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Fargo (City of) ND

Update to credit analysis

Summary

The City of Fargo, ND's (Aa1 negative) credit attributes include a growing economy, which is bolstered by its role as a regional economic hub; healthy operating reserves despite declines in sales tax revenue in each of the past three years; and a moderate pension burden. Credit challenges include an elevated debt burden and high fixed costs, which are expected to increase with upcoming bond issuances.

Credit strengths

» Growing tax base and regional economy

» Healthy reserve levels despite recent declines in sales tax revenue

» Revenue raising flexibility

Credit challenges

» Elevated debt burden and high fixed costs expected to further increase given additional borrowing plans

» Multi-year declines in sales tax revenue

Rating outlook

The negative outlook reflects our expectation that continued declines in sales tax revenue will pressure the city's credit quality. Additionally, downward rating movement may occur if the city's borrowing does not keep pace with growth in the city's tax base and revenues.

Factors that could lead to an upgrade

» Significant reduction in the debt burden

» Growth in revenue and tax base valuation that outpaces growth in debt

» Improvement in resident income levels

Factors that could lead to a downgrade

» Further growth in the debt burden or fixed costs

» Declines in tax base valuation or resident income indices

» Weakening of operating reserves or liquidity

Key indicators

Exhibit 1

Fargo (City of) ND	2014	2015	2016	2017	2018
Economy/Tax Base					
Total Full Value ($000)	$8,160,453	$9,197,014	$10,298,301	$11,117,387	$11,455,368
Population	110,725	113,464	115,950	118,099	125,031
Full Value Per Capita	$73,700	$81,057	$88,817	$94,136	$91,620
Median Family Income (% of US Median)	107.5%	105.6%	103.2%	101.3%	101.3%
Finances					
Operating Revenue ($000)	$155,590	$138,107	$148,625	$141,171	$150,615
Fund Balance ($000)	$92,314	$107,625	$68,360	$55,608	$103,051
Cash Balance ($000)	$71,910	$111,898	$130,482	$96,754	$89,314
Fund Balance as a % of Revenues	59.3%	77.9%	46.0%	39.4%	68.4%
Cash Balance as a % of Revenues	46.2%	81.0%	87.8%	68.5%	59.3%
Debt/Pensions					
Net Direct Debt ($000)	$426,572	$537,347	$588,076	$578,956	$658,535
3-Year Average of Moody's ANPL ($000)	$180,579	$182,222	$195,974	$209,625	$228,210
Net Direct Debt / Full Value (%)	5.2%	5.8%	5.7%	5.2%	5.7%
Net Direct Debt / Operating Revenues (x)	2.7x	3.9x	4.0x	4.1x	4.4x
Moody's - adjusted Net Pension Liability (3-yr average) to Full Value (%)	2.2%	2.0%	1.9%	1.9%	2.0%
Moody's - adjusted Net Pension Liability (3-yr average) to Revenues (x)	1.2x	1.3x	1.3x	1.5x	1.5x

The table above reflects data through the close of fiscal 2018. Fund balance levels in the table above are reflected as reported in CAFR data and do not include certain Moody's adjustments for the city's debt refunding's.
Source: Moody's Investors Service; Fargo audited financial statements; US Census Bureau

Profile

The city of Fargo is the county seat of Cass County (Aa3) and encompasses approximately 48 squares miles on the eastern border of North Dakota (Aa1 positive) across the Red River from the city of Moorhead, MN (Aa3). The city provides municipal services including public safety and water and sewer utilities.

Detailed credit considerations

Economy and tax base: growing tax base serves as regional economic hub

Fargo's economy will continue to be supported by its long-standing role as a regional economic center for surrounding agricultural communities in North Dakota and Minnesota (Aa1 stable). However, economic growth is slowing, as indicated by declining sales tax revenue. For building permits, multi-family construction has slowed in the current year, but other building permit activity has increased.

Fargo's economic base is diverse with significant health care, education, retail and information technology sectors. The North Dakota State University (NDSU; A1 stable) and its Research and Technical Park are top employers in the area. The city's largest employer, Sanford Hospital Health, employs approximately 9,300 people and expanded its operations in 2018 with a $410 million, 400-bed addition. Fargo's unemployment rates have historically trended well below those of the US. The city's population has grown rapidly in recent decades, with a 17% increase between 2000 and 2010 and another 12% increase since 2010.

The city's $12.1 billion tax base has been steadily increasing since 2006. Valuation increased at an average annual rate of 11% between 2015 and 2017. Tax base valuation has continued to grow, albeit at a more moderate pace, with increases of 3% and 8% growth in 2018 and 2019, respectively. For 2020, the city is projecting 6.6% valuation growth. Overall building permit activity has moderated in recent years. The top ten property taxpayers represent just 3.5% of the city's full valuation.

Financial operations and reserves: healthy reserves and revenue raising flexibility will partially mitigate recent declines in state aid revenues and local sales tax

Despite declines in state aid and sales tax revenues, the city's financial position is expected to remain sound due to healthy financial reserves and available revenue raising flexibility. The city closed fiscal 2018 with a $2.3 million General Fund operating deficit which decreased available reserves to $28.4 million or 29% revenues, from $31 million or 33.5% of fiscal 2017 revenues. The city had originally budgeted for a $1.2 million surplus in the General Fund, but revised the budget to finance equipment purchases for the new city hall. For fiscal 2019, management budgeted for a $305,000 surplus in the General Fund. Year-to-date results show a $800,000 General Fund deficit, driven primarily by increased expenditures for public safety salaries, and additional costs for overtime due to increased snow fall.

The city has a 2% sales tax that generated $48 million in fiscal 2018, and is used to pay for capital improvement projects and debt service on outstanding sales tax debt and some utility debt. Sales tax revenues have declined by 7.8% over the last three years. However, year-to-date results show sales tax collections up by 3.8% from fiscal 2018.

The city retains considerable revenue raising flexibility, and maintains significant margin under its property tax cap. As a result of rapid tax base growth in recent years, the city has reduced its mill rate and maintained property tax revenue growth. The city's 2018 operating mill rate is 13 mills below its allowable charter millage. Property taxes are the largest source of revenue for the city at $32 million or 33% of General Fund revenues in fiscal 2018. Intergovernmental revenues are the second largest revenue source at $22 million or 23% of revenues, which was relatively flat in comparison to fiscal 2017 revenue.

LIQUIDITY

The city's liquidity is strong. In its General Fund, the city had a net cash position of $31 million or a healthy 32% of revenues at the close of fiscal 2018. Across operating funds, the city has a net cash position of $89 million or a healthy 59% of revenues.

Over 90% of the city's GO debt is supported by special assessments and an increasing number of taxpayers choose to prepay their assessments, which has led to a substantial accumulation of approximately $30 million in pre-paid special assessments at the close of fiscal 2018. As the city's liquidity has increased, the city has taken steps to match some of these prepaid inflows with its debt service requirements, by scheduling earlier call dates for some of its debt.

Debt and pensions: elevated and growing debt burden; moderate pension burden

Elevated debt and fixed costs are a key credit challenge for Fargo. The city's debt burden is high relative to full value (5.8%) and revenues (5x). Debt levels will likely increase given planned borrowing. These figures include $33 million in special assessment bonds the city plans to issue in July 2019. The overall debt burden, which includes borrowing by overlapping entities, is also high at 7.6% of full value.

In recent years, the city has made significant investments in infrastructure, much of which is repaid with special assessments on benefiting property owners. Debt service on nearly all of the city's outstanding GO bonds is supported by special assessments on benefitting properties rather than a general debt service levy, although the city pledges to levy for debt service if special assessments are insufficient. These assessments are typically levied on existing owner- occupied housing units and developer-owned properties.

Going forward the city's overall debt burden could potentially more than double to finance a large-scale flood mitigation project. This $2.8 billion project, spearheaded by the US Army Corps of Engineers, was approved in 2014 and a project participation agreement was finalized between the Army Corps, the State of North Dakota, and local entities in June 2016. This project is expected to protect against flooding equivalent to 100-year flood levels for the entire Fargo-Moorhead region. The project will be funded with a combination of federal grants, state of North Dakota commitments, and debt issued by Fargo, Cass County, and the Flood Diversion Authority, which is primarily in Cass County. Although a specific debt structure has not been identified, it is likely that city, county and authority debt would be supported with a combination of special assessment and sales tax revenues, some of which has already been voter approved.

The city's debt service was equivalent to a high 26% across operating fund (General and Debt Service) revenues in fiscal 2018. Total fixed costs, including debt service and pensions, are even higher at 33% of operating revenues.

DEBT STRUCTURE

The majority of the Fargo's debt is fixed rate and amortizes over the long term. The city has a $100 million variable rate direct bank loan placed with Wells Fargo to finance pre-construction costs of the flood diversion project. In order to fund pre-construction costs, the city and county each obtained separate short-term, interest-only bank loans. The city's is in the process of renewing the loan. The loan originally matured in July 2019, and will be extented out to a 2021 maturity date. The city plans to refinance as long-term debt when the project plan is finalized. The loan has been included in the city's net direct debt.

The bank loan is payable solely from the city's ½ cent flood control sales tax, with interest payable monthly equivalent to LIBOR. Default triggers include various events, but primarily failure to make payments, or an S&P GO rating downgrade to below BBB-. This would trigger an acceleration of the loan after seven days (due to a downgrade) or after 180 days (if caused by other events of default). Fargo has no other parity debt that would be impaired upon acceleration.

Principal amortization of long term debt is slow with 52% of all debt retired in ten years. Of the city's GOULT-secured debt, $34 million is paid with property taxes and $420 million is paid with special assessments. These assessment bonds are ultimately secured by an unlimited, dedicated property tax levy and are included in the city's direct debt burden calculations. The city also has $66 million in sales tax debt (unrated) and $24 million in annual appropriation bonds (Aa3 negative), which are rated two notches below the city's GO rating due to the risk of non-appropriation and the less essential nature of the project (a scoreboard and video board equipment for FargoDome).

DEBT-RELATED DERIVATIVES

The city does not have any exposure to any debt-related derivatives.

PENSIONS AND OPEB

The city's pension burden is moderate. The city participates in three single employer plans: City of Fargo Employees Pension Plan, City of Fargo Firefighters Relief Association Retirement Plan, City of Fargo Police Pension Plan. The city also participates in one state multi-employer cost-sharing plan, the North Dakota Public Employees System (NDPERS). Moody's adjusted combined net pension liability (ANPL) for the city, under our methodology for adjusting reported pension data, was $238 million as of fiscal 2018. The ANPL over the past three years averaged 1.5x operating revenues and 2% of full valuation. The ANPL uses a market-based interest rate to value accrued pension liabilities. Approximately 60% of the ANPL is from the city's combined single employer plans, versus the state plan.

North Dakota statutes establish local government retirement contributions as a percent of covered compensation. The employer contribution rates are currently set a 7.12% of payroll for NDPERS. The city's total fiscal 2018 pension contribution was $10.1 million, or 6.7% of operating revenues. Contributions to NDPERS from all participating governments in aggregate amounted to only 66% of the plan's "tread water" indicator in 2017, down from 70% of the plan's "tread water" in 2016.[1]

In July 2012, the Fargo city council adopted a resolution to improve pension funding levels for its three single employer plans per actuarial recommendations. Through fiscal 2018 the city increased its annual contributions by 5%. Further, the city has determined it will not increase pension benefit levels until a reported 110% funded ratio is met for each respective plan. The city does not provide other post employment benefits (OPEB).

Management and governance: strong institutional framework

North Dakota cities have an Institutional Framework score of "Aa", which is strong. The sector's major revenue source, property taxes, are subject to a cap of 105 mills, which can be overridden at the local level with voter approval. Revenues and expenditures tend to be predictable. Across the sector, fixed and mandated costs are generally high due to elevated debt service costs.

Rating methodology and scorecard factors

The US Local Government General Obligation Rating Methodology includes a scorecard, a tool providing a composite score of a local government's credit profile based on weighted factors we consider most important, universal and measurable, as well as possible notching factors dependant on individual credit strengths and weaknesses. Its purpose is not to determine the final rating, but rather to provide a standard platform from which to analyze and compare local government credits.

Exhibit 2

Fargo (City of) ND

Rating Factors	Measure	Score
Economy/Tax Base (30%) [1]		
Tax Base Size: Full Value (in 000s)	$12,075,380	Aaa
Full Value Per Capita	$96,579	Aa
Median Family Income (% of US Median)	101.3%	Aa
Notching Factors:[2]		
Institutional Presence		Up
Regional Economic Center		Up
Finances (30%)		
Fund Balance as a % of Revenues	68.4%	Aaa
5-Year Dollar Change in Fund Balance as % of Revenues	-18.0%	Ba
Cash Balance as a % of Revenues	59.3%	Aaa
5-Year Dollar Change in Cash Balance as % of Revenues	-9.6%	Baa
Management (20%)		
Institutional Framework	Aa	Aa
Operating History: 5-Year Average of Operating Revenues / Operating Expenditures	1.0x	Baa
Debt and Pensions (20%)		
Net Direct Debt / Full Value (%)	5.8%	Baa
Net Direct Debt / Operating Revenues (x)	4.6x	Baa
3-Year Average of Moody's Adjusted Net Pension Liability / Full Value (%)	1.9%	Aa
3-Year Average of Moody's Adjusted Net Pension Liability / Operating Revenues (x)	1.5x	A
	Scorecard-Indicated Outcome	Aa2
	Assigned Rating	Aa1

[1] Economy measures are based on data from the most recent year available.
[2] Notching Factors are specifically defined in the US Local Government General Obligation Debt methodology dated December 16, 2016.
[3] Standardized adjustments are outlined in the GO Methodology Scorecard Inputs Updated for 2019 publication
Source: Moody's Investors Service; Fargo's audited financial statements; US Census Bureau

Endnotes

1 Employer contributions that tread water equal the sum of current year service cost and interest on reported net pension liabilities at the start of the year, using reported assumptions. If plan assumptions are met exactly, contributions equal to the tread water indicator will prevent the reported net pension liabilities from growing.

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