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Ratings

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## Summary:

# Smithfield, Rhode Island; General Obligation

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## Table Of Contents

## Summary:

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| Credit Profile | | |
|---|---|---|
| US$4.365 mil GO rfdg bnds (federally taxable) ser 2020B due 01/15/2031 | | |
| *Long Term Rating* | AA/Stable | New |
| US$2.165 mil GO rfdg bnds (tax-exempt) ser 2020A due 01/15/2031 | | |
| *Long Term Rating* | AA/Stable | New |
| Smithfield GO bnds | | |
| *Long Term Rating* | AA/Stable | Affirmed |

## Rating Action

S&P Global Ratings assigned its 'AA' long-term rating to Smithfield, R.I.'s series 2020A and 2020B general obligation (GO) bonds. At the same time, we affirmed our 'AA' long-term rating on the town's GO debt outstanding. The outlook is stable.

The town's full faith credit pledge, including a pledge to levy ad valorem taxes without limitation as to rate or amount on all real property within the town, secures the bonds. The 2020A and 2020B bonds are refunding outstanding GO debt for interest rate savings.

### Credit overview

Smithfield is a primarily residential town about 15 miles northwest of Providence. Over the past three audited years, it produced two operating surpluses on a GAAP basis; however, we believe its performance is inflated due to actual contributions falling below its full pension actuarially determined contributions (ADCs). We believe pension and other postemployment benefits (OPEBs) present a long-term credit risk for the town, due to optimistic assumptions and poor funding discipline. Currently, Smithfield maintains strong available reserves and our view of its financial management practices remains good, which we believe provides rating stability. We do not anticipate changing the rating within the outlook period. We continue to see economic pressure over the next six-to-12 months, although management reports little direct financial effects from COVID-19 or the recession to-date.

The long-term rating reflects our view of the following factors for the town:

- Strong economy, with access to a broad and diverse metropolitan statistical area (MSA);
- Strong management, with good financial policies and practices under our Financial Management Assessment (FMA) methodology;
- Weak budgetary performance, with slight operating deficits in the general fund and at the total governmental fund level in fiscal 2019;
- Strong budgetary flexibility, with an available fund balance in fiscal 2019 of 13.8% of operating expenditures;
- Very strong liquidity, with total government available cash at 24.4% of total governmental fund expenditures and

8.2x governmental debt service, and access to external liquidity we consider strong;

- Weak debt and contingent liability position, with debt service carrying charges at 3.0% of expenditures and net direct debt that is 48.5% of total governmental fund revenue, and significant medium-term debt plans and a large pension and OPEB obligation and the lack of a plan to sufficiently address it, but low overall net debt at less than 3% of market value; and
- Strong institutional framework score.

### Environmental, social, and governance factors

Our rating incorporates our view regarding the indirect risks posed by the COVID-19 pandemic. Absent the implications of COVID-19, we consider the town's social risks in line with those of the sector. We view Smithfield's governance risks as being in line with those of peers. We also view environmental risks as average for the sector.

## Stable Outlook

### Downside scenario

We could lower the rating if the town were to experience a material weakening of available reserves, particularly if rising retirement or debt service costs limit its ability to develop a plan to restore reserves to current levels.

### Upside scenario

We could raise the rating if the town were to develop a credible plan to address its retirement liabilities and demonstrate over multiple years that it is able to adhere to the plan, coupled with sustaining strong budgetary performance, along with continued growth in wealth and income metrics.

## Credit Opinion

### Strong economy

We consider Smithfield's economy strong. The town, with a population of 21,821, is in Providence County in the Providence-Warwick MSA, which we consider to be broad and diverse. It has a projected per capita effective buying income of 104.5% of the national level and per capita market value of $140,209. Overall, market value grew by 1.0% over the past year to $3.1 billion in 2021. The county unemployment rate was 3.9% in 2019.

Smithfield is a primarily residential community, although it has a sizable commercial and industrial base. Residential properties constitute approximately 66% of the town's total assessed value (AV). Smithfield's AV increased by 9% from 2019 to 2020, following a statistical revaluation. Management reports continued redevelopment, particularly in the commercial sector, which we believe is likely to lead to stability in the underlying tax base and wealth metrics.

According to the Bureau of Labor Statistics, county-level unemployment rose to 18.7% in April 2020, before declining to 11.3% in September. Local unemployment has generally remained a few percentage points lower, but we believe county-level unemployment is likely to remain elevated. To date, management has reported little change in its property tax collection rate and we expect the underlying tax base to remain stable. However, we will monitor how high unemployment rates affect the town's finances amid our projection of a slow, prolonged economic recovery. (For more information on our view of the economy, see "The U.S. Economy Reboots, With Obstacles Ahead," published Sept. 24, 2020, on RatingsDirect.)

### Strong management

We view the town's management as strong, with good financial policies and practices under our FMA methodology, indicating financial practices exist in most areas, but that governance officials might not formalize or monitor all of them on a regular basis.

Smithfield's management team uses both trend analysis and zero-based budgeting when developing the annual budget. It looks at two years of revenue and expenditure data, and works with department heads to build departmental budgets each year. In preparation of its annual budget, the town conducts a detailed review of departmental requests and historical spending. In addition, it reviews projected tax revenues, internal transfers, health care cost trends, and personnel expenditures. However, we believe its budget assumptions and projections continue to rely on overly optimistic pension funding assumptions. It uses its annually updated five-year long-term financial projection as a tool to guide decision-making. Its six-year capital plan, which identifies projects and funding sources, is updated biannually.

The town also performs internal monitoring of its budget-to-actual performance, and the finance director reports to the town monthly to address variances and propose budget amendments when necessary. In addition, the town submits a quarterly budget-to-actuals report to the state Department of Municipal Finance, the Auditor General's Office, and the Department of Education. Furthermore, it maintains pension and OPEB investment policies, and management reports earnings and holdings to the town council monthly.

Smithfield formalized and approved a reserve policy in its town charter, which calls for a minimum unassigned fund balance of 5% of the subsequent year's general fund budgeted expenditures. In November 2014, the town charter was amended to annually increase fund balance by 0.6% until the fund balance policy minimum reaches 8% in fiscal 2020. Historically, the town has met and sustained reserves in accordance with its stated fund balance policy. Smithfield has a formal debt management policy that outlines approved debt types and sets limitations on debt as a percentage of the tax base and debt service as a percentage of general fund revenues. It also requires integration with the capital plan.

### Weak budgetary performance

Smithfield's budgetary performance is weak, in our opinion. The town had slight operating deficits of negative 0.6% of expenditures in the general fund and negative 1.1% across all governmental funds in fiscal 2019.

Our view of weak performance combines our view of the town's recent financial results, along with the uncertain budgetary environment and our expectation that the town will not fully fund its fire pension trust fund contribution, leading to an adjusted deficit result in both operations and total governmental performance. For analytical consistency, we adjusted for recurring net transfers, pension contributions below the required contribution, and the expenditure of bond proceeds in our calculation of general fund and total governmental fund performance. We also combined the town's general fund and school unrestricted fund, consistent with our view of municipalities across the state. We also accounted for the ongoing revenue and expenditure uncertainty in the current economic recovery and ongoing pandemic.

The town works to incorporate capital investment into the annual budget, to limit bond issuances. We believe this has led to some volatility in performance, but believe the underlying operational budget is balanced. However, in 2019, we viewed the town as having an operating deficit, despite a GAAP surplus, due to the $897,000 adjustment for underfunding the fire pension trust fund annual contribution. The town is working through its 2020 audit process, but we expect operating performance to remain approximately consistent with recent years. We also expect total governmental funds performance to be approximately balanced.

Its fiscal 2021 operating budget totals $76.7 million, an approximately $2 million increase from 2020. The town held its property tax rate stable, with growth in property tax revenue reflecting growth in the levy. Property taxes generally account for nearly 80% of audited operating revenue and intergovernmental aid, including school aid but not state on-behalf payments, is about 15%. We expect this revenue mix to remain relatively consistent. The state has not yet adopted a budget, and we believe midyear aid cuts, particularly to schools, are a possibility. We estimate a 20% school aid cut would total about $1.6 million, which we believe the town could partially incorporate into the budget without materially lowering its year-end reserve position. If other revenue or expenditure areas were to come in worse than budget, which we believe is a possibility with state aid and hotel/meal excise taxes, budgetary performance could be pressured.

### Strong budgetary flexibility

Smithfield's budgetary flexibility is strong, in our view, with an available fund balance in fiscal 2019 of 13.8% of operating expenditures, or $10.6 million.

In addition to the town's assigned and unassigned reserves, we also consider re-appropriated unexpended balance available. This is committed fund balance that is re-appropriated annually to the subsequent year's expenditures. The town generally appropriates reserves into its budget, but due to better-than-budget performance, has maintained relatively stable reserve levels, which we expect will continue. We do not anticipate a significant change in reserve levels at this time.

### Very strong liquidity

In our opinion, Smithfield's liquidity is very strong, with total government available cash at 24.4% of total governmental fund expenditures and 8.2x governmental debt service in 2019. In our view, the town has strong access to external liquidity if necessary.

The town has issued GO debt periodically over the past ten years, supporting our view of its strong access to external liquidity. It has two privately placed debt obligations, one of which is being refunded by the current issuance. The outstanding seven-month, $20 million GO bond anticipation note (BAN) does no present a potential liquidity pressures, as there are no payment provisions that change on the occurrence of certain events.

Though the state allows for what we view as somewhat permissive investments, we believe the town does not currently have aggressive ones. It invests its cash in low-risk assets, including U.S. securities and highly-rated money market funds. Smithfield consistently had very strong cash balances and we do not anticipate a change in our view of its overall liquidity profile.

### Weak debt and contingent liability profile

In our view, Smithfield's debt and contingent liability profile is weak. Total governmental fund debt service is 3.0% of total governmental fund expenditures, and net direct debt is 48.5% of total governmental fund revenue. Negatively affecting our view of the town's debt profile are its significant medium-term debt plans. Overall net debt is low at 1.2% of market value, which is, in our view, a positive credit factor.

Following this issuance, the town will have approximately $46 million in total direct debt. Of this, approximately $5.5 million is self-supporting enterprise debt, along with an additional $2.7 million in revenue-supported BANs. The town expects to issue up to $25 million in debt as part of an outstanding school project, along with about $4.5 million for a fire station. We believe these issuances could materially add to the town's debt profile, although management expects approximately 40% state reimbursement on its school debt for the current authorization, totaling $45 million.

### Pension and other postemployment benefits

- We believe a credit weakness is Smithfield's large pension and OPEB obligation, without a plan in place that we think will sufficiently address it.
- Additionally, we anticipate costs are likely to grow, given low funded ratios, optimistic assumptions, and poor funding discipline within the town's largest pension plans.
- The town also offers OPEBs to eligible retirees. It established a trust to begin prefunding the liability; the trust is about 7.9% funded, with an OPEB liability of about $44.4 million.

As of June 30, 2019, the town participates in the following defined benefit plans:

- Employees' Retirement System of Rhode Island (ERSRI): 54.3% funded, $34 million proportionate share of the net pension liability (NPL)
- Fire Pension Trust Fund: 61.5% funded, $16.5 million NPL
- Police Pension Trust Fund: 39.5% funded, $15.7 million NPL
- Municipal Employees' Retirement System (MERS) Police Employees Plan: 89.6% funded, $1.9 million NPL
- MERS Fire Employees Plan: 102.4% funded, $35,000 net pension asset
- MERS General Employees COLA Plan: 83.9% funded, $3.0 million NPL
- MERS General Employees Plan: 88.1% funded, $1.7 million NPL

Smithfield's combined required pension and actual OPEB contributions totaled 10.7% of total governmental fund expenditures in 2019. Of that amount, 9.2% represented required contributions to pension obligations, and 1.5% represented OPEB payments. The town made its full annual required pension contribution to each plan except for the Fire Pension Trust Fund, which it underfunded by about $897,000, or 12% of the total combined required contribution. The town is required to make payments equal to 100% of the ADC. for the state-administered plans (ERSRI and MERS), but its contributions for the locally administered funds--the Fire Pension Trust Fund and Police Pension Trust Fund--have historically been below required levels. However, it has contributed more than the required contribution to the police plan in each year since 2015.

ERSRI and the two locally administered plans combined account for about 71% of the town's total pension liability of approximately $185 million, and 91% of its NPL of $73 million. ERSRI met our static funding metric, but did not meet our minimum funding progress metric. The Fire Pension Trust Fund did not meet our static or minimum funding progress metrics. We note that the town contributes to the Fire Trust Fund on a contractual basis, and it has underfunded relative to the required contribution in each of the past six years, which we expect to continue. The town expects to continue meeting or exceeding the required contribution to the Police Pension Trust Fund.

Given the low-funded ratios, particularly in the locally administered plans where funding discipline historically lagged the required contribution, we believe costs are likely to escalate. We view the local fire and police plans' discount rate of 7.5% as elevated relative to our 6.0% guideline, and believe the plans are likely to have contribution volatility. We further note that the local fire plan has a crossover date, indicating assets are expected to be insufficient to meet obligations, although the date is not until 2075. While the town recently changed actuaries, we believe some assumptions including the mortality tables and discount rates remain aggressive, and are likely underestimating the town's outstanding liability, which could lead to cost increases. We expect pension costs will grow, particularly if assumptions are not met. Smithfield recently adopted an amendment to the town charter, which requires it to achieve 30% OPEB funding within ten years. While the town expects to contribute $250,000 more than the pay-as-you-go amount, as it is not making the required OPEB contribution nor making material adjustments to benefits for future retirees, we expect the OPEB liability and costs will continue to grow over the next several years.

### Strong institutional framework

The institutional framework score for Rhode Island municipalities is strong.

## Related Research

- S&P Public Finance Local GO Criteria: How We Adjust Data For Analytic Consistency, Sept. 12, 2013
- Alternative Financing: Disclosure Is Critical To Credit Analysis In Public Finance, Feb. 18, 2014
- Criteria Guidance: Assessing U.S. Public Finance Pension And Other Postemployment Obligations For GO Debt, Local Government GO Ratings, And State Ratings, Oct. 7, 2019
- Through The ESG Lens 2.0: A Deeper Dive Into U.S. Public Finance Credit Factors, April 28, 2020