



RATING ACTION COMMENTARY

Fitch Rates Virginia Beach, VA's Stormwater Revs at 'AAA'; Outlook Stable

Tue 15 Sep, 2020 - 3:07 PM ET

Fitch Ratings - New York - 15 Sep 2020: Fitch Ratings has assigned an 'AAA' rating to the following bonds issued by Virginia Beach, VA:

--\$75.2 million stormwater revenue bonds, series 2020A; and

--\$13.6 million stormwater revenue refunding bonds, series 2020B.

The bonds are scheduled to sell via competition the week of Sept. 21, 2020. Proceeds will be used to fund a portion of the system's capital program, refund select maturities of the series 2010A and 2010B bonds and pay costs of issuance.

In addition, Fitch has affirmed the following ratings:

--Approximately \$67 million stormwater revenue bonds at 'AAA'.

Fitch has assessed the Standalone Credit Profile (SCP) of the stormwater utility system at 'aaa'.

The 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 its strong revenue defensibility and 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 increase over the next five years with additional planned debt and rising capital needs, but the ratios are anticipated to remain supportive of the rating over the forward look.

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 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. Economic activity is 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 system serves the entire incorporated city limits, including around 132,000 customer accounts. The system consists of a combination of pipes, canals, ponds and lake systems. The secondary drainage system is made up of pipe systems and open ditch systems that convey stormwater to the primary drainage system.

KEY RATING DRIVERS

Revenue Defensibility 'aa'

Very Favorable Demographics, Strong Rate Flexibility

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

Operating Risks 'aa'

Very Low Cost Burden; Increasing Capital Spending

Operating risks are considered very low based on a favorable operating cost burden and capital spending that has exceeded the pace of annual depreciation. Average annual capital spending over the next five years at \$60 million is well above the five-year historical average (about \$27 million). The lifecycle ratio is considered very low and given the level of investment associated with the current capital improvement program (CIP), should continue to support the operating risk assessment of 'aa'.

Financial Profile 'aaa'

Very Strong Financial Profile; Leverage Uptick Expected

The system's financial profile reflects an exceptionally strong net leverage ratio of 1.9x in fiscal 2019. The 'aaa' assessment considers the expectation that an increased CIP spending

and debt issuance will erode the financial profile near-term but should still remain below 5x over the forward look. The liquidity profile, while neutral to the assessment, is solid with 508 days' cash on hand (DCOH) and Fitch-calculated coverage of full obligations (COFO) of 9.2x

ESG - Environmental: The Virginia Beach stormwater system has an Environmental, Social and Governance (ESG) Relevance Score of '4' for Exposure to Environmental Risks, reflecting significant flood events and risk associated with sea level rise and land subsidence, which has become a critical issue in the Hampton Roads region and for the city. The rating reflects the city's efforts to mitigate its vulnerable flooding position through a comprehensive and far-reaching capital plan informed by scientific modeling.

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 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 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 limited obligations of the city, payable solely from net revenues of the city's stormwater system and any other money or sources pledged by the city.

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. Wealth levels exceed and unemployment levels are lower than the national rates, respectively.

Rates are set independently by city council and are based upon an equivalent residential unit (ERU), equal to 2,269sf of impervious surface area. Stormwater fees are billed together with the water and sewer utility bill and are billed monthly in arrears, contributing to very high collection rates. Delinquent accounts are subject to water service suspension and unpaid fees and interest constitute a lien against the property, ranking on parity with liens for unpaid taxes, including real estate taxes.

The fiscal 2019 stormwater fee was \$13.93 per month and is considered affordable for over 80% of the city's population. A planned increase of \$0.035 per day in fiscal 2021 was postponed to provide relief to residents and businesses to offset potential impacts of the coronavirus pandemic. However, the city's adopted fiscal 2021 budget includes a one-time general fund transfer to the stormwater fund of \$3.1 million to offset the elimination of the

2021 ERU increase. The five-year \$0.035 per day rate increase was extended by one year, through fiscal 2026, to account for the 2021 suspension.

OPERATING RISKS

The system's operating risk profile is assessed at 'aa' with very low operating cost burden and lifecycle needs. A low operating cost burden reflects the stormwater utility's limited operations, which consist of managing the conveyance of intermittent flows. The lifecycle ratio was 16% in fiscal 2019, reflecting a five-year trend of low lifecycle needs and solid capital investment. Fitch expects this ratio to remain well below the 45% Fitch threshold for the 'aa' assessment, as capital spending continues to outpace annual depreciation costs, which have exceeded 400% over the last five years.

The current five-year fiscal 2020 to 2024 CIP totals \$301 million, and while higher than historical CIPs, remains within the scope of what Fitch anticipated in its last review. The CIP focuses on addressing core issues related to flood control, including sea level rise, water quality, regulatory compliance, and operations and maintenance. Spending will address flooding in certain targeted areas and meet expanded compliance requirements associated with the Municipal Separate Storm Sewer System Program. Actual capital spending has historically tracked lower than budget, therefore the proposed CIP represents what Fitch believes is a conservative estimate of total spending. Debt has historically been issued on a reimbursement basis, resulting in lower actual issuances than planned due to the lower capital spending levels.

Intermediate-term capital spending should continue at the pace of the current five-year spend. However, the city has a 13-year goal of executing \$1.3 billion on local flooding and stormwater mitigation efforts, depending on evolving conditions, or a significant increase in current annual spending levels. Fitch will continue to monitor the rate of capital spending and debt issuances and the resulting impact on leverage.

FINANCIAL PROFILE

The financial profile is assessed at 'aaa'. Net adjusted debt/adjusted funds available for debt service was 1.9x in fiscal 2019, and has remained around this level since fiscal 2015 due to strong financial performance driven by steady rate increases and reductions in net debt resulting from solid cash reserves. Liquidity was assessed as neutral to the rating in 2019,

with COFO of 9.2x and DCOH of 508. Fitch-calculated debt-service coverage for the year was 6x.

Fitch Analytical Stress Test (FAST)

The FAST considers the potential trend of key ratios in a base case and stress case. The stress case is designed to impose a capital cost increase of 10% above expected levels and evaluate potential variability in projected key ratios. The FAST incorporates the system's forecast and capital spending estimates of around 62% of budgeted levels based on actual historical commitment rates. The expense forecast includes a fiscal 2020 reduction in transfers to the general fund, primarily attributable to the elimination of capital funds that have historically been transferred from the stormwater fund in support of general fund flood mitigation capital spending. This cost elimination will be ongoing over the medium term, supplanted by the system's increased CIP spending. The forecast also incorporates ongoing annual rate increases through at least 2026 and an additional \$172 million in new debt. The FAST outcomes point to a near-term increase in leverage that briefly exceeds 5x in fiscal 2023 but declines below 5.0x in fiscal 2024.

ASYMMETRIC ADDITIVE RISK CONSIDERATIONS

No asymmetric additive risk considerations affected this rating determination.

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

Virginia Beach Stormwater: Exposure to Environmental Impacts: '4'

Except for the matters discussed above, 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 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 \(pub. 03 Apr 2020\) \(including rating assumption sensitivity\)](#)

ADDITIONAL DISCLOSURES

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Virginia Beach (VA)

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