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CREDIT OPINION
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Lakeville (City of) MN

Update to credit analysis following upgrade to Aaa stable

Summary

The City of Lakeville (Aaa stable) has an affluent tax base in the Twin Cities (Minneapolis; Aa1 stable; St. Paul, Aa1 stable) metropolitan area and its credit profile benefits from the robust economic and financial performance that were exceptionally resilient throughout the coronavirus pandemic along with continued solid management practices that are expected to support strong credit fundamentals over the long-term. The city's primary challenge remains above average leverage with high fixed costs.

On June 23, 2021 we upgraded the city's general obligation unlimited tax rating to Aaa from Aa1 and assigned a stable outlook.

Credit strengths

» Large and growing affluent tax base near the Twin Cities

» Very strong financial profile with substantial alternate liquidity

Credit challenges

» Above average leverage related to long-term debt and pension burdens

» High fixed costs

Rating outlook

The stable outlook reflects the expectation that the city's robust economic and financial performance will continue supporting strong credit fundamentals for several years.

Factors that could lead to an upgrade

» Not applicable

Factors that could lead to a downgrade

» Substantial tax base contraction or sustained weakening of resident incomes

» Significant narrowing of operating reserves and liquidity

» Further growth in leverage or fixed costs

Key indicators

Lakeville (City of) MN	2016	2017	2018	2019	2020
Economy/Tax Base					
Total Full Value ($000)	$6,520,717	$6,921,610	$7,472,127	$8,160,104	$8,909,956
Population	59,786	61,056	62,489	63,915	63,915
Full Value Per Capita	$109,068	$113,365	$119,575	$127,671	$139,403
Median Family Income (% of US Median)	161.1%	161.0%	163.4%	160.2%	160.2%
Finances					
Operating Revenue ($000)	$37,269	$39,818	$40,784	$44,590	$51,724
Fund Balance ($000)	$28,536	$31,892	$33,442	$37,876	$47,697
Cash Balance ($000)	$40,163	$33,625	$34,043	$44,662	$57,167
Fund Balance as a % of Revenues	76.6%	80.1%	82.0%	84.9%	92.2%
Cash Balance as a % of Revenues	107.8%	84.4%	83.5%	100.2%	110.5%
Debt/Pensions					
Net Direct Debt ($000)	$115,545	$109,802	$108,212	$107,737	$117,461
3-Year Average of Moody's ANPL ($000)	$57,795	$60,853	$62,557	$61,054	$70,682
Net Direct Debt / Full Value (%)	1.8%	1.6%	1.4%	1.3%	1.3%
Net Direct Debt / Operating Revenues (x)	3.1x	2.8x	2.7x	2.4x	2.3x
Moody's - adjusted Net Pension Liability (3-yr average) to Full Value (%)	0.9%	0.9%	0.8%	0.7%	0.8%
Moody's - adjusted Net Pension Liability (3-yr average) to Revenues (x)	1.6x	1.5x	1.5x	1.4x	1.4x

Source: Moody's Investors Service, US Census Bureau, audited financial statements

Profile

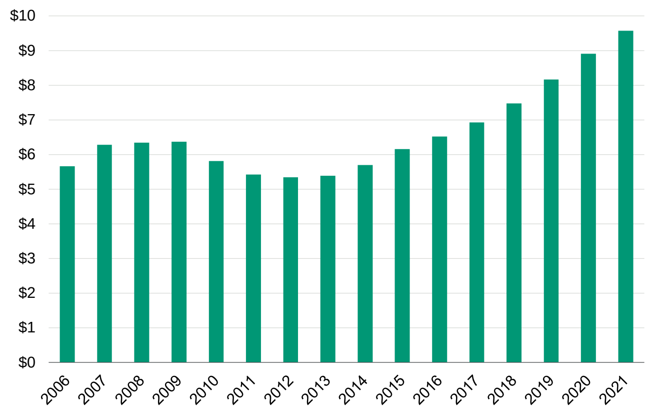
The City of Lakeville is located about 20 miles south of downtown Minneapolis and encompasses nearly 40 square miles in Dakota County (Aaa stable). The city serves a rapidly growing population with about 64,000 residents. The city's primary functions include general government administration, police and fire protection, street maintenance, engineering, planning and zoning, parks and recreation, and community and economic development services. The city also operates two enterprise funds for four off-sale liquor stores and a water, sanitary sewer, street light and environmental resources utility.

Detailed credit considerations

Economy and tax base: large, affluent tax base near Twin Cities

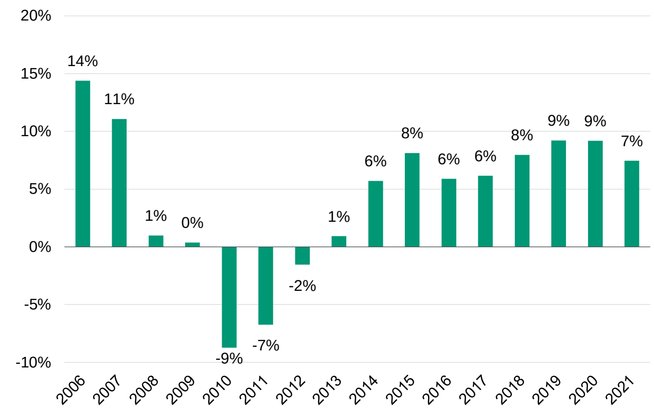
The city's tax base will continue growing for several years given the current levels of economic development and the growing population. The city's tax base is now nearing $10 billion, following eight consecutive years of strong growth (see exhibit) and has remained exceptionally resilient through the coronavirus pandemic. The city's tax base is about 79% residential with smaller commercial (11%) and industrial sectors (7%). Despite the recent national economic slowdown, the city continued benefiting from ongoing residential and commercial development, including 639 new single-family home permits issued during 2020 and a 750,000 square foot Amazon warehouse. Fiscal 2020 was a record year for both the total number of new building permits and the total valuation of the new permits, with a combined permit value of more than $400 million. The city's strong local economy is also driving favorable employment trends compared to the state and national figures. As of April 2021, the city's unemployment rate (3.3%) was below the state's rate (4.1%) and below the national rate (5.7%).

Exhibit 2
Lakeville's tax base nearing $10 billion...
($ in billions)



Note: FY06 — FY12 figures reflect Indicated Market Value; FY13 — FY21 figures reflect Economic Market Value
Source: Minnesota Department of Revenue

Exhibit 3
... following eight consecutive years of strong growth
Annual change in the city's full value



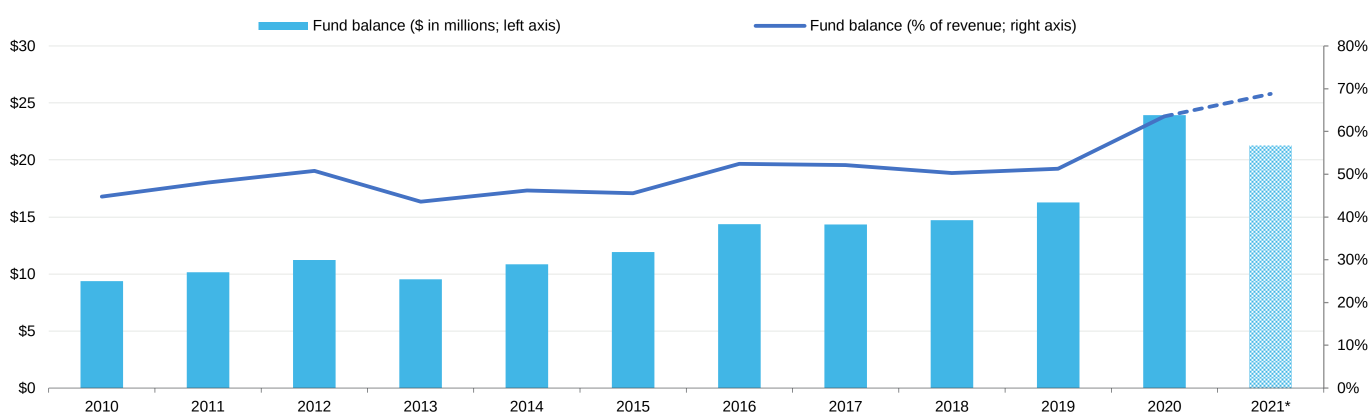
Note: FY06 — FY12 figures reflect Indicated Market Value; FY13 — FY21 figures reflect Economic Market Value
Source: Minnesota Department of Revenue

The growth in the city's tax base has largely been driven by the residential development needed to support the city's growing population. Between 1990 to 2010, the city's population more than doubled to nearly 56,000 residents and has shown continued growth in recent years. The city's comprehensive plan shows the city's population exceeding 83,000 residents by 2040. About 30% of the city is available to accommodate future development.

Financial operations and reserves: very strong financial profile supported by ample reserves and substantial alternate liquidity

The city's financial profile will likely remain very strong because of sizable reserves, conservative budgeting practices and the limited financial impact from the coronavirus pandemic. Fiscal 2021 is tracking better than budget and the city expects to close the year operationally balanced with a possible modest use of general fund reserves for one-time capital items. The city closed the prior fiscal year with one of the largest surpluses in recent history driven by a combination of $4.8 million in state and federal funding related to the pandemic, permit revenue was up $2.2 million compared to budget and expenses came in about $1.6 million under budget. The city closed the year with an available general fund balance of about $24 million, equal to a robust 64% of revenue.

Exhibit 4
City of Lakeville's financial reserves further bolstered by pandemic related federal support following trend of consistently strong financial performance
City of Lakeville, MN's general fund operating history



Source: audited financial statements; budget documents

Property taxes are the city's primary revenue source, comprising about 58% of revenue, which provides the city with a great degree of flexibility because state levy limits are not currently in place for cities. The city receives limited state and federal aid and does not have significant reliance on economically sensitive revenues.

Liquidity

The city's liquidity is strong with fiscal 2020 operating cash at $57 million, equal to 111% of revenue across the general fund and debt service fund. The city closed fiscal 2020 with total governmental liquidity of more than $125 million, of which $38 million is unrestricted cash held in a capital projects fund which City Council has complete discretion over, providing a substantial source of alternate liquidity should the city need it.

The city's two major enterprise funds include its Liquor Fund and the Utility Fund. The Liquor Fund accounts for operations of the city's three liquor stores, while the Utility Fund accounts for water and sanitary sewer activities. The enterprises closed fiscal 2020 with about $19 million in cash, equal to more than 440 days cash on hand. Neither enterprise has relied on the general fund for operating support.

Debt and pensions: above average leverage; high fixed costs

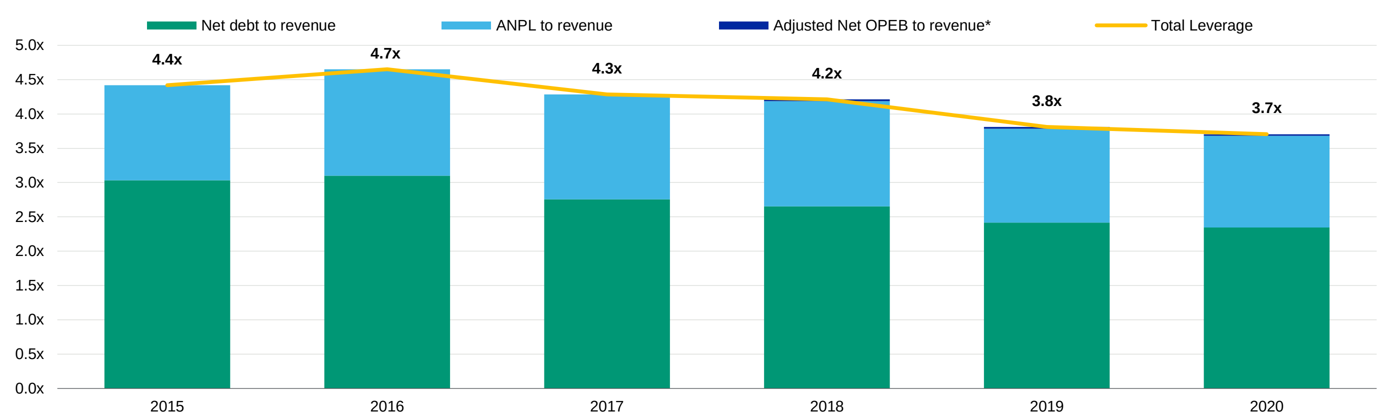
The city's leverage related to long-term debt and pension liabilities will remain high for the Aaa rating but has come down in recent years. Inclusive of the 2021 bonds, the city has a net debt burden of about $121 million or 1.2% of full value and 2.3x revenue.

The city's adjusted net pension liability (ANPL), based on a 2.7% discount rate, totals about $90 million while the three year average totals $71 million, equal to 0.7% of full value and 1.4x operating revenue. In comparison, the city's reported net pension liability, based on a 7.5% discount rate, totals about $11 million.

The city's total fixed costs, consisting of debt service and retirement contributions, are high, typically hovering around 30% of operating revenue. The city's debt burden is the primary driver of the high fixed costs, most of which is supported by an unlimited tax levy.

Exhibit 5

The city's total leverage remains above average and will be a primary credit challenge at the Aaa rating but the recent history of strong revenue growth is contributing to a declining leverage profile



**Adjusted NOL not available pre-GASB 75*
Source: Audited financial statements; Moody's Investors Service

Legal security

The city's GOULT bonds are supported by the city's full faith and credit pledge and the authority to levy a dedicated property tax unlimited as to rate and amount. The GOULT bonds are additionally secured by statute.

The city's lease revenue debt is supported by its pledge to make annual lease payments, which are subject to annual appropriation, per the lease-purchase agreements.

Debt structure

All of the city's debt is fixed rate and long term.

Debt related derivative

The city has no debt related derivatives.

Pensions and OPEB

The city participates in two multiple-employer cost-sharing plans, the General Employees Retirement Fund (GERF) and the Public Employees Police and Fire Fund (PEPFF). Minnesota statutes establish local government retirement contributions as a share of annual payroll. The state of Minnesota approved legislation in 2018 that modified benefits and modestly increased contributions for some pension plans. Employer contributions from cities to the police and fire plan, for example, increased to 17.7% in 2020 from the previous rate of 16.2%. The total employer contributions to the Police and Fire plan from all participating governments were equal to about 120% of tread water in 2020. [1]

Other post-employment benefits (OPEB) obligations do not represent a material credit risk for the city. The city does not offer explicit OPEB benefits, but allows retired employees to stay on its healthcare plan, creating an implicit rate subsidy. Both the city's reported net OPEB liability and our adjusted net OPEB liability for the city, based on the use of a different discount rate, total about $1 million.

ESG considerations

Environmental

Environmental considerations are not material to the city's credit profile. According to data from Moody's affiliate Four Twenty Seven, Dakota County's environmental hazard scores range from no risk to medium risk for the five environmental factors considered including heat stress, water stress, extreme rainfall, sea level rise and exposure to hurricanes and typhoons.

Social

Social considerations are a factor in the city's credit profile. The median age of city residents (37) is in line with the state (38) and national (38) medians. The city's population has been growing for several decades, increasing to 64,000 residents in 2019 from 15,000 in 1980. Median family incomes are strong, equal to 160% of the national median.

Governance

Minnesota cities have an Institutional Framework score of "Aa," which is strong. The sector has one or more major revenue sources that are not subject to any caps. Revenues tend to be predictable, as cities rely primarily on property taxes and state Local Government Aid (LGA), which is distributed based on demographic and tax base factors. Revenue-raising flexibility is strong. There are no levy limits currently in place for cities and the state last imposed limits for one year in 2014. Across the sector, fixed and mandated costs are relatively high. Expenditures mostly consist of personnel costs, which are highly predictable.

The city's governing body consists of a mayor and four council members, all elected at large. The mayor serves a four-year term of office and council members serve overlapping four-year terms. The city administrator is responsible for the daily management of city business and the administration of policy as directed by the council. The city's policy is to budget an underlying operating surplus each year to maintain the general fund Balance Ratio, as of December 31, between 40%-50% of the next year's expenditures.

Rating methodology and scorecard factors

The US Local Government General Obligation Debt methodology includes a scorecard, a tool providing a composite score of a local government's credit profile based on the weighted factors we consider most important, universal and measurable, as well as possible notching factors dependent 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.

Lakeville (City of) MN

Scorecard Factors and Subfactors	Measure	Score
Economy/Tax Base (30%) [1]		
Tax Base Size: Full Value (in 000s)	$9,573,907	Aa
Full Value Per Capita	$149,791	Aa
Median Family Income (% of US Median)	160.2%	Aaa
Finances (30%)		
Fund Balance as a % of Revenues	92.2%	Aaa
5-Year Dollar Change in Fund Balance as % of Revenues	44.0%	Aaa
Cash Balance as a % of Revenues	110.5%	Aaa
5-Year Dollar Change in Cash Balance as % of Revenues	35.0%	Aaa
Management (20%)		
Institutional Framework	Aa	Aa
Operating History: 5-Year Average of Operating Revenues / Operating Expenditures (x)	1.1x	Aaa
Debt and Pensions (20%)		
Net Direct Debt / Full Value (%)	1.2%	Aa
Net Direct Debt / Operating Revenues (x)	2.3x	A
3-Year Average of Moody's Adjusted Net Pension Liability / Full Value (%)	0.7%	Aaa
3-Year Average of Moody's Adjusted Net Pension Liability / Operating Revenues (x)	1.4x	A
Notching Adjustments:[2]		
Other Scorecard Adjustment Related to Debt and Pensions: High fixed costs		Down
Standardized Adjustments [3]: Unusually Strong or Weak Security Features - Secured by Statute		Up
	Scorecard-Indicated Outcome	Aaa
	Assigned Rating	Aaa

[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.
[3] Standardized adjustments are outlined in the GO Methodology Scorecard Inputs.
Source: US Census Bureau, audited financial statements

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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