Garland, Texas

Water and Sewer System Revenue Bonds
New Issue Report

Ratings

New Issue

Water and Sewer System Revenue Refunding and Improvement, Bonds, New Series 2014	AA+

Outstanding Debt

Water and Sewer System Revenue Bonds	AA+

Rating Outlook
Negative

Related Research
2014 Water and Sewer Medians (December 2013)
2014 Outlook: Water and Sewer Sector (December 2013)

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New Issue Details

Sale Information: Approximately $39,585,000 Water and Sewer System Revenue Refunding and Improvement Bonds, New Series 2014, to sell May 20 via negotiation.

Security: A subordinate lien on net revenues of Garland's water and wastewater system (the system).

Purpose: To refund portions of the system's outstanding prior lien debt and improve and enlarge the city's combined utility system and to pay costs of issuance.

Final Maturity: March 1, 2034.

Key Rating Drivers

Uncertainty in Financial Position: The Negative Rating Outlook incorporates the likelihood of diminishing financial flexibility, reduced debt service coverage (DSC), and weak results in other key financial metrics based on current declining trends.

Lack of Notching: Legal covenants on the series 2014 new series are essentially unchanged from the prior lien bonds, combined with a the currently high 'AA+' rating level, contribute to the lack of notching between the senior and subordinate liens.

Decline in DSC: Senior lien annual DSC dropped to 2.0x and total DSC declined to 1.6x in fiscal 2012 and 2013. Liquidity improved, although it remains below average for the 'AA' rating category at 172 days cash on hand in fiscal 2013.

Wholesale Cost Pressures, Assured Supply: The system has assured water supply through 2030 under a perpetual contract with the North Texas Municipal Water District (NTMWD). However, the terms of the contract are somewhat disadvantageous due to the minimum annual payment being calculated on the maximum historical usage, even in wet weather years.

Increasing Debt Levels: Direct system debt per customer levels are on par with 'AA' category medians, but grow to high levels when taking into consideration off-balance sheet debt of the NTMWD. Debt levels are expected to increase given the bulk of the system's capital program is anticipated to be debt-funded. High debt levels are somewhat offset by the city's rapid amortization, with a significant portion of system debt paid off in 10 years.

Diminishing Rate Flexibility: The city retains a modest amount of rate flexibility relative to Fitch's affordability threshold, but rates are higher than surrounding area providers. Additional increases to keep pace with wholesaler and debt service cost increases could reduce affordability over the medium-to-long term.

Rating Sensitivities

Diminished Financial Cushion: Realization of projected declines in DSC over the course of the forecast period and ongoing weakness in other key financial metrics would likely result in a downgrade.

Rating History — Senior Lien

Rating	Action	Outlook/ Watch	Date
AA+	Affirmed	Negative	5/9/14
AA+	Affirmed	Negative	4/13/14
AA+	Affirmed	Negative	4/25/13
AA+	Affirmed	Stable	5/17/12
AA+	Revised	Stable	4/30/10
AA	Affirmed	Negative	3/11/05
AA	Assigned	Stable	8/1/03

Rating History — Subordinate Lien

Rating	Action	Outlook/ Watch	Date
AA+	Assigned	Negative	5/9/14

Related Criteria

Revenue-Supported Rating Criteria (June 2013)

U.S. Water and Sewer Revenue Bond Rating Criteria (July 2013)

Credit Profile

The water system serves approximately 70,000 city customers and purchases its water on a wholesale basis under a perpetual contract from NTMWD, of which Garland is a member city. Existing and projected water supplies from NTMWD reportedly are sufficient to meet all customer demands through 2030. The wastewater system serves around 67,000 customers within the city, as well as portions of five other cities, including the city of Dallas.

Weakened Financial Performance

System operations have been pressured by fluctuating weather conditions, efforts to conserve water, and a somewhat disadvantageous water supply contract. Management is committed to maintaining financial health as evidenced in its timely rate hikes and ongoing commitment to adjust charges as needed. Rates have increased consistently since 2009 to provide additional revenue to support increasing operating and debt service costs.

The monthly bill at $73.65 (assuming usage of 7,500 gallons per month for water and 6,000 gallons per month for sewer) is the highest in the Dallas/Fort Worth Metroplex and currently registers at around 1.7% of median household income (MHI), still falling under Fitch's 2% of MHI affordability threshold. Forecasts provided by management indicate continued rate increases in future years. Anticipated annual water rate increases, ranging from 6% to 10%, are higher than the more modest wastewater rate increases of 3% annually through 2018.

Due to the Texas drought, water use restrictions were implemented late in fiscal 2011. Reduced water demand during the 2012 summer months led to a loss in operating revenue, resulting in a decline in net revenues available for debt service in fiscal 2012. Audited fiscal 2012 results point to senior lien annual DSC declining to 2.0x (1.5x net of transfers out) from a high of 3.0x in fiscal 2011. Including debt service requirements of about $30 million in outstanding general obligation debt issued for system improvements, all-in coverage dropped to 1.6x (1.2x net of transfers out) for the year from a good 2.4x in fiscal 2011. Fiscal 2013 estimates are similar with senior lien and total DSC of 2.0x and 1.4x, respectively, but management reports that sales are lagging approximately 10% behind fiscal 2013 volumes as water use restrictions remain in effect due to the drought.

Through the fiscal 2018 forecast period, senior lien coverage dips to 1.6x in fiscal 2014 but rebounds to 2.4x by 2018 while all-in DSC falls to 1.3x in fiscal 2014 and grows to 1.6x over the same forecast period. The city's forecast assumes increased debt service costs from planned debt issuances on the new lien, annual rate increases and conservative annual operating expense growth.

Driving the lower coverage levels is the increasing purchased water costs and growing debt service requirements. Water costs associated with the NTMWD contract increased 9.6% in 2011 and accounted for more than 50% of the water fund's operating expenses. NTMWD raised its water rate by 11% in fiscal 2014, and the city has been informed that district rate will increase by around 10% in fiscal year 2015, due to necessary upgrades to meet regulatory requirements. Maintenance of sound debt service coverage commensurate with the high rating is a key credit consideration given the city's plan to further leverage the system for capital projects.

Fitch notes that transfers out of the system are high, averaging 12% over the past five fiscal years. Transfers out of the system combined with limited surplus cash from operations after payment of operating and debt service costs have left a minimal amount of free cash available to cover depreciation (free cash to depreciation at 16% in fiscal 2013). Fitch will continue to monitor system financial performance. Any further decline in financial margins will be viewed negatively and may be inconsistent with the present the rating level.

Liquidity levels have improved to over 170 days cash on hand (DCOH) after a low of 82 DCOH in fiscal 2008. Given capital needs are anticipated to be predominantly debt-funded, cash balances are expected to remain at similar levels, or within historical norms, over the forecast period.

Growing Debt Burden

The system's capital improvement plan (CIP) for fiscal years 2014–2018 totals $169 million, up 24% from the prior five-year plan. The CIP is expected to be financed exclusively from debt. Approximately 65% of the CIP addresses sewer system improvements that will ensure compliance with new and enhanced regulatory and operational standards while the remaining 35% is for water system improvements.

Direct system debt per customer of $1,802 aligns closely to the 'AA' category median of $1,812, but debt to net plant is high at 59% compared to the 'AA' median of 47%. Including NTMWD obligations supported by the system, system debt levels increase by approximately 55% and are well above category 'AA' rating median levels. Although the system's CIP is anticipated to be 100% debt funded, debt levels are expected to remain relatively stable due to the above-average pace of existing debt amortization (principal payout at 69% and 99% in 10 and 20 years, respectively).

The current offering will refund $24 million of the system's series 2004A senior lien bonds and also fund capital investment. While secured by the net revenues of the system, the series 2014 bonds will be paid on a subordinate basis to the currently outstanding bonds. The legal covenants associated with the new lien are largely unchanged from the prior lien outstanding bonds with both liens requiring a sum sufficient rate covenant. The senior lien will be closed and all future debt will be issued on the new working subordinate lien. Due to the high credit quality of the system, the minimal changes to bond covenants and the closing of the senior lien bonds, there will be no rating distinction made between the two liens. However, should credit quality weaken and the variance between debt service coverage for each lien widens substantially, a rating distinction between the two liens may be warranted.

Mature, Stable Economic Base

Garland (GOs rated 'AAA' by Fitch with a Stable Rating Outlook) benefits from its location within the Dallas-Fort Worth metropolitan area. Manufacturing and distribution remain the city's primary economic engines and the city's industrial market reportedly is the second largest in the Dallas-Fort Worth Metroplex. The city's unemployment rate, measured at 5.9% in December 2013, is slightly higher than the state (5.6%) and metropolitan statistical area (5.4%) but remains better than the national (6.5%) average. Local wealth levels within the city, as measured by per capita buying income and median household income, are slightly higher than state but are on par with national averages.

Covenants

Security

All bonds are secured by a pledge of the net revenues of the city's the system. The outstanding prior lien bonds are senior to the new series 2014 bonds. With this issuance the lien on the prior lien bonds will be closed. The new series 2014 revenue bonds are paid subsequent to the prior lien bonds. A debt service reserve will not be funded in association with the series 2014 bonds.

Rate Covenant

The sum-sufficient rate covenant is weak. As part of the covenant, the city is required only to set rates and charges sufficient to pay operations and maintenance (O&M) expenses, pay debt service costs, maintain the parity debt service reserve, and pay all other outstanding system indebtedness.

Additional Bonds Test

New Lien Additional Bonds Test: Additional similarly secured bonds may be issued if net revenues for the last complete fiscal year or any 12 consecutive calendar months (not more than 90 days prior to passage of the authorizing ordinance) be at least 1.25x the current average annual debt service on the prior lien bonds and 1.00x on MADS on prior lien and similarly secured bonds.

Debt Service Reserve Fund

A debt service reserve will not be funded for the series 2014 bonds.

The reserve requirement on the outstanding prior lien bonds is equal to the average annual debt service requirement (on a fiscal year basis) for all outstanding prior lien debt. The reserve requirement may be funded over a period of not more than 60 months and may be satisfied by either cash or a surety policy. As of March 15, 2014, the system had a debt service reserve fund cash balance of $4,134,375. The debt service reserve fund cash balance is to provide additional security for the system's series 2009, series 2010, series 2011, series 2011A, series 2012, and series 2013.

Flow of Funds

Gross revenues of the system are deposited into the system fund and dispersed as follows:

- For O&M expenses.
- For the payment of parity debt service on prior lien bonds.
- For the payment of debt service on subordinate lien bonds.
- To fund the parity debt service reserve fund, if needed.
- For any lawful purpose.

Financial Summary

($000, Audited Fiscal Years Ended Sept. 30)

	2007	2008	2009	2010	2011	2012	2013
Balance Sheet							
Unrestricted Cash and Investments	9,130	9,128	13,534	15,348	24,184	26,941	26,224
Accounts Receivable	6,391	6,705	6,725	9,953	11,710	10,775	11,406
Other Current Unrestricted Assets	1,016	1,291	2,067	14	13	190	22
Current Liabilities Payable from Unrestricted Assets	(4,573)	(4,909)	(5,685)	(5,445)	(16,872)	(17,999)	(19,630)
Net Working Capital	11,964	12,215	16,641	19,870	19,035	19,906	18,022
Net Fixed Assets	302,261	350,863	378,698	391,330	398,361	400,044	413,048
Net Long-Term Debt Outstanding	191,231	224,217	232,506	243,631	252,898	248,080	242,287
Operating Statement							
Operating Revenues	60,462	67,215	72,974	81,326	92,822	89,059	92,635
Non-Operating Revenues	4,807	2,205	1,492	348	181	298	70
Connection Fees	-	4,227	64	227	464	887	626
Gross Revenues	65,269	73,647	74,530	81,901	93,467	90,244	93,331
Operating Expenses (Excluding Depreciation)	(38,218)	(40,565)	(43,212)	(46,003)	(49,156)	(52,500)	(55,800)
Depreciation	(11,707)	(12,902)	(14,272)	(15,897)	(16,951)	(17,750)	(18,307)
Operating Income	15,344	20,180	17,046	20,001	27,360	19,994	19,224
Net Revenues Available for Debt Service**	27,051	33,082	31,318	35,898	44,311	37,744	37,531
Senior Lien Debt Service Requirements	9,535	11,845	12,867	14,352	15,002	18,796	19,090
Total Debt Service Requirements	15,756	13,899	16,276	17,041	18,800	23,371	23,919
Financial Statistics							
Senior Lien Debt Service Coverage (x)	2.8	2.8	2.4	2.5	3.0	2.0	2.0
Total Debt Service Coverage (x)	1.7	2.4	1.9	2.1	2.4	1.6	1.6
Days Cash on Hand	87	82	114	122	180	187	172
Debt to Net Plant (%)	63	64	61	62	63	62	59
Outstanding Long-Term Debt per Customer ($)	1,442	1,717	1,751	1,842	1,907	1,804	1,802
Free Cash to Depreciation (%)***	31	85	45	60	91	24	16

[a]Equals gross revenues less operating expenses. [b]Equals net revenues available for debt service less operating transfers out, less total debt service, divided by depreciation. Note: Numbers may not add due to rounding.

The ratings above were solicited by, or on behalf of, the issuer, and therefore, Fitch has been compensated for the provision of the ratings.