

RatingsDirect®

Summary:

Royal Oak, Michigan; General Obligation

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Credit Profile

US\$31.055 mil ltd tax GO bnds (cap imp bnds) ser 2018 due 10/01/2044

Long Term Rating AA+/Stable New

Royal Oak cap imp rfdg bnds (ltd tax GO)

Long Term Rating AA+/Stable Affirmed

Rationale

S&P Global Ratings assigned its 'AA+' long-term rating to Royal Oak, Mich.'s series 2018 limited-tax general obligation (GO) capital improvement bonds. At the same time, S&P Global Ratings affirmed its 'AA+' long-term rating and underlying rating (SPUR) on existing GO debt. The outlook is stable.

The 2018 bonds and existing rated GO debt are limited-tax general obligations of the city payable from ad valorem taxes levied on all taxable property within the city or from any other legally available funds of the city. The taxing power of the city is subject to applicable constitutional, statutory, and charter limitations. Despite these limitations, we rate the limited-tax GO debt on par with our view of the city's general creditworthiness, as reflected in the city's unlimited-tax GO bond rating. The series 2018 capital improvement bonds will be used to finance the construction of a new city hall, police headquarters, and park in the downtown area of the city.

The 'AA+' ratings reflect our assessment of the following factors for the city:

- Very strong economy, with access to a broad and diverse metropolitan statistical area (MSA);
- Very strong management, with strong financial policies and practices under our Financial Management Assessment (FMA) methodology;
- Adequate budgetary performance, with balanced operating results in the general fund but an operating deficit at the total governmental fund level in fiscal 2017;
- Very strong budgetary flexibility, with an available fund balance in fiscal 2017 of 49% of operating expenditures;
- Very strong liquidity, with total government available cash at 104.8% of total governmental fund expenditures and 50.5x governmental debt service, and access to external liquidity we consider strong;
- Very weak debt and contingent liability profile, with debt service carrying charges at 2.1% of expenditures and net direct debt that is 244.6% of total governmental fund revenue, as well as a large pension and other postemployment benefit (OPEB) obligation and the lack of a plan to sufficiently address the obligation; and
- Strong institutional framework score.

Very strong economy

We consider Royal Oak's economy very strong. The city, with an estimated population of 59,006, is located in Oakland County in the Detroit-Warren-Dearborn, Mich., MSA, which we consider to be broad and diverse. The city has a

projected per capita effective buying income of 146% of the national level and per capita market value of \$104,460. Overall, the city's market value grew by 8.0% over the past year to nearly \$6.12 billion for taxes payable in fiscal year 2018. The county unemployment rate was 4.2% in 2016.

William Beaumont Hospital remains the city's largest employer, with about 13,300 employees; the hospital has been an anchor for the community for many years. The city's employment opportunities have broadened in recent years as new technology startup companies have attracted young professionals. Also, Royal Oak has added upscale and trendy dining opportunities, and serves as a regional entertainment hub with local attractions like the Detroit Zoo and several theaters. The 12-square-mile city is located just 10 miles north of downtown Detroit. Residents have extensive employment opportunities throughout Oakland County, but the city sees an increase in daytime population from those who commute into Royal Oak for work. The city's tax base is primarily residential (77% of the 2017 taxable valuation), and commercial uses make up a majority of the remaining valuation, at 16%. Assessed values have risen slightly each year over the past three years, averaging a 3% annual increase from 2014 to 2017. Officials expect the tax base growth to continue in fiscal 2018.

Very strong management

We view the city'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.

The city performs a line-by-line analysis submitted by each department when building its budget, and it has many years of historical information, with a focus on the last three years. The city also anticipates revenues and expenditures for each department. Management reports to its city commission members on budget-to-actual results at least quarterly over the past year; however, the reporting is typically done monthly. The city can amend the budget as needed and typically amends it four to five times per year.

The city has a five-year financial plan that is updated each year and presented to commission members on an annual basis. The five-year capital plan is updated annually, is provided to city commission annually, and identifies sources and uses. Further, the capital plan is presented to and adopted by the city's planning commission annually.

The investment policy adheres to state guidelines. The city updates the commission monthly on investment performance and holdings. Its debt management policy mainly adheres to state guidelines. City officials have a formal reserve policy of maintaining reserves at no less than 10% and no more than 25% of budgeted operating expenses in the general fund, in part to manage unexpected revenue shortfalls or to provide for unanticipated contingencies and emergencies.

Adequate budgetary performance

Royal Oak's budgetary performance is adequate in our opinion. The city had balanced operating results in the general fund of negative 0.1% of expenditures, but a deficit result across all governmental funds of 5.8% in fiscal 2017.

The city's budgetary performance has been adjusted to include recurring transfers and to exclude one-time transfers across the governmental funds. General fund performance includes the operations of the combined general fund and public safety fund.

Among these exclusions in fiscal 2017 were transfers out of the general fund to the local street fund for one-time

projects, and a transfer in from the city's self-insurance funds after a look-back correction generated a one-time payment to the general and other funds, which we believe will help support capital needs in future years. For fiscal 2018 and fiscal 2019, management plans to utilize some reserves for cash contributions toward capital projects in the general fund and across total governmental funds. The city typically outperforms its budgetary predictions, and we usually do not include one-time spending in our assessment of budgetary performance; therefore, we expect the general fund operational performance to remain close to break even in fiscal 2018 and fiscal 2019. However, we understand total governmental funds will continue to show a use of reserves in the near future, leading to our expectation that the city will maintain adequate overall budgetary performance.

If the general fund outperforms budgeted expectations in future years, and the total governmental funds are maintained closer to break-even operations, we could see the city's budgetary performance improve to strong.

Very strong budgetary flexibility

Royal Oak's budgetary flexibility is very strong, in our view, with an available fund balance in fiscal 2017 of 49% of operating expenditures, or \$22.8 million. We expect the available fund balance to remain above 30% of expenditures for the current and next fiscal years, which we view as a positive credit factor.

The budgetary flexibility assessment considers the assigned and unassigned balances in the general and public safety funds. We understand that the city could utilize reserves from the general fund or public safety fund during fiscal 2018 and fiscal 2019; however, the potential use of reserves would not materially affect the overall financial reserve position. Therefore, we expect budgetary flexibility to remain very strong within the two-year outlook horizon. Additionally, the city typically achieves better-than-budgeted ending financial results, and may not utilize all reserves outlined in projections.

Very strong liquidity

In our opinion, Royal Oak's liquidity is very strong, with total government available cash at 104.8% of total governmental fund expenditures and 50.5x governmental debt service in 2017. In our view, the city has strong access to external liquidity if necessary.

The city has been a frequent issuer of GO and revenue debt for the past 20 years. The city has confirmed that it does not have any alternative financing obligations that could materially affect its liquidity position. Additionally, we are not aware of any other contingent liabilities that could materially weaken the city's cash position in the next two years with respect to total governmental expenditures or total governmental debt service.

Very weak debt and contingent liability profile

In our view, Royal Oak's debt and contingent liability profile is very weak. Total governmental fund debt service is 2.1% of total governmental fund expenditures, and net direct debt is 244.6% of total governmental fund revenue.

We have included the city's series 2018 parking system revenue bonds, which are expected to be issued simultaneously with the limited-tax GO bonds. While we have not rated the parking revenue bonds, we have included the new 2018 series in our assessment of the city's total debt burden, although the bonds are expected to be entirely self-supported with parking system revenues. All debt that is secured solely by enterprise revenue debt is given credit for self-support and is not included in our assessment of net direct debt of the city. Debt that is secured by a property

tax pledge but is routinely paid from enterprise revenue has also been excluded from our assessment of net direct debt. We understand there are no additional debt plans at this time.

The city's total debt burden is high, and includes the taxable 2017 bonds, which were issued to defray the costs of the unfunded other postemployment benefit (OPEB) and pension liabilities. The city fully funded all of its previously outstanding unfunded OPEB liability and a portion of the unfunded pension liability.

In our opinion, a credit weakness is Royal Oak's large pension and OPEB obligation, without a plan in place that we think will sufficiently address the obligation.

While the city fully funded the unfunded liability associated with OPEB and funded a portion of the city's pension plan, the police and fire portion of the city's pension plan remains outstanding and open to new hires of the group. The plan is a single-employer defined benefit pension plan, and carries a net pension liability of \$61.62 million at June 30, 2017, down from \$85.67 million in fiscal 2016 due to the one-time contribution of bond proceeds from the 2017 pension obligation bonds. The funded ratio on the plan, after bond proceeds were deposited improved to 71.5%, up from 59.3%. The city was able to entirely pay off the unfunded OPEB liability with bond proceeds, and the total OPEB liability was overfunded at June 30, 2017, with a net asset of \$8.46 million, representing a 106.8% funded ratio. Royal Oak's combined required pension and actual OPEB contributions totaled 22.5% of total governmental fund expenditures in 2017. Of that amount, 8.7% represented required contributions to pension obligations, and 13.8% represented OPEB payments. The city made its full annual required pension contribution in 2017. The funded ratio of the largest pension plan is 71.5%.

While retirement costs are expected to drop significantly as a result of the issuance of pension and OPEB funding bonds, debt carrying charges will rise when new debt service payments come on line in fiscal 2018. Total fixed cost burden, including both retirement and debt service payments, was 25% in fiscal 2017. The overall fixed cost burden is expected to decline from 25% to 22% (15% debt service expenditures and 7% retirement costs) by fiscal 2018, which we still view as a significant portion of the budget.

We believe the pension obligation bonds could cause budgetary pressure for the city if invested bond proceeds do not perform as expected, or if other assumptions made in determining the liabilities do not hold true. If the 7.75% investment rate of return is not met in future years, we believe the city could come under budgetary pressure due to increased fixed costs in addition to an already high debt and retirement cost burden.

Strong institutional framework

The institutional framework score for Michigan municipalities with a population between 4,000 and 600,000 is strong.

Outlook

The stable outlook reflects our anticipation that Royal Oak will maintain its very strong budgetary flexibility and liquidity and strong budgetary performance positions despite any budgetary pressures related to fixed debt- and retirement-related costs. As a result, we do not expect to change the ratings within our two-year outlook period. The city's proximity to Detroit and Oakland County also lends stability to the ratings.

Downside scenario

To the extent that the assumptions made in determining the total liability of the city's retirement obligations do not hold true, including the assumed rate of return on investments, we believe the city could face budgetary pressure, given that fixed costs are already high. If the city's budgetary performance or flexibility were to weaken for any reason, we could consider a lower rating. Additionally, if the city's commitment and discipline related to funding ongoing retirement obligations wanes in future years, the overall credit quality of the city could be negatively affected.

Upside scenario

If the economic metrics continue to show sustainable improvement, and if the city is able to reduce overall fixed debt and retirement costs to sufficiently mitigate concerns about potentially optimistic investment return assumptions, we could raise the ratings.

Related Research

2017 Update Of Institutional Framework For U.S. Local Governments

Ratings Detail (As Of April 16, 2018)		
Royal Oak GO (ASSURED GTY)		
<i>Unenhanced Rating</i>	AA+(SPUR)/Stable	Affirmed
Royal Oak cap imp (Vehicle Purchase Proj)		
<i>Unenhanced Rating</i>	AA+(SPUR)/Stable	Affirmed
Royal Oak Bldg Auth, Michigan		
Royal Oak, Michigan		
Royal Oak Bldg Auth (Royal Oak) bldg auth rfdg bnds		
<i>Long Term Rating</i>	AA+/Stable	Affirmed

Many issues are enhanced by bond insurance.

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