

CREDIT OPINION

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Northbrook (Village of) IL

Update to credit analysis

Summary

The Village of Northbrook, IL's (Aaa negative) main credit strengths are its high resident wealth and income derived from close ties to the extensive Chicago (Ba1 negative) economy and its very healthy fund balance and liquidity. Further, the village's home-rule designation grants it broad legal flexibility to raise local taxes and fees to address rising expenditure pressures. The village recently increased its property tax levy by 17.4%. At the same time, the village's debt and pension burdens are high and fixed costs, notably pension contributions, will likely continue to rise in the coming years and may necessitate further budgetary adjustments.

Credit strengths

- » Affluent tax base with close ties to the extensive Chicago economy
- » Very healthy fund balance and liquidity
- » Broad legal flexibility to raise local taxes and fees

Credit challenges

- » Debt burden is high for the rating category
- » The village's pension burden is also high and contributions will likely continue to rise in the coming years

Rating outlook

The negative outlook reflects the expectation that growth in the village's pension and fixed cost burdens could drive downward rating action.

Factors that could lead to an upgrade

- » Moderated debt and pension burdens
- » Growth in pension contributions that keeps pace with the plans' funding needs and forestalls rising unfunded liabilities

Factors that could lead to a downgrade

- » Continuation of pension contribution practices that enable rising unfunded liabilities
- » Growth in the village's debt or pension burdens

» Narrowed fund balance or liquidity

Key indicators

Exhibit 1

Northbrook (Village of) IL	2013	2014	2015	2016	2017
Economy/Tax Base					
Total Full Value (\$000)	\$7,241,356	\$6,442,676	\$6,556,872	\$6,234,268	7,459,029
Population	33,283	33,396	33,572	33,170	33,170
Full Value Per Capita	\$217,569	\$192,918	\$195,308	\$187,949	\$224,873
Median Family Income (% of USMedian)	210.6%	217.0%	217.5%	217.5%	217.5%
Finances					
Operating Revenue (\$000)	\$45,650	\$48,086	\$50,335	\$47,673	\$51,515
Fund Balance (\$000)	\$17,137	\$18,477	\$20,962	\$21,256	\$23,491
Cash Balance (\$000)	\$19,395	\$22,427	\$26,272	\$28,090	\$26,317
Fund Balance as a % of Revenues	37.5%	38.4%	41.6%	44.6%	45.6%
Cash Balance as a % of Revenues	42.5%	46.6%	52.2%	58.9%	51.1%
Debt/Pensions					
Net Direct Debt (\$000)	\$58,944	\$68,875	\$67,557	\$71,756	\$74,224
3-Year Average of Moody's ANPL (\$000)	\$100,209	\$114,488	\$136,602	\$170,429	\$201,552
Net Direct Debt / Operating Revenues (x)	1.3x	1.4x	1.3x	1.5x	1.4x
Net Direct Debt / Full Value (%)	0.8%	1.1%	1.0%	1.2%	1.0%
Moody's - adjusted Net Pension Liability (3-yr average) to Revenues (x)	2.2x	2.4x	2.7x	3.6x	3.9x
Moody's - adjusted Net Pension Liability (3-yr average) to Full Value (%)	1.4%	1.8%	2.1%	2.7%	2.7%

Source: Moody's Investors Service, Northbrook's audited financial statements, U.S. Census Bureau

Profile

Located 25 miles north of downtown Chicago in Cook County, the Village of Northbrook encompasses 13 square miles and has a population of over 33,000 residents.

Detailed credit considerations

Recent developments

In December 2017, the Village of Northbrook's Board approved a \$2.7 million, or 17.4%, increase in its property tax levy. The levy will largely support increased pension contributions after the village lowered the assumed rate of return in its public safety pension plans.

The village closed fiscal 2017 with an available operating fund balance of \$23.5 million, or a healthy 45.6% of revenues. This represents a \$2.2 million, or 10.5%, increase over 2016. The village's three-year average Moody's adjusted net pension liability (ANPL) grew to \$202 million, a 19% increase from fiscal 2016, and an elevated 3.9x revenues.

Economy and tax base: affluent North Chicago suburb with sizable commercial presence

We expect the village's economic profile to remain a credit strength given its close ties to the Chicago metropolitan area and high quality housing stock. The village's tax base is diverse, combining corporate and commercial developments with a wealthy residential tax base. The top taxpayer is the Northbrook Court Shopping Center, which comprises 2.3% of equalized assessed valuation. The large high-end regional mall anchors the village's significant retail sector. In addition to the shopping center, other top employers include Underwriters Labs and Glenbrook High School, all of which employ nearly 4,000. Median family income in the village is strong at 217% of the US median.

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The village's sizable \$7.5 billion tax base increased 20% in the most recent year but remains well below its 2009 peak. Declines in valuation have not negatively impacted revenue given the village's flexibility to adjust tax rates upwards and maintain annual levy stability. There are several notable projects under development, which should contribute to a rising tax base in the coming years. Lurie Children's Hospital recently completed its expansion and a large mixed-use development was also completed. In addition, Lifetime Fitness is set to open in the fall of 2018 and a 300-unit residential development will also be constructed.

Financial operations and position: strong financial profile benefits from significant revenue raising flexibility

The village's financial position is strong and operations are supported by substantial flexibility provided by home rule status. In December 2017, the Village of Northbrook's Board approved a \$2.7 million, or 17.4%, increase in its property tax levy. As a home rule unit of government in Illinois, Northbrook has broad legal flexibility to raise local tax rates and fees. The levy will largely support increased pension contributions after the village lowered the assumed rate of return in its public safety pension plans.

The village's operating reserves remained stable in fiscal 2017. The village closed fiscal 2017 with an available operating fund (general, debt service and pension funds) balance of \$23.5 million, or a healthy 45.6% of revenues, which is a \$2.2 million, or 10.5%, increase over 2016.

The village's fund balance policy is to maintain general fund balance at no less than 40% of revenues, a level currently exceeded. For fiscal 2018, the village expects a \$200,000 to \$400,000 surplus, which incorporates a rise in pension contributions.

LIQUIDITY

The village closed fiscal 2017 with an operating net cash position of \$26.3 million, or a healthy 51.1% of revenues. The village's primary enterprise operations are its water, sanitary sewer and stormwater utilities. Total enterprise liquidity was very strong at the close of fiscal 2017 with well over a year's cash on hand across all enterprise funds. Of the \$20.6 million cash held in enterprise funds, \$8.1 million is unspent bond proceeds. Net of the bond proceeds, unrestricted cash is equivalent to 551 days of operating expenses.

Debt and pension liabilities: above average debt burden and growing pension liabilities

Northbrook's fixed costs will rise given growing debt and pension obligations. The village's debt burden is high for its rating category. Net of \$36.9 million of GO debt being repaid by the village's utility funds, the direct debt burden is 1% of full value and 1.4x operating revenue. As part of its a five-year capital improvement plan, the village expects to issue \$25.9 million of GO debt over five years beginning in 2020.

The village's fiscal 2017 fixed costs, consisting of debt service and retirement plan contributions, were 22% of revenue. However, had the village contributed to its pension plans amounts sufficient to forestall growth in reported net liabilities, fixed costs could have consumed close to 30% of revenue. This is discussed in more detail below.

DEBT STRUCTURE

All the village's debt is fixed rate and 56% of principal is scheduled to be repaid within the next ten years.

DEBT-RELATED DERIVATIVES

The village is not a party to any swap agreements.

PENSIONS AND OPEB

Village employees participate in one of three defined benefit pension plans: a single-employer police plan, single-employer fire plan, or the multi-employer agent Illinois Municipal Retirement Fund (IMRF). On a reported basis, liabilities more than doubled since 2014 growing to \$101 million in fiscal 2017 from \$44 million in fiscal 2014, driven in part by a lowering of the discount rate. The village's three-year average Moody's adjusted net pension liability grew 76% over the same period to \$202 million, or an elevated 3.9x revenues. Key contributors to unfunded liability growth are weak asset returns relative to the assumed rate of return and village contributions that, while conforming to actuarial contributions, were not sufficient to fully cover annual interest accruals. Furthermore, new accounting standards increased the ANPL associated with the IMRF plan.

In fiscal 2017, the village's contributions to its police and fire plans were far short of "treading water," that is forestalling growth in the reported net pension liabilities of the plans assuming other plan assumptions hold. Across the two plans, the village's contribution fell \$3.8 million short of treading water, equal to 7.4% of operating revenue. The IMRF contributions were a stronger 101% of the amount

necessary to tread water. After accounting for employee contributions, government contributions that tread water are equal to the sum of current year service cost and interest on reported net pension liabilities at the start of the year.¹

For fiscal 2018, the village lowered the assumed investment rate of return in its police and fire pension plans to 7.0% from 7.5%. This change in the discount rate drove an immediate increase in the contribution recommended by plan actuaries. The village reports it increased its contribution to its police and fire plans to \$6.4 million in fiscal 2018. Although this is a notable jump in payments from fiscal 2017 and prior years, we estimate it still falls short of the amount needed for the plans to tread water. We therefore anticipate further growth in the village's unfunded pension liabilities in the coming year.

The village has a modest other post-employment benefit (OPEB) unfunded liability of \$9.0 million, which primarily represents the implicit rate subsidy of allowing retirees to stay on the village's healthcare plans. Retirees pay 100% of post-employment healthcare premiums.

Management and governance: home rule status provides ample revenue raising flexibility

Illinois cities have an institutional framework score of "A," or moderate. Revenue predictability is moderate, with varying dependence on property, sales, and state-distributed income taxes. Revenue-raising ability is also usually moderate but can vary. Home rule entities, such as Northbrook, have substantial revenue-raising authority. Expenditures are moderately predictable but cities have limited ability to reduce them given costs for pension benefits that enjoy strong constitutional protections.

Endnotes

- ¹ Our "tread water" indicator measures the annual government contribution required to prevent reported net pension liabilities from growing, given the entity's actuarial 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 the tread water indicator 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 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.

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