S&P Global Ratings

RatingsDirect®

Summary:

Mercer County, New Jersey; General Obligation; General Obligation Equivalent Security; Note

Primary Credit Analyst:
John Kennedy, New York + 1 (212) 438 2128; john.kennedy@spglobal.com

Secondary Contact:
Christian Richards, Boston (1) 617-530-8325; christian.richards@spglobal.com

Table Of Contents

Summary:

Mercer County, New Jersey; General Obligation; General Obligation Equivalent Security; Note

Credit Profile		
US$124.594 mil BANs of 2020 ser A due 06/10/2021		
Short Term Rating	SP-1+	New
Mercer Cnty GO		
Long Term Rating	AA+/Negative	Outlook Revised
Mercer Cnty BANs of 2020 ser A due 06/10/2021		
Short Term Rating	SP-1+	Affirmed

Rating Action

S&P Global Ratings revised its outlook to negative from stable and affirmed its 'AA+' long-term rating on Mercer County, N.J.'s general obligation (GO) bonds and debt issued by the Mercer County Improvement Authority (MCIA) and guaranteed by the county. At the same time, we assigned our 'SP-1+' short-term rating to the county's $124.594 million series 2020 GO bond anticipation notes (BANs) and affirmed our 'SP-1+' short-term rating on the county's outstanding GO BANs.

The outlook revision reflects our view that there is at least a one-in-three likelihood that the nationwide economic recession and state budgetary pressure stemming from the COVID-19 pandemic will weaken the county's economy and financial position to an extent that they are no longer comparable with those of peers at the present rating level. Officials estimate that county unemployment may currently hover around 9%, lower than the estimated state average, owing to stability in the State of New Jersey's hiring and staffing up to this point. However, with the state capital Trenton as the county seat, Mercer County's employment base is more sensitive than its peers to changes in state hiring and staffing decisions, which is outside the county's control. Its sectoral concentrations in higher education and health care may likewise increase its susceptibility to increases in unemployment from the current pandemic-driven recession, despite the fact that they had historically buttressed the economy. S&P Global Economics forecasts national unemployment could reach 19% in May, which would be closer to the reported Depression-era peak of 25% than to the 10% high during the global financial crisis. We believe this would likely materially affect our view of the economy, along with driving negative financial results and declining reserves.

Although the county's financial performance has been strong since the global financial crisis, nontax revenues, such as recreational facility and sheriff's foreclosure fees, may vary and underperform expectations. The governing body intends not to rely on fund balance to bridge temporary budgetary imbalances. Accordingly, freeholders approved a large scale expenditure reduction for 2020 designed to offset a potential $5 million revenue shortfall. Officials also proactively identified an additional layer of expenditure reductions to offset even lower revenue assumptions if necessary. We view this type of planning as indicative of the current rating. Even so, certain revenues, reimbursements, and future expense growth remain uncertain and outside the county's control for 2020 and 2021. Accordingly, we believe there is a heightened probability that Mercer County will not replenish all of the fund balance it annually incorporates into its budget over the next one-to-two years despite its intentions, especially in the case of prolonged shelter-in-place orders or state expenditure reductions. However, in our opinion, the outlook could be revised to stable if the county's economic and financial positions remained generally stable, and in line with those of its similarly-rated peers.

The county's full-faith-and-credit pledge, including an agreement to levy unlimited ad valorem taxes on all taxable property within county limits, secures its GO bonds and BANs. The short-term BAN rating reflects our high investment-grade, long-term rating and the county's low market risk profile. In our view, and in accordance with our criteria, titled "Bond Anticipation Note Rating Methodology" (published Aug. 31, 2011, on RatingsDirect), we assess the county's market risk as low because of its strong market access, information availability, and takeout authorization. Proceeds from the BANs will redeem outstanding BANs and provide new-money financing for various open-space and general capital projects.

The rating on MCIA debt reflects our view of the county's unconditional guarantee of full and prompt payment of principal and interest on the bonds when due and payable. The guarantee qualifies as a form of credit enhancement and, in our view, is based on the county's unconditional promise to pay the guaranteed obligation on the due date when remedies against the primary obligors are exhausted. For issues that carry the county's guarantee, none of the transactions include obligors with unenhanced ratings that exceed the rating on the county.

Credit overview

Mercer County has a very large tax base and a very strong economy, located between--and with access to--Philadelphia and New York City. Management has leveraged the strength of the economy to produce strong financial results over the past several years, leading to improved reserve levels. Its past and planned efforts to control expenditures have helped the county manage additional budgetary pressure from escalating fixed costs associated with growing debt and retirement costs, although mandatory participation in the state's poorly-funded pension plans will likely lead to elevated required contribution increases over the next few years.

The long-term rating further reflects our view of the county's:

- Very strong economy, with access to a broad and diverse metropolitan statistical area (MSA);
- Adequate management, with standard financial policies and practices under our Financial Management Assessment (FMA) methodology;
- Adequate budgetary performance, with an operating surplus in the current fund in fiscal 2018, but event-risk from COVID-19 and the developing recession;
- Strong budgetary flexibility, with an available fund balance in fiscal 2018 of 11.1% of operating expenditures;
- Very strong liquidity, with total government available cash at 18.0% of current fund expenditures and 128.4% of governmental debt service, and access to external liquidity we consider strong;
- Very weak debt and contingent liability position, with debt service carrying charges at 14.0% of expenditures and net direct debt that is 179.8% of current fund revenue; rapid amortization, with 87.8% of debt scheduled to be retired in 10 years; and a large pension and other postemployment benefit (OPEB) obligation without an authorized

mechanism to keep costs from increasing as a share of the budget and potentially affecting performance over the long term; and

- Strong institutional framework score.

Environmental, social, and governance factors

Our rating incorporates our view regarding the indirect risks posed by the COVID-19 pandemic. Absent the implications of COVID-19, we consider the county's social risks in line with those of the sector. We view the district's governance risks as being generally in line with those of peers, although pension funding discipline and assumption choices at the state level will likely lead to elevated and volatile costs for the county. We also view environmental risks as being in line with the sector standard.

Negative Outlook

The negative outlook reflects the one-in-three chance that the rating could be lowered if the county's economy (including unemployment metrics) or fund balance materially worsened over the next one-to-two fiscal years. The outlook further includes the potential for reduced miscellaneous revenue and state grants in the current and next fiscal year budgets, leaving the district susceptible to fiscal pressure. Conversely, we could revise the outlook to stable if the district maintained approximately balanced operations and unemployment below 10%. Although our outlook is generally for two years, we see significant downside risks as a result of the COVID-19 pandemic and resulting recession over the next six-to-12 months.

Credit Opinion

Very strong economy

We consider the county's economy very strong. Mercer County, with an estimated population of 371,183, is in the Trenton MSA, which we consider to be broad and diverse. It has a projected per capita effective buying income of 129% of the national level and per capita market value of $124,905. Overall, market value was stable over the past year at $46.4 billion in 2020.

Mercer County residents enjoy easy access to both the New York and Philadelphia MSAs due to an expansive transportation network, which includes the New Jersey Turnpike and Interstate 95. State and local government is the largest sector, followed by education and health services. The county unemployment rate was 3.2% in 2018, below corresponding state and national levels. During the Great Recession, its unemployment rate reached 8.4%. Management indicated that the current unemployment rate likely hovers around 9%, which it believes is lower than the state average. The State of New Jersey employs a significant number of county residents, and it has largely maintained its staffing levels to this point. This stability has likely kept the unemployment rate from climbing above 10%. However, the state's staffing decisions are largely out of the county's control, and we believe a sizable permanent loss of state tax revenue will require it to make structural budget adjustments absent very strong economic growth next year. (See "New Jersey; Appropriations; General Obligation; Miscellaneous Tax; Moral Obligation; Sales Tax," published April 29, 2020.)

The county is also home to five colleges, including Princeton University, Rider University, and the College of New Jersey. Multiple hospitals are among the top employers, including Capital Health Systems, RWJ University Hospital, University Medical Center and Princeton, and St. Francis Medical Center. While these institutions have historically buttressed the county's very strong economy, both education and health care sectors are vulnerable to the effects of social distancing and other decisions made to safeguard the community from COVID-19 spread, which supports our view of an economic contraction in 2020. Please see the article, titled "An Already Historic U.S. Downturn Now Looks Even Worse" (published April 16, 2020) and "U.S. Jobs Market Buckles Under The Coronavirus Pandemic" (published April 2, 2020). We believe national headline unemployment could reach 19% in May, which would be closer to the reported Depression-era peak of 25% than to the 10% high during the global financial crisis. As a result, we will monitor the longer-term effects of the current downturn on the labor market and the economy overall.

Adequate management

We view the county'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. Highlights include:

- The county's finances are supported by conservative budgeting estimates that use a three-year historical review to estimate revenues and expenditures. We note that, despite annual appropriation of surplus, Mercer County has had a recent history of better-than-budgeted results.
- Budget-to-actual reports are reviewed by the county's CFO biweekly and presented monthly to the county executive and a board of chosen freeholders if any irregularities are present. The budget may be amended as needed throughout the year in accordance with state statutes.
- While the county does not have any long-term financial planning, capital planning is done annually as part of the budgeting process for the current year plus an additional five years with identified projects, costs, and funding sources.
- Mercer County's cash management plan mirrors state guidelines for allowable investments, with interest earnings reviewed monthly.
- The county lacks formally adopted debt management policies, but follows state guidelines.
- Its informal reserve policy is to maintain a minimum surplus level of 5%-7% of current fund budget, to which it currently adheres and reserves have been well above those levels.

Adequate budgetary performance, reflecting event risk

Mercer County's budgetary performance is adequate, in our opinion, reflecting historically strong operations but a high likelihood of short-term revenue volatility from COVID-19 and the developing recession.

In fiscal 2018, the county generated an audited surplus of $11.5 million due primarily to better-than-expected and unanticipated revenues, including a multimillion-dollar settlement with the state. The county had operating surpluses of 3.4% of expenditures in the current fund in fiscal 2018. Unaudited results for fiscal 2019 suggest it produced a small positive operating surplus of 0.5% of expenditures. Strong miscellaneous revenue performance and liquidation of interfund receivables contributed to this result. Additionally, the county increased appropriation, open-space, and insurance reserves during the year. Approximately three-quarters of Mercer County's revenue comes from property taxes, which we view as likely to be more stable in the current environment. The county is guaranteed 100% collections by the participating municipalities. The state authorized municipalities to delay May 1 property tax collections. While we understand some municipalities have indicated they will delay payments to the county, we do not expect the latter will experience cash-flow issue problems or rely on cash-flow borrowing.

We expect nontax revenues will be significantly more volatile. The county collected miscellaneous (including anticipated and unanticipated) revenues totaling $65.8 million in 2018, or 19% of current fund revenue. Included in that figure were $7.5 million in airport income, $6.7 million in recreation facility fees, and $2.4 in foreclosure-related sheriff's fees. We believe all of these might be pressured for fiscal 2020 given travel restrictions, facility closures, and a foreclosure moratorium.

In response to the pandemic and recession, county freeholders reviewed and cut $2 million in expenditures from the introduced 2020 budget to keep the property tax levy approximately equal to the 2019 levy as taxpayer relief. Management expressed its commitment to refrain from relying on fund balance to balance the 2020 budget, and stated that the county's governing body echoed that sentiment. To that end, officials identified spending cuts for scenarios including $5 million and $10 million reductions in revenue. County freeholders approved the plan for the former scenario, which includes freezing vacancies, promotions, and new hire requests for the remainder of 2020. The latter includes additional expenditure reductions. In either case, lower overtime costs are likely to help bridge imbalances. Management's scenarios for maintaining budgetary balance for 2020 include receiving 75% FEMA reimbursement for pandemic-related expenditures and grants from the FAA to make airport profits whole under a CARES Act program. The CARES Act also authorizes New Jersey to request federal funding on behalf of Mercer County, and the county has asked the state to request and remit this funding. Even so, officials do not expect to receive CARES Act funding through the state given its own budgetary pressures. The county is currently not eligible to receive federal funding directly because its population is below 500,000; we understand New Jersey's senior U.S. Senator Robert Menendez is seeking to make changes in this provision of the federal law.

The introduced fiscal 2020 budget totals $351.8 million and includes $11.7 million in anticipated miscellaneous revenue and the use of $13.4 million of fund balance, which the county has historically replenished during the year with positive revenue variances and cost savings. We believe budgetary pressures could extend into fiscal 2021, particularly if economic activity does not rebound quickly. Pension costs, in particular, could increase if pension asset underperformance and possible reductions in state contributions require increased local government contributions to make up shortfalls. In addition to current exceptions in the state's tax levy increase cap, county officials expect that the state will revise the cap formula for fiscal year 2021 to allow additional flexibility. Management indicated that the county would have to make significant reductions in staff and services if this alteration does not materialize.

Strong budgetary flexibility

Mercer County's budgetary flexibility is strong, in our view, with an available fund balance in fiscal 2018 of 11.1% of operating expenditures, or $37.5 million.

The county's current fund reserves ranged from $16.3 million to $25.6 million in each year from fiscal years 2009 through 2016. However, in fiscal 2017, Mercer County had a strong operating result, increasing current fund reserves to $28.1 million, followed by the 2018 result, which raised reserves to $37.5 million. The unaudited results for 2019 suggest fund balance rose to $39.3 million, or 11.2% of expenditures.

Although officials do not intend to use fund balance to balance the budget, we believe there is an increased chance that the county may be forced to spend down reserves if the positive revenue variations that historically replenished appropriated fund balance do not materialize.

Very strong liquidity

In our opinion, Mercer County's liquidity is very strong, with total government available cash at 18.0% of current fund expenditures and 128.4% of governmental debt service in 2018. In our view, the county has strong access to external liquidity, if necessary.

Our analysis of the county's liquidity includes unrestricted investments of $15.8 million. We believe Mercer County's strong access to external liquidity is demonstrated by its frequent debt issuances, including GO bonds, BANs, and guarantee provided to various security types. Although the state allows for what we view as permissive investments, we believe the county does not currently have aggressive ones, with the majority in highly rated and liquid mutual funds and fixed-income securities. The county does not maintain any nonremote contingent liquidity risk, as it does not have any privately placed bank debt. It has consistently maintained very strong liquidity and we do not anticipate a material change to these ratios.

We note that the county did purchase short-term debt issued by its underlying municipalities to facilitate funding while municipal credit markets remained squeezed in March and April. We do not currently view these purchases as likely to pressure liquidity, although we will continue to monitor this practice. Although some municipalities have indicated they plan to delay property tax payments to the county, we do not believe the county's liquidity will be severely constrained or that it will have to rely on cash-flow borrowing.

Very weak debt and contingent liability profile

In our view, Mercer County's debt and contingent liability profile is very weak. Current fund debt service is 14.0% of current fund expenditures. The county's net direct debt, excluding debt issued on behalf of underlying local governments but guaranteed by the county, is 115.2% of current fund revenue. Including the guaranteed debt, net direct debt is 179.8% of current fund revenue. Approximately 88% of the direct debt is scheduled to be repaid within 10 years, which, is in our view, a positive credit factor. In our opinion, a credit weakness is Mercer County's large pension and OPEB obligation, without a plan and allowable mechanism to keep costs from increasing as a share of the budget and potentially affecting performance over the long term.

We calculate that the county has approximately $407 million in direct debt that it issued, and $164 million issued by MCIA and guaranteed by the county. We understand the county expects to issue between $40 million and $50 million in new-money debt over each of the next two years, although it will amortize an approximately offsetting amount. In addition, it is still considering moving forward with an airport terminal project, for which it would likely issue more debt. Management indicates it will likely establish an airport utility fund and that the fund and debt service should be self-supporting. We understand the county does not have an estimate for how much debt it will issue for the airport project. Officials indicate management could revise these plans if airport usage remains low over the next one-to-two years.

Pension and other postemployment benefits

- We view pension and OPEB liabilities as a source of credit pressure for Mercer County, as with most New Jersey local governments.
- While it is currently managing pension costs, we believe the county has limited ability to control future growth of these liabilities.
- OPEBs are, by state statute, funded on a pay-as-you-go basis, which, given claims volatility as well as medical cost and demographic trends, is likely to lead to escalating costs.

Mercer County participates in the following state-administered pension plans:

- Police and Firemen's Retirement System: 60.20% funded with a crossover date in 2076, with a proportional share of the net pension liability equal to $111.1 million
- Public Employees' Retirement System: 42.04% funded with a crossover date in 2057, with a proportional share of the net pension liability equal to $166.3 million

Although the county is handling pension and OPEB costs, combined contribution costs for pension and OPEBs represent 8.5% of expenditures in fiscal 2018, with 4.8% to pension obligations and 3.7% to OPEB payments. Total fixed costs increase to 22.5% when including debt service payments. Although the county funds 100% of its actuarially determined contributions (ADCs), contributions fell short of both static and minimum funding progress, in part because of poor assumptions and methodologies, but also due to the state's continued underfunding of its portion of the ADC. The plans' 30-year, level-dollar open amortization schedule will result in slow funding progress. For more details and information on these risks, see our report, "New Jersey Pension Funding: State Actions Reverberate At The Local Level" (published Dec. 12, 2018). We also believe there is a significant possibility the state will reduce annual pension contributions or delay scheduled contribution increases because of the current recession, which could result in higher required contributions for Mercer County.

OPEB liabilities are funded on a pay-as-you-go basis, which, given claims volatility as well as medical cost and demographic trends, could lead to escalating costs in the short term. The actuarially determined OPEB liability totals $295.5 million. New Jersey does not allow counties to establish dedicated OPEB trusts. If pension or OPEB costs escalate, we believe these expenditures could crowd out others associated with operations and could create budgetary pressure over the long term.

Strong institutional framework

The institutional framework score for New Jersey counties is strong.

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

Ratings Detail (As Of May 18, 2020)

Ratings Detail (As Of May 18, 2020) (cont.)		
Mercer Cnty BANs		
Short Term Rating	SP-1+	Affirmed
Mercer Cnty GO bnds ser 2020 due 02/15/2032		
Long Term Rating	AA+/Negative	Outlook Revised
Mercer Cnty Imp Auth, New Jersey		
Mercer Cnty, New Jersey		
Mercer Cnty Imp Auth cnty secured rev rfdg bnds (mercer cnty projs) (Mercer Cnty)		
Long Term Rating	AA+/Negative	Outlook Revised
Mercer Cnty Imp Auth GO		
Long Term Rating	AA+/Negative	Outlook Revised
Mercer Cnty Imp Auth (Mercer Cnty Cmnty Coll Proj)		
Long Term Rating	AA+/Negative	Outlook Revised
Mercer Cnty Imp Auth (Mercer Cnty) cnty secd open space rev rfdg bnds		
Long Term Rating	AA+/Negative	Outlook Revised
Mercer Cnty Imp Auth (Mercer Cnty) cnty secd rev rfdg bnds (Mercer Cnty Spl Svc Sch Dist Proj)		
Long Term Rating	AA+/Negative	Outlook Revised
Mercer Cnty Imp Auth (Mercer Cnty) lse rev bnds (County Of Mercer Courthouse Annex Project)		
Long Term Rating	AA+/Negative	Outlook Revised
Mercer Cnty Imp Auth (Mercer Cnty) GO		
Long Term Rating	AA+/Negative	Outlook Revised
Mercer Cnty Imp Auth (Mercer Cnty) GO lse rev rfdg bnds (County Equipment And Imp Proj)		
Long Term Rating	AA+/Negative	Outlook Revised
Mercer Cnty Imp Auth (Mercer Cnty) GO (FGIC)		
Unenhanced Rating	AA+(SPUR)/Negative	Outlook Revised

Many issues are enhanced by bond insurance.

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.