

RatingsDirect®

Summary:

Mesquite, Texas; Water/Sewer

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Summary:

Mesquite, Texas; Water/Sewer

Credit Profile

US\$18.58 mil wtrwks and swr sys rev rfdg bnds ser 2020 dtd 05/01/2020 due 03/01/2040

Long Term Rating AA/Stable New

Mesquite wtrwks (AGM)

Unenhanced Rating AA(SPUR)/Stable Affirmed

Rating Action

S&P Global Ratings assigned its 'AA' long-term rating to Mesquite, Texas' series 2020 waterworks and sewer system revenue bonds. At the same time, we have affirmed our 'AA' rating on the city's outstanding revenue debt. The rating reflects, in our opinion, the combination of very strong enterprise and financial risk profiles. The outlook is stable.

Credit overview

Net revenues of the water and sewer system secure the \$18.58 million series 2020 bonds. After the issuance, Mesquite will have approximately \$97.3 million in outstanding revenue debt. Officials intend to use series 2020 bond proceeds to provide funds for improvements, additions, and extensions to the system and pay for the cost of issuance. Mesquite indicates it has not entered into any direct-purchase bank debt. The stable outlook reflects our opinion that planned rate adjustments, if enacted, will allow Mesquite to maintain all-in debt service coverage (DSC) and liquidity at levels that are commensurate with historical trends despite some expected slowdowns as a result of economic contraction. We consider bond provisions credit neutral. In our opinion, the rating reflects very strong enterprise and financial risk profiles. Management has to date been successful in maintaining a multiyear capital plan, strong coverage levels, and an extremely strong liquidity position for the system.

The enterprise risk profile reflects our opinion of Mesquite's:

- Service area participation in the broad and diverse Dallas-Fort Worth-Arlington metropolitan statistical area (MSA) economy;
- Diverse customer base with good income indicators;
- Moderate rate affordability and county poverty rate; and
- Good operational management practices and policies under our Operational Management Assessment (OMA) methodology.

The financial risk profile reflects our opinion of Mesquite's:

- Strong and consistently stable all-in DSC at about 1.2x from fiscal years 2017-2019;
- Extremely strong unrestricted liquidity, which grew from 167 to 233 days' cash on hand during the past three audited fiscal years;

- Moderate debt position with a debt-to-capitalization ratio of under 43% when including the series 2020 revenue bonds; and
- Strong financial management practices and policies under our Financial Management Assessment (FMA) methodology.

Environmental, social, and governance factors

Overall, we believe that management has mitigated most of its environmental, social, and governance-related risk by adopting, adhering to, and adjusting operating and financial policies and procedures. The city has a sanitary sewer overflow initiative with the Texas Commission on Environmental Quality, essentially a proactive measure for preventive collection system maintenance. It has recently completed asset management plans for both the water and sanitary sewer systems, providing a risk-based replacement strategy for replacing water and sanitary sewer systems infrastructure. To preserve the water supply as much as possible during the drought and the period Lake Texoma was unavailable, management asked member cities to implement progressively stricter water conservation measures, eventually including limited outdoor watering, to reduce demand by at least 10%. Mesquite and other district cities complied. All of this was coming even as the North Texas Municipal Water District (NTMWD) began a series of double-digit rate increases for the Texoma project and its newest reservoir, the Lower Bois D'Arc Creek project north of the Dallas area in Fannin County.

Increasing costs, coming, especially at a time when conservation limited the cities' retail revenues, led four of the most built-out members--Plano, Richardson, Garland, and Mesquite--to ultimately ask the Texas Public Utility Commission (PUC) in late 2016 to review the district's rates. We understand that NTMWD has been directed by the PUC to complete a cost-of-service analysis. The PUC plans on meeting next year to resolve the issue. While we can predict neither the timing nor the outcome of the case, we don't believe this affects the city's or district's credit quality. While we believe the utilities' revenues may experience some declines for fiscal 2020, ultimately, our expectation is that management will continue to manage the system, whether in delaying self-funded capital projects or by developing operational efficiencies to maintain sound coverage levels. The utility also has over 233 days' cash on hand, which we believe provides a cushion against short-term disruptions. While we continue to monitor events related to COVID-19, we do not currently expect it to affect the utilities' ability to maintain budgetary balance and pay debt service costs. (For more information, see our article "COVID-19's Potential Effects In U.S. Public Finance Vary By Sector," published March 5, 2020 on RatingsDirect.)

Stable Two-Year Outlook

Downside scenario

The rating could come under pressure should there be a drop in system coverage levels below the historical all-in coverage performance of about 1.2x or deterioration in the unrestricted liquidity below historically stable levels as a result of a prolonged recession. There could also be pressure on the rating if there is deterioration in the overall economic fundamentals of the service area.

Upside scenario

A higher rating could be warranted if there's sustained growth in the city's all-in DSC, coupled with stability and growth in the liquidity position.

Credit Opinion

Bonds provisions are credit neutral and include:

- A debt service reserve, funded at average annual debt service;
- A rate covenant that stipulates maintaining rates at a minimum of 1.0 x annual debt service; and
- An additional bonds test that allows additional debt issuance but only if net revenue for the previous fiscal year, adjusted by approved rates or system improvements, is, at least, 1.25x maximum annual debt service (MADS).

Enterprise risk

Mesquite is a mature suburb and a primarily a residential community in Dallas County about 14 miles east of downtown Dallas. The system provides retail water and sewer service to almost 41,000 customers in Mesquite, with an estimated 143,350 residents. While it remains largely built-out, the city offers entertainment and shopping in the form of its namesake rodeo, as well as a long-tenured regional shopping mall. The residents have access to a diverse employment base in the Dallas-Ft. Worth-Arlington MSA. Income indicators are what we consider good, with median household effective buying income (MHHEBI) equal to 93% of the national average. Current unemployment is low, in our view, at about 3.2%, and has historically tracked lower than the national average. The system's 10 largest customers account for less than 10% of total operating revenues. The system is a customer of NTMWD for treated water, as well as sanitary sewer. The NTMWD agreements for water and sewer services are take-or-pay minimum purchase contracts.

The system is a distribution and collection system, with NTMWD providing all water supply, water treatment, and sewer treatment services. Growth in the number of metered accounts and water sales has been relatively flat for the past five years, with the only fluctuations in sales attributable to weather. The customer base is diverse, because the system does not rely on any of its principal customers for operating revenues. The city council consistently passes through wholesale rate increases from NTMWD, most recently in fiscal 2019, with additional adjustments likely given the district's ongoing major water supply and treatment plant projects. Base-rate increases, excluding NTMWD pass-through costs, have been less frequent but still implemented as necessary after an annual review of rates; the most recent full rate study was completed for fiscal 2019 and led to a rate adjustment of 4.5%. The residential water and sewer bill, based on actual average provided by the city, is moderate at about \$93, or 2.12% of MHHEBI based on average usage of about 5,000 gallons monthly.

Based on our OMA, we view Mesquite to be a '3' on a scale from '1' to '6', '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 our view of the system's role as a distribution- and collection-only system, which greatly reduces operational risk to Mesquite. While wholesale rate increases continue to strain Mesquite's all-in coverage metric, they provide the city a secure, long-term water supply as well as wastewater treatment capacity at least through the life of

the bonds, and likely beyond. The identification of a succession plan, regularly performed rate studies, and a robust cyber-security management plan are also viewed as positive.

Financial risk

All-in coverage is S&P Global Ratings' adjusted DSC metric that treats certain recurring financial obligations as if they were debt. In Mesquite's case, we incorporate the minimum contractual payments made to NTMWD as we view them as debt-like obligations rather than an operating expense. We also make an adjustment to include transfer payments to the general fund for administrative costs since we view them as a recurring use of utility revenues and exclude the transfers for the capitalization of equipping them. The city's all-in coverage metrics are strong and have been stable in the previous three years, in our view. Its all-in coverage metrics have consistently remained about 1.2x in the previous three audited years. Mesquite not only continues to pass along any wholesale rate increases from NTMWD, but also recently adjusted its retail rate schedule, a move that it believes will bolster its finances over time. Based on the city's cost-of-service study, we expect its future all-in DSC to be consistent with levels which we view as strong.

Liquidity is an identified strength of the system. Unrestricted cash and investments have grown from about \$22 million in fiscal 2017 to about \$34.3 million in fiscal 2019. The unrestricted cash and investments at fiscal year-end stood at the equivalent of 233 days' cash on hand, which far exceeds the management minimum requirement of 60 days' reserve requirements. In relation to the city's capital improvement plan (CIP), these amounts may fluctuate slightly. However, based on management's indications, we expect the unrestricted liquidity position to remain stable. Mesquite also benefits from being a distribution and collection-only system, resulting in limited liquidity risks due to more limited infrastructure investment needs.

Currently, we consider the system's debt-to-capitalization ratio moderate at under 43%, with just under \$97.3 million of debt outstanding after including this issuance. The city maintains a comprehensive multiyear CIP. Its current CIP calls for approximately a leveraging up of about \$37.5 million in the next two years for various improvement projects and expansions associated with the system, which Mesquite has indicated will 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 \$11.98 million and had a net citywide pension liability of \$147.9 million as of Sept. 30, 2019. About 15% of that is allocable to the water and sewer utility fund. The reported overall funding ratio for the plan was 74%, calculated as plan fiduciary net position over total pension liability.

Based on our 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. These 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.

Ratings Detail (As Of April 14, 2020)

Ratings Detail (As Of April 14, 2020) (cont.)

Mesquite wtrwks		
<i>Long Term Rating</i>	AA/Stable	Affirmed
Mesquite wtrwks & swr sys rev rfdg bnds		
<i>Long Term Rating</i>	AA/Stable	Affirmed

Many issues are enhanced by bond insurance.

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