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Summary:

Falmouth Town, Massachusetts; General Obligation

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Table Of Contents

Rationale

Outlook

Related Research

Summary:

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Credit Profile

Falmouth Twn GO <i>Long Term Rating</i>	AAA/Stable	Upgraded
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Rationale

S&P Global Ratings raised its rating on Falmouth, Mass.' general obligation (GO) debt one notch to 'AAA' from 'AA+'. The outlook is stable.

The rating action reflects our opinion of the town's improved financial management conditions and consistently strong budgetary performance, which has led to the maintenance of very strong budgetary flexibility. The town's maintenance of its very strong liquidity and economy, with access to the Barnstable metropolitan statistical area (MSA), further supports the rating.

The town's full-faith-and-credit pledge, subject to limitations of Proposition 2 1/2, secures the bonds. We rate the limited-tax GO debt on par with our view of Falmouth's general creditworthiness.

We rate Falmouth higher than the sovereign because we believe the town can maintain better credit characteristics than the nation in a stress scenario based on its predominantly locally derived revenue base and our view that pledged revenue supporting debt service on the bonds is at limited risk of negative sovereign intervention. In 2017, local property taxes generated 72% of revenue, demonstrating a lack of dependence on central government revenue.

The rating reflects our opinion of the town's:

- Very strong economy, with access to a broad and diverse MSA;
- Very strong management, with strong financial policies and practices under our Financial Management Assessment (FMA) methodology;
- Strong budgetary performance, with operating surpluses in the general fund and at the total-governmental-fund level in fiscal 2017;
- Very strong budgetary flexibility, with an available fund balance in fiscal 2017 of 24% of operating expenditures;
- Very strong liquidity, with total government available cash at 21.8% of total-governmental-fund expenditures and 2.5x governmental debt service, and access to external liquidity we consider strong;
- Adequate debt-and-contingent-liability position, with debt service carrying charges at 8.7% of expenditures and net direct debt that is 74.1% of total-governmental-fund revenue, as well as low overall net debt at less than 3% of

market value; and

- Strong institutional framework score.

Very strong economy

We consider Falmouth's economy very strong. The town, with an estimated population of 31,412, is in Barnstable County in the Barnstable Town MSA, which we consider broad and diverse. The town has a projected per capita effective buying income of 138% of the national level and per capita market value of \$360,375. Overall, market value grew by 1.1% over the past year to \$11.3 billion in fiscal 2017. The county unemployment rate was 4.7% in 2016.

Falmouth is on the southwest end of Cape Cod, about 75 miles southeast of Boston in Barnstable County. The town is an affluent and primarily residential community with a population that swells to 90,000 in the summer. Falmouth boasts the longest coastline in Massachusetts with developed waterfront property for high-end residential homes. About 92% of assessed value comes from residential properties with about 6% from commercial and industrial sites. Officials continue to see a strong and active real estate market with homes selling far above market value and many homeowners and developers choosing to build new homes, generating additional revenue for the town. The town's commercial sector also continues to grow as new restaurants are opening up and various businesses continue to seek expansion opportunities. A new 77-room hotel is also in the preliminary stages of planning.

The town's local economy takes advantage of its coastal location with tourism and marine science as its two anchors. The Woods Hole Oceanographic Institute is the world's largest private, nonprofit oceanographic research, engineering, and education organization; it employs 1,396. The Marine Biology Laboratory and National Marine Fisheries employ an additional 500 people in the fields of oceanography and marine biology. The Massachusetts Military Reservation, the training grounds for military reservists in Massachusetts, is also partially in Falmouth with approximately 1,833 full-time employees. About 80% of these full-time employees live on the base; an additional 3,000 reservists station there on weekends. Ballymeade Country Club, which will feature an 80-room hotel, has begun construction; town officials expect this to add to the property tax base and create jobs. Overall, we expect the town's economy will likely remain very strong.

Very strong management

We view the town's management as very strong, with strong financial policies and practices under our FMA methodology, indicating financial practices are strong, well embedded, and likely sustainable.

Previously, we viewed the town's financial management policies and procedures as good. We now view them as strong due to the town's strengthened formal reserve policy that limits unassigned fund balance to a minimum 15%-25% of general fund expenditures and prohibits the town from using reserves to sustain operating deficits or operations.

The town regularly monitors revenue and expenditures and makes realistic budget assumptions based on a five-year trend. Management shares budget-to-actual results with finance committee members quarterly. Management also provides the committee with monthly reports on local receipts, which contain reporting on investment income but not holdings. Management reports holdings annually in the audit.

The town follows a comprehensive annually updated 10-year capital plan that examines facilities and infrastructure improvements. It also has a multiyear financial plan that identifies future issues, leading to revenue and expenditure

decisions with a long-term perspective. Structural balance is a clear goal in decision-making. The town maintains an investment policy and basic debt policy. The debt policy limits general fund debt service to 5% of expenditures. However, there is no metric, other than state statutes, that limits overall debt.

Strong budgetary performance

Falmouth's budgetary performance is strong, in our opinion. The town had operating surpluses of 3.5% of expenditures in the general fund and 4.4% of expenditures across all governmental funds in fiscal 2017.

We adjusted fiscal 2017 results for recurring transfers and one-time capital expenditures paid for with bond proceeds. Management attributes fiscal 2017 positive results to the town's conservative budgeting and revenue estimates, including stronger-than-budgeted building permit fees and motor-vehicle excise-tax revenue, as well as higher-than-expected hotel and meals tax revenue. The town also had cost savings across various departments, which led to lower-than-expected expenditures. Before this, the town had posted general fund surpluses of \$5.9 million and \$7.1 million in fiscal years 2016 and 2015, respectively.

The fiscal 2018 budget totals \$134.4 million and includes a \$4 million fund-balance appropriation the town has done historically. Management indicates budget-to-actual results are tracking the budget favorably with revenue outpacing the budget. Officials are currently projecting to end fiscal 2018 with another general fund surplus. Due to the town's conservative budgeting and continued management of its tax levy to accommodate budgetary growth, which has led to positive financial operations during the past three fiscal years, we expect budgetary performance will likely remain, at least, strong.

Falmouth's leading revenue source is property taxes at 72% of general fund revenue followed by intergovernmental revenue at 16%. Tax collections have been, in our view, strong, averaging 98% during the past three fiscal years.

Very strong budgetary flexibility

Falmouth's budgetary flexibility is very strong, in our view, with an available fund balance in fiscal 2017 of 24% of operating expenditures, or \$32.2 million.

The town has consistently increased available reserves during the past three fiscal years. The fiscal 2018 budget includes a \$4 million fund-balance appropriation, which it has done historically. Management, however, expects to end fiscal 2018 with another increase in reserves similar to prior fiscal years. The town also has a formal policy to maintain unassigned fund balance between 15% and 25% of the operating budget, which includes several stabilization accounts for capital, water, and special education. Management expects to continue to add to reserves until the town reaches the higher threshold of the targeted amount, at which point it will begin allocating budgeted reserves to pay down the other-postemployment-benefit (OPEB) liability.

Very strong liquidity

In our opinion, Falmouth's liquidity is very strong, with total government available cash at 21.8% of total-governmental-fund expenditures and 2.5x governmental debt service in fiscal 2017. In our view, the town has strong access to external liquidity if necessary.

We believe the town's regular debt issuance supports its strong access to external liquidity. Falmouth does not have any variable-rate or direct-purchase debt. It has consistently maintained very strong liquidity, and we expect our

assessment of liquidity to remain unchanged during the outlook period.

Adequate debt-and-contingent-liability profile

In our view, Falmouth's debt-and-contingent-liability profile is adequate. Total-governmental-fund debt service is 8.7% of total-governmental-fund expenditures, and net direct debt is 74.1% of total-governmental-fund revenue. Overall net debt is low at 1% of market value, which is, in our view, a positive credit factor.

The town has approximately \$163.6 million in total direct debt, \$42.3 million of which is water-enterprise debt we consider self-supporting and \$10.4 million of which the town expects to receive back from the commonwealth in the form of reimbursements for school-building construction. Management expects to borrow an additional \$32 million during the next two years to three years; the majority of which is for the remainder of its wastewater project, which is also expected to be self-supported.

Falmouth was under pressure from the commonwealth and the Environmental Protection Agency to clean up its water systems on Cape Cod, so the town embarked on a sizable water-and-wastewater capital project to replace existing septic systems with sewer systems. Officials indicate the majority of the project is complete with the remainder finished by the end of 2018. The town issued most bonds for the project through Massachusetts Clean Water Trust, a low-interest loan program administered by the commonwealth. We understand Falmouth services this debt through a combination of user charges from the system and betterments.

Falmouth's combined required pension and actual OPEB contribution totaled 7.7% of total-governmental-fund expenditures in fiscal 2017. Of that amount, 4.9% represented required contributions to pension obligations and 2.8% represented OPEB payments. The town made its full annual required pension contribution in fiscal 2017.

Town employees participate in the Falmouth Contributory Retirement System. Using updated reporting standards in accordance with Governmental Accounting Standards Board Statement Nos. 67 and 68, the town's proportionate share of the net pension liability was about \$69.2 million with a 64% funded ratio at Dec. 31, 2016, based on an assumed rate of return of 7.5%. We believe this weak funded ratio is due to numerous years of underfunding, aggressive assumptions, and weak market performance. Due to the funded ratio, we believe contributions will likely continue to rise during the next few fiscal years. Town management expects to fund the pension in full by fiscal 2032 before funding the OPEB liability more aggressively.

Falmouth pays OPEB on a pay-as-you-go basis. Its unfunded actuarial accrued liability was \$121.6 million at June 30, 2016. The town has established an OPEB trust fund with a current balance of \$356,371. Falmouth appropriated \$100,000 for the fund in fiscal 2018; it plans to continue to do so annually.

While retirement costs have remained manageable, we expect these costs will likely continue to increase because of the low funded ratios and large liabilities. Should pension and OPEB costs increase and pressure the budget, our assessment of the town's debt-and-contingent-liability profile could weaken.

Strong institutional framework

The institutional framework score for Massachusetts municipalities is strong.

Outlook

The stable outlook reflects S&P Global Ratings' opinion of Falmouth's very strong economy, supported by its access to the Barnstable MSA. We believe Falmouth's very strong management and consistently strong budgetary performance, which has led to very strong budgetary flexibility, further support the rating. Although the town has large long-term liabilities and increasing retirement costs, we believe management will likely make the necessary budgetary adjustments to maintain balanced financial operations.

Therefore, we do not expect to change the rating during the two-year outlook period. While unlikely to occur, if finances were to deteriorate significantly or experience budgetary pressure due to low pension funding levels, leading to a drawdown on reserves, we could lower 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
- 2017 Update Of Institutional Framework For U.S. Local Governments

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed 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 the S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.

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**Massachusetts Department of Revenue
Division of Local Services
Municipal Databank/Local Aid Section**

**Standard & Poor's Bond Ratings
Definitions of Long-Term Bond Ratings**

AAA

An obligation rated AAA has the highest rating assigned by Standard & Poor's. The obligor's capacity to meet its financial commitment on the obligation is extremely strong.

AA

An obligation rated AA differs from the highest-rated obligations only in small degree. The obligor's capacity to meet its financial commitment on the obligation is very strong.

A

An obligation rated A is somewhat more susceptible to the adverse effects of changes in circumstances and economic conditions than obligations in higher-rated categories. However, the obligor's capacity to meet its financial commitment on the obligation is still strong.

BBB

An obligation rated BBB exhibits adequate protection parameters. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the obligor to meet its financial commitment on the obligation.

Obligations rated BB, B, CCC, CC, and C are regarded as having significant speculative characteristics. BB indicates the least degree of speculation and CC the highest. While such obligations will likely have some quality and protective characteristics, these may be outweighed by large uncertainties or major exposures to adverse conditions.

BB

An obligation rated BB is less vulnerable to nonpayment than other speculative issues. However, it faces major ongoing uncertainties or exposure to adverse business, financial, or economic conditions which could lead to the obligor's inadequate capacity to meet its financial commitment on the obligation.

B

An obligation rated B is more vulnerable to nonpayment than obligations rated BB, but the obligor currently has the capacity to meet its financial commitment on the obligation. Adverse business, financial, or economic conditions will likely impair the obligor's capacity or willingness to meet its financial commitment on the obligation.

CCC

An obligation rated CCC is currently vulnerable to nonpayment and is dependent upon favorable business, financial, and economic conditions for the obligor to meet its financial commitment on the obligation. In the event of adverse business, financial, or economic conditions, the obligor is not likely to have the capacity to meet its financial commitment on the obligation.

CC

An obligation rated CC is currently highly vulnerable to nonpayment.

C

A subordinated debt or preferred stock obligation rated C is currently highly vulnerable to nonpayment. The C rating may be used to cover a situation where a bankruptcy petition has been filed or similar action taken, but payments on this obligation are being continued. A C also will be assigned to a preferred stock issue in arrears on dividends or sinking fund payments, but that is currently paying.

D

An obligation rated D is in payment default. The D rating category is used when payments on an obligation are not made on the date due even if the applicable grace period has not expired, unless Standard & Poor's believes that such payments will be made during such grace period. The D rating also will be used upon the filing of a bankruptcy petition or the taking of a similar action if payments on an obligation are jeopardized.

Plus (+) or Minus (-)

Ratings from AA to CCC may be modified by the addition of a plus or minus sign to show relative standing within the major rating categories.

r

This symbol is attached to the ratings of instruments with significant noncredit risks. It highlights risks to principal or volatility of expected returns which are not addressed in the credit rating.

N.R.

An issuer designated N.R. is not rated.

SPUR denotes Standard & Poor's underlying rating for insured bonds.

SPURs are public information. We also have confidential shadow ratings on select insured bonds.