14 Apr 2020 | New Rating

Fitch Rates St. Mary's County, MD's $30MM GO Bonds 'AA+'; Outlook Stable

Fitch Ratings-New York-14 April 2020:

Fitch Ratings has assigned a 'AA+' rating to the following general obligation (GO) bonds of St. Mary's County, Maryland:

--$30 million Consolidated Public Improvement Bonds, Series 2020.

In addition, Fitch has affirmed the following county ratings at 'AA+':

--Issuer Default Rating (IDR).

--$70.6 million outstanding county GO bonds.

The Rating Outlook is Stable.

The bonds are expected to be sold competitively on April 28, 2020. The proceeds will be used to finance various capital projects within the county.

SECURITY

The bonds are general obligations of the county, whose full faith and credit and unlimited taxing power are irrevocably pledged to repayment of the bonds.

ANALYTICAL CONCLUSION

The 'AA+' IDR and GO rating reflect the county's superior gap-closing capacity underscored by its unlimited legal ability to raise revenue, solid expenditure flexibility and high reserves within the context of expected revenue volatility through the current economic stress. The rating also reflects the county's low long-term liability burden and Fitch's expectation for natural revenue growth in line with to above the level of U.S. economic performance. The county's economy is highly concentrated in the military and specifically with Naval Air Station (NAS) Patuxent River.

Economic Resource Base

St. Mary's County is located in the southern part of Maryland bordering the Patuxent and Potomac rivers and Chesapeake Bay. The county's 2018 population of about 113,500 has increased by roughly 8% since 2010. Population growth reflects, in part, continued expansion at the NAS, which is home to the Naval Air Systems Command and the Naval Air Warfare Center Aircraft Division headquarters.

KEY RATING DRIVERS
Revenue Framework::'aaa'

Fitch expects county revenues to grow above the rate of inflation but below GDP given continued population growth and development at NAS. In addition, federal funding stability for NAS helps to mitigate potential income tax declines. The county's property tax levy and rate are not subject to limitation, providing significant legal revenue-raising flexibility and a budgetary tool to counteract periods of income tax instability.

Expenditure Framework::'aa'

The county's pace of spending growth is expected to be generally in line with revenue growth. Carrying costs for debt and retiree benefits are low, and the county has strong legal control over employment terms given the absence of collective bargaining. Education costs make up about one-half of the county's spending, and any reductions require state approval, somewhat limiting flexibility.

Long-Term Liability Burden::'aaa'

The county's combined debt and net pension liability (NPL) burden is low at about 4% of personal income. Additional debt plans are not expected to notably impact ratios given the rapid amortization of outstanding debt and the county's modest pension burden.

Operating Performance::'aaa'

The county's superior budget flexibility and strong general fund balance position it to manage through the upcoming downturn while maintaining a high level of fundamental financial flexibility.

RATING SENSITIVITIES

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

--Significant economic diversification and tax base growth that reduces the county's economic and revenue reliance on NAS.

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

--Material reductions in federal and military funding to NAS could weaken the revenue growth prospects of the county and potentially the rating.

--While not expected due to the stable employment base associated with NAS, significant income tax declines that are not matched by responsive expenditure adjustments could reduce the county's liquidity and its currently high level of fundamental financial flexibility.

Best/Worst Case Rating Scenario

International scale credit ratings of Public Finance 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

Sectorwide Coronavirus Implications: The ongoing coronavirus outbreak and related government containment measures worldwide creates an uncertain global environment for U.S., state and local governments and related entities in the near term. While St. Mary's County's most recently available fiscal and economic data may not fully reflect impairment, material changes in revenues and expenditures are occurring across the country and are likely to worsen in the coming weeks and months as economic activity suffers and public health spending increases. Fitch's ratings are forward looking; as such, Fitch will monitor developments in state and local governments as a result of the severity and duration of the outbreak and incorporate revised expectations for future performance and assessment of key risks.

CREDIT PROFILE

The NAS is a significant factor in the local economy with over 25,000 direct workers, and it supports a workforce of over 60,000 when including indirect and induced labor. Fitch's rating assumes the NAS' role as the United States Navy's principal research, engineering and test center makes severe cuts at the federal level unlikely.

The county's regional airport was designated a Federal Aviation Administration test site for unmanned aircraft systems (UAS) in 2014, in partnership with the University of Maryland, attracting private investments in research and manufacturing. The University System of Maryland is currently constructing an approximately $80 million UAS-focused research facility in the county that is expected to be completed in 2021.

The county's unemployment rate has remained generally in line with the state and national averages. Wealth indicators are above U.S. averages in part due to a cluster of higher wage technology jobs in the area, largely supporting operations at NAS.

Revenue Framework

Typical of Maryland counties, property and income taxes produce the bulk of general fund revenue, at approximately 48% and 42%, respectively, in fiscal 2019. Property tax revenues have continued to increase, reflecting an appreciating underlying tax base. The county's tax base remained stable throughout the Great Recession. Income tax revenues have also continued to increase, reflecting modest employment growth and increasing wage levels, although recent record growth in unemployment may result in declines in the near term.

General fund revenues grew ahead of inflation but below national GDP over the 10 years through fiscal 2019, although revenue growth was subdued by a property tax rate decrease in 2016. Taxable assessed values and income tax collections outpaced national GDP growth over the same period. The income tax rate was increased in the fiscal 2020 budget, but those gains may be offset in the future due to the economic repercussions of the pandemic. The stability of property taxes and the federal funding that backs income tax collections related to NAS support Fitch's expectation of solid growth prospects for revenue.

The county's independent legal ability to increase the real property tax rate is not subject to any limitation on the tax rate or levy; the county last increased its tax rate in 2001, and its property tax rate is the fifth lowest in the state amongst counties. The income tax rate for fiscal 2020 is 3.17%, leaving marginal flexibility below the statutory maximum rate of 3.2%.

Expenditure Framework

The county provides a wide range of services, including education, public safety and public works. The county's largest expenditure category is education at roughly half of general fund outlays, followed by public safety at about 20%.

Fitch expects the natural pace of spending growth to remain in line with to marginally above expected revenue trends given steady population growth and solid spending controls.

The county maintains solid expenditure flexibility with modest spending associated with debt service, actuarially determined pension payments (including the normal cost for the state's teachers' pension plan) and other post-employment benefit (OPEB) contributions, which totaled 11% of fiscal 2019 governmental spending. The county is not a party to any collective bargaining agreements, giving management broad legal control over employee-related spending that is the key driver of the general fund budget.

Maryland counties fund a significant portion of school budgets. According to the state's maintenance of effort (MOE) mandate, education spending on a per pupil basis cannot decline year-over-year without state approval, which somewhat limits the county's spending flexibility. The state granted approval to reduce education spending during the Great Recession to some counties. Annual increases in the MOE are limited to 2.5% year-over-year.

Long-Term Liability Burden

Total long-term liabilities are low at roughly 4% of total personal income. The fiscal 2020-2025 six-year capital improvement plan (CIP) totals approximately $346 million and is funded with roughly $166 million in new debt. While debt funding in the CIP is sizable compared to the county's outstanding direct debt of $116 million after this issuance, the debt burden would remain low when compared to personal income even if all planned debt were issued in the near term.

The county provides pension benefits to Sheriff's Office employees through the St. Mary's Sheriff's Office Retirement Plan (SORP). The county consistently funds 100% of its actuarially determined contribution to the SORP plan. All permanent full-time employees, other than those covered by the SORP, participate in the State Retirement and Pension System of Maryland, a cost-sharing defined benefit plan. While the county has consistently funded its full required contribution to the plan, until 2017 the state had not historically funded the actuarially determined contribution, contributing to the somewhat weak ratio of fiduciary net position to total pension liability of 60% (when adjusted by Fitch to reflect its standard 6% discount rate assumption). The aggregate Fitch-adjusted NPL of the two plans totals $131 million or roughly 2% of personal income, which we consider manageable.

The county provides OPEB to retirees under age 65. The county stopped advance funding its OPEB trust in fiscal 2016 and began making payments on a pay-as-you-go basis to offer taxpayer relief. As of the June 30, 2019 actuarial report, the OPEB trust covered approximately 89% of the total liability, utilizing a blended discount rate of 7.07%. The unfunded liability was less than 1% of personal income. Fitch does not expect OPEB liability growth to become a credit concern.

Operating Performance

Fitch expects the county to manage through economic downturns with a high level of fundamental financial flexibility given the consistency of its operating results and reserves through prior periods of stress and the county's solid expenditure flexibility. While general fund unrestricted reserves were about $63 million, or 28%, of fiscal 2019 spending, reserve levels should be lower at the end of fiscal 2020 due to the one-time utilization of $14.8 million in fund balance to fund pay-as-you-go capital and reduce future borrowing needs. However, year-end results are expected to keep reserve levels above the county's 15% reserve policy, which we believe supports the county's 'aaa' operating performance assessment.

The county has a track record of careful budgeting. During the last recession the county froze positions, deferred hiring, deferred replacement of vehicles and cut budgets by 5%, among other measures. While management does not report any significant revenue declines due to the coronavirus as of yet, Fitch expects that county management would take similar measures to mitigate potential financial stress. Liquidity has historically been sufficient, and management reports that they do not currently anticipate any liquidity pressures.

The adopted fiscal 2020 general fund budget was $238 million and represented a 10% increase over the prior year's budget. The one-time utilization of fund balance for capital projects and personnel cost increases drove budgetary growth. Results so far this year have been mostly positive compared to budget, but the county will be monitoring for shortfalls. Due to time lags in the collection and distribution of receipts, revenue shortfalls in the largest of the county's economically sensitive revenues, income taxes, are not expected to be fully felt until the back half of fiscal 2021. The proposed budget for fiscal 2021 maintains the real property tax and income tax rates from the prior year and totals $251 million. The final budget is scheduled to be approved by the county commissioners in May.

Asymmetric Additional Risk Considerations

The 'AA+' GO rating and IDR consider the employment concentration associated with the sizable presence of the Naval Air Station in the county to be an asymmetric risk to the rating. NAS and supporting industries constitute a significant portion of the county's economy. A base reduction or closure, although not anticipated, could have material downside risks to the county's credit quality.

Criteria Variation

None

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

ESG issues are credit neutral or have only a minimal credit impact on the entity(ies), either due to their nature or the way in which they are being managed by the entity(ies). For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

St. Mary's County (MD) [General Government]; Long Term Issuer Default Rating; Affirmed; AA+; RO:Sta
----St. Mary's County (MD) /General Obligation - Unlimited Tax/1 LT; Long Term Rating; Affirmed; AA+; RO:Sta

Contacts:
Primary Rating Analyst
Patrick Goggins,
Analyst
+1 646 582 4695
Fitch Ratings, Inc.
Hearst Tower 300 W. 57th Street
New York 10019

Secondary Rating Analyst
Kevin Dolan,
Director
+1 212 908 0538

Committee Chairperson
Michael Rinaldi,
Senior Director
+1 212 908 0833

Media Relations: Sandro Scenga, New York, Tel: +1 212 908 0278, Email: sandro.scenga@thefitchgroup.com

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Applicable Criteria

[U.S. Public Finance Tax-Supported Rating Criteria (pub. 27 Mar 2020) (including rating assumption sensitivity)]

Applicable Model

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

FAST States & Locals - Fitch Analytical Stress Test Model, v2.4.0 (1)

Additional Disclosures

Dodd-Frank Rating Information Disclosure Form

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