

CREDIT OPINION

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 Rate this Research

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Oak Lawn (Village of) IL

Update to credit analysis following downgrade to Baa3

Summary

The [Village of Oak Lawn's](#) (Baa3 negative) credit profile will continue to be challenged by a high and growing pension burden. The village's pension contribution practices are very weak and are not in compliance with state law. Local pension plans in Illinois (Baa3 stable) can request the state withhold revenue from a sponsoring municipality if it does not make minimum statutory pension contributions. The village has limited financial position to respond to such a diversion though officials report that no such request is imminent. The village is planning to ramp up contributions in coming years, the burden of which will be eased by a descending debt service schedule. The village currently dedicates a significant \$4 million annually to capital, reducing future governmental borrowing needs and also providing additional budgetary flexibility. 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 October 10th, we downgraded the village's General Obligation rating to Baa3 from Baa2.

Credit strengths

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

Credit challenges

- » Very narrow fund balance and liquidity
- » High 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 negative outlook reflects our expectation that although village actions to increase pension funding will slow the rate at which unfunded liabilities are growing, plan status will continue to worsen and potentially strain the village's budget over the next several years. The village's pension underfunding also creates a direct risk to liquidity because it is not in compliance with state law. Lack of improvement in other credit factors, especially fund balance and liquidity, would add to downward pressure on the rating.

Factors that could lead to an upgrade

- » Significant and sustained improvement in fund balance and liquidity
- » A moderated pension burden achieved through improved plan status and/or material tax base and revenue growth
- » Material budgetary adjustments that enable more adequate funding of pensions

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 revenues to pension funds that creates additional operating pressures

Key indicators

Exhibit 1

Oak Lawn (Village of) IL	2013	2014	2015	2016	2017
Economy/Tax Base					
Total Full Value (\$000)	\$3,468,158	\$3,272,165	\$3,044,524	\$2,953,214	\$3,083,694
Population	56,765	56,969	56,980	56,774	56,690
Full Value Per Capita	\$61,097	\$57,438	\$53,431	\$52,017	\$54,396
Median Family Income (% of USMedian)	112.8%	111.6%	108.2%	107.9%	107.9%
Finances					
Operating Revenue (\$000)	\$57,953	\$57,191	\$67,033	\$60,110	\$61,396
Fund Balance (\$000)	\$5,985	\$6,233	\$6,421	\$4,895	\$3,292
Cash Balance (\$000)	\$6,946	\$5,485	\$5,254	\$1,566	\$1,877
Fund Balance as a % of Revenues	10.3%	10.9%	9.6%	8.1%	5.4%
Cash Balance as a % of Revenues	12.0%	9.6%	7.8%	2.6%	3.1%
Debt/Pensions					
Net Direct Debt (\$000)	\$88,527	\$86,417	\$76,517	\$72,344	\$70,842
3-Year Average of Moody's ANPL (\$000)	\$192,685	\$206,898	\$231,375	\$278,832	\$306,603
Net Direct Debt / Full Value (%)	2.6%	2.6%	2.5%	2.4%	2.3%
Net Direct Debt / Operating Revenues (x)	1.5x	1.5x	1.1x	1.2x	1.2x
Moody's - adjusted Net Pension Liability (3-yr average) to Full Value (%)	5.6%	6.3%	7.6%	9.4%	9.9%
Moody's - adjusted Net Pension Liability (3-yr average) to Revenues (x)	3.3x	3.6x	3.5x	4.6x	5.0x

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

Profile

The Village of Oak Lawn is an inner ring Chicago suburb located approximately 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

The village's tax base will remain a credit strength given economic ties to Chicago and average resident income levels. The village remains very closely linked to the Chicago economy with residents have direct transportation access to the city's central business district via regional commuter rail. Despite tax base growth of 20% over the last two years, driven by increased development activity

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and the triennial reassessment, the village's tax base remains 27% below its prerecessionary high. More moderate tax base growth is expected to continue into the next assessment year given increased redevelopment activity including several new commercial developments and expansion of operations of a large regional health system. 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 and have weakened over the last several years. As of 2016, median family income within the village was estimated at 107.9% of the national level, down from 120.4% in 2010. At 3.2% as of May 2018, the village's unemployment rate is slightly lower than state and national levels.

Financial operations and reserves: limited financial position

The village's financial position is expected to remain limited given growth in operating expenditures including annual pension contributions and other personnel costs. The village closed fiscal 2017 with a \$3.3 million reduction in available general fund reserves to a narrow \$881,000 or 1.7% of operating revenue. Across village operating funds (combined general, debt service and police investigation funds), available reserves totaled \$3.3 million and 5.4% of operating revenue. Total fund balance across these funds was higher at \$8.3 million and 13.4% of operating revenue but included \$4.9 million in long-term advances for capital projects. The recent operating deficit was driven by a combination of factors, including unbudgeted growth in overtime expenditures and lower than budgeted operating revenue related to a delayed sale of certain village property, weaker than anticipated sales and income taxes receipts and delayed execution of a PILOT agreement with a local hospital.

The village budgeted for balanced operations in fiscal 2018 and management reports year to date, operations are tracking better than budget with an estimated general fund surplus of approximately \$2 million given lower than budgeted expenditures across a number of departments. The village'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 over the next decade to address a large and growing unfunded pension burden. The village will benefit from budgetary relief associated with declining debt service costs that are paid out of the general fund. The village also maintains approximately \$4 million in utility tax revenue that is currently directed to its capital fund that could be used to rebuild reserves or help supplement increased contributions.

LIQUIDITY

The village's cash position is narrow and has necessitated the use of short-term borrowing to sustain operations. Across major operating funds, net cash was limited at \$1.9 million and 3.1% of revenue. The village's cash position is net of \$1.5 million in proceeds from a line of credit. The village recently renewed its agreement for a \$3 million LOC but does not expect to need to draw on it in fiscal 2018.

Across all governmental funds, liquidity is also limited. Fiscal 2017 governmental cash was equivalent to 11% of revenue. This is a low net governmental cash position relative to other local governments. Village enterprise funds also maintain narrow liquidity, equivalent to 32 days of operations.

Debt and pensions: high pension burden expected to grow

The village's debt burden is moderate, but its pension and fixed costs burdens are high and likely to rise. Direct debt of the village is equal to 2% of full valuation and 1.2x operating revenue. A small share of the village's general obligation debt is repaid with net water and sewer enterprise revenue. The village maintains a \$20 million revolving line of credit with Northern Trust Company, which it is using to finance initial improvements to its regional water system. 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. By the close of 2019, the village will likely refinance its credit line with long-term bonds secured by its own net revenue. At this time, the village has no plans to issue new debt for governmental purposes.

While the village's debt burden is moderate, its pension burden is high and growing. At the close of fiscal 2017, its three year average Moody's adjusted net pension liability (ANPL) was equivalent to a high 5x operating revenue and 9.9% of full valuation. At the same time, the village's contribution to its pension plans in fiscal 2017 consumed an above average 13% of operating revenue, up from 6% in fiscal 2013. Total fixed costs, consisting of debt service and retirement plan contributions, were a significant 28% of operating

revenue. The Village of Oak Lawn manages two single employer defined benefit pension plans for its police and fire employees. General employee pension benefits are accounted for in the village's account with the Illinois Municipal Retirement Fund (IMRF).

DEBT STRUCTURE

As of fiscal 2017, the village had drawn \$14.4 million on its revolving water system line of credit. According to the terms of agreement, any balance not paid in full by December 1, 2019 will be due to the bank in equal installments through December 1, 2021. The village expects to retire the line of credit with new bonds before December 2019.

The village's debt service schedule is descending, providing the village additional financial flexibility over the longer term. From fiscal 2017 to 2025, currently scheduled debt service paid from the general fund falls \$6.6 million to \$3.1 million. Amortization of existing debt is slow with 54% of principal set to be retired over the next 10 years.

DEBT-RELATED DERIVATIVES

The village is not party to any derivative agreements.

PENSIONS AND OPEB

The village'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 2017 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"¹ 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 the village's actual contributions and the amount necessary to tread water was equivalent to very substantial 8% of operating revenue in fiscal 2017. The village's expected fiscal 2018 contribution also falls \$2.6 million short of the payment required by state statutory formula. Given this gap, the local pension boards could request that the Illinois Comptroller divert state revenues to the pension funds from the village. Officials report that no such request is imminent. Still, we view the shortfall in from the statutory contribution as a significant risk especially given the village's limited reserve position. The village 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 to the village. As of January 1, 2016, the most recent actuarial valuation date, the plan had an unfunded actuarial accrued liability of \$29 million or 0.5x operating revenue. The plan is funded on a pay as you go basis and fiscal 2017 contributions were \$1.2 million or 1.9% of operating revenue.

Management and governance: home rule status provides substantial legal revenue authority

The Village of Oak Lawn's home rule status provides it broad legal flexibility to raise revenue as it is not subject to property tax levy limits, has no statutory debt ceiling, and has the power to impose a variety of taxes without voter approval. However, the village has kept its property tax levy fairly flat over recent years and does not expect to make significant adjustments to the levy going forward.

Illinois cities have an Institutional Framework score of A, which is moderate compared to the nation. Institutional Framework scores measure a sector's legal ability to increase revenues and decrease expenditures. Revenue-raising ability is moderate overall but varies considerably. Home rule entities, like the Village of Oak Lawn, have substantial revenue-raising authority. Expenditures are moderately predictable but cities have limited ability to reduce them given strong public sector unions and pension benefits that enjoy strong constitutional protections. The village has been particularly challenged by costs associated with fire safety, including minimum manning requirements and unbudgeted overtime expenditures.

Endnotes

¹ Our "tread water" indicator measures the annual government contribution required to prevent reported net pension liabilities from growing, based on reported assumptions. An annual government contribution that treads water equals the sum of employer service cost and interest on the reported net pension liability at the start of the fiscal year. A pension plan that receives an employer contribution equal to tread water will end the year with an unchanged net pension liability relative to the beginning of the year if all plan assumptions hold. Net liabilities may decrease or increase in a given year due to factors other than the contribution amount, such as an investment performance that exceeds or falls short of a plan's assumed rate of return. Still higher contributions will always reduce unfunded liabilities faster, or will allow unfunded liabilities to grow more slowly than lower contributions. The degree to which contributions fall below the "tread water" indicator can help quantify a structural operating imbalance stemming from pensions, even

under reported assumptions. A contribution below the "tread water" level in effect suppresses expenditures by leaving an implied interest on net pension liabilities unpaid, akin to borrowing at the assumed rate of return for operations.

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