Rating Action

S&P Global Ratings lowered its rating two notches to ‘A-’ from ‘A+’ on Appleton, Minn.’s general obligation (GO) debt outstanding. At the same time, we assigned our ‘A-’ rating to the city’s series 2020A GO health care facilities refunding bonds. The outlook is stable.

The city's full-faith-and-credit pledge and ability to levy unlimited ad valorem property taxes secure the bonds. Officials intend to pay debt service with net revenues of the city’s hospital, nursing home and related facilities, but the rating is based on the unlimited ad valorem tax pledge. The 2020A bond proceeds will finance a current refunding of the city’s series 2004 GO health facilities bonds for interest cost savings.

Credit overview

The downgrade reflects our view of the city’s multiple challenges, including potential pressures to operations driven by sizable general and governmental fund receivables, large portions of which are due from a highly reliant municipal hospital, in conjunction with a very weak local economy that maintains a highly concentrated tax base.

The city’s audited available fund balance contains a significant receivable owed to the general fund from the city’s water, sewer, and garbage fund; after removal, the city’s reserves would fall to a level that we would consider nominally low. While the city does have additional liquidity available (including committed funds and liquor fund cash) that we include in our calculation, we believe that this receivable is unlikely to be fully paid down in the near term and poses limitations on the city’s reserve levels. In addition, the city maintains multiple governmental and enterprise fund receivables owed to the city from its municipal hospital, Appleton Area Health Services. The total amount of the receivables equals nearly $3.0 million, which is higher than the city’s annual expenditures and its cash levels. City and hospital management are implementing measures to help alleviate these loans and put repayment plans into place. However, we believe that given the current COVID-19 pandemic and repercussions that are likely to occur including reduced hospital usage, the hospital will continue to rely heavily on the city for cash flow as we believe revenues are likely to fall in 2020, leading to imbalanced hospital operations.

Appleton also operates in a very weak local economy, with low economic metrics in regards to wealth and income levels, which is further weakened by extreme concentration in its tax base. One taxpayer, CoreCivic, accounts for 40% of the total tax base. While taxpayers have been historically stable, if there were any significant changes, specifically if CoreCivic were to leave, the city’s valuations would decrease substantially, which would lead to a worsening of our view of its economic metrics, and would likely decrease revenues for the city as well. Its debt profile is also a credit weakness, with debt service carrying charges accounting for nearly 27% of total expenditures, with plans to issue additional debt that will nearly double the city’s direct debt outstanding.

City operations have been stable in recent years. While we do not expect any significant deviations in performance, we believe Appleton could face potential pressures similar to those in previous downturns, given that the U.S. economy is currently in a recession, reports S&P Global Economics ("An Already Historic U.S. Downturn Now Looks Even Worse," published April 16, 2020, on RatingsDirect). Such effects could possibly including decreases to local government aid (LGA) from the state, which could lead to operational imbalance if the city does not manage corresponding expenditures. However, we believe that management is monitoring potential changes and beginning to determine possible cost-cutting measures, if that occurs. Even given the current recessionary circumstance, we believe the city will maintain credit characteristics comparable with those at the current rating level over the two-year outlook period.

The 'A-' underlying rating reflects our assessment of the city’s creditworthiness, specifically its:

- Very weak economy, with a concentrated local tax base and significant population decline;
- Adequate management, with standard financial policies and practices under our Financial Management Assessment (FMA) methodology;

- Adequate budgetary performance, with operating results that we expect could deteriorate in the near term relative to fiscal 2018, which closed with operating surpluses in the general fund and at the total governmental fund level;
- Very strong budgetary flexibility, with an available fund balance in fiscal 2018 of 54% of operating expenditures;
- Very strong liquidity, with total government available cash at 87.1% of total governmental fund expenditures and 3.2x governmental debt service, and access to external liquidity that we consider strong;
- Very weak debt and contingent liability profile, with debt service carrying charges at 26.8% of expenditures and net direct debt that is 212.7% of total governmental fund revenue, and high overall net debt at greater than 10.0% of market value, but rapid amortization, with 70.7% of debt scheduled to be retired in 10 years; and
- Adequate institutional framework score.

Stable Two-Year Outlook

Downside scenario

We could lower the rating if the city's financial performance deteriorates, resulting in much lower reserves, primarily if the city's enterprises (including both the water, sewer and garbage fund as well as the municipal hospital) begin to pressure general fund operations.

Upside scenario

While we don't view this as likely given current macroeconomic conditions, we could raise the rating if the city's highly concentrated tax base moderates significantly, coupled with a substantial decrease or elimination of the water, sewer, and garbage fund receivable, stabilization of hospital performance, and improvement in the city's debt profile.

Credit Opinion

Very weak economy

We consider Appleton's economy very weak. The city, with an estimated population of 1,398, is located in Swift County. It has a projected per capita effective buying income of 80.3% of the national level and per capita market value of $41,994. Overall, the city's market value grew 3.4% over the past year to $58.7 million in 2019. Weakening Appleton's economy are a concentrated local tax base, with the 10-largest taxpayers accounting for 70.8% of the total tax base and its demographic profile, which includes significant population decline of 7%. The county unemployment rate was 3.7% in 2018.

Appleton's tax base primarily consists of commercial and industrial values (making up 66% of tax capacity, before tax increments), which grew in recent years as new firms have moved into the city and existing firms have expanded. As a result, net tax capacity (NTC) grew nearly 3% from 2015-2019. Although small, the city has a fairly diverse employment base, with health care, education, government and manufacturing leading as top employers; however, the tax base is highly concentrated, with the 10-largest taxpayers accounting for 71% of the total tax base, and the largest taxpayer--CoreCivic--accounting for 40% alone. CoreCivic, the owner of a large private prison that closed in 2010, continues to maintain the facility in the hopes that it will one day reopen; however, management does not expect this to occur in the immediate future. While we do view the tax base concentration as a credit risk, all taxpayers, including CoreCivic, have been in the community for decades and, according to management, have no plans to leave. However, if CoreCivic does not reopen and sells the property, removing it from the tax base, there could be negative rating pressure on the city, given its considerable share of the overall tax base.

Given the sizable taxpayer concentration, as well as the city's significant population decline, we expect our view of the city's local economy will continue to remain very weak for the foreseeable future, particularly given the COVID-19-induced recession.

Adequate management

We view the city's management as adequate, with standard financial policies and practices under our FMA methodology, indicating the finance department maintains adequate policies in some but not all key areas.

Management, using a traditional line-item approach, refers to at least three years of historical financial information and consults outside sources to create budgetary projections. Reporting to the council on budgetary performance is done on a monthly basis and, while the performance typically tracks close to the budget and amendments are not necessary, they can be made if needed. There is no formalized long-term financial plan in place currently, but management plans to implement one. Capital projects, primarily for water-infrastructure needs, are tracked in the city's capital improvement plan (CIP), which lists project costs and funding sources, but it is not a five-year rolling plan. While the city lacks formal policies in relation to investment, debt and fund balance management, it follows state guidelines and has an informal target to maintain reserves between 35%-50% of operating expenditures, which it has been well above on an unassigned level.

Adequate budgetary performance

Appleton's budgetary performance is adequate, in our opinion. The city had operating surpluses of 9.9% of expenditures in the general fund and of 2.4% across all governmental funds in fiscal 2018. Our assessment accounts for the fact that we expect budgetary results could deteriorate somewhat from unaudited 2019 results, , based on the city's budgeted deficit for fiscal 2020.

For our analysis, we adjusted general fund expenditures to include annually recurring transfers. City operations have been mostly stable in recent years, with mixed operating results, but an overall increasing reserve position in each of the past three fiscal years. The budget is fairly predictable, in our view, with mostly consistent results, which management attributes to conservative budgeting techniques. Most fluctuations across governmental funds have been the result of one-time capital spending, portions of which have been funded by bond proceeds. Fiscal 2019 year-end unaudited results show an essentially breakeven result, and are very close with the original budget. For 2020, the budget is structured for a slight deficit of roughly $98,000 (or 4.5% of general fund expenditures), reflecting the addition of the city's administrator's position. Currently, performance is tracking closely with the budget, with no major deviations across governmental funds.

While general fund performance has not yet been affected by the underperformance of the municipal hospital, we note that the hospital, although recently showing an improvement in its operations, has been substantially subsidized by the city in recent years, and has historically maintained a negative net position. We believe the hospital's reliance on the city, for both debt service and interfund loans, could eventually pressure the city's rating if the amount owed to the city increases or if the hospital becomes more operationally reliant on the city's governmental funds. New management teams, at both the city and the hospital, are implementing new measures to decrease this reliance, but the hospital's history of underperformance, coupled with general economic uncertainty and the likelihood that the COVID-19 pandemic will decrease elective surgeries and other and nonessential hospital visits, decreasing hospital usage overall in 2020, lead us to believe there is event risk surrounding the hospital that, in our view, will likely result in a decline in revenues and continued substantial reliance on the city.

Management is conscious of the potential pressures that could arise given the severe economic downturn due to COVID-19, specifically in regards to possible delays or decreases in revenues. It is continually monitoring expenditures as it receives new information, however, management believes the impact will likely not be felt until 2021. In previous recessions, there were no substantial decreases in property tax receipts, so management expects that portion of revenue to be mostly stable. The general fund benefits from a revenue structure that has historically been stable and predictable, consisting mostly of property taxes (42%) and state aid (43%), referred to as LGA in Minnesota. While we are not aware of reductions to LGA at this time, cuts to certain government types, including to Appleton specifically, have occurred during previous recessions. If the state makes reductions, we believe the city will work to appropriately manage its budget to decrease expenditures and maintain mostly balanced operations. However, if the city is required to expend additional support, including general or governmental fund transfers, to the hospital for operations and cannot adjust for that in its budget, our view of the city's budgetary performance could worsen and there could be additional downward pressure on the rating.

Very strong budgetary flexibility

Appleton's budgetary flexibility is very strong, in our view, with an available fund balance in fiscal 2018 of 54% of operating expenditures, or $1.1 million. We expect the available fund balance to remain above 30% of expenditures for the current and next fiscal years. The available fund balance includes $617,000 (30.5% of expenditures) in the general fund and $482,000 (24% of expenditures) that is outside the general fund, but legally available for operations. Management is drafting a resolution, which includes a repayment plan for the receivable, however, we do not expect any substantial decreases in the amount owed over the near term, as the timing for repayment is over 15 years.
Our view of the city's available fund balance is hindered by a sizable receivable, totaling $1.5 million, owed to the general fund from the water, sewer, and garbage fund. Purely available reserves (assigned and unassigned) are low, in our view, on a nominal basis, after removing the receivable, which is included in the audited unassigned portion of the general fund.

After adding in cash available in the city's liquor fund and funds earmarked as committed in the general fund, both of which can be made available for operations, if necessary, our view of the city's reserves remains very strong. However, this is additionally encumbered by multiple interfund loans that the hospital owes to various governmental and city enterprise funds, which totaled $2.9 million in 2018. While these loans are not all directly owed to the city's general fund, they highlight the hospital's continued reliance on the city for cash flow and debt service payments. While we understand that the city has historically managed these receivables and that its overall support for the hospital has been stable in the past, we believe that, given current macroeconomic conditions, the hospital could require additional support if revenues decrease substantially due to the COVID-19 pandemic. If the support necessary goes beyond the historically managed interfund loans, or if the loans begin to increase, it could further pressure the rating.

Very strong liquidity

In our opinion, Appleton's liquidity is very strong, with total government available cash at 87.1% of total governmental fund expenditures and 3.2x governmental debt service in 2018. In our view, the city has strong access to external liquidity if necessary.

The city's $2.7 million in cash and investments in fiscal 2018 were held primarily in cash deposits, money market accounts and certificates of deposit, which we do not consider aggressive. We believe that Appleton has strong access to external liquidity, given its history of issuing debt within the past 20 years. The city maintains two privately placed GO debt obligations, issued in 2016 and 2017. The aggregate amount outstanding for both issues totals $464,000 and is included in our calculation of direct debt. Issued to finance the purchase of hospital equipment and to complete roof improvements, the agreements for both issues contain no events of default or covenant violations that we deem nonstandard in accordance with our contingent liquidity criteria. We expect our view of the city's liquidity to remain very strong given historically high cash levels, even when considering potential pressures that are likely to arise because of the current recessionary environment.

Very weak debt and contingent liability profile

In our view, Appleton's debt and contingent liability profile is very weak. Total governmental fund debt service is 26.8% of total governmental fund expenditures, and net direct debt is 212.7% of total governmental fund revenue. Negatively affecting our view of the city's debt profile is its high overall net debt of 14.7% of market value. Approximately 70.7% of the direct debt is scheduled to be repaid within 10 years, which is in our view a positive credit factor.

We calculate net direct debt at $6.7 million. The city plans to issue between $4.8 million-$5.0 million of GO debt within the next two years to fund the construction of a water treatment facility. Given our already very weak view of the city's debt profile, emphasized by high carrying charges and high levels of debt in relation to the tax base, we do not expect our view of it to worsen. However, we do view the city's debt profile as a major credit weakness, which we believe could limit expenditure flexibility if recessionary pressures lead to extensive cost pressures.

Pension and other postemployment benefits (OPEB)

Appleton's pension contributions totaled 2.2% of total governmental fund expenditures in 2018. The city made its full annual required pension contribution in 2018. The city does not offer any OPEB.

We do not believe that pension liabilities represent a medium-term credit pressure, as contributions are only a modest share of the budget, and we believe the city has the capacity to absorb higher costs without pressuring operations. Appleton participates in two multiple-employer, defined-benefit pension plans that have seen recent improvements in funded status, although plan statutory contributions have regularly fallen short of actuarial recommendations. Along with certain plan-specific actuarial assumptions and methods, this introduces some long-term risk of funding volatility and cost acceleration.

The city participates in the following plans:

- Minnesota General Employees Retirement Fund (GERF): 80.2% funded (as of June 30, 2019), with a city proportionate share of the plan's net pension liability of $333,000.
- Minnesota Police and Fire Fund (PEPFF): 89.3% funded (June 30, 2019), with a proportionate share of $233,000.

Total contributions to GERF and PEPFF were 89% and 94%, respectively, of our minimum funding progress metric and were slightly above static funding in both cases. Annual contributions are based on a statutory formula that has typically produced contributions lower than the actuarially determined contribution for each plan. In our view, this increases the risk of underfunding over time, if the state legislature does not make adjustments to offset future funding shortfalls. Other key risks include a 7.5% investment rate-of-return assumption (for both plans) that indicate some exposure to cost acceleration as a result of market volatility, and an amortization method that significantly defers contributions through a lengthy, closed 30-year amortization period based on a level 3.25% payroll growth assumption. Regardless, costs remain only a modest share of total spending, and we believe they are unlikely to pressure the city's medium-term operational health.

Adequate institutional framework

The institutional framework score for Minnesota cities with a population between 1,000 and 2,500 and an audit required by state statute is adequate.