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Hamilton (City of) OH

Update to credit analysis following downgrade

Summary

The City of Hamilton (A1) is a moderately sized community located between Cincinnati (Aa2 stable) and Dayton (Aa2 stable). While starting to show signs of improvement, the city's economy has historically been constrained by its muted population growth and below average median family income. The city's financial operations are sound, though reserves have steadily declined in recent years due to a series of one-time expenditures for economic development and capital projects. The city's leverage is above-average, characterized by a moderate debt burden and elevated pension burden. The city's debt burden is expected to grow considerably in the near-term due to borrowing associated with the construction of a new convention center, sports complex, and hotel.

On August 15th, the city's issuer and general obligation limited tax ratings were downgraded to A1 from Aa3.

Credit strengths

» Sound financial operations with close fiscal oversight

» Favorable location, within commuting distance of Cincinnati and Dayton

Credit challenges

» Reliance on economically-sensitive income tax revenues

» Limited population growth and below-average median family income

» Elevated debt and pension burden

Rating outlook

Outlooks are typically not assigned to local governments with this amount of debt.

Factors that could lead to an upgrade

» Significant and sustained improvement in reserves

» Moderation of debt and pension burden

» Economic expansion that improves resident incomes

Factors that could lead to a downgrade

» Weakening of the city's tax base and/or resident wealth and income

» Continued draws on financial reserves

Key indicators

Exhibit 1

Hamilton (City of) OH	2013	2014	2015	2016	2017
Economy/Tax Base					
Total Full Value ($000)	$2,315,903	$2,166,527	$2,150,177	$2,142,327	$2,271,328
Population	62,350	62,366	62,359	62,259	62,127
Full Value Per Capita	$37,144	$34,739	$34,481	$34,410	$36,559
Median Family Income (% of US Median)	74.8%	74.2%	73.9%	74.3%	74.3%
Finances					
Operating Revenue ($000)	$45,651	$43,551	$44,693	$45,993	$48,508
Fund Balance ($000)	$14,970	$16,152	$16,869	$11,736	$11,375
Cash Balance ($000)	$15,566	$17,052	$14,272	$15,712	$13,484
Fund Balance as a % of Revenues	32.8%	37.1%	37.7%	25.5%	23.4%
Cash Balance as a % of Revenues	34.1%	39.2%	31.9%	34.2%	27.8%
Debt/Pensions					
Net Direct Debt ($000)	$25,370	$22,965	$20,490	$17,965	$26,445
3-Year Average of Moody's ANPL ($000)	$182,734	$191,580	$185,512	$175,337	$171,471
Net Direct Debt / Full Value (%)	1.1%	1.1%	1.0%	0.8%	1.2%
Net Direct Debt / Operating Revenues (x)	0.6x	0.5x	0.5x	0.4x	0.5x
Moody's - adjusted Net Pension Liability (3-yr average) to Full Value (%)	7.9%	8.8%	8.6%	8.2%	7.5%
Moody's - adjusted Net Pension Liability (3-yr average) to Revenues (x)	4.0x	4.4x	4.2x	3.8x	3.5x

Sources: Audited financial statements, Moody's Investors Service, U.S. Census Bureau

Profile

The City of Hamilton is the county seat of Butler County (Aa1) and serves an estimated population of 62,000 as of 2017. The city provides traditional municipal services and owns and operates four utilities: water, wastewater, gas, and electric. As of 2017, the city employed 629 full time equivalents.

Detailed credit considerations

Economy and tax base: moderately sized community located between Cincinnati and Dayton

Economic development within the city could provide a slight boost to the city's tax base, though flat population trends and a weak socioeconomic profile could limit growth. With a full value of $2.3 billion as of 2018, the city's tax base grew by a healthy 6% last year due to improving property values and new commercial and residential development. While still 16% below its pre-recession level, the tax base will likely continue to rebound given ongoing development activity.

The city has grown increasingly diversified over the past decade, with major employers currently spanning the government, health care, and advanced manufacturing sectors. Total employment grew for four consecutive years through 2017 and as of May 2018 the city's unemployment rate stood at 4.2%, in line with the state (4.2%) and above the national (3.6%) rates for the same period. Resident incomes remain below-average compared to similarly rated local governments, with median family income equal to 74.3% of the national median.

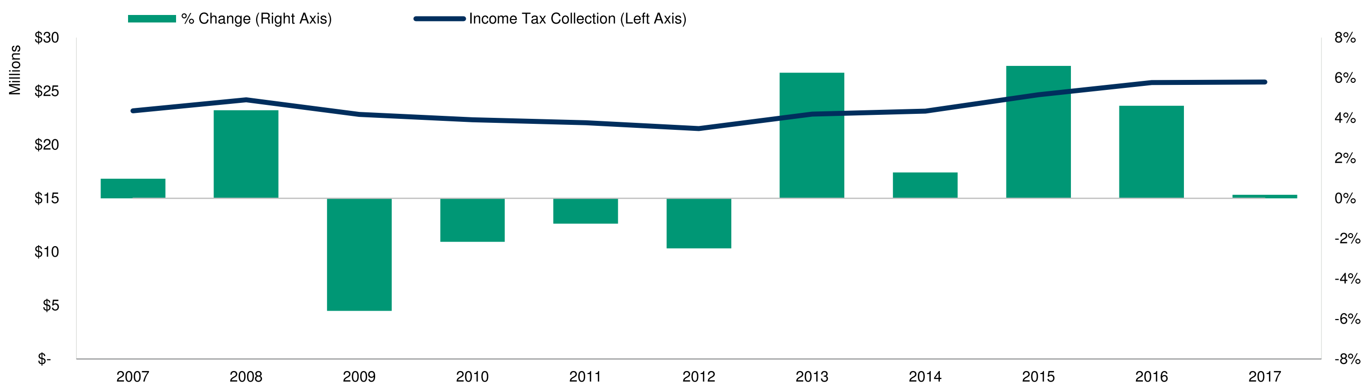
Financial operations and reserves: balanced operations, but recent decline in reserves

The city's financial position is expected to remain sound due to balanced operations and prudent management. The city's available general fund balance fell to $7.6 million (21.3% of revenue) in fiscal 2017 from $13.6 million (40.7% of revenues) in fiscal 2015 due to planned one-time expenses for economic development and capital projects. Approximately $4.5 million of the draw will be reimbursed with proceeds from an upcoming bond sale, and officials expect available fund balance to exceed $12 million (34% of revenues) by the close of fiscal 2018. Despite the expected improvement in fiscal 2018, the city's available general fund balance will remain below the median for A1 rated Ohio cities, which is 43%. Officials are forecasting balanced operations in fiscal 2019 and expect no additional draws on reserves.

Across all of the city's operating funds[1], the city's available operating fund balance at the end of fiscal 2017 was $11.4 million, equal to 23.4% of revenues.

Income taxes are the city's largest source of revenue, accounting for 48% of operating revenues in fiscal 2017. Income tax collections have shown moderate growth over the last five years (see Exhibit 2), with a compound average growth rate (CAGR) of 3.7%. Longer-term growth trends have been more tepid, with a 10-year CAGR of 1.1%.

Exhibit 2
Income tax collections likely to extend growth trend in 2018



Source: City of Hamilton, OH

LIQUIDITY
The city's combined operating funds ended fiscal 2017 with a cash balance of $13.5 million, an amount equal to 27.8% of annual revenues. The city's liquidity is slightly below the median for other A1 rated Ohio cities, which is 36%.

Debt and pensions: heightened debt and pension burden
The city's combined debt and pension burden are heightened. Following an upcoming debt issuance, the city's net direct debt burden will be approximately $41 million, equal to 1.8% of full value and 0.8x operating revenue. Moody's three-year average adjusted net pension liability (ANPL) for the city is equal to an elevated 7.6% of full value and 3.5x operating revenue. Fixed costs are moderate and will grow to an estimated 14% following the upcoming sale.

DEBT STRUCTURE
An estimated 45% of the city's debt is comprised of general obligation limited tax (GOLT) bonds, followed by income tax bonds (38%), bond anticipation notes (16%), and special assessment debt (1%). Roughly 33% of the city's annual debt service requirements are paid for from its self-supporting utilities. Net of utility-supported debt, the city's debt burden falls to 1.4% of full value and 0.7x operating revenues.

The city's debt burden could increase substantially within the next year due to planned borrowing that will facilitate the construction of a convention center, sports complex, and 220 room hotel. While the project plan is not yet finalized, its total cost is estimated to be $147 million. The city plans to borrow around $34 million of nontax revenue, GOLT, and revenue bonds to help finance construction of the site. The project's remaining costs will be covered by a variety of sources including equity contributions from a private developer, federal and state historic credit contributions, and new market tax credits, among other sources.

The borrowing would nearly double the city's debt burden, bringing it to approximately 3.3% of full value and 1.6x operating revenue. Additionally, if pursued, the project will introduce a new source of contingent liability risk as approximately $22 million of the city's planned $34 million borrowing is expected to be repaid by either TIF payments or operating revenues of the facility. The facility will be privately owned and operated, limiting the city's exposure to the amount of debt it incurs on behalf of the project.

DEBT-RELATED DERIVATIVES

The city is not party to any derivatives.

PENSIONS AND OPEB

City employees are members of the Ohio Public Employees Retirement System (OPERS) and the Ohio Police & Fire Pension Fund (OP&F). Ohio has the legal ability to adjust pension benefits and increase employee contributions to improve the funding of public pension plans. Additionally, state statute establishes a 30-year target for amortizing unfunded liabilities of all cost-sharing plans, providing clear legal guidance for when reforms are required. In 2012, such reforms were triggered for all state plans and the legislature acted by reducing benefits and increasing employee contributions. Notably, none of the reforms resulted in increased local government (i.e. employer) contributions.

Despite the positive impact of the 2012 reforms, unfunded liabilities will likely grow as statewide contributions remain below the amount necessary to tread water[2]. Fiscal 2017 employer contributions, which are set by the state as a share of annual payroll, were 83% and 87% of the amounts needed to tread water in OPERS and OP&F, respectively. The combined Moody's ANPL of the two plans grew by 6.4% between 2016 and 2017—the result of a lower Moody's discount rate. On a reported basis, the combined net liability of the two plans fell by 25% between 2016 and 2017 due to favorable investment returns.

Management and governance: prudent financial management, moderate institutional framework

The City of Hamilton's management has a history of maintaining balanced operations and adjusting ongoing expenditures to match ongoing revenues. Additionally, management maintains an Economic Budget Stabilization Fund to help insulate the city from any unexpected declines in income tax collections. The city has levied a 2% municipal income tax since 1991, offering a full credit to residents who work and pay income taxes to other municipalities. City Council maintains the authority to adjust the credit, and while there is no immediate plan to do so, officials estimate elimination of the credit would generate approximately $3 million annually (equal to 8% of 2017 general fund revenue).

Ohio cities have an institutional framework score of "A," or moderate. The volatility of income taxes, typically the primary source of operating revenue, results in low revenue predictability. Cities also rely on voter-approved property taxes to support activities such as public safety and street maintenance. Cities have a moderate ability to raise revenues, as voter authorization is necessary to raise income tax rates above 1%. Cities can also increase property tax rates above their charter caps with voter authorization. Expenditures mostly consist of personnel costs, which are moderately predictable. However, these costs tend to be impacted by labor agreements, resulting in moderate expenditure reduction ability.

Endnotes

1 Hamilton's operating funds include the general, golf course, public safety/health income tax, safety services, police pension, policy levy, fireman's pension, fire EMS levy, refuse, and debt service funds.

2 Our "tread water" indicator measures the annual government contribution required to prevent reported net pension liabilities from growing, given the entity's actuarial assumptions. An annual government contribution that treads water equals the sum of employer service cost and interest on the reported net pension liability at the start of the fiscal year. A pension plan that receives an employer contribution equal to the tread water indicator will end the year with an unchanged net pension liability relative to the beginning of the year if all plan assumptions hold. Net liabilities may decrease or increase in a given year due to factors other than the contribution amount, such as investment performance that exceeds or falls short of a plan's assumed rate of return. Still, higher contributions will always reduce unfunded liabilities faster, or will allow unfunded liabilities to grow more slowly than lower contributions.

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