

FITCH AFFIRMS PALM COAST, FL'S UTILITY SYSTEM REVS; OUTLOOK REVISED TO POSITIVE

Fitch Ratings-Austin-08 February 2017: Fitch Ratings has affirmed the 'A+' rating on Palm Coast, FL's (the city) following obligations:

--\$84.1 million utility system improvement and refunding revenue bonds, series 2013.

The Rating Outlook is revised to Positive from Stable.

SECURITY

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

KEY RATING DRIVERS

IMPROVED FINANCES DRIVE OUTLOOK REVISION: The Outlook revision to Positive from Stable reflects the continued improvement of the system's finances after a period of weakness caused by stagnant revenue growth and increased debt service.

ELEVATED DEBT BURDEN: The system's debt profile remains slightly elevated but is expected to continue improving in upcoming years. Amortization compares favorably to similarly rated systems with nearly all debt retired in 20 years.

SOLID OPERATING PROFILE: Water treatment facilities have ample capacity and water supply is adequate for the intermediate term. Sewer treatment capacity is currently being expanded and will provide comfortable excess capacity for the intermediate term, as well.

MANAGEABLE CAPITAL NEEDS: The current capital improvement plan (CIP) is flat in comparison to the last CIP and is primarily driven by construction of a second wastewater treatment plant (WWTP). The system has no plans to issue additional debt.

IMPROVING LOCAL ECONOMY: The city's unemployment rate continues to decline after peaking at over 14% in 2009. Permitted building activity within the city has grown steadily since 2011 and new development is expected to add to the system's customer base.

RATING SENSITIVITIES

CONTINUED STRENGTH OF FINANCIAL PROFILE: If Palm Coast's water and sewer system is able to sustain its improved liquidity position along with the debt service coverage (DSC) levels achieved in recent years, a rating upgrade could occur.

CREDIT PROFILE

The city is located along the Atlantic coast in north-central Florida in Flagler County, between Daytona Beach and St. Augustine. The system provides water and wastewater services to a mostly residential combined customer base of over 76,000 customers. The service area encompasses the city and portions of unincorporated Flagler County.

FINANCES IMPROVED, GROWTH SUPPORTS EXPECTED POSITIVE TRAJECTORY

DSC and liquidity both weakened during the recession as the system's sales revenue growth stagnated and connection fee revenue decreased, but the system's finances have shown steady improvement since 2011. Based on preliminary audit results for fiscal 2016, senior lien and all-in DSC is expected at 2.6x and 2.1x, respectively. Both metrics compare favorably to similarly rated systems. Liquidity as measured by days cash on hand (DCOH) has also improved gradually for the last five years to nearly 450 DCOH in fiscal 2016 from less than 100 DCOH in fiscal 2011. This metric also is stronger than that of similarly rated systems.

No forecast was provided by management, but the approved fiscal 2017 budget reflects a 14% increase in operating expenses (OpEx) over fiscal 2016, primarily associated with WWTP #2 expenses. Operating revenue for fiscal 2017 appears conservative as it is lower than preliminary fiscal 2016 results. If the system is able to maintain DSC and liquidity levels near current levels in the face of increasing OpEx it could see additional positive rating action.

MIXED DEBT PROFILE, BURDEN SHOULD CONTINUE DECREASING

Debt per customer is better than the categorical median and is expected to continue declining as no new debt issuances are expected. Refunding transactions closed in fiscals 2016 and 2017 also helped reduce the debt burden. While debt to net plant at 79% is in line with the 'A' rating category (median 76%), debt to equity is elevated and weaker than similarly rated systems. Positively, the system benefits from relatively rapid amortization with 97% of debt fully retired in 20 years.

SUPPLY AND CAPACITY SUFFICIENT FOR ANTICIPATED GROWTH

The system's three water treatment plants (WTPs) currently provide capacity that is more than double the average annual usage (based on 2015 usage). Additionally, the system's current supply under its consumptive use permit is expected to be sufficient through at least 2024. Supplemental supply could come from the development of additional local groundwater that is more brackish. Under that scenario, one of the system's existing WTPs could be expanded to handle the brackish supply, and the necessary discharge permit is already in place.

Currently the system has only one WWTP in operation, but a second plant is under construction and expected to be operational by November 2018. Once completed, total sewer capacity will be more than 150% of average sewer flows in 2015. The additional capacity is expected to be sufficient through at least 2023 based on management's growth projections. Jointly, the water and sewer system is well-poised to accommodate growth through the intermediate term.

LOCAL ECONOMY CONTINUES TO IMPROVE, NEW DEVELOPMENT EXPANDS CUSTOMER BASE

The city's unemployment rate peaked in 2009 at over 14%, but is down to 5.6% as of November 2016. The poverty rate has also declined and was lower than county and state rates as of 2015. Building permits have nearly recovered to pre-recession levels. Despite a period of minimal to negative growth, the city's population has more than doubled since 2000 and was estimated at over 81,000 in 2016. Management reports new commercial developments within the central city along with residential growth rebounding in the city's periphery. The new developments will expand the system's customer base. Future growth potential is promising as there are still thousands of platted but undeveloped residential lots.

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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 Lumesis.

Applicable Criteria

Revenue-Supported Rating Criteria (pub. 16 Jun 2014)

<https://www.fitchratings.com/site/re/750012>

U.S. Water and Sewer Revenue Bond Rating Criteria (pub. 30 Nov 2016)

<https://www.fitchratings.com/site/re/890402>

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