One California Street, 31st Floor
San Francisco, CA 94111-5432
tel 415 371-5000
reference no.: 40436578

March 16, 2018

City of Arlington
238 N. Olympic
Arlington, WA 98223
Attention: Mr. James Chase, Finance Director

Re: ***Arlington, Washington, Limitd Tax General Obligation Bonds***

Dear Mr. Chase:

S&P Global Ratings has reviewed the rating on the above-listed obligations. Based on our review, we have raised the underlying rating (SPUR) from "A+" to "AA-" while affirming the stable outlook. A copy of the rationale supporting the rating and outlook is enclosed.

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Please send hard copies to:

S&P Global Ratings
Public Finance Department
55 Water Street
New York, NY 10041-0003

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S&P Global Ratings
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S&P Global Ratings

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Summary:

Arlington, Washington; General Obligation

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Table Of Contents

Summary:

Arlington, Washington; General Obligation

Credit Profile		
Arlington GO (AGM)		
Unenhanced Rating	AA-(SPUR)/Stable	Upgraded

Many issues are enhanced by bond insurance.

Rationale

S&P Global Ratings raised its long-term rating to 'AA-' from 'A+' on Arlington, Wash.'s series 2014 limited-tax general obligation (LTGO) bonds based on the application of its Issue Credit Ratings Linked To U.S. Public Finance Obligors' Creditworthiness criteria, published Jan. 22, 2018, on RatingsDirect. The outlook is stable.

The rating action reflects our view of the city's improving local economy that includes access to a growing metropolitan statistical area that we consider broad and diverse. In addition, the rating action reflects the city's recent increase and maintenance of cash-basis available fund balances to a level above 15% of general fund operating expenditures, as well as its recently amended fund balance reserve policy to support maintenance of the current fund balance level.

Limited general obligation security

The city's full faith, credit, and resources, including the obligation to levy taxes on property within statutory limitations, secure the limited-tax GO bonds. These limits include a state restriction on property tax revenue growth to 1% per year (excluding new construction) and a maximum levy rate that is affected by the city's relatively recent annexation into the Sno-Isle Intercounty Rural Library District. We rate the LTGO debt at the same level of the city's general creditworthiness as would be reflected in the rating of an unlimited-tax GO bond.

The 'AA-' LTGO ratings reflect our opinion of the district's:

- Strong economy, with access to a broad and diverse metropolitan statistical area (MSA);
- Strong management, with "good" financial policies and practices under our financial management assessment (FMA) methodology;
- Adequate budgetary performance, with an operating deficit in the general fund but an operating surplus at the total governmental fund level in fiscal 2016;
- Strong budgetary flexibility, with an available cash reserve in fiscal 2016 of 24% of operating expenditures;
- Very strong liquidity, with total government available cash at 99.1% of total governmental fund expenditures and 12.6x governmental debt service, and access to external liquidity we consider strong;
- Adequate debt and contingent liability position, with debt service carrying charges at 7.9% of expenditures and net direct debt that is 70.2% of total governmental fund revenue, as well as rapid amortization, with 68.6% of debt scheduled to be retired in 10 years, but overall net debt that we consider high because sufficiently current

overlapping debt figures are not available; and

- Adequate institutional framework score.

Strong economy

We consider Arlington's economy strong. The city, with an estimated population of about 20,000, is located in northern Snohomish County in the Seattle-Tacoma-Bellevue, Wash., MSA, which we consider broad and diverse due to its vicinity to the Seattle-Everett economic region. Our recent economic data shows that the city has a projected per capita effective buying income (EBI) of 91.5% of the national level and a per capita market value of $107,000. We note that our prior rating report in 2014 showed a projected per capita EBI of 100%, however we observed similar per capita EBI fluctuations in similar entities located north of Seattle.

The city is located about 45 miles north of Seattle and, as a result, the city's tax base trends mirror that of Seattle-Everett peers as the fiscal 2018 assessed value (AV) posted a very strong 10.2% annual growth to $2.5 billion--a level that is notably above the pre-recession high of $2.3 billion in fiscal 2009. The city lost a significant amount of AV between 2009 and 2014, as it shed 33% or $578 million. Despite the declines, the recent performance since 2014 has been extremely strong, as the tax base posted annual growth rates of between 5.1% and 10.3% and ultimately grew by $770 million or 45% to the fiscal 2018 level.

Looking ahead, we anticipate that the city's AV growth will continue at or near the historical trend. Overall, we are forecasting stable-to-positive growth for the western U.S. Pacific states as continued home price appreciation, strength within the region's housing starts, and vibrant regional economies have helped boost local government tax receipts throughout much of the region, including the city's AV results. As a result, we expect the broader macroeconomic forces to support our view and expectation of a stable to positive AV result within the near future. For additional information, please refer to our U.S. State And Local Government Credit Conditions Forecast (published Nov. 1, 2017, on RatingsDirect).

Strong management

We revised our view of the city's management to 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. Key management practices and policies include realistic and well-grounded revenue and expenditure assumptions and frequent council review of budget-to-actual performance. The city maintains a roughly 16% fund balance reserve policy through an 8% mandated reserve and a one-month operating reserve (about 8%), which it has met based upon the most recent audit. The city maintains a master facilities plan that meets our FMA criteria due to the length and frequency of updates. In addition, the city adopted an investment management policy that include frequent transparency to city council. The city recently revised its debt management policy to a level of detail that meets our FMA criteria. Finally, the city maintains a 10-year capital plan that meets our FMA criteria for both length and frequency of updates.

Adequate budgetary performance

As the city follows a calendar year fiscal, our base year follows the most recent audit from Dec. 31, 2016 where the state produced a cash-basis financial report. For that year, the city produced an adjusted cash-basis operating deficit of 4.6% of expenditures in the general fund and a surplus of 4.2% across all governmental funds. We note that our adjustments include below the line sources and uses of cash. Looking ahead, we anticipate the city will maintain at least adequate performance within the general fund and total governmental funds, as the recently released budget shows continued stability.

Strong budgetary flexibility

Arlington's budgetary flexibility is strong, in our view, with an available cash reserve in fiscal 2016 of 24% of operating expenditures, or $3.5 million. Negatively affecting budgetary flexibility, in our view, is the city's use of cash accounting, which reduces clarity about the amount of funds that are truly available in both audit and budget reporting.

We note that that the city historically posted a very low nominal cash-basis available fund balance of $77 or 0% of general fund operating expenditures in fiscal 2011. Since then, the city made replaced management and began a rigorous plan to rebuild reserves as using significant spending cuts, personnel reductions, and an across-the-board 5% historical pay cut.

During this time, the city demonstrated its ability and willingness to raise taxes: Voters approved a permanent property tax increase of 58 cents per $1,000 of AV. Voters also approved implementing a transportation benefit district in August 2013, whose taxes were expected to create an aggregate $6 million of new revenue, although that revenue is restricted to transportation expenses. At this point, we believe that the city has posted a strong track record of recovery intermixed with growth in the city's fund balance and we no longer believe that the city has limited its ability to cut spending.

Very strong liquidity

In our opinion, Arlington's liquidity is very strong, with total government available cash at 99% of total governmental fund expenditures and 12.6x governmental debt service in 2016. We expect the current liquidity levels will not likely fall below the threshold levels in the coming years. In our view, the city has strong access to external liquidity if necessary due to its track record in the past 20 years of issuing LTGO bonds. Finally, the city's excess cash and investments are held in high-grade securities, as regulated by the city's investment policy, and we do not consider its investment exposure aggressive.

Adequate debt and contingent liability profile

In our view, Arlington's debt and contingent liability profile is adequate. Total governmental fund debt service is 7.9% of total governmental fund expenditures, and net direct debt is 70.2% of total governmental fund revenue. Approximately 68.6% of the direct debt is scheduled to be repaid within 10 years (based upon the base year of fiscal 2016), which is in our view a positive credit factor. Negatively affecting our view of the city's debt profile is its overall net debt burden we consider high because sufficiently current overlapping debt figures are not available.

The city participates in cost-sharing multiple employee defined benefit and defined contribution pension plans administered by the Washington State Department of Retirement Systems (DRS). Specifically, the city participates in PERS I and PERS II/III which are regulated by the Washington State Legislature. In addition, the city participates in LEOFF I, LEOFF II, and the VFFRPF plans for public safety officials. Altogether the city's pension payments into the system were 100% of the state requirement, which equated to about 4.9% of its governmental expenditures for fiscal 2016, which we consider average. We note that the LEOFF I plan is fully funded and the city hasn't made a contribution to the plan since fiscal 2000.

Finally, the city offers other postemployment benefits (OPEB) through LEOFF I, although the benefit payments are typically less than $50,000 per year. As a result, the combined pension and OPEB contribution is 4.9% of total governmental funds expenditures.

Adequate institutional framework

The institutional framework score for Washington municipalities is adequate.

Outlook

The stable outlook reflects our opinion that the city will maintain cash-basis available reserves above 15% of general fund operating reserves, or a level that we consider strong. In addition, the stable outlook also reflects our view that the city's economy will remain at least stable. As a result, we do not expect to change the rating within our two-year outlook horizon.

Downside scenario

We could lower the rating if the city's cash-basis available reserves were to fall below $500,000, if the city's economy were to deteriorate, or if the city were to enter into a structural imbalance with no plan to correct.

Upside scenario

We could raise the rating if the city's economy were to improve. We could also raise the rating if the city were to produce GAAP-basis financial reports that add transparency and comparability to national peers.

Related Research

- U.S. State And Local Government Credit Conditions Forecast, Nov. 1, 2017
- S&P Public Finance Local GO Criteria: How We Adjust Data For Analytic Consistency, Sept. 12, 2013
- 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 the S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.