

## CREDIT OPINION

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 Rate this Research

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# Mesquite (City of) TX Muni Drage. Util. Syst.

Update to credit analysis following assignment of initial Aa2 drainage revenue rating

## Summary

City of Mesquite, TX, drainage utility system's (Aa2) credit profile is bolstered by strong financial performance as evidenced by healthy reserves and consistently high debt service coverage. The credit will continue to benefit from a moderately sized and expanding service area as well as a modest debt profile. The credit is limited by a modestly sized scale of operations.

## Credit strengths

- » Healthy reserves
- » Consistently strong coverage levels
- » Modest debt profile
- » Moderately sized and expanding service area

## Credit challenges

- » Modestly sized scale of operations
- » Somewhat weak legal provisions

## Rating outlook

Moody's generally does not assign outlooks to local governments with this amount of debt outstanding.

## Factors that could lead to an upgrade

- » Significant expansion of system size
- » Substantial increases in coverage and liquidity

## Factors that could lead to a downgrade

- » Weakened financial metrics including declining debt service ratios and erosion of cash
- » Significant leveraging without corresponding revenue growth

## Key indicators

Exhibit 1

Mesquite Municipal Drainage System, TX					
System Characteristics					
Asset Condition (Net Fixed Assets / Annual Depreciation)	35 years				
System Size - O&M (in \$000s)	\$884				
Service Area Wealth: MFI % of US median	84.%				
Legal Provisions					
Rate Covenant (x)	1.25				
Debt Service Reserve Requirement	DSRF funded at less than 3-prong test OR springing DSRF (A)				
Management					
Rate Management	A				
Regulatory Compliance and Capital Planning	Aa				
Financial Strength					
	2014	2015	2016	2017	2018
Operating Revenue (\$000)	\$2,807	\$3,381	\$3,818	\$4,014	\$4,063
System Size - O&M (\$000)	\$688	\$697	\$825	\$698	\$884
Net Revenues (\$000)	\$2,119	\$2,684	\$2,993	\$3,316	\$3,179
Net Funded Debt (\$000)	\$2,250	\$1,854	\$1,483	\$1,084	\$693
Annual Debt Service (\$000)	\$527	\$497	\$500	\$493	\$497
Annual Debt Service Coverage (x)	4.0x	5.4x	6.0x	6.7x	6.4x
Cash on Hand	1303 days	1880 days	2329 days	2869 days	1410 days
Debt to Operating Revenues (x)	0.8x	0.5x	0.4x	0.3x	0.2x

Source: City of Mesquite, TX's Comprehensive Annual Financial Reports, Moody's Investors Service

## Profile

The system supports a large service area in the [City of Mesquite](#) (Aa2), just east of the [City of Dallas](#) (A1 stable). The local economy is anchored by retail, distribution and manufacturing and benefits from its favorable location near Dallas. The city's population is approximately 144,000 as of 2017.

## Detailed credit considerations

### Service area and system characteristics: modestly sized system serves large and growing service area and stable customer base

Mesquite's drainage system will continue to serve a large service area though with modest operational size, and benefit from a stable customer base which is poised to grow in the near term given ongoing economic activity and strong residential development trends. The local economy is anchored by retail, distribution and manufacturing and benefits from its favorable location near Dallas.

Mesquite established its municipal drainage utility fund in 1992 to finance stormwater improvement projects throughout the city and comply with the Environmental Protection Agency mandated storm water quality requirements. Residential and commercial customers are billed monthly through the city's utility billing system. After two months of nonpayment of the utility bill, customers are subject to termination of all utility services.

Population growth within the city has been stable with the most recent census reporting an increase of 12.3% to 139,824 residents in 2010, and more recent data showing an increase of 3.1% since then to 144,118 residents. Despite population increase, resident income indices within the city, though improving, have fallen relative to national levels, reaching an estimated 84% (median family income),

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and 70.8% (per capita income) in 2017, both expressed as a percentage of national levels. Favorably, the median home value is 61.5% of the US, suggesting the city is relatively affordable. Utility customer accounts have been stable and totaled around 40,000 for fiscal 2018.

The drainage system's infrastructure is moderately sized with net fixed assets of \$35.7 million and is in relatively good condition with a strong remaining useful life of 35 years. Operational scope is modest though, with operation and maintenance expenditures totaling less than \$900,000 in fiscal 2018. The modest operational size reflects the more simple nature of the drainage system compared to other utility services.

#### **Debt service coverage and liquidity: coverage and cash are very strong despite infrequent rate increases**

The system's financial metrics should remain strong, benefiting from a stable revenue source, strong management team and prudent practices in spite of infrequent rate increases. The pledge supporting the bonds is gross revenues which have provided very strong coverage, of over five times over the past five years. From a net revenue perspective which is the measure for the rate covenant, the system's annual debt service coverage has also been strong, exceeding 4 times annually over the past five years.

In fiscal 2018, debt service coverage based on net revenues was 6.4 times, slightly down from the 6.7 times reported in the previous year. In fiscal 2019, city officials anticipate continued strong coverage as the results are modestly outperforming budgeted expectations through January. The maximum annual debt service (MADS) of \$1 million, including the April sale is scheduled for fiscal 2020 and fiscal 2018 net revenues will provide weaker but still ample coverage of 3.3 times. The city anticipates using revenues from a tax increment revenue zone (TIRZ) to support about half of debt service. Net of the TIRZ supported amounts, fiscal 2018 net revenues will provide continued strong MADS coverage of 6.6 times.

The drainage system collects revenues from a fixed monthly rate for all single family residential properties, and the fee for commercial properties is based on square footage of impervious area. After leaving rates steady for many years, the city increased the drainage fees for three years in a row through fiscal 2016. There are no plans to increase the fees further at this point.

#### **LIQUIDITY**

The system's liquidity position is very strong. At the end of fiscal 2018, the drainage system cash position was \$3.4 million or a very strong 1,410 days cash on hand. The city plans to use some cash to fund some improvements to the drainage system but will likely continue to maintain healthy liquidity given annual revenues provide excess and ample cash beyond what is utilized for operations.

#### **Debt and legal covenants: modest debt profile supported by adequate legal covenants**

The system's debt profile will likely remain modest given minimal anticipated debt needs. With the April 2019 issuances, debt totals \$9 million and debt to operating revenues is a manageable 2.27 times. Excluding the amounts expected to be supported by TIRZ revenues, debt to operating revenues is modest at 0.5 times. The system expects modest additional debt issuance over the next few years, with \$1.3 million annually slated for the next two years.

The bonds are secured by gross revenues of the system. Legal provisions are somewhat weak, especially as excess revenues can flow to any lawful purpose of the city. The rate covenant requires rates to be imposed that will sustain net revenues at a 1.25 times average annual debt service coverage, an additional bonds test of 1.25 times average annual debt service coverage, and maintenance of a debt service reserve equal to average annual debt service.

#### **DEBT STRUCTURE**

All of the system's debt is in fixed rate. The debt service schedule is descending with the final maturity expected in 2039.

#### **DEBT-RELATED DERIVATIVES**

The city is not party to any interest rate swaps or other derivative agreements.

#### **PENSIONS AND OPEB**

All system employees are employees of the City of Mesquite. The city is a participant in the Texas Municipal Retirement System, a multi-employer agent pension plan. Please see our report dated April 10, 2019, for more details on the city's pension plan.

**Management and governance: formal policies and regular monitoring support strong financial management**

The City of Mesquite has a Council/Manager form of government with a mayor and six council members. The city demonstrates good governance by annual capital planning for the system which is incorporated into the 5-10 year capital improvement plan. Additionally, the system's formal policy include a working capital goal of 25% of annual expenditures and 25% of debt service. Additionally, the days cash on hand minimum requirement is 60 days with a goal of 120 days. The five year projections indicate the city will maintain working capital levels between 95-130 days. While rates have historically been increased infrequently, the city actively monitors rates and coverage levels and will likely increase rates if needed.

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