.8% of expenditures.

Management and Governance

Connecticut cities, towns and boroughs have an Institutional Framework score of Aa, which is high compared to the nation. Institutional Framework scores measure a sector's legal ability to increase revenues and decrease expenditures. Connecticut cities' major revenue source, property taxes, is not subject to any caps. Unpredictable revenue fluctuations tend to be minor, or under 5% annually. Across the sector, fixed and mandated costs are generally greater than 25% of expenditures. Connecticut has public sector unions and additional constraints, which limit the ability to cut expenditures. Unpredictable expenditure fluctuations tend to be minor, under 5% annually.

Legal Security

The 2017 bonds are secured by the borough's general obligation unlimited tax pledge.

Use of Proceeds

Bond proceeds will finance improvements to the incinerator plant.

Obligor Profile

Naugatuck has a population of 32,000 and is located in north-central New Haven County approximately 33 miles southwest of the City of Hartford (Ba2 negative).

Methodology

The principal methodology used in the general obligation rating was US Local Government General Obligation Debt published in December 2016. The principal methodology used in the lease backed rating was Lease, Appropriation, Moral Obligation and

Comparable Debt of US State and Local Governments published in July 2016. Please see the Rating Methodologies page on www.moody.com for a copy of these methodologies.

Ratings

Exhibit 2

Naugatuck (Borough of) CT

Issue	Rating
General Obligation Bonds (AMT), Series A	Aa3
Rating Type	Underlying LT
Sale Amount	\$6,505,000
Expected Sale Date	05/10/2017
Rating Description	General Obligation
General Obligation Bonds, Series B (Federally Taxable), 2017 Series B	Aa3
Rating Type	Underlying LT
Sale Amount	\$1,700,000
Expected Sale Date	05/10/2017
Rating Description	General Obligation

Source: Moody's Investors Service

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