

RatingsDirect®

Summary:

Lewisville, Texas; Water/Sewer

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Credit Profile

US\$16.9 mil wtrwks and swr sys rev bnds ser 2021 due 02/15/2037

Long Term Rating AAA/Stable New

Lewisville wtrwks & swr sys rev bnds ser 2009 dtd 06/01/2009 due 02/15/2025

Long Term Rating NR

Lewisville WS

Long Term Rating AAA/Stable Affirmed

Rating Action

S&P Global Ratings assigned its 'AAA' long-term rating to Lewisville, Texas' series 2021 waterworks and sewer system revenue bonds. At the same time, we affirmed our 'AAA' rating on the city's outstanding revenue debt. The outlook is stable.

Net revenues of the water and sewer system secure the approximately \$16.9 million series 2021 bonds. After the issuance, Lewisville will have just over \$78.35 million in outstanding parity revenue debt. Officials intend to use series 2021 bond proceeds to construct several improvements to the utility collection and distribution system, including capacity expansion in the wastewater treatment plant and other improvements.

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 1.10x annual debt service; and
- An additional bonds test that allows additional debt issuance but only if net revenues cover average annual debt service of all debt, including proposed debt, at least 1.25x average annual debt service or 1.1x maximum annual debt service (MADS).

Credit overview

Lewisville's ratings reflects our assessment of its projected all-in coverage (DSC), low leverage, and favorable overall economic considerations of the customer base. The waterworks and sewer system maintains affordable service rates that we believe benchmark well to those of its peers in the Dallas metropolitan statistical area (MSA) and provide for additional rate-raising flexibility. In our view, the waterworks and sewer system's financial metrics are comparable to our medians for rated utilities at the 'AAA' rating level; as of Sept. 30, 2020, the system maintained over a years' cash on hand and all-in coverage (which includes transfers out and payments to the city of Dallas) improved to 1.9x in fiscal 2020 from 1.7x the prior year, which lends additional financial strength.

The waterworks and sewer system performed a comprehensive rate study in early 2020 that recommended

approximately 4.0% annual rate increases per annum through 2024 (which we consider manageable) which we anticipate will likely to result in sound financial results over the outlook period (about 1.6x all-in coverage), even as annual debt service escalates over this period. About 75% of the upcoming \$87 million capital improvement program (CIP) will be funded with new debt; as a result, annual debt service is anticipated to rise to about \$11 million in fiscal 2024 from about \$8 million presently.

The primary credit risks center on the water and sewer system's identified capacity needs, particularly related to the sewer utility. Sewer flow rates have increased to the point where they are at or above 75% of the permitted capacity; the Texas Commission for Environmental Quality mandates that the utility be under design for capacity improvement, and when the flow rate exceeds 90% of the permitted capacity, the utility needs to be under construction for those improvements. Lewisville is also in the final stages of completing a water distribution and treatment master plan. The result of this plan will lead to a future expansion of the water treatment plant to increase its capacity to 30 million gallons per day (mgd) from the current 20.5 mgd capacity over a ten-year period.

Lewisville is a largely bedroom community about 20 miles north of Dallas in Denton County, on the shores of Lewisville Lake. Its access to Dallas has contributed to the population growing to over 113,000 in 2019 from over 104,000 in 2009, an increase of 8.7%. Income indicators are we consider healthy, with median household effective buying income (MHHEBI) equal to 106% of the national average as of 2019. Current unemployment levels are about 6.0% as of January 2021, which we still consider elevated as a result of the economic downturn, although it is below the national average (6.8%). We understand the city will be incorporating utility customers located in Castle Hills as part of a planned annexation which we consider credit neutral.

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

- Service area participation in the broad and diverse Dallas-Fort Worth-Arlington MSA economy with above-average income metrics. The pandemic slowdown did not materially affect usage levels, revenues or delinquencies which we believe demonstrates the resilience of the service area economy;
- Diverse and stable customer base with no significant concentration. We consider the system's customer base diverse, with the 10 largest customers accounting for almost 9% of total operating revenues. Commercial employers in the city include JP Morgan Chase, which is the city's largest employer, and Xerox Corp., as well as a number of corporate transportation and distribution centers;
- A resilient response to Winter Storm Uri, with power being maintained throughout the storm for the water system and only minor damage to the system costing about \$1 million. Almost all of the necessary repairs have been completed;
- Affordable rates, with an average monthly combined bill of \$71.20 as of fiscal 2021, equivalent to about 1.53% of MHHEBI and further supported by Denton's low county poverty rate. We also believe management has a credit supportive attitude toward rate increases, with an emphasis on limiting one-time cost escalations and it has a practice of passing through to wholesale cost increases from its water purchases from Dallas; and
- Comprehensive operational management practices and policies that include strong asset management programs for monitoring existing infrastructure and future capacity needs, coupled with well-defined drought, disaster management and cybersecurity plans. The city obtains untreated and treated surface water from Lewisville Lake under terms of a contract with Dallas, which was renewed for a 30-year term in 2016.

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

- Historically stable and robust all-in debt service coverage (DSC) exceeding 1.7x over the last two years, up from about 1.5x in fiscal 2018. We note that during fiscal year 2018, there was a significant increase in raw and treated water purchases due to extremely dry weather conditions which adversely affected the utility's cost of service. When calculating all-in DSC, we consider all transfers made to the general fund for franchise fees, payments in lieu of taxes (PILOTs), and indirect reoccurring operating expenses of the water and sewer fund as debt-like obligations of the system. We also treat the take-or-pay requirements to Dallas Water Utilities (of just under \$3 million in fiscal 2020) as debt-like obligations rather than an operating expense.
- Healthy unrestricted liquidity, which has risen from 413 days' to 511 days' cash on hand (~\$29 million to \$32.8 million) during the past three audited fiscal years. On a forward-looking basis, we believe this can be sustained at over 400 days despite modest annual cash drawdowns of about \$4 million-\$5 million for capital improvements. The system's reserve policies state that it will strive to maintain working capital of at least 20% budgeted expenditures on hand;
- Low debt position with a debt-to-capitalization ratio of just over 20% when including the series 2021 revenue bonds. We also view positively the efforts to rapidly amortize their existing debt. The current CIP calls for an additional \$64 million for various improvement projects and expansions associated with the system in the next five years; and
- Strong financial management practices and policies. Financials are monitored on a monthly basis and the city council receives semi-annual updates. Management reports that a new administrative directive was introduced during fiscal 2020 addressing its budgetary response during an emergency or disaster situation.

The stable outlook reflects our opinion that planned rate adjustments, pass-through of all wholesaler costs, and steady customer growth will allow Lewisville to maintain stability in its financial risk profile as it funds its upcoming CIP.

Environmental, social, and governance factors

Overall, we believe that management has mitigated most of its environmental, social, and governance (ESG)-related risk by adopting, adhering to, and adjusting operating and financial policies and procedures. The wastewater system's permit was renewed for an additional five-year term earlier this year, and the system complies with all regulatory requirements. An updated sustainability plan is expected to be approved by City Council in fiscal 2021 continuing the city's emphasis on green infrastructure.

While we believe it's possible the utility's revenues may experience some declines for fiscal 2021 as a result of the pandemic or winter storm Uri (which caused a minor disruption), ultimately, our expectation is that management will maintain sound coverage levels. The utility also has over 500 days' cash on hand, which we believe provides a meaningful cushion against short-term disruptions. We believe the utility's governance factors are in line with those of its 'AAA' peers due to the strength of its operational and financial management.

Stable Outlook

Downside scenario

The rating could come under pressure should there be a sustained drop in the system's all-in coverage metrics and liquidity below historically stable levels or if the economic fundamentals of the service area deteriorate due to a loss of

a major customer or employer. Other potential sources of pressure could involve not fully passing through and recouping any increase in wholesale costs from Dallas, increased transfers to the general fund that are not recovered through rates, or escalation in planned capital spending.

Related Research

Through The ESG Lens 2.0: A Deeper Dive Into U.S. Public Finance Credit Factors, April 28, 2020

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