RATING ACTION COMMENTARY

Fitch Rates Mesa Water District, CA's Revenue COPS 'AAA'; Outlook Stable

Tue 12 May, 2020 - 2:56 PM ET

Fitch Ratings - Austin - 12 May 2020: Fitch Ratings has assigned a 'AAA' rating to the following Mesa Consolidated Water District Improvement Corporation, CA (the corporation) obligations issued on behalf of Mesa Water District, CA (the district):

--Approximately $56.5 million revenue certificates of participation (COPs), series 2020.

Fitch has also assigned a 'AAA' Issuer Default Rating (IDR) to the district.

In addition, Fitch has affirmed the ratings on the following outstanding district obligations:

--$23 million revenue COPs, series 2017 at 'AAA'.

The COPs are expected to sell via negotiation on or around June 2. Proceeds will be used to fund capital projects and pay issuance costs. The Rating Outlook is Stable.

ANALYTICAL CONCLUSION

The 'AAA' IDR reflects the district's very low net leverage, calculated as net adjusted debt/adjusted funds available for debt service (FADS), within a very strong revenue defensibility and low operating risks profile. The district maintains rate setting autonomy and a high degree of rate affordability. The district is embarking on a large, but manageable, capital improvement plan (CIP) primarily to ensure continued reliance on local water supplies and for pipeline repair and replacement. Net leverage is expected to increase with this debt issuance but it is expected to remain low and consistent with the 'AAA' IDR.

CREDIT PROFILE

The district serves an affluent service area within 18 square miles that include most of the city of Costa Mesa, parts of Newport Beach and unincorporated areas in Orange County, California. As a built-out community in Orange County, the district's population of about 115,000 is largely residential and stable.

The district benefits from access to an ample supply of ground water, which is managed by the Orange County Water District (OCWD). The district currently operates six clear water wells that produce water at about half the cost of imported water even with a basin equity assessment (BEA) from OCWD and two deep water wells that produce amber water that the district treats at its advanced treatment facility, the Mesa Water Reliability Facility (MWRF). Completion of the MWRF in fiscal 2013 essentially eliminated the district's dependence on costly imported water supplies. While the cost of treating amber water is relatively high compared with the district's traditional clear water
treatment, the amber water is plentiful and is not subject to the BEA or the district's groundwater allotment limits from the OCWD. Treatment costs are also expected to be lower than the cost of imported water over time.

The outbreak of the coronavirus and related government containment measures worldwide create an uncertain global environment for the water and sewer sector. While the system's performance through most recently available data has not indicated impairment, there has only been a marginal increase in the number of delinquent accounts reported, material changes in revenue and cost profiles are occurring across the sector and likely to worsen in weeks and months, as economic activity suffers and government restrictions are maintained.

Fitch's ratings are forward-looking in nature, and Fitch will monitor developments in the sector as a result of the coronavirus outbreak, as it relates to severity and duration, and incorporate revised expectations for future performance and assessment of key risks.

KEY RATING DRIVERS

Revenue Defensibility 'aa'

Very Strong Revenue Defensibility; Ample Rate Flexibility

All revenues are derived from its monopolistic business line. The district has the legal ability to set rates, and rates are affordable to the vast majority of the population served. The service area is very strong with high income levels, low unemployment and stable customer levels.

Operating Risks 'aa'
Low Operating Risks

The district's operating risks assessment is favorable, with a very low cost burden that benefits from plentiful local water supplies and well maintained plant assets.

Financial Profile 'aaa'

Very Low Net Debt; Manageable Leverage Needs

Net leverage is very low and is expected to remain within the 'aaa' assessment range following the current bond sale. There are no additional debt plans over the ensuing five years.

ASYMMETRIC ADDITIVE RISK CONSIDERATIONS

No asymmetric additive risk considerations affected this rating determination.

RATING SENSITIVITIES

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

--Considerations that could lead Fitch to potentially consider an upgrade are not relevant given the 'AAA' rating.
Factors That Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade:

--Although not expected, a sustained increase in net leverage to greater than 5.0x resulting from higher than expected borrowing and/or a material narrowing of financial margin could put pressure on the rating.

--A material increase in user charges coupled with moderate deterioration in the service territory economic fundamentals could weaken the revenue defensibility assessment and pressure the rating without improvement in leverage.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Public Finance 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 COPs are secured by installment payments made by the district to the corporation. The corporation has assigned its right to receive installment payments to the trustee for the benefit of COP holders. Payments from the district are an absolute and unconditional obligation of the district, payable from a pledge of net water system (the system) revenues.
**REVENUE DEFENSIBILITY**

Revenue Defensibility is assessed at ‘aa’.

All utility revenues are derived from a monopolistic business, with customer charges representing the largest source of revenue. The district has independent legal ability to increase service rates subject to Proposition 218 requirements and rates are deemed affordable for the vast majority of the population at more than 80%. Currently expected rate adjustments are not anticipated to materially change service affordability levels.

The customer mix, as a percent of fiscal 2019 water sales revenue, is diverse with about 64% residential, 24% commercial and 6% governmental. The remaining are irrigation and industrial accounts. Although the top 10 users account for more than 10% of revenues, the top 10 users are generally stable governmental enterprises. In fiscal 2019 the top 10 customers accounted for 12.3% of water revenues and the City of Costa Mesa was the largest customer, accounting for 2.4% of total water revenues.

**OPERATING RISKS**

The utility's operating risks are assessed at 'aa'.

This takes into consideration a very low operating cost burden and moderate life cycle investment needs supported by adequate capital investment. Operating costs, while trending upward over the last five years, are expected to remain very favorable for the foreseeable future. Capital spending has well-exceeded depreciation annually over the last five years and is expected to continue as the utility implements the current $85 million fiscal 2020-2024 CIP. Concerns relating to technology and completion risks of the planned capital projects are limited.

**FINANCIAL PROFILE**
The financial profile is assessed at 'aaa'.

Fitch's calculated net leverage was less than 1x at FYE 2019, which is well under the assessment range. The liquidity profile is neutral to the rating with coverage of full obligations at 3.3x and liquidity cushion of 461 days at the close of fiscal 2019.

Fitch's net leverage calculation includes the district's net pension liability, as adjusted upward by Fitch to reflect a 6% discount rate, and is offset by the district's $13.5 million pension trust fund. Overall, the district's net debt in fiscal 2019 was only $3.3 million due to its low debt and large cash reserves. Measured against the district's solid operating results of $14.7 million adjusted FADS for the period, the net leverage is only 0.2x. In the context of the district's 'aa' assessments for both revenue defensibility and operating risks, a net leverage of less than 5x suggests a 'AAA' analytical outcome. Including the series 2020 COPs, the Fitch Analytical Stress Test tool (FAST) output reflects our expectation that the district will maintain net leverage consistent with the rating.

The FAST base case utilized the district's operating projections that were most recently adjusted to reflect management’s expectation with regard to the coronavirus, which reflects a 7.8% decrease in fiscal 2020 revenue that is somewhat offset by a 6.4% decline in operating expenses. The projections also reflect annual 5% rate increases, that were adopted through fiscal 2022, and assume additional 5% rate increases for fiscal years 2023 and 2024, although these are subject to board approval and Proposition 218 hearings.

The base case reflects net leverage rising to 3.9x in fiscal 2020 as a result of the current debt issuance, with swift declines thereafter back to under 1x by fiscal 2024. The FAST rating case, which layers an additional 10% in capital spending on the base case, reflects net leverage peaking in 2020 at 4.0x and then continuing a downward trend to 1.2x in fiscal 2024. Fitch also applied additional stresses to revenue in its forward looking assessment related to the effects of the coronavirus and possible lower than planned rate actions. The results increased net leverage marginally but remained supportive of the 'aaa' assessment. The district does not plan to issue additional debt over the next five years.

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

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

RATING ACTIONS

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Public Sector, Revenue-Supported Entities Rating Criteria (pub. 27 Mar 2020) (including rating assumption sensitivity)
U.S. Water and Sewer Rating Criteria (pub. 03 Apr 2020) (including rating assumption sensitivity)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form
Solicitation Status
Endorsement Policy

ENDORSEMENT STATUS

Mesa Consolidated Water District (CA) | EU Endorsed
Mesa Consolidated Water District Improvement Corporation (CA) | EU Endorsed

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