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Summary:

McPherson, Kansas; General Obligation

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Credit Profile

US\$9.95 mil GO bnds ser 2018-139 dtd 11/01/2018 due 08/01/2030

| | | |
|-------------------------|------------|----------|
| <i>Long Term Rating</i> | AA-/Stable | New |
| McPherson GO | | |
| <i>Long Term Rating</i> | AA-/Stable | Affirmed |
| McPherson GO | | |
| <i>Long Term Rating</i> | AA-/Stable | Affirmed |
| McPherson GO | | |
| <i>Long Term Rating</i> | AA-/Stable | Affirmed |

Rationale

S&P Global Ratings assigned its 'AA-' long-term rating to McPherson, Kan.'s series 139 of 2018 general obligation (GO) bonds. At the same time, S&P Global Ratings affirmed its 'AA-' long-term ratings on the city's existing GO debt. The outlook is stable.

The bonds are GOs of the city for which its full faith, credit and resources are irrevocably pledged. An unlimited ad valorem tax pledge secures the bonds. In addition to the ad valorem pledge, special assessments levied on properties that benefit from the bond proceeds further secure the city's existing GO bonds. However, we rate these bonds based on the city's unlimited ad valorem pledge because we don't believe we have sufficient information to rate the special-assessment pledge.

Proceeds of the series 2018 bonds will fund various street and drainage improvements.

The rating reflects our opinion of the city's:

- Weak economy, with projected per capita effective buying income at 100.9% of the national level and market value per capita of \$66,449;
- Strong management, with good financial policies and practices under our Financial Management Assessment (FMA) methodology;
- Strong budgetary performance, with operating surpluses in the general fund and at the total governmental fund level in fiscal 2017;
- Very strong budgetary flexibility, with an available cash reserve in fiscal 2017 of 97% of operating expenditures;
- Very strong liquidity, with total government available cash at 3.0x total governmental fund expenditures and 25.0x governmental debt service, and access to external liquidity we consider strong;
- Adequate debt and contingent liability profile, with debt service carrying charges at 11.8% of expenditures and net direct debt that is 85.5% of total governmental fund revenue, as well as rapid amortization, with 82.9% of debt

scheduled to be retired in 10 years; and

- Strong institutional framework score.

Weak economy

We consider McPherson's economy weak. The city, with an estimated population of 13,195, is located in McPherson County. The city has a projected per capita effective buying income of 100.9% of the national level and per capita market value of \$66,449. Overall, the city's market value was stable over the past year at \$876.8 million in 2019. The county unemployment rate was 2.8% in 2017.

McPherson is the county seat and principal commercial center of McPherson County. The city, encompassing 7.4 square miles, is located approximately 50 miles northwest of Wichita. The local economy has a significant industrial component that includes oil refining, plastics, pharmaceuticals, and fiberglass. Major employers include Pfizer Inc. (1,500 employees), United School District No. 418 (720), CHS Inc. (540), McPherson Hospital (333), and Viega, LLC (250).

McPherson's tax base has grown steadily over the past five years, averaging approximately 4% per year since 2013, spurred by ongoing development and expansions of major employers. In 2016, the CHS refinery concluded a multi-year period of facility upgrades and improvements that expanded its production capacity, reaffirming the plant's commitment to the local economy. In addition, Pfizer is completing a multi-year expansion project that is expected to add several hundred jobs over the next five years. The city has also experienced positive trends in its residential, retail, and industrial sectors. Given the city's stable trend of ongoing development, we do not expect our view of the local economy to weaken in the near term.

Strong management

We view the city'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.

Officials use three years of historical data when making revenue and expenditure assumptions, as well as maintaining dialogue with the local appraiser's office and state officials to incorporate any economic or statutory changes in McPherson's annual assumptions. The budget may be amended as needed, subject to state requirements, and commissioners are updated monthly on budget-to-actual performance. The city has adopted a capital improvement plan with some funding sources identified, but the timeline for projects is not specifically defined. Formalized policies with regard to debt and investment management have been adopted; however, the city's \$3 million general fund reserve target is informal. The city does not engage in long-term financial planning, but focuses on maintaining its reserve fund while accounting for long-term infrastructure needs.

Strong budgetary performance

McPherson's budgetary performance is strong, in our opinion. The city had operating surpluses of 1.9% of expenditures in the general fund and of 5.6% across all governmental funds in fiscal 2017.

We adjust for recurring transfers in and out of the general fund, and for capital projects funded through debt proceeds and available cash. After adjusting for those recurring general fund transfers, the city's general fund operating results

have been positive over the past three audited years. Results across all governmental funds over the past three years have resulted in some deficit spending, which is likely attributable to planned capital spending.

In fiscal 2017, McPherson reported positive net operating performance, which allowed the city to add approximately \$178,000 to its ending unencumbered cash balances. General fund revenues were 6% higher than budgeted, while final expenditures were in line with budgeted expectations. Ad valorem property taxes (29%), utility fund transfers (21%), and sales taxes (21%) are the primary sources of general fund revenues. Since fiscal 2014, these revenue streams have remained relatively stable.

Consistent with Kansas budget law, McPherson's budgets include uses of existing reserves; however, we recognize that actual results are often significantly better than budgeted. For fiscal 2018, officials report that expenditures are trending in line with the budget while revenues are on track to exceed original projections. Based on current trends, the city expects to report at least balanced results.

Very strong budgetary flexibility

McPherson's budgetary flexibility is very strong, in our view, with an available cash reserve in fiscal 2017 of 97% of operating expenditures, or \$9.0 million. We expect the available cash reserve to remain above 30% of expenditures for the current and next fiscal years, which we view as a positive credit factor. The cash reserve includes \$4.5 million (48.6% of expenditures) in the general fund and \$4.5 million (48% of expenditures) that is outside the general fund but legally available for operations. In our view, McPherson's use of cash accounting, which reduces clarity about the amount of funds that are truly available, negatively affects budgetary flexibility.

In addition to the general fund unencumbered balances, we view funds in the city's capital improvement and equipment reserve funds as available, which adds flexibility to McPherson's reserves. As of fiscal 2017, the city maintained \$2.6 million and \$1.9 million in unencumbered balances in the capital improvement and equipment reserve funds, respectively. However, these funds are not budgeted, and the city uses them to address ongoing capital needs. As of August 2018, capital spending reduced the cash balance in the capital improvement reserve to \$1.6 million while reserve levels in the equipment reserve fund have remained relatively stable. McPherson has an informal policy to maintain a general fund balance of at least \$3 million. In addition, the city has historically maintained very strong unencumbered cash levels that have consistently been well over 30% of expenditures. Given the city's stable operating performance and lack of plans to materially reduce reserves to its informal policy level, we believe budgetary flexibility will remain at levels we consider very strong over the next two years.

Very strong liquidity

In our opinion, McPherson's liquidity is very strong, with total government available cash at 3.0x total governmental fund expenditures and 25.0x governmental debt service in 2017. In our view, the city has strong access to external liquidity if necessary.

The city's strong access to external liquidity is demonstrated through its access to the market in the past two decades. McPherson has issued GO- and revenue-backed bonds in recent years. The city has historically had what we consider very strong cash balances and, therefore, we do not believe its cash position will materially weaken despite plans to continue to use reserves to address ongoing capital needs. All of the city's investments comply with Kansas statutes and are primarily held in state pools, which we do not consider aggressive.

The city's series 2017A GO temporary notes were issued via a direct placement with Peoples Bank and Trust Company. The outstanding par amount is \$2.6 million or 7% of total direct debt. Upon reviewing the documents, we note that the debt does not contain any permissive provisions, such as acceleration, that we view as a potential liquidity risk.

Adequate debt and contingent liability profile

In our view, McPherson's debt and contingent liability profile is adequate. Total governmental fund debt service is 11.8% of total governmental fund expenditures, and net direct debt is 85.5% of total governmental fund revenue. Approximately 82.9% of the direct debt is scheduled to be repaid within 10 years, which is in our view a positive credit factor.

McPherson does not have any swaps or variable-rate debt. The city's debt profile is primarily tax-backed, including GO bonds and temporary notes. Over the next 12 months, McPherson expects to issue \$7.8 million of additional long-term financing, including \$2.7 million of permanent financing to redeem the series 2017A temporary notes. At this time, we do not expect planned debt issuance to further weaken our view of the city's debt profile.

McPherson's pension contributions totaled 5.2% of total governmental fund expenditures in 2017. The city made its full annual required pension contribution in 2017.

The city participates in the Kansas Public Employees' Retirement System (KPERS) and the Kansas Police and Firemen's Retirement System (KP&F). Both are part of a state-administered, cost-sharing, multiple-employer, defined-benefit pension plan. Under state law, the employer contribution rates are determined based on the results of an annual actuarial valuation. McPherson has historically met in full the statutorily required contribution. As of Dec. 31, 2016, KPERS was 67% funded and KP&F was 73% funded. The city's very strong budgetary flexibility and fairly low pension contribution compared with expenditures somewhat offset our concerns about the plan's relatively low funded ratio because we believe McPherson has the flexibility to handle contribution rate increases the state could impose. The city offers other postemployment benefits in the form of group health insurance, but the cost of the subsidy has not been quantified.

Strong institutional framework

The institutional framework score for Kansas municipalities with more than \$275,000 in annual gross receipts and more than \$275,000 in GO or revenue bonds outstanding is strong.

Outlook

The stable outlook reflects our expectation that McPherson will maintain its very strong budgetary flexibility and liquidity, supported by stable operating performance. In addition, the outlook is based on our view that the local economy will continue to experience stable economic growth. We do not expect to change the rating over the two-year outlook horizon.

Upside scenario

We could raise the rating if key economic indicators were to improve to levels we considered comparable with those of higher-rated peers, or, all else equal, if, upon completion of various planned capital projects, management can

demonstrate its ability to sustain operating reserves in excess of 75% of expenditures.

Downside scenario

We could lower the rating if budgetary performance weakens, resulting in significant and sustained draws on reserves.

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
- Incorporating GASB 67 And 68: Evaluating Pension/OPEB Obligations Under Standard & Poor's U.S. Local Government GO Criteria, Sept. 2, 2015
- 2017 Update Of Institutional Framework For U.S. Local Governments

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.

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