



RATING ACTION COMMENTARY

Fitch Rates Virginia Beach, VA's Water and Sewer Revs 'AAA'; Outlook Stable

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Fitch Ratings - New York - 28 Sep 2020: Fitch Ratings has assigned a 'AAA' rating to the following bonds issued by Virginia Beach, VA:

--\$50 million water and sewer revenue bonds, series 2020A;

--\$60.13 million water and sewer refunding revenue bonds, series 2020B.

The bonds are scheduled to sell via competition the week of Oct. 12, 2020. Series 2020A proceeds will be used to reimburse previous expenditures for water and sewer capital projects addressing rehabilitation and replacement, system expansion, roadway and storm water coordination projects and regulatory compliance. Proceeds of the 2020B bonds will be used to refund selected maturities of series 2010A-2, 2010B, and 2010C, and to pay costs of issuance. The series 2020A and 2020B bonds will include a debt service reserve fund equivalent to the maximum annual debt service on all bonds outstanding.

In addition, Fitch has affirmed the following ratings:

--Approximately \$207.8 million (pre-refunding) water and sewer revenue bonds at 'AAA'.

Fitch also has assessed the Standalone Credit Profile (SCP) of the water and sewer system (the system) at 'aaa'.

The Rating Outlook is Stable.

ANALYTICAL CONCLUSION

The 'aaa' SCP assessment and 'AAA' bond rating reflect the system's very low financial leverage in the context of very strong revenue defensibility and a very low operating risk profile, both assessed as 'aa'. The strength of the system's revenue defensibility is rooted in the system's very strong revenue-raising ability, supported by a broad, diverse, and mostly residential base within the city of Virginia Beach, as well as its very strong rate flexibility. The system's operating risk profile is bolstered by its very low operating cost burden and moderate lifecycle investment needs. System net leverage is expected to remain very low and stable over the five-year outlook relative to historical outcomes, reflecting a stable rate of annual capex and only a moderate level of additional borrowing.

Coronavirus Considerations

The recent outbreak of coronavirus and related government containment measures worldwide creates an uncertain global environment for the Water and Sewer sector. While the system's performance through most recently available data has not indicated material impairment, changes in revenue and cost profile are occurring across the sector. Fitch's ratings are forward-looking in nature. Fitch will continue to monitor developments in the sector as a result of the virus outbreak and incorporate any revised expectations for future performance and assessment of key risks as appropriate.

CREDIT PROFILE

Virginia Beach (Issuer Default Rating [IDR] AAA) is located in the Hampton Roads region of Virginia along the Atlantic Ocean and the Chesapeake Bay. It is the most populous city in the Commonwealth, with a 2019 census estimated population of roughly 450,000, up almost 3% since 2010.

The city's water system primarily consists of water distribution assets extending to a customer base of approximately 135,000. Potable water is provided through a long-term wholesale water treatment and conveyance services contract by the city of Norfolk (IDR AA+, water revenue bonds AA+/Stable). The city pays for a proportional share of Norfolk's operations and maintenance expenses, depreciation, and a rate of return on assets. The contract with Norfolk was recently extended through 2060.

In the 1990s, the city constructed a pipeline and obtained rights to pump surface water from Lake Gaston to address water supply needs. The Lake Gaston project, completed in 1997, includes a 76-mile, 60-inch diameter pipeline extending from a tributary of Lake Gaston to the city of Norfolk's treatment facilities, and provides Virginia Beach with an ample long-term independent water supply source.

The sewer system is a collection and conveyance system that includes collector lines, force mains, and pump stations. Sewer flows are transported to the treatment facilities operated by the region's highly rated sewer treatment provider, the Hampton Roads Sanitation District (HRSD, senior lien revenue bonds rated 'AA+'). HRSD provides direct retail sewer treatment and disposal services within Virginia's Hampton Roads region to around 470,000 accounts. HRSD's service territory encompasses 3,087 square miles and includes nine cities, eight counties, and several large military installations with a population of 1.78 million. HRSD bills Virginia Beach's approximately 132,000 customers directly for treatment service.

KEY RATING DRIVERS

Revenue Defensibility 'aa'

Very Favorable Demographics, Strong Rate Flexibility

Revenues are derived entirely from the city's exclusive right to provide water and sewer service within its service area. The service area's demographic characteristics are very favorable, supported by average customer growth, and income and unemployment metrics that compare favorably to national averages.

Operating Risks 'aa'

Very Low Cost Burden; Low Lifecycle Needs

Operating risks are considered very low based on a favorable operating cost burden and a lifecycle ratio averaging 42% since fiscal 2015.

Financial Profile 'aaa'

Very Strong Financial Profile to Remain Stable

The system's financial profile reflects a very low net leverage ratio of 3.4x in fiscal 2019. The liquidity profile, while neutral to the assessment, is solid with 413 days' cash on hand (DCOH), and Fitch-calculated coverage of full obligations (COFO) of 1.95x. These metrics are expected to remain stable over the five-year window.

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:

--Not applicable given the 'AAA' rating.

Factors that could, individually or collectively, lead to a negative rating action/downgrade:

--Net leverage exceeding 5.0x on a sustained basis in the context of 'aa' revenue defensibility and operating risk profile assessments;

--Realization of projected capital spending and planned debt over the course of the forecast period that materially exceeds current expectations and increases leverage beyond expected levels.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Sovereigns, Public Finance and Infrastructure 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 bonds are payable from a first lien pledge of the net revenues of the system including connection fees.

REVENUE DEFENSIBILITY

Revenue defensibility is strong and assessed at 'aa'. All revenues are derived from services or business lines exhibiting monopolistic characteristics in a service area with steady customer growth, stronger demographics and moderate rate flexibility. Economic activity and demand characteristics are heavily influenced by the federal government owing to the presence of several U.S. naval installations, in addition to a strong tourism component, real estate, agriculture, and trade and retail industry. The region's unemployment rate in July 2020 was 7.8% (heightened due to the coronavirus pandemic), which is favorable relative to state and national averages. Income levels are above average with median household income (MHI) at 123% of the U.S. average.

Water and sewer rates are set independently by city council and are considered affordable for the vast majority of the population. Monthly charges based on Fitch's standard 7,500 gallons per month (gpm) of water flows and 6,000 gpm of sewer flows equate to around \$119. Until 2019, the system had not increased water rates since 2010, despite concurrent wholesale water rate increases of about 2% per year from Norfolk. The 2019 rate increase from \$4.41 to \$4.90 related to the Norfolk contract extension. Additional rate increases under consideration are expected to be relatively moderate, or around 3.5% overall.

OPERATING RISKS

The system's operating risks are assessed at 'aa' which takes into consideration a very low operating cost burden with moderate life cycle investment needs supported by adequate capital investment. The system's operating cost burden has

averaged \$4,371 per million gallons (mg) of flows over the last five years, below the \$6,500 per mg threshold for the current 'aa' subassessment. The capital planning and management subassessment of 'aa' reflects a life cycle ratio of 43% as of fiscal 2019, just below Fitch's 45% 'aa' subassessment threshold. Capital spending as a percent of depreciation has been relatively high, averaging almost 133% of depreciation since fiscal 2015, but the lifecycle ratio has steadily increased (i.e., has weakened) from 40% in fiscal 2015, indicating a need to increase annual capex in order to update aging assets. While the lifecycle ratio could exceed Fitch's threshold over the next few years, overall operating risk is unlikely to weaken as a result.

Fiscal 2020-2024 capital spending totals \$166.5 million and focuses heavily on renewal and replacement of existing system assets. Most spending is dedicated to the sanitary sewer conveyance network, including spending on the system's extensive pump station infrastructure, but also in part to support the city's contributions towards a regional wet weather management program and sanitary sewer overflow reduction effort, managed by HRSD. This regional program is underway to comply with a state Special Order of Consent and federal consent decree to reduce the discharge of untreated sewage from various regions within HRSD's service area. The city's current spending plan remains consistent with historical commitment levels, and should sustain around this rate of spend beyond the five-year horizon.

FINANCIAL PROFILE

The financial profile is assessed at 'aaa'. Fitch's calculated net leverage is currently very low at 3.3x for fiscal 2019 and has been less than this level since fiscal 2015. The planned debt issuances to support the CIP are expected to increase leverage over the forward look, but ratios should remain below 5.0x. Although sound, the liquidity profile is neutral to the rating with coverage of full obligations at 1.95x and a liquidity cushion of 413 days at the close of fiscal 2019. Fitch calculated all-in debt service coverage for the year was 2.4x.

Fitch Analytical Stress Test (FAST)

The FAST base case was informed by the system's forecast, which assumes modest out-year rate increases, coronavirus-driven revenue decline, and a stable operating expense budget including around \$68 million in additional borrowings. The base case results point to net leverage staying within a 2.8x to 3.8x bandwidth. The FAST stress case, which layers an

additional 10% in capital spending on the base case, also points to relative stability, albeit in a slightly higher bandwidth between 2.9x - 3.9x. In both cases Fitch expects leverage to remain stable beyond fiscal 2024 as capital spending sustains at a similar pace, and supportive of the current rating level.

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.

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APPLICABLE CRITERIA

[Public Sector, Revenue-Supported Entities Rating Criteria \(pub. 27 Mar 2020\) \(including rating assumption sensitivity\)](#)

[U.S. Water and Sewer Rating Criteria \(pub. 03 Apr 2020\) \(including rating assumption sensitivity\)](#)

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