

RatingsDirect®

Summary:

Mesquite, Texas; Water/Sewer

Primary Credit Analyst:

Theodore A Chapman, Dallas (1) 214-871-1401; theodore.chapman@standardandpoors.com

Secondary Contact:

Scott W Sagen, New York (1) 212-438-0272; scott.sagen@standardandpoors.com

Table Of Contents

Rationale

Outlook

Related Criteria And Research

Summary:

Mesquite, Texas; Water/Sewer

Credit Profile

US\$16.795 mil wtrwks and swr sys rev rfdg and imp bn ds ser 2016 dtd 03/15/2016 due 03/01/2036

| | | |
|-------------------------|-------------|-----|
| <i>Long Term Rating</i> | AA/Negative | New |
|-------------------------|-------------|-----|

Mesquite wtrwks

| | | |
|--------------------------|-------------------|-----------------|
| <i>Unenhanced Rating</i> | AA(SPUR)/Negative | Outlook Revised |
|--------------------------|-------------------|-----------------|

Rationale

Standard & Poor's Ratings Services revised its outlook to negative from stable and affirmed its 'AA' rating on Mesquite, Texas' waterworks and sewer system revenue debt. We also assigned our 'AA' rating to the city's series 2016 waterworks and sewer system revenue refunding bonds.

The outlook revision reflects our view of the system's all-in coverage metric, which is somewhat below the median for 'AA' rated peers. We recognize the inherent difficulties in implementing aggressive water conservation measures such as the city did for several years while addressing fixed costs in its revenue requirements. Since water restrictions were lifted in 2015, the system's financial risk profile is beginning to rebound but a return to a stable outlook would be predicated mainly on sustaining that improvement over the next two years, all other things being equal.

The ratings reflect our opinion of the system's extremely strong enterprise risk profile, including:

- A stable, primarily residential, customer base that benefits from participation in the strong, broad and diverse Dallas metropolitan statistical area (MSA);
- The city's role as a distribution and collection-only system; treatment is provided by the North Texas Municipal Water District (NTMWD), which greatly reduces operational risk to the city; and
- Management's willingness to adjust rates as necessary, including passing through in full any wholesale increases received from NTMWD. We believe an adjustment to rates implemented in November 2014 should improve all-in debt service coverage (DSC).

The ratings also reflect Mesquite's strong financial risk profile, characterized by:

- Coverage metrics that have been thin for the rating level in recent years. Although legal provisions are based on average annual debt service, actual annual requirements--which reflect a front-loaded maturity schedule--are currently much higher and have caused all-in coverage to trend toward 1.1x in the past three years;
- Extremely strong liquidity and reserves; and
- Strong financial management, as the city has a number of policies and best practices that should support a consistent financial performance in the future. It is also a key in maintaining the current rating, as there is a better-than-average likelihood that the system's finances will rebound within the next two years.

The system's first-lien pledge of net revenues secures the bonds. Bond proceeds will be used primarily to refund for savings various maturities of the series 2005, 2006, and 2007 revenue bonds. A debt service reserve fund in the

amount of average annual debt service provides additional liquidity.

The system's financial performance is, on balance, strong, even if coverage metrics based on Standard & Poor's calculations have weakened in recent years. Working capital at fiscal 2014 year-end totaled \$11.8 million, which was equivalent to a solid three months of operating expenses. Initial results for fiscal 2015 show an improvement to \$13 million, and the fiscal 2016 budget assumes further growth to \$15 million. The difficulty for the city, however, was that as the drought worsened from 2011 through 2015, it led to below-budgeted sales in both 2013 and 2014 and barely sufficient all-in coverage in each year. All-in coverage bounced back in fiscal 2015 to 1.17x, which is still thin, resulting in our outlook revision.

The city 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. All-in coverage is Standard & Poor's adjusted DSC metric that treats certain costs as if they were debt-like--such as take-or-pay minimums--even if they are legally treated as operating expenses. With the new rates, it is our view that all-in coverage could improve to over 1.2x and at least stay there, if not move higher, throughout management's forecast.

The system provides retail water and sewer service to almost 41,000 mainly residential customers in Mesquite, a mature Dallas suburb of roughly 142,000 residents. The system is a distribution and collection system, with all water supply, water treatment, and sewer treatment services provided by the NTMWD. Growth in the number of metered accounts and water sales has been flat for the past five years, with the only fluctuations attributable to weather. The customer base is diverse, with the 10 leading customers accounting for about 12% of operating revenues. Mesquite's median household effective buying income (MHHEBI) is 101% and 102% that of the state and nation, respectively.

Based on our Operational Management Assessment (OMA), we view Mesquite to be a '3' 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 system's role as a distribution- and collection-only system, which greatly reduces operational risk to the city. While wholesale rate increases continue to pressure the city'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, or likely beyond. The city also has a sanitary sewer overflow initiative in place with the Texas Commission on Environmental Quality, essentially a proactive measure for preventive collection system maintenance.

The city council consistently passes through wholesale rate increases from NTMWD, most recently in October 2015, with additional adjustments likely given the district's ongoing major water supply and treatment plant projects. Base-rate increases, exclusive of NTMWD pass-through costs, have been less frequent but have still been implemented as necessary based on an annual review of rates. As such, a residential water and sewer bill, assuming 6,000 gallons of service, is still very affordable at about \$77, or 2.1% of MHHEBI.

The system annually makes significant transfers to the city's general fund. Transfers are limited by policy to 20% of customer charges and have historically been \$4.5 million per year. Based on our Financial Management Assessment (FMA), we view Mesquite to be a '1' on a scale of 1-6, with '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 deemed

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 web site, and robust policies on debt management and permitted investments.

Outlook

The negative outlook reflects Standard & Poor's opinion that due to the level of buildout in Mesquite and the overall participation in the Dallas MSA, the enterprise risk profile is likely to remain extremely strong in the next two years. As such, we view the financial risk profile, especially all-in coverage, as the key driver of rating. A return to a stable outlook would be predicated on the system's ability to generate moderately stronger all-in coverage metrics consistently at or above 1.2x, even with expected variances in weather. While we concede the difficulty in balancing water conservation measures and fixed operating requirements, should the all-in coverage expected in fiscal 2015 and the 2016 budget turn out to be anomalies, rather than the baseline, in a sustained financial rebound, we could lower the rating, likely by one notch.

Related Criteria And Research

Related Criteria

- USPF Criteria: Rating Methodology And Assumptions For U.S. Municipal Waterworks And Sanitary Sewer Utility Revenue Bonds, Jan. 19, 2016
- USPF Criteria: Methodology: Definitions And Related Analytic Practices For Covenant And Payment Provisions In U.S. Public Finance Revenue Obligations, Nov. 29, 2011
- USPF Criteria: Assigning Issue Credit Ratings Of Operating Entities, May 20, 2015
- Criteria: Use of CreditWatch And Outlooks, Sept. 14, 2009

Ratings Detail (As Of March 8, 2016)

Mesquite wtrwks

| | | |
|-------------------------|-------------|-----------------|
| <i>Long Term Rating</i> | AA/Negative | Outlook Revised |
|-------------------------|-------------|-----------------|

North Texas Mun Wtr Dist (Lower East Fork) (Mesquite & Seagoville)

| | | |
|--------------------------|-------------------|-----------------|
| <i>Unenhanced Rating</i> | AA(SPUR)/Negative | Outlook Revised |
|--------------------------|-------------------|-----------------|

Many issues are enhanced by bond insurance.

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.globalcreditportal.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com. Use the Ratings search box located in

the left column.

Copyright © 2016 Standard & Poor's Financial Services LLC, a part of McGraw Hill Financial. All rights reserved.

No content (including ratings, credit-related analyses and data, valuations, model, software or other application or output therefrom) or any part thereof (Content) may be modified, reverse engineered, reproduced or distributed in any form by any means, or stored in a database or retrieval system, without the prior written permission of Standard & Poor's Financial Services LLC or its affiliates (collectively, S&P). The Content shall not be used for any unlawful or unauthorized purposes. S&P and any third-party providers, as well as their directors, officers, shareholders, employees or agents (collectively S&P Parties) do not guarantee the accuracy, completeness, timeliness or availability of the Content. S&P Parties are not responsible for any errors or omissions (negligent or otherwise), regardless of the cause, for the results obtained from the use of the Content, or for the security or maintenance of any data input by the user. The Content is provided on an "as is" basis. S&P PARTIES DISCLAIM ANY AND ALL EXPRESS OR IMPLIED WARRANTIES, INCLUDING, BUT NOT LIMITED TO, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE, FREEDOM FROM BUGS, SOFTWARE ERRORS OR DEFECTS, THAT THE CONTENT'S FUNCTIONING WILL BE UNINTERRUPTED, OR THAT THE CONTENT WILL OPERATE WITH ANY SOFTWARE OR HARDWARE CONFIGURATION. In no event shall S&P Parties be liable to any party for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs or losses caused by negligence) in connection with any use of the Content even if advised of the possibility of such damages.

Credit-related and other analyses, including ratings, and statements in the Content are statements of opinion as of the date they are expressed and not statements of fact. S&P's opinions, analyses, and rating acknowledgment decisions (described below) are not recommendations to purchase, hold, or sell any securities or to make any investment decisions, and do not address the suitability of any security. S&P assumes no obligation to update the Content following publication in any form or format. The Content should not be relied on and is not a substitute for the skill, judgment and experience of the user, its management, employees, advisors and/or clients when making investment and other business decisions. S&P does not act as a fiduciary or an investment advisor except where registered as such. While S&P has obtained information from sources it believes to be reliable, S&P does not perform an audit and undertakes no duty of due diligence or independent verification of any information it receives.

To the extent that regulatory authorities allow a rating agency to acknowledge in one jurisdiction a rating issued in another jurisdiction for certain regulatory purposes, S&P reserves the right to assign, withdraw, or suspend such acknowledgement at any time and in its sole discretion. S&P Parties disclaim any duty whatsoever arising out of the assignment, withdrawal, or suspension of an acknowledgement as well as any liability for any damage alleged to have been suffered on account thereof.

S&P keeps certain activities of its business units separate from each other in order to preserve the independence and objectivity of their respective activities. As a result, certain business units of S&P may have information that is not available to other S&P business units. S&P has established policies and procedures to maintain the confidentiality of certain nonpublic information received in connection with each analytical process.

S&P may receive compensation for its ratings and certain analyses, normally from issuers or underwriters of securities or from obligors. S&P reserves the right to disseminate its opinions and analyses. S&P's public ratings and analyses are made available on its Web sites, www.standardandpoors.com (free of charge), and www.ratingsdirect.com and www.globalcreditportal.com (subscription) and www.spcapitaliq.com (subscription) and may be distributed through other means, including via S&P publications and third-party redistributors. Additional information about our ratings fees is available at www.standardandpoors.com/usratingsfees.