

FITCH AFFIRMS PALM COAST, FL'S UTILITY SYSTEM REVS AT 'A+'; OUTLOOK STABLE

Fitch Ratings-New York-05 March 2015: Fitch Ratings affirms the ratings on Palm Coast, FL's (the city) approximately \$150 million in outstanding utility system revenue bonds at 'A+'.

The Rating Outlook is Stable.

SECURITY

The bonds are payable from the net revenues of the city's water and sewer system (the system) and pledged connection fees.

KEY RATING DRIVERS

STABLE FINANCES: Financial results are stable with most metrics near 'A' category medians for water and sewer utility systems rated by Fitch.

SOLID OPERATING PROFILE: Water treatment facilities have ample capacity and water supply is adequate for the intermediate term. Sewer treatment capacity is somewhat constrained but can be expanded. According to the city, local groundwater supply is sufficient for at least the next 15 years.

ELEVATED DEBT BURDEN: The system's debt profile remains slightly elevated but in line with similarly rated systems. Amortization is somewhat slow and the possibility of additional debt will keep debt ratios high.

MANAGEABLE CAPITAL NEEDS: Capital needs remain manageable despite the planned construction of a second wastewater treatment plant (WWTP), which increases capital spending by approximately \$20 million over the previous capital improvement plan (CIP).

STABLE ECONOMY: Anchored by retail trade and services, tourism, and local government, the local economy remains stable.

RATING SENSITIVITIES

FINANCIAL PERFORMANCE AND DEBT: The rating is sensitive to shifts in various credit fundamentals including changes in financial performance and the debt burden. The Stable Rating Outlook reflects such shifts are unlikely over the next several years.

CREDIT PROFILE

Palm Coast is located near the Atlantic coast in northeastern Florida's Flagler County, approximately 40 miles north of Daytona Beach and 25 miles south of St. Augustine. The city's utility system provides services to a mostly residential retail customer base of 43,000 water and 35,000 sewer accounts in 2014. The service area encompasses the city and a portion of unincorporated Flagler County.

SOLID OPERATING PROFILE AND CAPITAL BASE

The operating profile is stable and well-managed. Water is pumped from the Surficial and Floridan aquifers and treated at one of three city-owned treatment plants. The water treatment plants have a combined 15.4 million gallons per day (mgd) of treatment capacity, more than sufficient to meet the system's average daily demand of approximately 7 mgd.

Water withdrawal is regulated by a consumptive use permit issued by the St. Johns River Water Management District (SJRWMD). The permit was recently extended for an additional 20 years and included an increase in the withdrawal to roughly 11 mgd. Water supply is sufficient through the permit period, and supplementary supply could come from the development of additional local groundwater including from the more brackish Lower Floridan Aquifer.

The wastewater utility is a collection, treatment, and disposal system. The city's sole WWTP, with a current capacity of 6.8 mgd, treats the average daily flow of 5 mgd for 100% re-use for golf-course and other irrigation. Plant capacity is somewhat limited, although it can be expanded to eventually accommodate up to 9.1 mgd of flow. Construction of a second WWTP has made its way back into the five-year CIP. Once completed, the new plant will treat 2 mgd, providing increased capacity for the service area's expanding commercial activity.

STABLE FINANCIAL PERFORMANCE

Financial performance has been stable with improved metrics over the past several years. The system ended fiscal 2013 with net revenues covering senior lien debt service by 1.8x, results that were similar to fiscal 2012. When including subordinate lien state revolving fund loans, all-in debt service coverage (DSC) was still satisfactory at 1.5x. Excluding connection fees, DSC was 1.7x on the senior bonds and 1.4x all-in. These metrics are an improvement over the relatively weak fiscal 2008-2010 results, but are still slightly below the 'A' category medians.

Annual free cash flow has also improved over the past few years but remains below average. A multi-year rate plan that increased rates by 8% on April 1, 2013, followed by additional 4% increases for fiscals 2014 and 2015 is viewed favorably by Fitch. The rate increases led to improved operating revenues and free cash flow in fiscal 2014. In addition, a temporary decline in annual debt service for fiscal 2014, led to strong DSC levels for the year.

Updated financial projections provided by the city show DSC on the senior bonds maintained at 1.8x for fiscals 2015-2017 before a slight improvement to 1.9x in 2018-2020. The projections include some customer growth and additional SRF debt service. In addition, previously approved automatic annual rate indexing is expected to allow revenues to keep pace with operating cost increases over the long term.

The system's liquidity has improved due to enhanced margins, lower annual capital spending in 2011-2013 relative to prior years, liquidation of the debt service reserve and new money bond proceeds related to the series 2013 bonds (in place of internal sources). The system ended fiscal 2014 with approximately \$11.7 million in unrestricted cash and renewal and replacement funds, equivalent to a solid 277 days cash on hand (DCOH). Fitch projects liquidity will decline but remain satisfactory based on the city's CIP and planned funding sources, which includes roughly 40% from pay-as-you-go sources.

Rates have been on the rise but remain competitive. Currently, rates are affordable at approximately \$70 for combined service assuming 5,000 gallons in fiscal 2015, or 1.8% of median household income (MHI). However, when using monthly consumption that approximates the national average (7,500 gallons per month) rates are above Fitch's affordability threshold (2% of MHI). Rates are expected to rise only modestly with inflation over the next few years, but could rise further with expectations for additional debt.

ELEVATED DEBT BURDEN; MANAGEABLE CAPITAL NEEDS

The system's debt profile remains elevated, although debt metrics approximate the medians for 'A' category. Debt per customer was \$2,062 in fiscal 2014, and debt to net plant totaled 86%. Debt carrying costs are also high with annual debt service equivalent to 37% of gross revenues in fiscal 2013. The high debt burden is partially offset by a low (but rising) average age of plant and manageable capital needs. Debt amortization is below-average with 41% of outstanding principal retired over the next 10 years. Slow amortization of existing debt coupled with the potential for an additional \$30 million in SRF loans in fiscal 2017 or 2018 will leave debt ratios elevated for the foreseeable future.

LOCAL ECONOMY BENEFITS FROM PARTICIPATION IN LARGER MSA

The city's location near the Atlantic coast continues to attract both full-time and seasonal residents, retirees, and tourists. The local economy remains anchored by retail trade and services, tourism, and local government. The city benefits from its participation in the greater Palm Coast-Daytona-Port Orange metropolitan statistical area (MSA) economy, which includes 375,000 residents in total.

The city and the metropolitan area experienced very rapid development and population growth prior to the recession. As the economy slowed, so did the growth. However, a rise in building permits and growth in taxable retail sales and tourist development taxes within the city point to an economic recovery. The city has also seen a decline in both the number of home foreclosures and the unemployment rate; unemployment declined to 8% in November 2014, which while still elevated relative to the state and national rates, is well below the peak rates in 2010.

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In addition to the sources of information identified in Fitch's Revenue-Supported Rating Criteria, this action was additionally informed by information from Creditscope.

Applicable Criteria and Related Research:

- 'Revenue-Supported Rating Criteria' (July 2014);
- 'U.S. Water and Sewer Revenue Bond Rating Criteria' (July 2013);
- '2015 Water and Sewer Medians' (December 2014);
- '2015 Outlook: Water and Sewer Sector' (December 2014).

Applicable Criteria and Related Research:

Revenue-Supported Rating Criteria

http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=750012

U.S. Water and Sewer Revenue Bond Rating Criteria

http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=715275

2015 Water and Sewer Medians

http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=818409

2015 Outlook: Water and Sewer Sector

http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=818410

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