

# RatingsDirect®

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## Summary:

# Watertown, Connecticut; General Obligation; Note

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### Credit Profile

US\$7.2 mil GO bnds iss 2019 dtd 10/15/2019 due 10/15/2039		
<i>Long Term Rating</i>	AA+/Stable	New
US\$5.0 mil GO BANs dtd 10/24/2019 due 10/23/2020		
<i>Short Term Rating</i>	SP-1+	New
Watertown GO		
<i>Long Term Rating</i>	AA+/Stable	Outlook Revised

## Rationale

S&P Global Ratings revised its outlook to stable from negative on Watertown, Conn.'s outstanding general obligation (GO) debt. At the same time, we assigned our 'AA+' long-term rating to the town's issue of 2019 GO bonds and affirmed our 'AA+' long-term rating on its outstanding GO debt. The outlook on all the ratings is stable.

Additionally, we assigned our 'SP-1+' rating to the town's 2019 GO bond anticipation notes (BANs) due Oct. 23, 2020, and affirmed our 'SP-1+' rating on the town's existing short-term debt.

### Credit summary

Watertown's GO debt was on negative outlook due to multiple years of deficits stemming from over-expenditures on health care. This led to a material decline in reserve levels. The outlook revision to stable reflects management's changes to health care, leading to stable health care expenditures, and overall conservative budgeting practices, resulting in an expected return to positive operations in fiscal 2019. Additionally, owing to significant unbudgeted state aid, the town is on its way to restoring reserves to pre-drawdown levels. Outside of health care expenditures, the town has produced generally positive budgetary variances at year-end, owing to its culture of conservative budgeting and consistent monitoring throughout the year. We expect with the health care issue resolved, the town will continue to have break-even-to-positive operating results.

### Security and use of bond proceeds

Watertown's full-faith-and-credit pledge, payable from the levy of an unlimited ad valorem tax on all taxable property in the town, secures the series 2019 bonds and notes. The short-term rating reflects our criteria for evaluating and rating BANs. In our view, Watertown maintains a very strong capacity to pay principal and interest when the notes come due. The town has what we view as a low market risk profile, because it has strong legal authority to issue long-term debt to take out the notes and is a frequent issuer that regularly provides ongoing disclosure to market participants. We understand that the bond proceeds will permanently finance outstanding BANs, issued for water and sewer projects, and provide funding for the new municipal center. The 2019 BAN proceeds will provide funding for various road and public works projects.

The long-term rating further reflects our view of the following factors for the town, specifically its:

- Strong economy, with market value per capita of \$123,386 and projected per capita effective buying income (EBI) at 121% of the national level;
- Strong management, with good financial policies and practices under our Financial Management Assessment (FMA) methodology;
- Strong budgetary performance, with operating results that we expect could improve in the near term relative to fiscal 2018, which closed with slight operating deficits in the general fund and at the total governmental fund level in fiscal 2018;
- Strong budgetary flexibility, with an available fund balance that we expect will improve in the near term from its fiscal 2018 level of 6.4% of operating expenditures;
- Very strong liquidity, with total government available cash that we expect will improve in the near term relative to its fiscal 2018 levels at 14.4% of total governmental fund expenditures and 1.7x governmental debt service, and access to external liquidity we consider strong, but an exposure to a nonremote contingent liability risk;
- Strong debt and contingent liability position, with debt service carrying charges at 8.6% of expenditures and net direct debt that is 76.4% of total governmental fund revenue, as well as low overall net debt at less than 3% of market value and rapid amortization, with 67.3% of debt scheduled to be retired in 10 years; and
- Strong institutional framework score.

### **Strong economy**

We consider Watertown's economy strong. The town, with an estimated population of 21,250, is a suburban and primarily residential community in west-central Connecticut in Litchfield County, approximately 30 miles north of New Haven and 35 miles southwest of Hartford. It has a projected per capita EBI of 121% of the national level and per capita market value of \$123,386. Overall, market value grew by 3.6% over the past year to \$2.6 billion in 2020. The county unemployment rate was 3.8% in 2018.

State Route 8 traverses the town, connecting residents with employment opportunities in the city of Waterbury and surrounding communities. Although the state struggled to regain its economic footing following the recession, Watertown's overall economic and employment conditions have remained stable relative to that of the regional labor market and the state, demonstrated by recent growth in the grand list for 2020.

Due to its location near major state and interstate highways and a low mill rate relative surrounding communities, Watertown maintains a sizable commercial and industrial presence. The manufacturing sector anchors the town's employment base, which also features education, health care, and commercial retail and services. Eight of its 10 leading employers are manufacturing firms, including The Siemon Co. (311 employees), Global Steering System (300), ALBEA (300), and Emerson (300). Watertown is also home to a private boarding school, The Taft School (250 employees), which continues to attract a diverse domestic and international student body. The town's 10 leading taxpayers account for 6.18% of total assessed value, representing a very diverse tax base, in our opinion.

While the town reports stability among its leading employers and taxpayers, management also indicates that development in existing residential subdivisions is ongoing. Additionally, a new urgent-care facility is likely to lead to an increase in equipment revenues, while providing additional jobs in town. Several redevelopments of long-vacant properties are underway or planned, likely leading to continued incremental growth in the grand list. Based on our

expectation that this slight uptick in tax base growth will continue to support Watertown's stable underlying wealth and income conditions, we believe its economic profile will remain strong over the next two years.

### **Strong management**

We view the town's management as strong, with good financial policies and practices under our FMA methodology, indicating financial practices exist in most areas, but that governance officials might not formalize or monitor all of them on a regular basis.

In development of its annual budget, management uses three years of historical data to forecast annual revenue and expenditure assumptions and to identify outlying budget line items. The town reviews each department's annual budget request and prioritizes operating and capital expenditures. Finance officials consult state information, in particular the governor's proposed budget, to estimate state revenue. While we note that the town faced difficulty budgeting for medical and workers' compensation claims, which compounded its budgetary stress, we recognize that officials worked with their insurance provider to analyze trends and develop budget solutions, which we anticipate will result in improved variances beginning in fiscal 2019, demonstrating an ability to adjust budgetary assumptions.

During each fiscal year, the town monitors the budget regularly, reporting budget-to-actual results monthly. Watertown also maintains a formal investment policy, which adheres to state statutes governing investments, and the town reports earnings and holdings in its annual audit.

Watertown has a formal five-year capital improvement plan (CIP) that identifies projects and costs across its various departments. While the town updates its CIP annually and incorporates these costs into its budget considerations, the plan does not identify funding sources across all years. However, Watertown does not currently maintain a formal long-term financial forecast.

However, the town maintains a formal debt management policy, which features local debt affordability limitations and management incorporates debt analysis into its annual budget process. Furthermore, management has historically met and sustained unassigned reserves in accordance with its fund balance policy. The formal policy calls for unassigned fund balance to be maintained a target of 7% to 12% of the following year's operating revenue, and if the fund balance falls below the target minimum, the town will move to restore balance within a two-year period. The policy notes that this minimum reserve target assists with managing cash flows during the year and stabilize annual fluctuations in the property tax rate.

### **Strong budgetary performance**

Watertown's budgetary performance is strong, in our opinion. The town had slight operating deficits of negative 1.2% of expenditures in the general fund and negative 0.9% across all governmental funds in fiscal 2018. Our assessment accounts for the fact that we expect budgetary results could improve from 2018 results in the near term.

Historically, Watertown has produced balanced operations, supported by its strong budget development and monitoring framework. However, over the past few years, excessive medical claims have resulted in negative operating results. In fiscal 2017, the town reported higher-than-expected self-insurance medical claims, which accounted for the majority of the fiscal 2017 \$2.5 million year-end general fund deficit. Although the town has stop loss coverage, it reported a significantly higher-than-normal number of claims that reached the stop loss threshold of

\$150,000 per claim. In fiscal 2018, medical costs exceeded budget by \$1.8 million, partially offset by stronger-than-budgeted tax collections.

For fiscal 2019, the town changed its health care plan. Management is reporting that medical claims are on budget; it expects this to continue through 2020 and beyond. Initial projections for fiscal 2019 also include tax collections again exceeding budget, along with better-than-budgeted building permit fees. Perhaps most notably, the town received \$1.4 million in state grants in excess of budget. While the audit process is just beginning, management is projecting an approximately \$2.2 million addition to unassigned reserves on a GAAP basis.

Management reports that fiscal 2020, while early, is generally on budget. Medical costs are tracked nearly daily and are on target. Over the past several years, outside of the excess medical claims, the town's trend of revenues and expenditures outperforming the budget has continued. With the medical costs seemingly resolved, we anticipate the town will produce to at least break-even operations in 2020.

Watertown's revenue mix is generally stable, with property taxes accounting for about 73% of general fund revenue in fiscal 2018. Intergovernmental revenues were the second-largest source, accounting for 23% of revenues. Of the approximately \$18 million in intergovernmental revenues, about \$4.4 million (25%) was a pass-through payment from the state for the teacher's retirement system. Licenses, permits, and fees accounted for 2.9% of general fund revenues. This revenue mix has been relatively stable year to year. We expect that the town has resolved the budgetary pressure stemming from health care costs and we anticipate it will maintain adequate-to-strong budgetary performance.

### **Strong budgetary flexibility**

Watertown's budgetary flexibility is strong, in our view, with an available fund balance that we expect could improve in the near term from its fiscal 2018 level of 6.4% of operating expenditures, or \$5.0 million.

Watertown has a reserve policy to maintain an undesignated fund balance of 7%-12% of the following year's operating revenue, to which it has historically adhered. Given projections for fiscal 2019 surplus, we anticipate available fund balance growing to approximately \$7 million, which we expect will be greater than 8% of general fund expenditures. Consequently, we believe budgetary flexibility will improve relative to the close of 2018.

### **Very strong liquidity**

In our opinion, Watertown's liquidity is very strong, with total government available cash that we expect will improve in the near term relative to its fiscal 2018 levels at 14.4% of total governmental fund expenditures and 1.7x governmental debt service in 2018. In our view, the town has strong access to external liquidity if necessary. Weakening Watertown's liquidity position, in our assessment, is its exposure to a nonremote contingent liability that could come due within 12 months.

We adjusted the town's available cash to reflect cash held in the capital improvement and nonmajor funds, which we do not believe is readily available for liquidity purposes. In fiscal 2018, the town's available cash relative to expenditures declined approximately 1.4 percentage points, but we anticipate its cash will increase in the 2019 audit, given current year-end projections. With the majority of Watertown's cash invested in money market funds, certificates of deposit, and the state investment pool, which maintain maturities of less than one year, we believe the town's investments are not aggressive. Furthermore, Watertown is a regular market participant that has issued debt

periodically over the past 20 years, including GO bonds and notes.

As of fiscal year-end June 30, 2018, the town had a deficit of approximately \$1.66 million related to workers' compensation claims in its internal service fund, which could expose it to nonremote liquidity pressure. We note that Watertown reduced the net deficit by approximately \$694,000 in fiscal 2017 and by \$28,000 in fiscal 2018.

Management instituted several reforms to reduce medical expenses, including switching to a new insurance provider and moving over current employees to high-deductible medical insurance plans. However, if the internal service fund were to pressure budgetary performance, resulting in a deterioration of available cash, it could weaken our view of the town's liquidity position.

### **Strong debt and contingent liability profile**

In our view, Watertown's debt and contingent liability profile is strong. Total governmental fund debt service is 8.6% of total governmental fund expenditures, and net direct debt is 76.4% of total governmental fund revenue. Overall net debt is low at 2.4% of market value, and approximately 67.3% of the direct debt is scheduled to be repaid within 10 years, which are, in our view, positive credit factors.

Following this bond issue, Watertown has about \$62.7 million of total direct debt outstanding, which includes \$5 million in notes. The town has no overlapping or underlying debt.

Other than permanently financing outstanding notes, management has no specific plans to issue new debt over the next two years. In addition, it does not currently have any variable-rate or direct-purchase debt. Due to what we believe to be its low and affordable overall debt metrics, coupled with rapid amortization of existing debt, we do not expect Watertown's direct debt profile to change materially.

Watertown's combined required pension and actual other postemployment benefit (OPEB) contributions totaled 4.3% of total governmental fund expenditures in 2018. Of that amount, 2.0% represented required contributions to pension obligations, and 2.3% represented OPEB payments. The town made its full annual required pension contribution in 2018.

The town administers two pension plans: the town employee retirement system and the police benefit fund. It also participates in Connecticut Municipal Employees Retirement Fund (MERS) for all water and sewer employees hired before 1986. Watertown teachers participate in the State of Connecticut Teachers' Retirement System, a cost-sharing, multiple-employer, public employee retirement system, which is entirely funded by the state. The net pension liabilities for the systems are \$3.7 million for the town retirement system, \$7.6 million for the police benefit fund, and \$725,000 for MERS. The town and police plans have funded ratios of 85.9% and 74.2%, respectively; both plans use a 7.25% discount rate, which we view as slightly higher than average. The MERS plan has a funded ratio of 91.7%, measured using a discount rate of 8.0%. While we view the discount rate of 8.0% as high, given the size of the total liability and the high funded status, we do not expect this to become a significant budgetary pressure. Watertown has made its full actuarially determined contributions to all three plans over the last three fiscal years, and we expect it will continue to do so.

Watertown also administers an OPEB plan for its employees. The OPEB liability is funded on a pay-as-you-go basis, and the town contributed \$1.9 million, in fiscal 2018. The OPEB unfunded actuarial accrued liability was about \$72

million, and was 0% funded as of June 30, 2018; management reports this grew to about \$75.5 million at the close of fiscal 2019. At this time, we view the town's pension and OPEB costs as manageable, and we do not expect any changes to these plans to present a material pressure on the debt or financial profiles. However, should costs escalate significantly, we could revise our view of the town's debt and liabilities profile.

### Strong institutional framework

The institutional framework score for Connecticut municipalities is strong.

## Outlook

The stable outlook reflects our view that management took concrete steps to stabilize its budget and increase reserves. We expect continued balanced operating results, leading to maintenance of strong budgetary flexibility and very strong liquidity. Low debt and retirement costs and a stable economy provide additional rating stability. We do not expect to change the rating during the two-year outlook period.

### Downside scenario

Should the final 2019 audit show results materially worse than current projections, or if future drawdowns result in decreased reserves, we could lower the rating

### Upside scenario

We could raise the rating if economic indicators improve to levels comparable with those of higher rating peers, along with strengthened reserve levels.

## 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 October 7, 2019)

Watertown GO BANs		
<i>Short Term Rating</i>	SP-1+	Affirmed
Watertown GO BANs dtd 10/24/2019 due 10/23/2020		
<i>Short Term Rating</i>	SP-1+	Affirmed

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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