

## **RATING ACTION COMMENTARY**

# **Fitch Rates Minneapolis, MN's ULTGO Bonds at 'AA+'; Outlook Positive**

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Fitch Ratings - New York - 19 Jul 2022: Fitch Ratings has assigned a 'AA+' rating to \$124 million of unlimited tax general obligation (ULTGO) bonds, series 2022, to be issued by the City of Minneapolis, MN.

Fitch has also affirmed Minneapolis' Issuer Default Rating (IDR) and \$700 million in outstanding ULTGO bonds at 'AA+'.

The Rating Outlook is Positive.

The series 2022 bond proceeds will finance various infrastructure, capital and utility systems. The bonds will sell via competition in August.

## **SECURITY**

The bonds are general obligations of the city, backed by the city's full faith and credit and unlimited ad valorem taxing power. To pay debt service, the city is obligated to levy a tax without limit as to rate or amount on all taxable property within the city.

## **ANALYTICAL CONCLUSION**

The 'AA+' rating reflects the city's strong revenue growth prospects driven by an expanding population and income levels, broad independent revenue-raising ability, and solid budgetary management that has resulted in healthy reserves and considerable gap-closing capacity. The ratings also incorporate recent changes that have reduced the share of statewide net pension liabilities attributable to the city, along with pension reforms that have improved the long-term sustainability of the pension systems.

The Positive Outlook reflects Fitch's belief that the city's long-term liability burden will remain moderately low over time driven by statewide pension reforms and strong trends of population and income growth

### **Economic Resource Base**

Minneapolis is the largest city in the state of Minnesota with an estimated 2021 population of 425,336, an increase of 11.2% over the 2010 Census. Population growth has been strong as educated, younger workers have been attracted to the diverse employment opportunities in the city, as well as to the city's amenities and cultural attractions and easy commutability. Approximately 52% of residents hold a bachelor's degree or higher, compared with 33% nationally.

Along with its sister city of St. Paul, Minneapolis forms the core for the second-largest economic center in the U.S. Midwest, after Chicago. The city's broad and diverse economic base benefits from major employers in the stable health care, higher education and state and county government sectors. Minneapolis has a sizable retail and financial presence, being home to Ameriprise Financial, US Bancorp and Target Corporation.

### **KEY RATING DRIVERS**

#### **Revenue Framework: 'aaa'**

Revenue growth has generally kept pace with U.S. GDP growth over time, a trend that Fitch expects will continue in light of recent population gains, and a vibrant and diverse local economy. The city's independent legal ability to raise revenues is strong, but Fitch notes that the state has enacted temporary tax levy caps in the past.

#### **Expenditure Framework: 'aa'**

Fitch expects spending to grow in line with, to marginally above, the pace of revenue growth. Expenditure flexibility is solid and carrying costs for debt service and pension contributions are expected to remain moderate as a percentage of spending.

## **Long-Term Liability Burden: 'aa'**

Fitch's belief that the city's long-term liability burden will remain moderately low based on the city's future borrowing plans, statewide pension reforms and growing evidence that these improvements are sustainable in light of continued population and income growth.

## **Operating Performance: 'aaa'**

The city maintains superior financial resilience given its ability to adjust tax rates and spending to address both cyclical revenue shortfalls and other fiscal pressures. Reserve levels remain very high primarily driven by healthy general fund operations that have resulted in consistent operating surpluses.

## **RATING SENSITIVITIES**

Factors that could, individually or collectively, lead to positive rating action/upgrade:

--Ability to sustain a low long-term liability burden of less than 10% of personal income over time.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

--A slow-down in the city's economic growth driven by a weaker than currently anticipated economic recovery and/or lingering effects of the civil unrest within the city, that lower the revenue growth prospects over time;

--State implementation of new or permanent tax levy caps for localities that constrains revenue raising ability and limits future budgetary flexibility;

--Rising long-term liabilities that exceed 10% of personal income over a sustained period;

--Carrying costs increasing above their historic averages for an extended duration, weakening the city's expenditure flexibility and gap-closing capacity.

## **BEST/WORST CASE RATING SCENARIO**

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of

rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit <https://www.fitchratings.com/site/re/10111579>.

## **CURRENT DEVELOPMENTS**

Minneapolis has historically maintained very strong financial operations and unaudited 2021 results (FYE Dec. 30) indicate approximately \$140 million in general fund reserves, 27% of general fund spending, almost 50% higher than the city's fund balance target of 17%. This is despite using \$27 million of reserves to replenish the self-insurance fund to cover the settlement costs related to a civil lawsuit related to George Floyd's murder in 2021. The city's revenues performed close to budgeted assumptions while operating expenditures were roughly \$14 million, or 3.6% below the adopted budget.

The 2022 budget assumes a 5.45% property tax levy increase a \$47 million federal stimulus appropriation for revenue replacement, and \$17 million use of fund balance. The 2022 budget assumes a \$26 million, or 16% increase in the police budget to improve staffing levels due to above average attrition levels in 2020 and 2021 and to address voter approved public safety reforms associated with civil rights and racial equality.

After the approval of a ballot measure to change the city's government structure effective December 2021, the city is in the process of changing the city's governing structure to consolidate administrative authority over all operating departments under mayoral control. The reforms will create a new reporting structure including a City Attorney, Chief of Staff, Operations Officer and a Community Safety Officer that combine administrative functions, which will likely generate operating efficiencies. The reforms created the Office of Public Safety, which will include the police department and other relevant city departments to deliver public safety services.

The city's five-year outlook assumes that the city will annually increase its property tax levy by an average of 4.9% from 2023-2026. The city's long-term budgeting plan assumes the use of \$5 million in general fund balance in 2023 and 2024 and \$8.5 million in 2025, but the city has a history of outperforming its budgeted assumptions. The city also intends to utilize \$37.6 million and \$34 million in ARPA funds for revenue replacement in 2023 and 2024, respectively, which will supplement general fund revenues as the economy continues to recover from the pandemic related economic disruption. Fitch believes that the city could

face challenges to maintain structurally balanced operations if revenue growth is slower than projected, given its use of fund balance and federal stimulus to fund the operating budget.

## **CREDIT PROFILE**

Minneapolis's economy is very diverse. Major employers include entities in health care, banking, higher education and the retail trade. The city also includes a significant public-sector sector given the proximity of the state government. The five largest employers in the city are the University of Minnesota (17,691), Allina Health (10,856), Target Corporation (8,500), the Hennepin Health Care (7,111) and Wells Fargo Bank (7,000). Unemployment has historically tracked below the national average, and has been far below the U.S. rate in recent years.

The city's growth in assessed taxable values had slowed in 2021 and 2022 after a trend of significant growth from 2013 through 2020, including a 6.8% increase in 2020. Commercial property values are expected to decline by almost 5% for 2022 as vacancy rates remain depressed. The commercial declines have been offset by increases in the residential housing market over the same timeframe.

## **Revenue Framework**

The largest general fund revenue sources in 2021 were taxes (58%) and state and federal aid (18.7%). Other notable revenues include service charges and licenses and permits, which accounted for 11.6% and 8.4%, respectively. Property taxes accounted for the bulk of general fund tax revenues in 2021.

Fitch believes general fund revenues are likely to expand at or above U.S. GDP due to significant ongoing and planned residential and commercial construction. Fitch believes this growth trend is sustainable over the longer-term, but acknowledges medium-term downside risk if the economic recovery is slower than currently anticipated.

Sales tax revenue growth estimates for 2021 were below pre-pandemic levels, primarily driven by a decrease in lodging and entertainment taxes. Continued population growth is likely to sustain a steady expansion in sales and entertainment taxes, along with growth in the tax base.

The city's independent legal authority to increase revenues is essentially unlimited given the authority vested in the mayor and city council to adjust the property tax levy, along with service charges and user fees, with the levy being subject to approval by the city's board of

estimates and taxation. These revenue sources account for more than 50% of the general fund budget.

Minnesota has enacted statewide limits to local property tax levies in the past and could potentially do so again in the future. Statewide levy limits have generally been temporary in nature, expiring after one year. Minnesota has occasionally enacted multi-year tax levy caps -- most recently for fiscal years 2009 to 2011. The longest period of multi-year caps was from 1972 to 1992, at which time all caps were repealed. The limitations have never applied to taxes levied for debt service.

## **Expenditure Framework**

The city provides a broad array of services to residents, including police and fire protection, waste removal, water and sewer, public parks and recreation. Public safety was the largest general fund expenditure item at 58% of spending in 2021, followed by general government (17%) and public works (13%).

Fitch believes spending demands are likely to grow at a pace approximately equal to, or slightly above, the natural rate of revenue growth. Employee benefit growth will likely exceed the rate of inflation over the next several years. Management actively manages expenditure growth by managing the size of workforce through attrition and hiring freezes. The city experienced high attrition in 2020 and 2021, which resulted in savings and avoided a need for a layoff.

Fitch believes Minneapolis's expenditure flexibility is solid despite high fixed costs and a sizable workforce, given management's ability to adjust staffing levels and services-related spending. Minneapolis has a strong track record of reducing expenditures during times of economic stress.

Carrying costs dropped to 17.5% of governmental spending in 2021, following large principal repayments in 2019 and 2020. Minneapolis' \$1.1 billion six-year capital plan through 2027 is 58% debt funded (\$789.8 million), with the remaining 40% funded from various sources. The cash-funded portion of general government projects affords Minneapolis added budgetary flexibility, as management could cut back on cash-funded capital spending during a cyclical downturn. Contributions to the statewide pension plans in which the city participates are statutorily determined by the state, and are set below actuarially determined levels.

Minneapolis has contracts with 23 bargaining units representing 90% of its 4,276 full-time employees. Public safety makes up 40% of the unionized workforce. Police and fire fighters do not have the right to strike under Minnesota law, but most other collective bargaining units do have the right to strike, including clerical, technical and maintenance workers. The city has five expired contracts, which are current in negotiation including the fire contract.

### **Long-Term Liability Burden**

Minneapolis's long-term liability burden, which is approximately 8% of personal income, is low compared with the size and affluence of its economic resource base. Fitch-adjusted net pension liabilities account for almost 43% of the total liability, with direct and overlapping debt at 57%. Fitch believes that the long-term liability burden will remain low as steady increases in population and per capita income levels and rapid amortization of direct debt are likely to offset future borrowing.

The city reports proportionate shares of the NPLs for three statewide retirement systems: General Employees Retirement Fund, Public Employees Police and Fire Fund, and Teachers Retirement Association. The reported assets-to-liabilities ratio for all plans in aggregate was 90% as of June 30, 2021, reflecting the 6.5% discount rates used by all plans. The city's combined NPL for the three plans using a Fitch adjusted 6% discount rate indicates an 87% asset-to-liability ratio.

Minnesota's 2018 Omnibus Pension and Retirement Bill was signed into law on May 30, 2018, with provisions aimed at stabilizing the state's major pension plans. Reforms varied by plan and included reduced cost of living adjustments for current employees and higher employer and employee contributions. The savings generated by the reforms over a 30-year time horizon are estimated at \$3.4 billion. Because the bill did not mandate funding the full actuarially-determined contributions for all plans, unfunded liabilities likely will continue to rise over the long term if the plans' investment assumptions are not consistently achieved.

### **Operating Performance**

The Fitch Analytical Stress Test scenario analysis tool, which relates historical revenue volatility to U.S. GDP to support Fitch's assessment of operating performance, assumes a moderate economic downturn. Based on the scenario output, city revenues have modest exposure to moderate downturns. Fitch believes that the city has superior gap-closing ability given its broad revenue-raising flexibility and solid spending controls that provide the framework to quickly close budget gaps resulting from moderate economic downturns.

The city has a solid track record of conservative budgeting and maintained stable financial operations over time. Unrestricted general fund balances have exceeded 22% of general fund spending from 2014 through 2021. General fund reserves have exceeded the city's official policy of maintaining general fund reserves at minimum of 17% of current year spending and transfers out.

In addition to the sources of information identified in Fitch's applicable criteria specified below, this action was informed by information from Lumesis.

## REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

## PUBLIC RATINGS WITH CREDIT LINKAGE TO OTHER RATINGS

None of the public ratings of the city are associated with any 'upstream' ratings.

## ESG CONSIDERATIONS

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit

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## RATING ACTIONS

ENTITY / DEBT ↕	RATING ↕	PRIOR ↕
Minneapolis (MN) [General Government]	LT IDR    AA+ Rating Outlook Positive  Affirmed	AA+ Rating Outlook Positive
Minneapolis (MN) /General Obligation - Unlimited Tax/1 LT	LT    AA+ Rating Outlook Positive  Affirmed	AA+ Rating Outlook Positive



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## **APPLICABLE CRITERIA**

U.S. Public Finance Tax-Supported Rating Criteria (pub. 04 May 2021) (including rating assumption sensitivity)

## **APPLICABLE MODELS**

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

FAST Econometric API - Fitch Analytical Stress Test Model, v3.0.0 (1)

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Minneapolis (MN)

EU Endorsed, UK Endorsed

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