S&P Global
Ratings

Research

Summary:

Lexington-Fayette Urban County Government, Kentucky; General Obligation

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Credit Profile		
US$44.5 mil various purp GO bnds ser 2022B dtd 08/10/2022 due 11/01/2042		
Long Term Rating	AA/Stable	New

Rating Action

S&P Global Ratings assigned its 'AA' long-term rating to Lexington-Fayette Urban County Government (LFUCG), Ky.'s anticipated $44.5 million series 2022B various purpose general obligation (GO) bonds. The outlook is stable.

The series 2022B bonds will be used to finance various capital-related expenditures and provide funding for a land conservation program.

The series 2022B bonds are secured by LFUCG's full-faith-credit-and-resources pledge and an agreement to levy ad valorem property taxes. There are property tax limitations set forth in the state constitution and statutes. Section 157 of the constitution sets maximum property tax rates based on the obligor's population, and aggregate property tax revenue cannot grow more than 4% year over year, excluding new property, under Kentucky Revised Statutes (KRS) 132.020. Tax increases greater than 4% can be challenged by a voter recall, which could require a referendum if more than 10% of voters file a petition objecting to the tax increase. In practice, Kentucky local governments do not exceed the 4% collection increase limitation. We rate Kentucky local government GO debt, including that of LFUCG, based on the application of our "Issue Credit Ratings Linked To U.S. Public Finance Obligors' Creditworthiness" criteria (published Nov. 20, 2019). Any limitation imposed on the obligor's ability to raise revenue is embedded in our view of the obligor's general creditworthiness.

Credit overview

Lexington-Fayette Urban County Government serves the second-largest population in Kentucky. Its economic base is recovering as the COVID-19 pandemic progresses. Its largest source of revenue, taxes derived from wages and business profits, are on the upswing. However, the long-term pressure of managing recurring personnel and related expenses, including rising pension contributions, remains a challenge, in our view. Officials indicate fiscal 2022 ended better than expected, with a general fund surplus rather than the originally planned $8 million use of reserves due to positive budget variances. The 2023 budget is operationally balanced but officials plan to use the surplus from the prior year and federal stimulus funding to pay for one-time infrastructure projects and to provide funding for a neighborhood revitalization program.

For our latest U.S. economic forecast, see "Economic Outlook U.S. Q3 2022: The Summer Of Our Discontent", published June 27, 2022, on RatingsDirect.)

The 'AA' rating reflects our assessment of LFUCG's:

- Growing, broad and diverse local economy rebounding from the pandemic;
- Strong management, with good financial policies and practices under our Financial Management Assessment methodology and a strong institutional framework score;
- Adequate budgetary performance, as reflected in fiscal 2021 results and currently in 2022, supported by very strong budgetary flexibility and liquidity; and
- Very weak debt and contingent liability profile, with currently no plans to issue additional debt, and pension contributions for the time being remain manageable.

Environmental, social, and governance

We believe LFUCG's governance risks are elevated because of its weakly funded pension plans and its exposure to escalating contributions. We also analyzed environmental and social risks and consider them neutral in our credit analysis.

Stable Outlook

Upside scenario

We could raise the rating if LFUCG's economy improves to a level commensurate with that of higher-rated peers while managing its very weak debt and pension liabilities and maintaining structurally balanced budgets and very strong reserve and liquidity levels.

Downside scenario

We could lower the rating if we believe rising costs, including pension and other postemployment benefits (OPEB) contributions, become unmanageable and we perceive the budget is becoming structurally imbalanced.

Credit Opinion

Strongly recovering economy bolstered by expansions of some of its largest employers

Lexington-Fayette Urban County Government serves as a regional economic center in the heart of Kentucky's Bluegrass region. The economy is anchored by the University of Kentucky (UK), which serves as its largest employer with 15,541 employees. Amazon is the second largest employer at 5,727, followed by Fayette County Public Schools with 5,620 employees.

The county unemployment rate peaked at 14.8% in April 2020 before subsiding to an average 5.7% for 2020. Strong economic recovery contributed to an average unemployment rate of 3.9% for 2021. We expect the economy to continue to show steady gains in 2022, with employment back to pre-pandemic levels and several larger employers announcing expansions. While many employees continue to take advantage of telecommuting opportunities at least on a part-time basis, LFUCG officials indicate office vacancies have not escalated at this time.

Strong financial management assessment

The government performs a line-by-line approach for its budgetary process; it uses five years of historical information for many items and it also uses a forecasting tool that is based on 20 years of trends. It uses the University of Kentucky Center for Business and Economic Research for its revenue estimates as well as health care consultants in coming up with its health insurance budget. The budget can be amended if needed and the council receives a monthly report on budget-to-actual results. Management uses forecasts, but mainly for internal purposes.

The government has a six-year capital plan that management updates annually and presents to the board with sources and uses identified. The capital plan is included in the budget document.

The government does have its own investment policy and it reports on an annual basis to its board members the holdings and performance. It has its own debt management policy, which includes some restrictions and thresholds on new debt issues. The reserve policy includes thresholds for maintaining an economic contingency fund as well as a defined amount of unassigned general fund reserves; which states the government must maintain a contingency designation fund funding goal of 10% of the previous year's total general fund revenue.

Management has cyber-mitigation measures in place and it has not had any issues with data breaches.

Lexington-Fayette Urban Government's budgetary performance has strongly rebounded, reflecting early cost adjustments and positive revenue performance

Fiscal 2021 general fund and total governmental fund performance was positive, and we expect this will continue in budget year 2022. Officials had expected a 7% year-over-year decline in revenue, mainly because of expected weakness in payroll withholdings and net profit revenue; instead, revenue outperformed expectations. This is at least partially driven by expansions at UK, Amazon, Baptist Health, and other large employers. At the start of the pandemic, officials froze hiring and used other expense adjustments to offset revenue declines. As revenue grew, those cost constraints were gradually loosened.

The general fund's largest revenue sources consist of employee withholding tax (54%), business net profit taxes (13%), insurance premium taxes (9%) and property tax revenues (6%).

Officials received $20 million of CARES Act funding in fiscal 2020, and an additional $5 million in 2021. Officials paid for public safety expenses, vaccination clinics, and other pandemic-mitigation efforts. The urban county government was allocated $120 million in total ARP (American Rescue Plan Act) funding and have received $90 million to date with the remainder to be received in July 2020. LFUCG is using the funds on one-time capital, salary support, community development, and local economic support initiatives.

The 2022 budget was balanced using $8 million of budget stabilization reserves, however, with revenue and expenditures showing positive budget variances, officials expect to outperform the budget. The 2023 budget is operationally balanced, but officials plan to use the prior year's surplus funds and ARP funding on one-time items and community investment programs.

Weakening our view of LFUCG's budgetary performance is the city-county's deferral of significant expenditures, which we think inflates the budgetary result ratios. While LFUCG made full payments required by the state to the County Employees Retirement System (CERS) pension plan, the required payments were not based on the actuarially determined contribution. Absorbing growing pension contributions into its budget as well as managing its overall personnel-related expenditures remain long-term challenges for the urban county government.

Personnel and related expenses face an upward trajectory, and inflationary pressure indicates supply and other costs could increase, but officials believe they are positioned to maintain a structurally balanced budget for 2023. We expect budgetary performance will remain at least adequate in the current and following year.

We adjusted general fund revenue and expenditures for routine transfers and deducted bond proceed expenditures from total governmental fund expenses.

Our calculation of the government's available general fund balance includes amounts committed and assigned in addition to the unassigned fund balance. Based on results expected in 2022 and balanced operations for the 2023 budget year, we expect the urban county government's budgetary flexibility will remain very strong. We also expect LFUCG's liquidity will also remain very strong.

Very weak debt and contingent liability profile with limited future debt plans

Officials currently have no plans to issue material amounts of additional debt. LFUCG has a total of $924 million of direct debt outstanding; of this amount, $706 million is GO debt.

The existing Lexington Center Corp.'s bonds are supported by convention center revenue as well as the urban county government's obligation to cover deficiencies. The existing general airport bonds are secured by airport revenue as well as LFUCG's GO pledge. Pledged revenue has weakened during the pandemic, but we do not believe support from LFUCG, if needed, would compromise its budget or its flexibility.

Pension and OPEB highlights:

We do not view pension and OPEB liabilities as an immediate source of credit pressure for LFUCG, despite the plans' lower funding levels and our expectation of cost escalation, given our view of the government's recovering revenue base and its budget controls. CERS plans are administered on the state level and LFUCG cannot increase contributions to help funding levels; additionally, the actuarial assumptions are established by the state.

The urban county government participates in the following plans, as reported in the 2021 audit:

- CERS non-hazardous: 57% funded with a net pension liability of $235 million;
- Policemen's and firefighters' retirement fund (PFRF): 69% funded, with a net pension liability of $349.6 million--single-employer plan;
- City's employees' pension fund (CEPF): fully funded, single employer plan that has been closed since 1983;
- CERS hazardous: net pension liability of $71 million;
- The net OPEB obligation for the single employer plans was $273.5 million; and
- CERS net OPEB liability is $95.7 million.

To address the CERS plans' poor funding levels, the legislature passed a bill that caps CERS employer-contribution increases at 12% annually through 2028. However, we believe pension payment acceleration over the long term is still a possibility. Currently, the statutory contributions to CERS hazardous and non-hazardous plans did not meet minimum or static funding progress, meaning contributions were not large enough to address the unfunded liabilities. Based on these factors, we do not believe there is a sufficient plan in place to address the large pension obligation.

For more information about Kentucky pensions, see "Pension Spotlight: Kentucky", published May 25, 2021.

Strong institutional framework

The institutional framework score for Kentucky home rule cities is strong.

Lexington Fayette Urban County Government, Ky.: Key Credit Metrics

	Most recent	Historical information		
		2021	2020	2019
Strong economy				
Projected per capita EBI % of U.S.	100			
Market value per capita ($)		100,702		
Population		325,812	327,704	327,056
County unemployment rate(%)		3.9	5.7	
Market value ($000)		32,813,158	34,634,858	33,213,875
Ten largest taxpayers % of taxable value	2.2			
Adequate budgetary performance				
Operating fund result % of expenditures		5.8	5.4	0.9
Total governmental fund result % of expenditures		5.2	(1.3)	0.3
Very strong budgetary flexibility				
Available reserves % of operating expenditures		27.0	22.6	17.0
Total available reserves ($000)		101,665	80,054	63,969
Very strong liquidity				
Total government cash % of governmental fund expenditures		50	24	25
Total government cash % of governmental fund debt service		415	235	209
Strong management				
Financial Management Assessment	Good			
Very weak debt & long-term liabilities				
Debt service % of governmental fund expenditures		12.1	11.7	12.1
Net direct debt % of governmental fund revenue	143			
Overall net debt % of market value	3.6			
Direct debt 10-year amortization (%)	62			
Required pension contribution % of governmental fund expenditures		11.6		
OPEB actual contribution % of governmental fund expenditures		1.1		
Strong institutional framework				

EBI--Effective buying income. OPEB--Other postemployment benefits. Data points and ratios may reflect analytical adjustments.

Related Research

- S&P Public Finance Local GO Criteria: How We Adjust Data For Analytic Consistency, Sept. 12, 2013
- Criteria Guidance: Assessing U.S. Public Finance Pension And Other Postemployment Obligations For GO Debt, Local Government GO Ratings, And State Ratings, Oct. 7, 2019
- Through The ESG Lens 2.0: A Deeper Dive Into U.S. Public Finance Credit Factors, April 28, 2020
- 2020 Update Of Institutional Framework For U.S. Local Governments