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RATING ACTION COMMENTARY

Fitch Rates Palm Coast, FL's Utility System Revs 'AA'; Outlook Stable

Fri 04 Jun, 2021 - 1:11 PM ET

Fitch Ratings - New York - 04 Jun 2021: Fitch Ratings has assigned a 'AA' rating to the following Palm Coast, FL obligations:

--Approximately $62.9 million utility system refunding revenue bonds, series 2021.

The bonds are expected to sell via competitive sale the week of July 12th. Proceeds of the bonds will be used to (i) advance refund a portion of the series 2013 bonds on a taxable basis and (ii) pay costs of issuance.

In addition, Fitch has affirmed the following ratings (pre-refunding):

--Approximately $71.8 million utility system improvement and refunding revenue bonds, series 2013.

Fitch has also assessed the Standalone Credit Profile (SCP) of the system at 'aa'. The SCP represents the standalone credit profile of the system on a stand-alone basis irrespective of its relationship with and credit quality of the city (assessed internally).

The Rating Outlook is Stable.

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ANALYTICAL CONCLUSION

The 'AA' bond rating and assessment of the SCP at 'aa' reflect the system's very strong financial profile that has benefitted from continued growth in connection fees and funds available for debt service (FADS) in recent years, despite an expanding capital program. Further, the rating reflects the system's very low leverage within the framework of very strong revenue defensibility assessed at 'aa' and low operating risk profile assessed at 'a'.

Leverage, as measured by net adjusted debt/adjusted FADS, has continued to decline, reaching a low of 3.8x in fiscal 2020 as outstanding debt amortized and FADS grew with concurrent rate increases and growing connection fee revenue. The system maintains rate-setting autonomy and very strong rate flexibility, and serves an area that exhibits favorable demand characteristics. The system's 'a' operating risk assessment reflects a low operating cost burden and moderate life cycle investment needs. Although the life-cycle ratio has continued to climb it still remains below Fitch's 'aa' threshold of 45% and is supported by robust capital spending that is expected to continue. Fiscal 2020's capital spending to depreciation ratio registered 120%.

Leverage is expected to increase slightly over the next few years as debt is issued to fund the system's wastewater treatment facility (WWTF) expansion. However, factoring the current debt refinancing, projected leverage levels should remain supportive of the current rating.

CREDIT PROFILE

Palm Coast was developed as a master planned retirement community in the 1970's and later incorporated in 1999. The city purchased the utility system in 2003 from the Florida Water Services Corporation. The city is located along the

Atlantic coast in north-central Florida in Flagler County, between Daytona Beach and St. Augustine.

The service area encompasses the city and adjacent unincorporated areas of Flagler County covering about 85 square miles. Population growth has been rapid, with a 12% increase from 2015 to 2020. The system provides retail water and wastewater services to a mostly residential combined customer base of more than 78,000 customers.

The potable water system treats groundwater from the surficial and Floridan aquifers at three water treatment plants (WTPs). Combined capacity of 16.6 million gallons per day (mgd) is roughly double average annual fiscal 2020 usage and supply is adequate for the intermediate term. The wastewater system entails collection, treatment and disposal services via two WWTFs. Treatment capacity is currently being expanded and will provide comfortable excess capacity. Both WWTFs provide reclaimed water service.

Fitch considers the system to be a related entity to the city for rating purposes given the city's oversight of the system, including the authority to establish rates. The credit quality of the city does not constrain the system's rating. However, as a result of being a related entity, the issue ratings could become constrained by a material decline in the general credit quality of the city.

Coronavirus Considerations

The recent outbreak of the coronavirus has not shown significant impairment to the system's revenue or cost profiles.

KEY RATING DRIVERS

Revenue Defensibility 'aa'

Affordable Rates, Favorable Service Area

Midrange customer growth, employment and median household income (MHI) support favorable service area characteristics. Rates are considered affordable for most of the population, however, near-term rate increases could erode rate flexibility a bit.

Operating Risks 'a'

Low Operating Cost Burden; Moderate Investment Needs

The system's low operating risk profile is supported by a life cycle ratio registering below 45%. Near-term capital spending should keep this life cycle ratio low. The operating cost burden, which is considered low, has been increasing annually.

Financial Profile 'aa'

Very Strong Financial Profile

Leverage is expected to increase slightly with near-term debt issuances but remain relatively stable, very low and supportive of the 'aa' assessment. The liquidity profile is neutral to the assessment.

ASYMMETRIC ADDITIVE RISK CONSIDERATIONS

No asymmetric additive risk considerations affected this rating determination.

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RATING SENSITIVITIES

Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade

--Sustained leverage approximating 5x or below in Fitch's base and stress cases, provided maintenance of current revenue defensibility and operating risks assessments.

--Improvement in the operating risks assessment, with a reduced operating cost burden.

Factors that Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade

--Sustained leverage approximating 7x or above in Fitch's base and stress cases, provided maintenance of current revenue defensibility and operating risks assessments.

--Rate affordability weakening to levels considered unaffordable for more than 25% of the service area population on a sustained basis that results in a reduced revenue defensibility assessment.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

SECURITY

The bonds are secured by a senior lien pledge of the net revenues of the city's water and sewer system and pledged impact fees.

REVENUE DEFENSIBILITY

Revenue defensibility is very strong, assessed at 'aa', with all of the system's revenue derived from services or business lines exhibiting monopolistic characteristics in a service area with favorable demographic trends. Income and unemployment levels are considered midrange, at 87% and 95% of the national averages, respectively. Unemployment had been declining annually and is still below national averages as of March 2021. Customer growth has registered at the midrange level the past four of five fiscal years.

The system has independent legal ability to increase service rates without external approval, supporting very strong rate flexibility. Based on 7,500 gallons per month consumption of water and 6,000 gallons per month sewer, rates are affordable for around 81% of the population. Rates are tiered to promote conservation with fixed charges comprising a healthy 35% of the bill.

A fiscal 2019 through 2023 rate package resulted in 6% water and sewer increases in fiscals 2019 and 2020 with consumer price index-based increases for fiscal years 2021 through 2023. The rate increases support an expanded capital improvement program (CIP) and increased contributions to the utility's renewal, replacement and improvement fund.

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OPERATING RISKS

The system's operating risks profile is assessed at 'a', which takes into consideration a low operating cost burden at $7,142 per million gallons in fiscal 2020. Capital investment needs are moderate, as evidenced by a life cycle ratio of 38%. The ratio is supported by a five-year average of capital spending to depreciation of 143%. Planned capital spending should keep the life cycle ratio near the current level over the rating cycle.

The system's fiscal 2021-2025 CIP totals $124.7 million. Most projects are associated with extension or expansion of infrastructure with additional plant upgrades. Planned expansion of WWTF #2 ($20 million) is projected for completion in 2023. About $13 million is for work at each of the three WTPs, including some capacity expansion. About $10.2 million is allocated to wellfield expansion and construction. Additionally, due to customer growth, the system plans to spend about $13.2 million installing home pretreatment effluent pump tanks.

Approximately $92.1 million is estimated for capital needs during the 2026-2030 timeframe. Water capacity expansion is expected with the potential for brackish water treatment improvements depending on growth patterns. The construction of a biosolids facility is also being considered. Positively, none of the projects are regulatory driven, allowing flexibility in timing and spending. Close to a third of the CIP is expected to be debt funded, including a state revolving fund loan for the WWTF expansion. The balance is funded with reserves, grants, impact fees and PAYGO.

FINANCIAL PROFILE

The financial profile is very strong and assessed at 'aa'. Leverage is considered very low at 3.8x in fiscal 2020. With 296 days cash on hand and coverage of full obligations at 2.8x, the liquidity profile is considered neutral to the assessment. Fitch calculated total debt service coverage for fiscal 2020 was 2.9x.

Fitch Analytical Stress Test (FAST)

The FAST considers the potential trend of key ratios in a base case and a stress case. The base and stress cases were informed by the issuer's forecast and CIP assuming a 70% execution rate. Other key assumptions include revenue and expense increases driven by service area growth, and continued strong connection fee income. The stress case is designed to impose a capital cost increase of 10% above expected levels and evaluate potential variability in projected key ratios. Fitch also sensitized connection fee and service fee growth to approximate more moderate growth over the forward looking scenario.

Base case results show leverage peaking at 5.2x in fiscal 2022 when the largest amount of debt is assumed to be issued, then gradually falling to 4.6x. The stress case results in a high of 5.4x, landing at about 5.0x by fiscal 2025. In all cases, leverage remains below 6.0x and supportive of the current rating.

SOURCES OF INFORMATION

In addition to the sources of information identified in Fitch's applicable criteria specified below, this action was informed by information from Lumesis.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Public Sector, Revenue-Supported Entities Rating Criteria (pub. 23 Feb 2021) (including rating assumption sensitivity)

U.S. Water and Sewer Rating Criteria (pub. 18 Mar 2021) (including rating assumption sensitivity)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Palm Coast (FL)	EU Endorsed, UK Endorsed

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