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Oak Lawn (Village of) IL

Update following downgrade to Ba1 and revision of outlook to stable

Summary

The Village of Oak Lawn's (Ba1 stable) credit profile is challenged by a growing pension burden and rising fixed costs to service those liabilities. Oak Lawn's pension contribution practices are weak and are not in compliance with state law despite significant contribution increases over the last decade. Local pension plans in Illinois (Baa3 stable) can request the state to withhold revenue from a sponsoring municipality if it does not make minimum statutory pension contributions. While local pension boards have stated they currently have no plans to do so as long as the Village adheres to its own pension funding policy, a diversion would significantly stress the Village's already narrow financial position. Under the Village's pension funding policy, public safety contributions will increase by about $1 million per year supported by recent revenue enhancements and descending debt service costs. The Village's large tax base with economic ties to Chicago (Ba1 stable), broad legal flexibility to raise local revenue and descending debt schedule are credit strengths.

On December 23, we downgraded the Village's general obligation rating to Ba1 from Baa3 and revised the outlook to stable from negative.

Credit strengths

» Sizable tax base with economic ties to the City of Chicago

» Significant legal flexibility to raise local revenue as a home rule unit of local government which it has recently done

» Descending debt service schedule with no plans for additional governmental debt

Credit challenges

» Very narrow fund balance and liquidity coupled with risks associated with possible revenue diversion

» Elevated pension burden that is expected to grow given contributions that remain well below plan funding needs

» High fixed costs and state constitutional and statutory protection of pension benefits limits expenditure flexibility

Rating outlook

The stable outlook reflects an expectation that fund balance and liquidity will remain weak but stable over the next two years given recent revenue increases and an absence of any current intentions for the public safety pension boards to request diversion of state share revenue.

Factors that could lead to an upgrade

» Reduced liquidity risk supported by significant and sustained improvement in fund balance and liquidity and / or contributions to public safety plans consistent with state law

» A moderated pension and fixed cost burden

Factors that could lead to a downgrade

» Further narrowing of fund balance and liquidity

» Slow revenue growth that constrains Financial flexibility and keeps the Village's pension burden from moderating

» Diversion of state revenue to pension funds that creates additional operating pressures

Key indicators

Exhibit 1

Oak Lawn (Village of) IL	2014	2015	2016	2017	2018
Economy/Tax Base					
Total Full Value ($000)	$3,272,165	$3,044,524	$2,953,214	$3,083,694	$3,560,270
Population	56,969	56,980	56,774	56,754	56,690
Full Value Per Capita	$57,438	$53,431	$52,017	$54,334	$62,802
Median Family Income (% of US Median)	111.6%	108.2%	107.9%	109.4%	109.4%
Finances					
Operating Revenue ($000)	$57,191	$67,033	$60,110	$61,396	$64,574
Fund Balance ($000)	$6,233	$6,421	$4,895	$3,292	$5,897
Cash Balance ($000)	$5,485	$5,254	$1,566	$1,877	$3,054
Fund Balance as a % of Revenues	10.9%	9.6%	8.1%	5.4%	9.1%
Cash Balance as a % of Revenues	9.6%	7.8%	2.6%	3.1%	4.7%
Debt/Pensions					
Net Direct Debt ($000)	$86,417	$76,517	$72,344	$70,842	$68,889
3-Year Average of Moody's ANPL ($000)	$206,898	$231,375	$278,832	$306,603	$319,624
Net Direct Debt / Full Value (%)	2.6%	2.5%	2.4%	2.3%	1.9%
Net Direct Debt / Operating Revenues (x)	1.5x	1.1x	1.2x	1.2x	1.1x
Moody's - adjusted Net Pension Liability (3-yr average) to Full Value (%)	6.3%	7.6%	9.4%	9.9%	9.0%
Moody's - adjusted Net Pension Liability (3-yr average) to Revenues (x)	3.6x	3.5x	4.6x	5.0x	4.9x

Source: audited financial statements, US census

Profile

The Village of Oak Lawn is an inner ring Chicago suburb located about twenty miles southwest of downtown with an estimated population of just over 56,000.

Detailed credit considerations

Economy and tax base: mature suburb of Chicago

Oak Lawn's tax base will remain a credit strength relative to its rating category given economic ties to Chicago, average resident income levels and recently increased development activity. The Village is very closely linked to the Chicago economy with residents have direct transportation access to the city's central business district via regional commuter rail. The tax base grew 20% over two years before declining by a more modest 3% in the current year. In total, the $3.5 billion tax base remains 30% below its prerecessionary peak of $4.5 billion. Moderate growth is expected over the next assessment year given several new commercial developments. The previous declining trend in value had little negative effect on the Village's budget given home rule flexibility to adjust local tax rates without voter approval.

Residential income levels within the Village are average though have weakened over the last several years. As of 2017, median family income within Oak Lawn was estimated at 108.2% of the national level, down from 120% in 2010. At 3.2% as of October 2019, the Oak Lawn's unemployment rate is slightly lower than state and national levels. The number of residents who call Oak Lawn home has remained stable at 56,000 for the last several decades.

Financial operations and reserves: limited financial position expected to remain stable

The Village's financial position is likely to remain limited given growth in operating expenditures including annual pension contributions and other personnel costs. Oak Lawn closed fiscal 2018 with a $700,000 improvement in total fund balance and a more robust $2.7 million improvement in available fund balance given a large repayment in interfund advances from a capital projects fund. In total, operations across its three major operating funds (combined general, debt service and police investigation funds) are expected to be largely stable over the next two years, with a general fund surplus in fiscal 2019 that is expected to be eliminated by a similarly sized draw on reserves in the police investigation fund in fiscal 2020. While budgeted at a deficit, the Village routinely outperforms budgeted expectations within police investigation fund given conservative revenue assumptions.

Oak Lawn's ability to strengthen its fund balance will be constrained by growing pension costs. The Village expects to increase public safety plan contributions by approximately $1 million per year for several years to address a large and growing unfunded pension burden. These increased contributions will be serviced by recent revenue enhancements put in place by the Village and declines in certain expenditures. The Village recently instituted several revenue enhancements which are expected to produce an additional $2.5 million for operations annually (see management section for additional detail). The Village will also benefit from budgetary relief associated with an annual reduction in debt service costs being funded from the general fund of approximately $500,000. The Village also maintains flexibility to redirect certain revenue currently dedicated to capital. Together, the changes will reduce the likelihood of further financial deterioration.

LIQUIDITY

Oak Lawn's cash position is narrow and has necessitated the use of short-term borrowing to sustain operations in previous years. Across major operating funds, net cash was limited at $3 million and 4.7% of revenue. Oak Lawn recently renewed its agreement for a $3 million LOC but does not expect to need to draw on it in fiscal 2020. The agreement contains a broad material adverse change clause that could lead to the accelerated repayment of debt if future draws were made. Across all governmental funds, liquidity is also limited. Fiscal 2018 governmental cash was equivalent to 13% of revenue.

This is a low net governmental cash position relative to other local governments. Oak Lawn's major enterprise fund, the Waterworks and Sewage Fund maintains a somewhat low 32 days of unrestricted liquidity but also has $4.8 million in restricted amounts that could be used to provide short term cash flow if needed.

Debt and pensions: very high pension burden and fixed costs

Oak Lawn will remain highly leveraged, despite lack of additional debt plans because its elevated unfunded pension liabilities will rise for several years. Direct debt of the Village is equal to 1.9% of full valuation and 1.1x operating revenue. The Village has no plans to issue governmental debt over the next two years.

The Village's contribution to its pension plans in fiscal 2018 consumed 13% of operating revenue, up substantially from 6% in fiscal 2013. Total fixed costs, consisting of debt service and retirement plan contributions, were a significant 27% of operating revenue. Had Oak Lawn contributed at sufficient levels to “tread water,” fixed costs would have been 32% of operating revenue.

DEBT STRUCTURE

The Village recently renewed its agreement for a $3 million LOC but does not expect to need to draw on it in fiscal 2020. The agreement contains a broad material adverse change clause that could lead to the accelerated repayment of debt if future draws were made.

In 2019, the Village extended a $20 million revolving line of credit (LOC) with Northern Trust Company which it is using to finance initial improvements to its regional water system before refunding the debt with state loans. The Village expects to refund current outstanding amounts in February with state loans. As owner of the regional water system, the Village may take on up to $200 million of state loans to finance large scale improvements to the system. It would repay the loans with increased wholesale charges to its municipal customers. The Village anticipates up to 95% of costs will be paid by the Illinois Environmental Protection Agency.

Oak Lawn's debt service schedule is descending, providing additional financial flexibility over the longer term. From fiscal 2018 to 2025, currently scheduled debt service paid from the general fund falls from approximately $6 million to $3 million. Amortization of existing debt is average with 57% of principal set to be retired over the next 10 years.

DEBT-RELATED DERIVATIVES

Oak Lawn has no derivative exposure.

PENSIONS AND OPEB

Oak Lawn's pension burden is high and expected to grow. Although the police and fire plans are single employer plans, the Village has no control over the benefits because they are established in state statute. All the Village can control are contributions. The Village's fiscal 2018 contribution fell far below the amount necessary to arrest growth in unfunded liabilities. We measure the extent to which contributions may be sufficient to keep unfunded liabilities from rising under plan assumptions with our “tread water” indicator. Contributions that tread water, using the local government pension plans' own discount rate assumptions, will keep unfunded liabilities from growing as long as other plan assumptions hold.

Across its three plans, the difference between Oak Lawn's actual contributions and the amount necessary to tread water was $3.2 million or equivalent to a substantial 5% of operating revenue in fiscal 2018. The Village's expected fiscal 2019 contribution also falls $2.8 million short of the payment required by state statutory formula. While contributions have increased substantially each year, the statutory contribution gap. Given this gap, the local pension boards could request that the Illinois Comptroller divert state revenue to the pension funds from the Village. Officials report that no such request is imminent and that both boards have signed agreements that they will not seek a revenue diversion so long as the Village adheres to its adopted pension funding plan. Still, we view the shortfall in from the statutory contribution as a risk especially given the Village's limited reserve position. Oak Lawn has adopted a plan to increase its public safety pension contributions approximately $1 million per year over the next decade.

Unfunded OPEB liabilities do not pose a significant credit challenge. As of January 1, 2018, the most recent actuarial valuation date, the plan had an adjusted net OPEB liability of $27 million or 0.5x operating revenue. The plan is funded on a pay as you go basis and fiscal 2018 contributions were $1.2 million or 2% of operating revenue.

Management and governance: strong legal flexibility to raise revenue, but officials face practical constraints

We assign a moderate institutional framework score of A to Illinois cities, but recognize that home rule cities such as Oak Lawn have additional strengths with the ability to raise a plethora of local taxes without approval from the state or voters. Expenditure flexibility is limited by strong pension protections (see Governance subsection), strong unions and public safety needs. Despite strong legal authority to raise revenue, the Village has reduced its property tax extension slightly over each of the past six years to keep its taxing burden stable. However, in the most recent year the Village instituted several revenue enhancements that will likely drive revenue growth going forward including an increase of its home rule sales tax rate to 1% from 0.75%, a new gaming tax and doubling of its motor fuel tax rate.

The legal framework for the Village's pension systems has been a key driver of the Village’s credit challenges. While the pension plans are single employer plans, benefit and funding levels are established by the state legislature instead of Village officials. Oak Lawn does not have the flexibility to make changes to benefits or substantially change contribution practices without legislative approvals. Most significantly, the state’s constitution provides strong protections to pension benefits, which the state’s Supreme Court has interpreted broadly to protect future benefit accruals.

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.

Exhibit 2

General Obligation methodology scorecard

Oak Lawn (Village of) IL

Rating Factors	Measure	Score
Economy/Tax Base (30%) [1]		
Tax Base Size: Full Value (in 000s)	$3,458,447	Aa
Full Value Per Capita	$61,006	A
Median Family Income (% of US Median)	109.5%	Aa
Finances (30%)		
Fund Balance as a % of Revenues	9.1%	A
5-Year Dollar Change in Fund Balance as % of Revenues	-0.1%	Baa
Cash Balance as a % of Revenues	4.7%	Baa
5-Year Dollar Change in Cash Balance as % of Revenues	-6.0%	Baa
Notching Factors:[2]		
Other Analyst Adjustment to Finances Factor: pension funding below state mandated levels increases risk of liquidity pressure		Down
Management (20%)		
Institutional Framework	A	A
Operating History: 5-Year Average of Operating Revenues / Operating Expenditures	1.0x	Baa
Notching Factors:[2]		
Unusually Strong or Weak Budgetary Management and Planning		Down
Other Analyst Adjustment to Management Factor (specify): home rule status		Up
Debt and Pensions (20%)		
Net Direct Debt / Full Value (%)	2.0%	A
Net Direct Debt / Operating Revenues (x)	1.1x	A
3-Year Average of Moody's Adjusted Net Pension Liability / Full Value (%)	9.2%	Baa
3-Year Average of Moody's Adjusted Net Pension Liability / Operating Revenues (x)	4.9x	Baa
Notching Factors:[2]		
Other Analyst Adjustment to Debt and Pensions Factor (specify): significant pension underfunding and high fixed costs		Down
	Scorecard-Indicated Outcome	Baa3
	Assigned Rating	Ba1

[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 publication.

Sources: US Census Bureau, Moody's Investors Service

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

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