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Ratings

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Summary:

Derby, Connecticut; General Obligation

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Credit Profile		
US$11.885 mil tax-ex GO bnds ser 2019A due 08/01/2039		
Long Term Rating	A+/Stable	New
US$11.67 mil federally taxable GO bnds ser 2019B due 08/01/2036		
Long Term Rating	A+/Stable	New
Derby GO		
Long Term Rating	A+/Stable	Downgraded

Rationale

S&P Global Ratings lowered its rating on Derby, Conn.'s general obligation (GO) debt to 'A+' from 'AA-'. At the same time, we assigned our 'A+' rating to the city's series 2019 series A and B GO bonds. The outlook is stable.

The rating action reflects our view of the city's reduction and restatement of fiscal 2017's available fund balance from $1.2 million to a negative $1.4 million and subsequent weak budgetary performance in fiscal 2018. The change in fund balance was due to several factors, including over-budgeting of revenues, lack of certain internal controls, and understatement of prior-year expenditures that were not fully realized and accounted for until fiscal 2018. While we understand management has begun to take corrective actions to rebuild the city's fund balance position, which we believe provides stability to the rating, we believe these measures are one-time adjustments necessary to avoid further financial deterioration and are characteristics of distressed communities. In addition, we also believe the budgetary environment will remain challenged. Supporting the rating, however, is the city's very strong liquidity and debt and contingent liability profile, coupled with a stable local economy.

Derby's full faith and credit pledge, payable from the levy of an unlimited ad valorem tax on all taxable property in the city, secures the series 2019 bonds. We understand officials plan to use series B proceeds and a portion of series A proceeds to refund a portion of the city's GO debt and restructure all nonsewer-related debt payments for fiscal years 2020 and 2021 totaling $1.8 million and $1.5 million, respectively. We understand the refunding bonds will contain an extension of maturity and the savings achieved in fiscal years 2020 and 2021 will be used toward the replenishment of Derby's fund balance. The remainder of series A bond proceeds will be used to permanently finance the city's existing short-term debt.

The long-term rating reflects our view of Derby's:

- Weak budgetary performance, with operating deficits in the general fund and at the total governmental fund level in fiscal 2017 and 2018;
- Very weak budgetary flexibility, with an available fund balance in fiscal 2018 of negative 4.9% of operating expenditures that is also low on a nominal basis at negative $2.5 million, as well as limited capacity to raise revenues due to consistent and ongoing political resistance;

- Adequate management, with standard financial policies and practices under our Financial Management Assessment (FMA) methodology;
- Strong economy, with access to a broad and diverse metropolitan statistical area (MSA);
- Very strong liquidity, with total government available cash at 9.3% of total governmental fund expenditures and 2.3x governmental debt service, and access to external liquidity we consider strong;
- Very strong debt and contingent liability position, with debt service carrying charges at 4.0% of expenditures and net direct debt that is 37.1% of total governmental fund revenue, as well as low overall net debt at less than 3% of market value; and
- Strong institutional framework score.

Weak budgetary performance

Derby's budgetary performance is weak, in our opinion. The city had operating deficits of negative 4.6% of expenditures in the general fund and negative 4.3% across all governmental funds in fiscal 2018.

Fiscal 2018 results include adjustments for one-time capital expenditures paid for with bond proceeds. Additionally, we adjusted for the city's deferred pension payments, which in fiscal 2016 amounted to $431,000.

The city has consistently experienced general fund deficits over the past five years. According to officials, the general fund deficits in fiscal years 2017 and 2018 were primarily due to the culmination of several factors. One of these included the double-counting of state revenues, particularly education cost-sharing grants for alliance districts, in the budgets between fiscal years 2017 and 2019, which as a result, led to significantly lower-than-budgeted revenues. The city also overestimated other certain state formula-based grants in fiscal years 2017 and 2018. In addition, health insurance costs were over budget by about $1 million as a result of the city switching to a new health plan which substantially increased employee medical claims in the last quarter of the fiscal year. Finally, the fiscal 2017 fund balance was also restated in the fiscal 2018 audit as a result of school department expenditures being understated in prior years and not previously fully accounted for. We also note the city's fiscal 2018 audit contains certain material weakness findings with regard to reporting and internal controls, which it has begun to address, according to management.

As of result of all this, Derby is taking several measures to rebuild its fund balance and better align revenues and expenditures. As part of this refunding, the city will be restructuring its fiscal year 2020 and 2021 principal payments of $1.8 million and $1.5 million, respectively, and extending them into future years and using the savings toward the rebuilding of its fund balance. Management is also planning to sell city-owned assets and properties that are not being used during this fiscal year, which is expected to net a minimum $450,000 or more, which will also be directed toward its fund balance. Other steps include initiating a tax sale, which is expected to net about $1 million, deferring pension contributions in fiscal years 2019 and 2020 and applying the savings--currently estimated at about $540,000 annually--toward the budget, and increasing taxes. Officials indicate the city has already begun to realize the effects of some of these measures and accrued some of the savings in its fiscal 2019 finances. On a budgetary basis, Derby ended fiscal 2019 with a $1.2 million general fund drawdown. Including the sale of assets, deferral of pension contributions, tax sale, and additional amounts budgeted for fund balance replenishment, which management expects will be reflected in the final audit, the city estimates to have ended fiscal 2019 with a $2.2 million general fund surplus.

While we understand these measures will help improve fund balance levels, we also believe these measures are indicative of a distressed community whose budgetary environment will remain challenged over the next few years.

The fiscal 2020 budget is balanced and totals $44.5 million, which represents a 4% increase over the prior year. As part of its efforts to better align revenues and expenditures, the city increased its mill rate by 2.5 mills, or 6.35%, over the prior year, which it had not done in the last three years. In addition, it has been addressing its material findings by improving its internal controls and instituting organization changes. This includes assigning additional staff for segregation of financial duties and timely reconciliation, providing more oversight of school department budget and grants, and implementing double-entry accounting standards for city and school department finances, as well as adjusting certain roles and responsibilities. Management also indicates it has also budgeted more conservatively with regard to state aid and does not expect any significant increases in health insurance costs in fiscal 2020. Property taxes account for 57% of general fund revenues, followed by intergovernmental revenue at 35%. Tax collections have averaged 99% over the past three years.

While we believe Derby is taking positive steps to restore its fund balance levels and modify its budgetary assumptions, we believe many of these measures are one-time in nature meant to address its current financial position. In addition, due to its history of posting negative financial operations over the last several years and our belief that the budgetary environment will remain challenged, we expect its budgetary performance will remain weak. However, we also believe its budgetary performance could improve to adequate levels if the city were to maintain consistent positive financial operations by properly aligning revenues and expenditures and mitigating the use of one-time adjustments to achieve balance results.

Very weak budgetary flexibility

Derby's budgetary flexibility is very weak, in our view, with an available fund balance in fiscal 2018 of negative 4.9% of operating expenditures. In addition, the city's reserves are low on a nominal basis at negative $2.5 million, which we view as vulnerably low and a negative credit factor. Impairing budgetary flexibility, in our view, is a limited capacity to raise revenues due to consistent and ongoing political resistance.

The city's budgetary flexibility is now very weak as a result of its negative financial operations in fiscal years 2017 and 2018 and restatement of fund balance. For fiscal 2019, on a budgetary basis, it estimates its fund balance to be at about negative $3.8 million. However, this does not include the sale of assets, deferral of pension contributions, tax sales, and funds toward its fund balance replenishment, which officials indicate will all be accrued and accounted for in the fiscal 2019 audit. With these funds included, the city estimates the fiscal 2019 audit will reflect a fund balance position of negative $1.6 million, or approximately negative 3.7% of budgeted expenditures.

With the debt restructuring, budgeted fund balance replenishment funds totaling about $500,000, and savings of $540,000 from deferral of pension contribution, the city expects its available reserves to improve to $1.2 million during fiscal 2020. In addition, it expects its fund balance levels to improve by another $2 million by fiscal year-end 2021 to $3.2 million.

Our view of the city's budgetary flexibility is also limited by its unwillingness to consistently raise sufficient revenues to match expenditures to mitigate any fund balance drawdowns. As a result, we expect budgetary flexibility to remain very weak during our outlook period. However, if the city were to succeed in rebuilding its fund balance position, continue to raise the necessary revenues to cover expenses, and consistently improve reserve levels through positive financial operations without the use of one-time measures, our view of its budgetary flexibility could change.

Adequate management

We view the city'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 city uses a form of zero-based budgeting, which management implemented to ensure expenditures and expenditure growth are examined annually. However, we believe its revenue and expenditure assumptions have been optimistic in the past and the city has not accurately accounted for some of its revenues and expenditures, including its school-related ones.

It has monthly meetings with the Board of Apportionment and Taxation, and has procedures in place for reviewing and amending the budget based on updated information and actual performance. It also maintains a five-year capital improvement plan that it updates annually, and which is linked to the operating budget. Derby's investments adhere to state guidelines, and the city maintains a basic debt management policy that the board adopted. It also maintains an adopted fund balance policy to keep reserves between 5% and 10% of expenditures. We note that Derby is below its fund balance policy and we do not expect it to be in compliance during the two-year outlook period.

Strong economy

We consider Derby's economy strong. The city, with an estimated population of 12,816, is in New Haven County, about nine miles west of New Haven. It is in the New Haven-Milford MSA, which we consider to be broad and diverse. The city has a projected per capita effective buying income of 98.3% of the national level and per capita market value of $80,657. Overall, market value grew by 0.9% over the past year to $1.0 billion in 2020. The county unemployment rate was 4.4% in 2018.

Derby's proximity to New Haven provides residents with employment opportunities. Although a majority of the city's tax base is residential, making up 68% of the grand list, it maintains a notable commercial and industrial presence, which consists of a combined 14% of the total tax base. The tax base remains diverse with the leading taxpayer accounting for 10.4% of the grand list. Some of Derby's largest employer (excluding city government) include Griffin Hospital (1,200), Home Depot (125), and Wal-Mart (125).

We expect that Derby will see incremental growth in its tax base. To facilitate redevelopment, officials acquired land adjacent to Main St. (Route 34) in expectation of the road-widening project completion in 2019. Management expects that development will include residential and commercial properties on approximately 40 acres and spur economic growth downtown. Currently, a 379-unit, mixed-use building one block from the train station is under development. Management is also working to redevelop existing properties throughout the city. In addition, a new fuel cell facility is being developed, which is expected to create new jobs and help grow the tax base. Officials expect these and other projects currently underway will help increase revenues and expand the tax base.

Despite the anticipated new growth along Route 34 and other ongoing projects, we do not expect substantial improvements in wealth and income metrics within the two-year outlook horizon. We expect that these metrics will remain relatively stable during that time, and that the city's access to the New Haven MSA will further stabilize the economy. We thus expect Derby's economy to remain strong through the outlook period.

Very strong liquidity

In our opinion, Derby's liquidity is very strong, with total government available cash at 9.3% of total governmental fund expenditures and 2.3x governmental debt service in 2018. In our view, the city has strong access to external liquidity if necessary.

The city has demonstrated strong market access by issuing GO bonds within the past several years. In addition, management is not aggressive in its use of investments. The city does maintain a bank loan with Webster Bank N.A currently totaling $1.1 million, which it will be refunding with this issuance. We note that the city's direct bank loan does contain acceleration provisions, but given their remoteness, we do not expect the direct loan to affect liquidity. The city has also not issued any cash-flow-related notes or tax anticipation notes and does not expect to do so. As a result, we expect its liquidity profile to remain very strong.

Very strong debt and contingent liability profile

In our view, Derby's debt and contingent liability profile is very strong. Total governmental fund debt service is 4.0% of total governmental fund expenditures, and net direct debt is 37.1% of total governmental fund revenue. Overall net debt is low at 1.8% of market value, which is, in our view, a positive credit factor.

Following this issuance, the city has approximately $35.8 million in total direct debt, including long-term capital leases and debt held in the water pollution control authority fund, which we view as fully self-supporting. Management does not anticipate issuing any new-money debt within the next two-to-three years.

Derby's combined required pension and actual other postemployment benefit (OPEB) contributions totaled 4.8% of total governmental fund expenditures in 2018. Of that amount, 3.0% represented required contributions to pension obligations, and 1.7% represented OPEB payments. The city made 73% of its annual required pension contribution in 2018.

Derby is the administrator of a single-employer defined-benefit pension plan (the City Public Employee Retirement System), which covers city employees not covered by state-administered systems. Using a 7.0% discount rate, the city reports a net pension liability of $3 million and a funded ratio of 83.8% as of fiscal 2018. It has historically underfunded its pension required contribution, which we adjusted for in budgetary performance. Management also expects to underfund its actuarially determined contribution in fiscal years 2019 and 2020 and apply the savings toward the city's fund balance.

Additionally, the city contributes to the Connecticut's Municipal Employees Retirement System (MERS), a defined-benefit pension plan offered by the state for municipal employees in participating municipalities. Derby reported a MERS proportionate net pension liability of $2.9 million at June 30. 2018. The system is 93% funded, measured using an 8.0% discount rate as of fiscal 2018, which we note is higher than average. The state has reduced the discount rate in fiscal 2019 to 7%. While view reducing the rate of return as a positive, we believe this will result in higher pension contributions for the city.

The city also provides OPEBs in the form of health and life insurance to eligible retirees. It does not maintain a trust to pre-fund benefits. Its unfunded actuarial accrued liability was $29.6 million, as of June 30, 2018.

Although we acknowledge the city has not been fully funding its annually required contribution (ARC) for the city plan, we note the pension plan is well funded at 83%, and costs remain manageable. However, we could view these factors negatively if funding substantially decreases, costs begin to accelerate as a percentage of expenditures, and management continues to defer pension payments. While we do not anticipate budgetary pressure from pensions or OPEBs in the near term, should the city continue to underfund the ARC or if MERS assumptions are not met, we expect that its costs will rise, potentially pressuring the budget.

Strong institutional framework

The institutional framework score for Connecticut municipalities is strong.

Outlook

The stable outlook reflects S&P Global Ratings' opinion of Derby's plan and willingness to make the necessary revenue and expenditure adjustments, albeit through several one-time measures, to restore available reserves to positive levels. In addition, we believe the changes it is instituting in its financial management operations and raising the necessary revenues after three years of no tax increase, support our view that it should begin to realize positive financial results and increase reserves in fiscal 2020. Therefore, we do not expect to change the rating within the two-year outlook horizon.

Downside scenario

Should the city prove unsuccessful in rebuilding its fund balance to positive levels over the next two years and continue to experience reductions in available reserves as a result of negative financial operations and misalignment of revenues and expenditures, we could lower the rating.

Upside scenario

If the city were to maintain consistent positive financial performance without the use of one-time adjustments or sources, leading to improvements in reserves levels while maintaining conservative budgetary assumptions, we could raise the rating.

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

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