

Summary:

Mesquite, Texas; Water/Sewer

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Credit Profile

US\$7.835 mil mun drainage util sys rev bnds ser 2019 dtd 05/01/2019 due 03/01/2039

Long Term Rating AAA/Stable New

Mesquite drainage

Long Term Rating AAA/Stable Upgraded

Rationale

S&P Global Ratings raised its rating on the city of Mesquite, Texas' drainage system debt outstanding to 'AAA' from 'AA+'. At the same time, S&P Global Ratings assigned its 'AAA' long-term rating to Mesquite's municipal drainage utility system revenue bonds series 2019. The outlook is stable.

The upgrade reflects our view that the drainage utility's extremely strong financial profile will be sustainable even with the periodic use of additional debt. The system has only about \$1.1 million in debt outstanding not including the 2019 bonds.

The rating reflects our opinion of a very strong enterprise risk profile and extremely strong financial risk profile.

The enterprise risk profile reflects our view of the system's:

- Stable, primarily residential, customer base that benefits from its participation in the strong, broad and diverse Dallas metropolitan statistical area (MSA);
- Very low fee; and,
- Good operational management practices that, when combined with the nature of drainage systems, means in our view very low operating risk to the city.

The financial risk profile reflects our view of the system's:

- Extremely strong financial capacity, which we think will continue given the high equity in the system and only additional debt;
- Robust system liquidity relative to the size of the annual budget, providing the city further flexibility in strategically deploying cash towards its capital plan; and
- Strong financial management practices and policies.

Bond proceeds will finance capital projects.

A first lien pledge on the net revenues of the city-owned and operated drainage (stormwater) system secures the bonds. A reserve fund covering average annual debt service provides additional liquidity. We understand that

management intends to use bond proceeds to fund general system-wide improvements and rehabilitation of drainage infrastructure in a tax increment reinvestment zone (TIRZ), which management estimates could eventually support a portion of the series 2019 bonds. For the purposes of our calculations, we assume no benefit to or offset of the debt service, but do not disagree that the project could generate enough cash flow to support at least some of the annual debt service payments. In addition, credit-neutral bond provisions include a rate covenant and additional bonds test both based on 1.25x average annual debt service.

The system has a predominantly local revenue base. Local service charges, through an autonomous rate-setting process, represent virtually all of the drainage utility's revenues. This, coupled with operating expense flexibility, limits exposure to federal revenues and allows us to rate the system above the rating on U.S.

Neither the drainage system nor the city's general fund are party to or affected by the ongoing rate dispute between the wholesale treated water provider--the North Texas Municipal Water District--and its member cities, including Mesquite.

Enterprise risk

Mesquite is a mature Dallas suburb of an estimated 143,350 residents almost entirely in Dallas County. Industrial employment bases anchor the city economy, even if over 90% of the drainage system customers are residential. The drainage system charge of \$3 per month per single-family equivalent are collected as part of billing of the nearly 41,000 retail water and sewer customers. While it remains largely built-out, the service territory's economy has improved in recent years, with new residential developments across the price spectrum. The city's flagship rodeo arena and the surrounding outparcels, as well as a long-tenured regional shopping mall, are both undergoing upgrades to remain marketable to both residents and visitors. While simply illustrative of the growth but not a drainage system rating factor, Mesquite's tax base grew by 10% in 2019 and is projected to grow another 4% to 5% in 2020. The city's median household effective buying income (MHHEBI) is in line with the nation's, as is its unemployment rate.

Based on our operational management assessment (OMA), we view Mesquite to be a '2' on a scale of 1-6, with '1' being the strongest. This indicates, in our view, that operational and organizational goals are generally well aligned, even if some challenges exist. The OMA of good reflects the inherently extremely low risk of stormwater systems--the city does not even have to maintain a municipal separate storm sewer system (MS4) permit--which keeps leverage and the fee relatively low. The system also benefits from the same strong management team that runs the city's waterworks and sanitary sewer system, which helps ensure succession planning and organizational continuity during a time when the largely built-out, mature city is experiencing steady new growth.

Consistent with our "Methodology: Industry Risk," published Nov. 19, 2013, we consider industry risk for the system to be very low, the most favorable assessment possible on a scale from '1' to '6', '1' being the strongest.

Financial risk

Our assessment of the financial risk profile reflects the system's overall extremely strong history of performance. Given the inherently low-risk nature of municipal drainage systems, only modest planned debt of \$2.6 million identified through 2021, and the room available to management should it consider adjusting the drainage fee, we believe the drainage system's financial capacity is likely to continue to be just as robust.

All-in debt service coverage (DSC) for the drainage system has been generally 6x or better historically, as the system had previously had very little debt. Even with the 2019 bonds, we estimate that DSC should be 2x-3x before any offset or partial self-support from the TIRZ. Once the previous drainage utility revenue bonds are paid off by 2022, the annual principal and interest requirements on the 2019 bonds--before any TIRZ offsets--will only be about \$200,000 more than Mesquite's current requirements. The drainage utility fund also has \$3.4 million in available reserves, equivalent to 3.7 years' annual operating expenses. We understand that the city will make strategic use of reserves to help offset the need for larger, if any, borrowing for projects.

The utility has outlined only \$2.6 million in capital projects through 2021 beyond what it is funding with the 2019 bonds. The city has indicated those projects will likely be primarily debt-funded. Mesquite provides pension benefits for all full-time employees through the statewide Texas Municipal Retirement System (TMRS), an agent multiple-employer, public-employee retirement system. Under state law governing TMRS, an actuary determines the contribution rate annually, and the city contributes to the TMRS plan at the actuarially determined rate. Mesquite made its annual contribution of \$9.7 million and had a net citywide pension liability of \$103.9 million as of Sept. 30, 2018. The reported overall funding ratio for the plan was 81%, calculated as plan fiduciary net position over total pension liability. We do not anticipate short-term, fixed-cost pressure resulting from the city's TMRS obligations. However, the amortization period is long, in our view, and the level percentage of payroll amortization method (assuming 3% annual payroll growth) creates negative amortization, because the net pension liability is to grow each year until contributions become large enough to reduce the unfunded liability. Therefore, we acknowledge the potential for the city's pension-related costs to increase, although we anticipate that any near-term increases should be manageable given Mesquite's very strong financial profile.

Based on our financial management assessment (FMA), we view Mesquite to be a '1' on a scale from '1' to '6', '1' being the strongest. An FMA of strong indicates that practices are strong, well embedded, and likely sustainable. The city maintains most of the best practices we believe are critical to supporting credit quality and these are well-embedded in the government's daily operations and practices. Formal policies support many of these activities, adding to the likelihood that these practices will continue and transcend changes in the operating environment or personnel. Practices include regularly updated long-term financial and capital plans, monthly budget-to-actual reports available on the city's website, and robust policies on debt management and permitted investments.

Outlook

The stable outlook is reflects S&P Global Ratings' expectation that the drainage fund's exceptionally strong financial profile will be sustainable over our two-year outlook horizon and likely beyond. Mesquite's mature development status, modest debt plans, and low operating risk all likely preclude any stress on the rating, in our opinion.

Downside risk would follow should the drainage fund's exceptionally strong financial risk profile weaken, in particular its DSC and available reserves. While unlikely, examples of factors that could pressure those two rating factors might include an unexpected need for large amounts of borrowing in a compressed timeframe--such as from an environmental infraction or natural disaster--or over-reliance on the system's surplus net revenues or available reserves to the detriment of cash flow or cash reserves.

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