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Summary:

Central Falls, Rhode Island; General Obligation

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Credit Profile

Central Falls GO

Unenhanced Rating

BBB(SPUR)/Positive

Upgraded

Many issues are enhanced by bond insurance.

Rationale

S&P Global Ratings raised its rating on Central Falls, R.I.'s general obligation (GO) debt three notches to 'BBB' from 'BB'. The outlook is positive.

The upgrade reflects our view that Central Falls is operating under a much stronger economic and management environment since emerging from bankruptcy in 2012. The city has had several years of strong budgetary performance, and has fully adhered to the established post-bankruptcy plan. We believe improved financial management controls and practices will likely continue to translate to strong budgetary operations even after state oversight ends in April 2018.

The positive outlook reflects the possibility that strong budgetary performance could lead to improved reserves in line with the city's new formal reserve policy. In our view, Central Falls' credit quality may improve if it can improve and sustain its gains in reserves and maintain compliance with its new policy, particularly once the bankruptcy plan and state oversight come to an end. Improving reserves over time would suggest that the city is positioning itself to better respond to revenue effects of the next recession.

Despite a trend of improved capacity to meet obligations, we note the city's debt and contingent liability profile is very weak. We view the pension and other postemployment benefit (OPEB) liabilities as a credit concern given the very low funded ratio and overall high fixed costs. We could remove the positive outlook should these pressures continue or increase and pressure budgetary performance.

The city's full faith and credit is pledged to the bonds.

The long-term rating reflects our assessment of the following factors, including Central Falls':

- Adequate management environment with improved, albeit "standard" financial policies and practices under our Financial Management Assessment (FMA) methodology;
- Strong budgetary performance, with an operating surplus in the general fund and break-even operating results at the total governmental fund level in fiscal 2016;
- Strong liquidity, with total government available cash at 28.7% of total governmental fund expenditures and 1.9x governmental debt service, but access to external liquidity we consider limited; and
- A strong institutional framework score.

Also reflected in the rating are the following factors we consider weaknesses, which include the city's:

- Weak economy, with projected per capita effective buying income (EBI) at 50.0% and market value per capita of \$25,089, though that benefits from access to a broad and diverse metropolitan statistical area (MSA);
- Weak budgetary flexibility, with a low nominal available fund balance (\$250,000) that could improve as a percent of expenditures in the near term from its fiscal 2016 level of 1.4%; and
- Very Weak debt and contingent liability position, with debt service carrying charges at 15.1% of expenditures and net direct debt that is 63.6% of total governmental fund revenue, and a large pension and OPEB obligation, but low overall net debt at less than 3% of market value and rapid amortization, with 88.9% of debt scheduled to be retired in 10 years.

Weak economy

We consider Central Falls' economy weak. The city, with an estimated population of 19,255, is in Providence County in the Providence-Warwick MSA, which we consider to be broad and diverse. The city has a projected per capita EBI of 50.0% of the national level and a low per capita market value of \$25,089 in 2016, which, in our view, indicates a limited tax base supporting the debt and is a negative credit factor. Overall, market value grew by 6.5% over the past year to \$483.1 million in 2016. The county unemployment rate was 6.4% in 2015 and continued to decline into 2016.

Although the unemployment rate of the city has always tracked higher than the state, it has also substantially improved over the last several years. According to the Rhode Island Department of Labor and Training, the city's unemployment rate was 5.4% in December 2016, compared with the state's 4.5%.

The city's tax base has also seen gains in the last few years and we believe it should continue to improve with a number construction projects in the pipeline.

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 state of Rhode Island oversaw the transition to local control earlier in 2013. In our view, since the bankruptcy, strong controls and fiscal oversight have been in place. The city has been required to file quarterly and annual attestations, stating that it adheres to the adopted bankruptcy plan that is designed to maintain balanced operations. The state oversight and the requirement of city officials to file quarterly and annual attestations enabled management to make timely budget adjustments if financial performance deviated from projections.

The city notes that it will continue to adhere to these strong budget monitoring practices even after the bankruptcy plan and state oversight end. Recently, it implemented a formal unassigned fund balance policy that maintains a minimum of 10% of prior-year general fund expenditures. The city will adhere to the plan once the bankruptcy plan ends at the end of fiscal 2017. Currently, the bankruptcy plan does not prevent the city from maintaining reserves at the policy level. Management notes it will fund its reserves in fiscal 2018, in part from funds currently available in the capital improvement fund. Notably, the policy will require a supermajority vote of the City Council to appropriate funds below the 10% target.

The city has been conservative in its budgeting assumptions and maintains a five-year budget forecast used to identify future gaps. It does not maintain a formal investment management policy but does adhere to strict state guidelines.

The city also does not have a debt management policy, but it does maintain a five-year capital improvement plan, although not all funding sources are identified.

Strong budgetary performance

Central Falls' budgetary performance is strong, in our opinion. The city had surplus operating results in the general fund of 11.0% of expenditures, and balanced results across all governmental funds of 0.2% in fiscal 2016. Our assessment accounts for the fact that we expect budgetary results could moderate somewhat from 2016 results in the near term.

The city has had five consecutive surplus years as it has strictly adhered to the bankruptcy plan. In 2012, Central Falls, with the aid of the state, negotiated reductions in the annual cost-of-living for current retirees, reduced pensions by up to 55%, and made changes to health insurance. In addition, it was able to achieve a collective bargaining agreement with labor unions through June 30, 2016. These adjustments enabled the federal judge to approve a six-year plan so that the city could live within its means over the six-year planning horizon. The plan elapses at the close of fiscal 2017.

We believe the city will maintain strong budgetary performance over the next two fiscal years as credit conditions in the region remain stable, and it has a revenue contingency built into its budget to mitigate any potential volatility. For fiscal 2017, the city is anticipating an additional general fund surplus. Management notes that its revenues are exceeding the budget and it continues to see strong collection rates on current and delinquent taxes. Also, expenses are 3% below budget.

We note the city's pension and OPEB liabilities will remain a budgetary pressure over the next decade given the very low funded ratio and overall high fixed costs. Notably, the city is continuing to over-fund the pension required contribution and has also appropriated roughly \$100,000 into its OPEB trust. These costs are continuing to increase and may strain future operations, particularly if economic or business conditions worsen and actuary assumptions are not met, revised or found to be inadequate.

Weak budgetary flexibility

Central Falls' budgetary flexibility is weak, in our view, with an available fund balance in fiscal 2016 of 1.4% of operating expenditures. In addition, the city's reserves are low on a nominal basis at \$250,000, which we view as vulnerably low and a negative credit factor.

We note that these levels of general fund reserves are in line with the bankruptcy plan, and that the city established a capital reserve account in 2013 with a current 2016 balance of \$3.9 million. Despite having established that account, the unassigned general fund balance remains weak, although we do anticipate it will improve. As noted above, the city anticipates funding reserves up to its policy target.

Strong liquidity

In our opinion, Central Falls' liquidity is strong, with total government available cash at 28.7% of total governmental fund expenditures and 1.9x governmental debt service in 2016. In our view, the city has limited access to external liquidity if necessary.

We expect cash balances to remain very strong. Moreover, the city does not have any contingent liquidity risk from any financial instruments with payment provisions that change on the occurrence of certain events. In addition,

management is not aggressive in its investments.

Very weak debt and contingent liability profile

In our view, Central Falls' debt and contingent liability profile is weak. Total governmental fund debt service is 15.1% of total governmental fund expenditures, and net direct debt is 63.6% of total governmental fund revenue. Overall net debt is low at 2.7% of market value, and approximately 88.9% of the direct debt is scheduled to be repaid within 10 years, which are, in our view, positive credit factors.

Debt service costs have increased over the last several years, but we anticipate debt service will decline considerably in 2021. Currently, the city does not have any future debt plans.

We view the city's pension and OPEB liabilities as a credit concern given the very low funded ratio and overall high fixed costs, and believe despite the city's best efforts to address the liabilities, costs will continue to escalate. Central Falls' combined required pension and actual OPEB contributions totaled a high 14.1% of total governmental fund expenditures in 2016. Of that amount, 12.7% represented required contributions to pension obligations, and 1.4% represented OPEB payments. Central Falls made 105% of its annual required pension contribution in 2016 and has budgeted to fund a similar amount in fiscal 2017.

Central Falls contributes to two-defined benefit pension plans: The City of Central Falls Pension Plan, a single-employer plan which is reported as a pension trust fund; and the Municipal Employees' Retirement System (MERS), an agent multiemployer defined-benefit pension plan of the State of Rhode Island, which covers substantially all of the city's employees except police officers and firefighters. The city also contributes to TIAA-CREF and the Employees' Retirement System of Rhode Island administered defined-contribution plan, which covers certain municipal employees participating in MERS.

According to the city's most recent actuarial studies, the combined unfunded actuarial accrued liability for the pension fund and OPEBs is \$31.4 million, including \$24.9 million for the pension fund, assuming a 7.5% discount rate, as of July 1, 2016, and \$6.5 million for OPEBs as of June 30, 2015. We note that the city increased the discount rate from 5.75% one year ago, which led to a net decrease in the overall net pension liability of \$7.2 million. The funded ratio for the Central Falls Pension Plan as of the actuarial valuation dated July 1, 2016, was very low at 24.1%. The city projects that it will be out of critical status in 2026, which it defines as having a funded ratio of about 60%. If all plan assumptions are met, management expects the plan to have a 100% funded ratio in 2030. Prior to entering bankruptcy, the city had a funded ratio of 8.7% in its locally administered pension funds.

As for the city's long-term OPEB liabilities, following bankruptcy, the liability was reduced by half and the city has established an OPEB trust with an initial deposit of \$100,000 in fiscal 2016; it has budgeted a \$100,000 contribution for fiscal 2017 and expects to continue contributing \$100,000 each year.

The city has been aggressive in funding its pension and OPEB liabilities and we believe the city will continue to remain pro-active. However, we believe that, given the current funded status and assumptions, that these liabilities will remain a budgetary pressure particular if market returns fall below expectations.

Strong institutional framework

The institutional framework score for Rhode Island municipalities is strong.

Outlook

The positive outlook reflects Central Falls' improved financial performance and ongoing adherence to the bankruptcy plan that we believe will likely continue to translate into it increasing budgetary flexibility, while it remains proactive in managing its long-term liabilities, ensuring cost increases do not materially weaken future financial performance and liquidity.

For us to consider raising the rating over the outlook horizon, the city would need to continue to demonstrate that it is sustaining its financial controls and procedures beyond the scope of the bankruptcy plan and state oversight, especially since we expect increasing costs and revenue limitations to remain ongoing challenges into the future. The city's ability to maintain a stable budgetary environment and make continued progress in managing its long-term liabilities would be important considerations in our evaluation of the rating.

We could revise our positive outlook if pension and OPEB liability funding pressures translate into a weakened budgetary performance over the next year or if management somehow falters in its ability to adhere to established policies and controls.

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