

RatingsDirect®

Summary:

Naugatuck Borough, Connecticut; Appropriations; General Obligation

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Credit Profile

US\$60.555 mil GO pension funding bnds ser 2021 due 08/15/2041		
<i>Long Term Rating</i>	AA-/Stable	New
US\$10.955 mil certs of part (Naugatuck Wastewater System Project) ser 2021A due 06/15/2042		
<i>Long Term Rating</i>	A+/Stable	New
US\$9.125 mil certs of part (Naugatuck Incineration Facilities Project) ser 2021B due 06/15/2042		
<i>Long Term Rating</i>	A+/Stable	New
US\$7.035 mil certs of part (Naugatuck Incineration Facilities Project) taxable ser 2021A due 06/15/2033		
<i>Long Term Rating</i>	A+/Stable	New

Rating Action

S&P Global Ratings assigned its 'AA-' long-term rating to Naugatuck Borough, Conn.'s \$60.6 million series 2021A general obligation (GO) pension obligation bonds (federally taxable) and affirmed its 'AA-' rating, with a stable outlook, on the borough's outstanding GO debt.

In addition, we assigned our 'A+' rating to the borough's \$11 million series 2021A wastewater system project certificates of participation (COPs), \$7.0 million series 2021A incineration facilities project (taxable), and \$9.1 million series 2021B incineration facilities project bonds. At the same time, we affirmed our 'A+' rating on the borough's existing COPs, based on our application of our "Issue Credit Ratings Linked To U.S. Public Finance Obligors' Creditworthiness" criteria published Nov. 20, 2019.

The series 2021A GO bonds are payable from the borough's full faith and credit GO pledge. Proceeds of the bonds will be used to fully fund the borough's pension plans.

The COPs (Naugatuck wastewater system revenue project 2021 series A and the Naugatuck incineration facilities project 2021, series A and B) are limited obligations secured under the trust agreement with US Bank (the trustee). We rate these obligations one notch lower than the borough's general creditworthiness, as reflected in the GO rating, to account for the appropriation risk associated with the lease payment. Base rent payments made by the borough under the lease agreement secure the certificates. The lease payments are subject to annual appropriation by the borough. Once appropriated, the lease payments that match bond service payments are triple net and not subject to counterclaim or set-off. The borough is obligated to maintain the equipment and it must make additional payments sufficient to cover taxes and insurance on the property.

Proceeds from the COPs will refinance a portion of the borough's series 2002 COPs and provide new money for improvements to the incinerator and wastewater facilities.

Credit overview

The rating on Naugatuck reflects our opinion of the borough's strong reserve levels within the reserve policy thresholds, consecutive operating surpluses in line with those of similarly rated peers, and ongoing economic development efforts with discussions surrounding new transit-oriented projects, including the creation of an inland port. These strengths are partially offset by the borough's elevated debt burden with the issuance of the pension obligation bonds and large other postemployment benefit (OPEB) obligation exceeding 1.0x the borough's budget. However, the stable outlook reflects the borough's continuance to meet the actuarially determined contributions (ADC) for the past two years with contributions from the bond proceeds bringing the two pension plans to fully funded levels. The outlook also reflects limited revenue volatility, with revenue concentration in less economically sensitive sources: property taxes (62% of revenue) and intergovernmental funding (33.2%).

Other factors supporting the long-term rating include our view of the borough's:

- Strong economy, with access to a broad and diverse metropolitan statistical area (MSA);
- Adequate management, with standard financial policies and practices under our Financial Management Assessment (FMA) methodology;
- Strong budgetary performance, with balanced operating results in the general fund and an operating surplus at the total governmental fund level in fiscal 2020;
- Strong budgetary flexibility, with an available fund balance in fiscal 2020 of 12.3% of operating expenditures;
- Very strong liquidity, with total government available cash at 13.7% of total governmental fund expenditures and 1.5x governmental debt service, and access to external liquidity we consider strong;
- Very weak debt and contingent liability profile, with post issuance debt service carrying charges at 11.4% of expenditures and net direct debt that is 97.9% of total governmental fund revenue, as well as a large OPEB obligation; and
- Strong institutional framework score.

Environmental, social, and governance factors

We analyzed the borough's environmental, social, and governance risks. While governance risks align with the sector as a whole, we note that concerns remain surrounding plans to address the outstanding OPEB liabilities, given the overall size of the OPEB liability. Similarly, while social risks align with the sector as a whole, population growth in the county remains stagnant at negative 0.7%.

Stable Outlook

Upside scenario

While we do not anticipate it during the outlook period, an improvement in the borough's fixed-charge costs and total outstanding liabilities, along with improved liquidity and reserves, could result in a higher rating over time.

Downside scenario

If Naugatuck budgetary performance deteriorates, caused by budgetary imbalance or an increase in fixed costs leading to decreased liquidity or reserves, we could lower the rating.

Credit Opinion

Strong economy

We consider Naugatuck's economy strong. The borough, with an estimated population of 31,481, is in New Haven County in the New Haven-Milford, CT MSA, which we consider broad and diverse. The borough has projected per capita effective buying income of 100.3% of the national level and per capita market value of \$80,095. Overall, market value grew by 2.0% over the past year to \$2.5 billion in 2022.

The borough is primarily residential, with residential properties accounting for 68% of the grand list values over the past three years. To diversify the tax base, the borough is undertaking three main redevelopment projects to help revitalize its commercial, commuter, and residential spaces. The main project is the enhancement of the downtown transit hub to increase the number of passenger trains that stop in the borough. The state has committed to increase the number of trains per day serving the Waterbury line that traverses the borough to 22, providing more stability in commuter access to other employment centers.

In addition, the borough is creating an industrial park that will potentially house the Inland Port of Naugatuck. The port project is currently on hold, awaiting clarification on the merger between the CSX and Pan Am Railways. If created, the port would provide access for intermodal shipping and storage needs in the tristate area. Currently, freight must be transported by truck from Canada to the New York-New Jersey area; however, the creation of the port would allow for rail transport from Canada to Naugatuck, with trucks taking the shipment the remainder of the way to the tristate area. As these two aforementioned projects and other development progress, the borough continues to realize organic growth in the tax base, with grand list values rising nearly 5.5% to more than \$2.4 billion in fiscal 2020, and an additional 0.9% in the past year to \$2.5 billion for fiscal 2021.

Leading employers (excluding the borough itself) include Walmart (358 employees); ION Bank (187); Big Y, a grocery store (181); and senior living facilities Beacon Brook (149) and Glendale Center (112). The top 10 taxpayers represent 7.4% of total assessed value, which we consider diverse. Management noted there have been no significant changes in employment metrics, with a county unemployment rate of 8.0% in 2020. After the onset of the pandemic, the unemployment rate rose to a high of 10.5% in July 2020; however, it has tempered to 7.9% as of April 2021.

While borough residents have access to employment in the broad and diverse New Haven MSA, we do not expect a significant change in underlying wealth and income metrics. As development proceeds, we expect that Naugatuck's economy will remain strong through our outlook period.

Adequate management

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

The management team is unchanged since our last review, with the team using two-to-three years of historical data for revenue and expenditure assumptions when developing the budget. Although capital planning is undertaken for road infrastructure, public works, and the police and fire departments, a formal, annually updated long-term capital plan is not currently maintained. Nor does Naugatuck maintain a formal, long-term financial plan or forecast. Management

does regularly report on budget-to-actual performance, with monthly updates to the board of finance. The borough formally adopted an investment policy, but does not report holdings and performance regularly. A formal debt management policy has not been adopted. Naugatuck formally adopted a general fund reserve policy that aims to hold available reserves at 8%-12% of expenditures, to which it has historically adhered.

Strong budgetary performance

Naugatuck's budgetary performance is strong in our opinion. The borough had balanced operating results in the general fund of 0.1% of expenditures, and surplus results across all governmental funds 1.9% in fiscal 2020. General fund operating results have been stable, at 0.5% in 2019 and 1.7% in 2018.

We have adjusted budgetary performance to account for recurring transfers into and out of the general fund, as well as for revenues and expenditures related to the Naugatuck High School renovations.

Fiscal 2020 operating performance was stable, driven mainly by the borough's conservative budgeting practices. The borough had surpluses at both the general fund and total governmental fund levels, primarily fueled by strong property tax collections of over 96% and strong investment income returns during the year. Expenses were similarly positive, with total expenses coming in \$3.9 million favorable to budget, partially due to educational-expense savings during the year.

With the fiscal 2021 budget, the borough included a \$3.3 million use of the fund balance to balance the budget. However, this is down from an anticipated \$4.2 million use of the fund balance in the fiscal 2020 budget, but is in line with previous years in which the borough included an approximately \$3.0 million use. The use of the fund balance in the budget is mitigated by historical budgetary performance exceeding expectations, supporting increases in the fund balance over the past few years. Fiscal 2021 performance is coming in better than expected, and management anticipates ending the year with another \$100,000 plus surplus.

The fiscal 2022 budget includes a \$2.4 million use of fund balance to balance the \$129.5 million budget. Although still including the use of fund balance, the borough has consistently reduced this use in each of the past two budgets. The budget is conservative, including a 96.8% property tax collection rate and increasing the contingency by \$200,000. The borough anticipates receiving about \$9.1 million in American Rescue Plan Act funding, consisting of \$3.1 million in direct non-entitlement aid and \$6.0 million in county disbursements. Management is awaiting further guidance on the uses of the proceeds; however, it may look to allocate the funding for the inland port or transportation district projects. Overall, we expect budgetary performance will remain strong during our outlook period.

Strong budgetary flexibility

Naugatuck's budgetary flexibility is strong, in our view, with an available fund balance in fiscal 2020 of 12.3% of operating expenditures, or \$16.0 million. Over the past three years, the total available fund balance has remained at a consistent level overall, totaling 12.4% of expenditures in 2019 and 11.7% in 2018.

Naugatuck's available fund balance has remained strong in the past three fiscal years, rising from a low of 10.0% in fiscal 2017 up to 12.3% as of fiscal 2020. Although management continues to include a use of fund balance in the budget during the year, we expect the surplus for fiscal 2021 will assist the borough's trend of reducing the amount used to balance the annual budgets. As a result, we expect Naugatuck will maintain strong budgetary flexibility during

our outlook period.

Very strong liquidity

In our opinion, Naugatuck's liquidity is very strong, with total government available cash at 13.7% of total governmental fund expenditures and 1.5x governmental debt service in 2020. In our view, the borough has strong access to external liquidity if necessary.

We adjusted total governmental cash to exclude restricted cash outside of the general fund and to include holdings in certificates of deposits with maturities of less than one year. Management has taken the approach of moving more cash into interest-bearing investment vehicles to provide additional interest income. Naugatuck does not have any outstanding contingent liabilities that would require the use of cash. Therefore, we expect the borough's liquidity will remain very strong.

Very weak debt and contingent liability profile

In our view, Naugatuck's debt and contingent liability profile is very weak. Total post-issuance governmental fund debt service is 11.4% of total governmental fund expenditures, and net direct debt is 97.9% of total governmental fund revenue.

With this issuance, the borough's debt burden rises to over \$152 million. Additional debt plans remain minimal, with preliminary thoughts of a new school building in approximately five years.

The purpose of the pension obligation bonds is to increase the funding of the Employees' Pension Fund from 75.07% to 100% and the Firemen's Pension Fund from 81.98% to 100%. The \$60.6 million pension obligation bonds increase the combined reported funded ratio from 78% to 100% and correspondingly increases net direct debt as a percent of government revenues from approximately 56% to 95%. Estimated near-term carrying charges for pension and OPEB are projected to decrease from 9.2% to 6.7%, while estimated debt service increases from 9.0% to 11.4%. Expected budgetary savings in the near term are 0.1%. For more information on the added volatility risks, see our article, "Pension Obligation Bonds' Credit Impact On U.S. State And Local Government Issuers," published Dec. 6, 2017, on RatingsDirect.

Pension and OPEB liabilities:

- We no longer view the borough's pension liabilities as a source of immediate credit pressure as the funding levels have improved for both managed plans as well as the proactive adjustment in the discount rate to 6%, in line with our guideline, to reduce investment volatility.
- Although Naugatuck has established an OPEB trust to fund the liability, the fund balance of the trust has not reached levels we would deem substantial enough to offset the large liability. We believe that given the size of the liability and respective funded ratio, the OPEB cost will increase and potentially stress the budget over time. The borough anticipates working with the unions when contracts expire to further address the liability.

Naugatuck participates in the following plans as of June 30, 2020:

- Employees' Pension Fund: 75.07% funded with a net pension liability of \$36.4 million.
- Firemen's Pension Fund: 81.98% funded with a net pension liability of \$7.9 million.

- A defined-benefit health care plan that provides medical, dental, and life insurance benefits to eligible retirees and their spouses: 4.40% funded with an OPEB liability of about \$227.7 million.

In addition to the locally administered plans, the borough participates in the Connecticut State Teachers' Retirement System (TRS), a cost-sharing multiple-employer, defined-benefit pension plan administered and funded by the state. Connecticut is statutorily required to make 100% of the required contribution on behalf of the borough, and Naugatuck does not currently recognize any liability under TRS.

Before the issuance of the pension obligation bonds, the borough's combined required pension and actual OPEB contributions were 9.2% of total governmental fund expenditures in 2020. Of that amount, 3.8% represented required contributions to pension obligations, and 5.3% represented OPEB payments. The upcoming adjustment to both plans' discount rate from 7.125% to 6.0% aligns with our guideline and we anticipate it will help reduce investment volatility. Since 2018, the borough funded 100% of pension ADCs, and contributions to the firemen's plan fell short of both static funding and minimal funding progress, with only the employees' plan falling below the static funding threshold. The plans' 16-year, closed, and payroll amortization levels of 3.85% for the firemen's plan and 3.60% for the employees' plan payroll amortization defers costs and we expect funding progress will remain slow.

Strong institutional framework

The institutional framework score for Connecticut municipalities is strong.

Related Research

- S&P Public Finance Local GO Criteria: How We Adjust Data For Analytic Consistency, Sept. 12, 2013
- Criteria Guidance: Assessing U.S. Public Finance Pension And Other Postemployment Obligations For GO Debt, Local Government GO Ratings, And State Ratings, Oct. 7, 2019
- Through The ESG Lens 2.0: A Deeper Dive Into U.S. Public Finance Credit Factors, April 28, 2020

Ratings Detail (As Of July 12, 2021)		
Naugatuck Boro cert of part (Naugatuck Incineration Facs Proj)		
<i>Long Term Rating</i>	A+/Stable	Affirmed
Naugatuck Boro cert of part (Naugatuck Wastewater Sys Proj)		
<i>Long Term Rating</i>	A+/Stable	Affirmed
Naugatuck Boro GO		
<i>Long Term Rating</i>	AA-/Stable	Affirmed
Naugatuck Boro GO rfdg bnds fed taxable		
<i>Long Term Rating</i>	AA-/Stable	Affirmed
Naugatuck Boro GO (MBIA) (National)		
<i>Unenhanced Rating</i>	AA-(SPUR)/Stable	Affirmed

Many issues are enhanced by bond insurance.

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed

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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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