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Mesquite (City of) TX

Update to credit analysis

Summary

The City of Mesquite, TX's (Aa2) credit profile is supported by a large, diverse tax base in proximity to employment centers throughout the Dallas-Fort Worth Metroplex. The city also benefits from strong financial management, conservative budgeting, and formal policies which drive a stable, though below median, financial reserve position. The profile is constrained by elevated fixed costs from an above average debt burden and increasing pension contributions as the city addresses the perennial underfunding of its pension plan.

We regard the coronavirus outbreak as a social risk under our ESG framework, given the substantial implications for public health and safety. We do not see any material immediate credit risks for the City of Mesquite as the city has a strong, diverse economy and sufficient liquidity to address near term obligations. However, the situation surrounding Coronavirus is rapidly evolving and the longer term impact will depend on both the severity and duration of the crisis. If our view of the credit quality of the City of Mesquite changes, we will update our opinion at that time.

Credit strengths

» Strategic location within the Dallas-Fort Worth metropolitan area

» Large tax base with ongoing development supporting strong growth in revenues

» Stable, policy-driven financial position coupled with strong financial management practices including multi-year planning

» Actively addressing internal service fund and pension system funding levels through increased contributions

Credit challenges

» Reserve levels, particularly liquidity, are weaker than the national Aa2 median

» Moderately elevated debt and pension liabilities

» Elevated fixed costs and tread water gap

Rating outlook

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

Factors that could lead to an upgrade

- Considerable growth in the tax base
- Strong operating performance enhancing reserve levels
- Moderation of debt and pension obligations

Factors that could lead to a downgrade

- Contraction in the tax base
- Reduction in financial reserves or inability to continue growing liquidity levels
- Inability to improve pension contributions relative to tread water levels

Key indicators

Exhibit 1

Mesquite (City of) TX	2015	2016	2017	2018	2019
Economy/Tax Base					
Total Full Value ($000)	$5,735,842	$5,962,561	$6,527,470	$7,095,832	$8,054,175
Population	143,584	143,771	144,118	143,350	145,030
Full Value Per Capita	$39,948	$41,473	$45,293	$49,500	$55,535
Median Family Income (% of US Median)	84.2%	84.4%	84.0%	84.0%	85.4%
Finances					
Operating Revenue ($000)	$103,809	$107,057	$114,001	$116,498	$125,070
Fund Balance ($000)	$16,409	$17,179	$19,016	$19,040	$20,773
Cash Balance ($000)	$9,713	$8,131	$8,122	$10,245	$12,022
Fund Balance as a % of Revenues	15.8%	16.0%	16.7%	16.3%	16.6%
Cash Balance as a % of Revenues	9.4%	7.6%	7.1%	8.8%	9.6%
Debt/Pensions					
Net Direct Debt ($000)	$131,139	$155,451	$152,023	$192,385	$212,960
3-Year Average of Moody's ANPL ($000)	$201,047	$237,355	$295,774	$313,256	$339,351
Net Direct Debt / Full Value (%)	2.3%	2.6%	2.3%	2.7%	2.6%
Net Direct Debt / Operating Revenues (x)	1.3x	1.5x	1.3x	1.7x	1.7x
Moody's - adjusted Net Pension Liability (3-yr average) to Full Value (%)	3.5%	4.0%	4.5%	4.4%	4.2%
Moody's - adjusted Net Pension Liability (3-yr average) to Revenues (x)	1.9x	2.2x	2.6x	2.7x	2.7x

Source: City of Mesquite, TX audited financial statements

Profile

The City of Mesquite is in Dallas County (Aaa stable), just east of the City of Dallas' (A1 stable) city limits on Interstate 20. The local economy is anchored by retail, distribution and manufacturing. The estimated population is 145,000.

Detailed credit considerations

Economy and tax base: strong, diverse tax base adjacent to Dallas

The city will continue to benefit from its strategic location within the DFW metroplex that provides for ample employment opportunities within, and adjacent to, the city, along with affordable housing options. The large size relative to the median for the rating category and the expected continuation of strong growth are key credit strengths. The local economy is anchored by retail, distribution and manufacturing.

Assessed value (AV) growth has been strong with values growing annually at an average of 8.9% over the past five years, reaching $8.8 billion in fiscal 2020. The tax base is primarily single family residential accounting for 58.8% of AV, and commercial and industrial properties accounting for 29.7% of AV. City officials report multiple ongoing residential, commercial and industrial projects that are under development that will materially increase assessed values and create hundreds of new jobs. Officials have not seen the pace of development change due to the coronavirus, but as the epidemic's presence continues to be felt, development schedules could be affected.

Residential income indices will continue to trail the national average, but is offset by the favorable cost of living in the city. The median family income is at 85.4% of the nation, while the median home value is an affordable 63% of the nation. The unemployment rate as of December 2019, using Dallas County as a proxy, was at 3.2%, which is near the state and national rates of 3.3% and 3.4%, respectively, but could increase due to the coronavirus.

Financial operations and reserves: stable reserves driven by formal policies

The city's general fund balance, though lower than peers, will remain satisfactory, driven by formal fund balance policies. Over the past four years, the city has produced surplus financial operations modestly growing reserves. In fiscal 2019 (FYE 9/30), the city's general fund produced a $1.8 million general fund surplus, growing the available general fund balance to $20.8 million, or an adequate 17% of general fund revenue. Although below peers, the consistency of the reserve position reflects strong financial management and adherence to formal policies. Including the debt service fund, the total operating fund balance was in line with the general fund balance, as the city does not hold material financial reserves in the debt service fund. The majority of operating revenues during the year were received from property taxes (44.6%), sales taxes (27%) and charges for services (13%).

The city adopted a balanced budget for fiscal 2020 driven by projected 7.8% growth in property tax revenues that offsets projected 3.6% growth in total expenditures. Favorably, city sales tax revenues in the first half of the year have produced 6% growth over the previous year's first six months of receipts. Five year projections indicate an expectation to maintain reserves near 60 days working capital per the city's policy, though the city has expressed the goal of 90 days or 25%. The fiscal 2020 budget is balanced, although officials are currently attempting to forecast the financial implications of the coronavirus' effect on the local economy.

LIQUIDITY

General fund cash has grown in recent years, but continues to face challenges from the deficit in the Group Medical Insurance fund. General fund cash grew to $12 million at the close of fiscal 2019, or 9.8% of general fund revenue. The cash position has grown from a low of $7.5 million, or 6.7% of general fund revenue in fiscal 2017. Operating cash was in line with general fund cash. As debt service is paid in February and August, the fiscal year end is a cash low point for the debt service fund.

The Medical Insurance Fund will continue to be a liability for the general fund, as general fund receivables have increased to address the short fall. Due to large claims in fiscal years 2012-14, Medical Insurance Fund expenditures were materially larger than revenues, necessitating the transfer of funds from the general fund. The city has actively made adjustments to the health plans to help lower expenditures and rebuild reserves, including hiring an outside firm to assist in controlling and monitoring medical claims and adopting a policy in January 2019 that required adequate revenues to cover expenditures annually.

Debt, pensions and OPEBs: elevated long term liabilities and fixed costs

The city's long term liabilities and fixed costs will remain elevated but manageable given the ongoing growth in the tax base and conservative financial management. Including the May 2020 issuances, the city has a total of $222.1 million in outstanding debt. Using fiscal 2020 AV, the debt burden is manageable at 2.5%, but higher than comparable peers. A modest amount of the debt is supported by the city's Economic Development Corporation, which if excluded, would reduce the debt burden to 2.2%.

The city plans to continue its practice of issuing general obligation bonds and certificates of obligation on an annual basis. The city plans on issuing approximately $32 million in fiscal 2021 and $38 million in fiscal 2022.

DEBT STRUCTURE

The city's debt is all fixed rate and amortizes over the long term. Debt service peaks in 2021 at a maximum of $19.9 million, gradually descending through financial maturity in 2040. Principal payout is average with 67% of debt retired in the next 10 years.

DEBT-RELATED DERIVATIVES

The city is not party to any derivatives or swap agreements.

PENSIONS AND OPEB

Mesquite will likely face growing pension contribution from its participation in the Texas Municipal Retirement System (TMRS), a multi-employer agent hybrid defined benefit plan as the city continues to improving funding levels and contributions to bridge the tread water gap. While the ability for the city to increase pension contributions is aided by the strong property tax revenue growth and the flexibility the city retains to adjust plan benefits, an inability to continue improving the funding trajectory will likely weaken the credit profile.

Mesquite's adjusted net pension liability (ANPL), based on a 4.22% discount rate, was $360.1 million in fiscal 2019, net of water, sewer and drainage support. In comparison, the city reported a GASB net pension liability of $147.9 million, based on a 6.75% discount rate. The three year ANPL for Mesquite was $339.4 million net of water and sewer and drainage support, or an above median 2.8 times operating revenues and 3.9% of the fiscal 2020 full valuation.

For fiscal 2019, the city contributed approximately $12 million to the retirement system (net of contributions made by the water and sewer and drainage funds), a nearly 31.6% increase over the prior year. The increase was part of a step up plan to bridge the "tread water" gap. Despite the increase, this contribution continued to be below the Moody's calculated "tread water" level of $14.4 million. The "tread water" indicator measures the annual government contribution required to prevent the reported net pension liability from growing, under reported assumptions. Contributions above this level cover all net pension liability interest plus pay down some principal. The city can provide cost of living adjustments (COLAs) on an ad hoc basis, granting a 50% COLA in 2019.

The city offers other post employment benefits (OPEB) in the form of healthcare benefits. OPEB is currently funded on a pay as you go basis and no contributions were recorded in 2019. As of fiscal 2019, the city reported a total liability of approximately $37.4 million, all of which was unfunded.

Total fixed costs including pension contributions (net of water and sewer and drainage support), and debt service payments was $33.8 million or a slightly elevated 27.6% of total operating revenues in fiscal 2019. If the city had contributed at the full "tread water" level, fixed costs would be a more elevated 29.4% of revenues. The city's ability to increase pension contributions while maintaining a manageable fixed cost burden will be a key consideration moving forward.

ESG considerations

Environmental

Environmental considerations are not material to the credit profile. Being that the city is in north Texas, it has exposure to tornadoes and flooding. Tornados could cause material property damage, but the city is insured through the Texas Municipal Intergovernmental Risk Pool for damage related to hurricanes, hail storms and flooding and has adequate financial reserves to provide short term liquidity in the interim.

Social

The city has a growing population east of Dallas with resident income indices near the slightly below the national average and housing prices materially below average, making the city an affordable location for residents. Additionally the city's location in respect to the DFW metroplex makes it an advantageous location for employment.

Governance

The City of Mesquite has a Council/Manager form of government with a mayor and six council members. Per the charter amendments approved by voters, the council members will now be elected from single member districts while the mayor will be elected at large. All positions will be elected in November every 2 years and members are subject to term limits.

The city demonstrates good governance by multiyear capital and financial planning with capital plans going out 5 to 10 years depending on the need, and financial planning going out 10 years. The city recently reviewed all financial policies including a comparison to various benchmarks to ensure continued fiscal health. Among the policies include a minimum fund balance requirement of 16.67% of revenue that was adopted in fiscal 2019, as well as a debt service tax rate requirement of 40% of the city's total tax rate. The city also has policies regarding reserves, funding policies for internal service funds, debt management, long range planning, disaster finance policy and procedure.

Texas Cities have an Institutional Framework score of Aa, which is high. Institutional Framework scores measure a sector's legal ability to increase revenues and decrease expenditures. Property taxes, one of the sector's major revenue sources are subject to a cap, which cannot be overridden. However, the cap of $25 per $1,000 of assessed values, with no more than $15 allocated for debt, still allows for significant revenue-raising ability. Unpredictable revenue fluctuations tend to be minor, or under 5% annually. Across the sector, fixed and mandated costs are generally greater than 25% of expenditures. Texas is a Right to Work state, providing significant expenditure-cutting ability. Unpredictable expenditure fluctuations tend to be minor, under 5% annually.

Rating methodology and scorecard factors

The US Local Government General Obligation Debt methodology includes a scorecard, a tool providing a composite score of a local government's credit profile based on the weighted factors we consider most important, universal and measurable, as well as possible notching factors dependent on individual credit strengths and weaknesses. Its purpose is not to determine the final rating, but rather to provide a standard platform from which to analyze and compare local government credits.

Exhibit 2

Mesquite (City of) TX

Scorecard Factors and Subfactors	Measure	Score
Economy/Tax Base (30%) [1]		
Tax Base Size: Full Value (in 000s)	$8,773,033	Aa
Full Value Per Capita	$60,491	A
Median Family Income (% of US Median)	85.4%	A
Notching Factors:[2]		
Other Analyst Adjustment to Economy/Taxbase Factor: Strong tax base growth, affordability, beneficial location		Up
Finances (30%)		
Fund Balance as a % of Revenues	16.6%	Aa
5-Year Dollar Change in Fund Balance as % of Revenues	3.1%	A
Cash Balance as a % of Revenues	9.6%	A
5-Year Dollar Change in Cash Balance as % of Revenues	0.3%	A
Notching Factors:[2]		
Other Analyst Adjustment to Finances Factor: Stable reserves driven by formal policies; cash and fund balance to increase driven by policies		Up
Management (20%)		
Institutional Framework	Aa	Aa
Operating History: 5-Year Average of Operating Revenues / Operating Expenditures	1.0x	A
Debt and Pensions (20%)		
Net Direct Debt / Full Value (%)	2.5%	A
Net Direct Debt / Operating Revenues (x)	1.8x	A
3-Year Average of Moody's Adjusted Net Pension Liability / Full Value (%)	3.9%	A
3-Year Average of Moody's Adjusted Net Pension Liability / Operating Revenues (x)	2.7x	A
Notching Factors:[2]		
Standardized Adjustments [3]: Unusually strong or weak security features: Secured by statute		Up
Other		
Credit Event/Trend Not Yet Reflected in Existing Data Sets: Large tread water gap though city increasing funding, has flexibility to adjust benefits, and is amortizing actuarial liability within 11 years		Down
	Scorecard-Indicated Outcome	Aa2
	Assigned Rating	Aa2

[1] Economy measures are based on data from the most recent year available.
[2] Notching Factors are specifically defined in the US Local Government General Obligation Debt methodology.
[3] Standardized adjustments are outlined in the GO Methodology Scorecard Inputs publication.
Source: US Census Bureau, Moody's Investors Service

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