

# Fitch: Rates Milwaukee, WI's \$110MM series 2022 bonds 'AA-'; Outlook remains negative

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Fitch Ratings has assigned a 'AA-' rating to the following city of Milwaukee, WI obligations:

- \$74.2 million general obligation promissory notes, series 2022 N3;
- \$28 million general obligation corporate purpose bonds, series 2022 B4;
- \$5 million taxable general obligation promissory notes, series 2022 T5;
- \$3.7 million taxable general obligation corporate purpose bonds, series 2022 T6.

Fitch has also affirmed Milwaukee's Issuer Default Rating (IDR) and the ratings on various Milwaukee obligations at 'AA-'.

The Rating Outlook is Negative.

Proceeds from the bonds and notes will be used to finance various public improvements and fiscal requirements of the city. The obligations will be sold via competitive sale on April 28, 2022.

## **SECURITY**

The bonds and notes are general obligations of the city, payable from taxes levied on all taxable property within the city, without rate or amount limitations.

## **ANALYTICAL CONCLUSION**

The 'AA-' rating reflects the city's moderate long-term liability burden, stagnant revenue growth prospects, and adequate expenditure flexibility. The rating also reflects the city's very strong financial resilience, although available reserves had eroded in recent years until an increase in 2020, partially driven by stimulus funds. Stimulus funds through the American Rescue Plan Act (ARPA) have enabled the city to offset revenue declines due to the pandemic. The city also utilized ARPA funds for general fund expenditures, which freed up levy dollars. Given the freed up levy dollars, the city was able to increase funding of the pension reserve fund, which partially addresses the upcoming pension contribution increases.

The Negative Outlook continues to reflect the city's long-term structural budget gap, with the city reliant on appropriations of its tax stabilization fund in recent years to balance the budget. Management has made progress in eliminating that appropriation; however, scheduled increases in pension may further pressure financial results in future years. The inability to solve the budget gap through revenue or expenditure solutions, implement a plan to maintain reserves at improved levels, and to sustainably meet increased pension contribution requirements may result in a downgrade.

## **Economic Resource Base**

Milwaukee serves as the economic engine for the surrounding region and has a diverse economic and employment base. However, wealth levels are generally below average and a relatively large proportion of the population is below the poverty level. The local economy maintains a reduced but still above-average reliance on manufacturing that in the past created vulnerabilities to recessionary employment shifts. The city's 2020 census population of 577,222 has been stagnant since the 2010 census and the labor force steadily declined over the past five years.

## **KEY RATING DRIVERS**

### **Revenue Framework: 'a'**

Fitch expects the city's two largest sources of revenue, state aid and property taxes, to remain stagnant or grow below the level of inflation. The city's independent legal ability to raise revenues is constrained by state law but is partially offset by the city's ability to independently increase non-tax revenue

sources.

### **Expenditure Framework: 'a'**

Fitch believes the city's flexibility of main expenditure items is adequate. Carrying costs for long-term liabilities claim a large and growing percentage of the governmental fund spending given the expectation for increasing pension contributions. The city operates within a fairly flexible labor environment. On average, the natural pace of spending growth is likely to be above that of slow expected revenue growth over time.

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

Milwaukee's long-term liabilities are a moderate burden on the city's resource base. The city participates in a well-funded pension plan. Future capital needs are manageable, and debt is rapidly repaid.

### **Operating Performance: 'aa'**

The stability of the city's revenue streams makes the city's finances less vulnerable to decline in economic downturns; however, reserves have been drawn on to fund operations for the last three years which has reduced its financial resilience cushion. The availability of the Public Debt Amortization Fund (PDAF) only partially offsets this concern. ARPA funds give the city some breathing room to address its long-term structural budget gap.

## **RATING SENSITIVITIES**

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

- Implementation of a plan to address its structural imbalance, including funding increasing pension contributions, either through permanent revenue increase or expenditure reductions;

- A fundamental improvement in the city's economy that notably improves growth prospects for revenues;

- A sustained increase in available general fund reserve levels providing what Fitch considers improved financial flexibility.

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

-Failure by the city to implement a plan to fund increasing pension costs over the long term and maintain reserve levels over time to support its financial resiliency.

-Inability to manage internal service funds cost pressures, leading to unexpected draws on general fund.

## **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**

The city had positive financial results in 2020, increasing available reserves from around \$39 million (4.2%) in 2019 to over \$167 million (24% of general fund expenditures). This was despite a small revenue decline, as management was able to cut expenditures and shift some spending to CARES Act funding. In 2021, management estimates that revenue increased, but was below budget. Expenditures were also below budget, which, combined with ARPA funds, enabled the city to replenish its \$6.5 million tax stabilization fund (TSF) appropriation. Management reports that the city may have a small increase in reserves.

For 2022, the city kept its expenditure reductions in place and plans to use ARPA funds to maintain city services at 2021 levels with no increases in user fees and a reduction in the appropriation of the TSF to only \$4 million. The city was allocated over \$394 million in ARPA funding and allocated \$66 million for recurring expenses and \$128 million for one-time expenses. Management had planned to levy \$10 million to its pension reserve fund but was able to increase the levy to \$40 million

after using ARPA funding for eligible general fund expenses. The pension reserve fund now stands at \$82 million.

The city had expected pension contribution costs to increase by \$70 million in 2023, largely due to reduction in the assumed rate of return to 7.5%. The prior assumed rate of return was 8%, which would have increased to 8.25% after 2022. Pension investment returns in 2021, which were well in excess of the assumed rate of return have reduced the estimated increase to \$50 million, an increase of 61% over 2021/2022 contributions.

Management plans to utilize the 2022 tranche of ARPA funds for eligible expenditures, which will further free up levy dollars to increase funding of the pension reserve fund and expects to have a sufficient amount in the fund to pay the higher pension contributions for the next two to three fiscal years without increasing revenue or cutting expenditures. In the next year, the city is working with the state legislature to enact a new local sales tax for the city that would raise \$55 to \$60 million annually as well as move new employees to the state pension plan. If this does not pass, the city may consider pension obligation bonds or would have to cut a significant portion of the city's budget. Failure to implement a new revenue stream at the next legislative session in January 2023 or sufficiently cut spending to close the budget gap, could lead to a downgrade.

## **CREDIT PROFILE**

Milwaukee is the largest city in the state of Wisconsin, encompassing a 97-square mile area located adjacent to Lake Michigan, 90 miles north of Chicago.

## **Revenue Framework**

The city remains dependent on state shared revenue for approximately 40% of its general fund revenues, making its finances somewhat vulnerable to the state's fiscal condition (Wisconsin's IDR is AA+/Stable). The city's second-largest source of revenue is its property tax at about 30%.

The historical rate-adjusted revenue growth trend has been positive on a nominal basis, but has not kept pace with inflation. Milwaukee is a well-developed urban center, so expectations for future growth are largely redevelopment-related. While continued revenue growth below the rate of inflation is expected, the city's general fund revenues have not demonstrated particular vulnerability to declines in

previous economic downturns.

Wisconsin municipalities are subject to statutory property tax revenue-raising limitations, which generally allow for growth in the operating levy only to reflect net new construction values added to the tax base. The city retains the ability to raise fees and charges providing sufficient revenue raising ability.

## **Expenditure Framework**

Public safety is the city's largest responsibility at 44% of total 2020 general fund spending, followed by general government at 38% and public works at around 14%.

The pace of spending growth, absent policy actions, is likely to be above growth in revenues, given the expected slow-growth environment for revenue and inflationary expenditure pressures. This includes significant growth in pension contribution costs beginning in 2023 by around \$50 million. The Negative Outlook partially reflects Fitch's concern that the city has not yet presented a plan to fund the higher pension contribution costs in the long run, although the increase in the pension reserve fund provides temporary breathing room.

Milwaukee's expenditure flexibility is adequate. The 2011 Wisconsin Act 10 enhances the city's ability to control spending by restricting collective bargaining rights of public employees and granting public employers significant flexibility over labor costs for nonpublic safety workers. Carrying costs are elevated at around 24% of 2020 total governmental expenditures. While Fitch views positively the reduction in the investment rate of return for the city's pension plan to 7.5%, resulting increased annual contributions beginning in 2023 will claim a growing portion of overall spending.

## **Long-Term Liability Burden**

The combined debt and pension burden is moderate at around 15% of personal income and is composed primarily of the city's Fitch-adjusted net pension liability (53% of the total) followed by direct debt (30%). Amortization is rapid, with around 87% of principal retired in 10 years, and the city has manageable capital needs and debt plans.

The PDAF has a balance of around \$40 million, which is governed by state statute

and the city commission. It is funded from a portion of the city's interest earnings. The city may use up to 40% of the balance to retire debt each year but typically appropriates an amount approximating investment earnings for this purpose. Fitch does not consider the PDAF as an offset to the city's long-term liability burden.

The city participates in the Employees' Retirement System of the City of Milwaukee, which in 2020 had a ratio of assets to liabilities of 72% when adjusted by Fitch to reflect a 6% investment rate of return. The recently approved decrease in the investment rate of return will increase the reported unfunded liabilities, but should not materially affect the Fitch-adjusted metric. The city also records a fairly large other post-employment benefit (OPEB) liability equal to around 7% of personal income.

## **Operating Performance**

Milwaukee's revenue history has generally been stable, but the city operates under a framework that inhibits its ability to accumulate general fund reserves. All operating surpluses are required to be reserved and budgeted for use in future fiscal years. The city experiences net operating deficits in years when officials appropriate larger amounts of prior-year surpluses. The city currently has higher level of reserves than in recent years, largely due to the large amount of stimulus payments through the CARES Act and ARPA.

Fitch considers the city's PDAF as a source of additional financial flexibility, with the city essentially able to transfer up to approximately \$38 million of notes to the general fund for operating purposes. The city would have to issue notes that could then be purchased by the PDAF as an investment and canceled by the city commissioners. Given the reliability and stability of the city's revenue, the city's midrange level of budgetary flexibility, and the additional flexibility provided by the PDAF, Fitch expects the city's gap-closing capacity to continue to be very strong despite recent draws.

The city typically appropriates a portion of its tax stabilization fund, which is part of the general fund, to the operating budget. The city lowered its TSF appropriation to \$4 million in 2022, lower than the \$6.5 million in 2021, \$10 million in 2020, \$16 million in 2019, and \$19 million in 2018. The balance in the TSF at the beginning of fiscal 2021 was around \$24 million. The city had relatively large unexpected medical costs in its self-insured health care fund in both 2018 and 2019, which led to consecutive draws on reserves in those years. While these unanticipated costs

are unlikely to be repeated on a regular basis, these draws illustrate the city's narrow operating environment, with stagnant revenue growth limiting the margin for expenditure increases.

The city has considered implementing a policy of maintaining fund balance levels at 10% of expenditures, which would require city council approval. The ability to maintain that level of available reserves would reduce the city's exposure to unexpected expenditures.

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.

## **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 [www.fitchratings.com/esg](http://www.fitchratings.com/esg)