FITCH RATES VIRGINIA BEACH, VA'S STORM WATER REVS AT 'AAA'; OUTLOOK STABLE

Fitch Ratings-New York-31 January 2019: Fitch Ratings has assigned a 'AAA' rating to Virginia Beach, VA's (the city) approximately $30 million storm water utility revenue bonds, series 2019.

Proceeds will be used to finance improvements and expansions to the storm water system (the system) and to pay costs of issuance. The bonds are expected to be sold competitively on Feb. 13, 2019.

In addition, Fitch has affirmed the 'AAA' rating on the following parity bonds:

--$41.8 million storm water utility revenue bonds, series 2010A-2, series 2010B and series 2015.

The Rating Outlook is Stable.

SECURITY
The bonds are limited obligations of the city, payable solely from net revenues of the city's storm water system and any other money or sources pledged by the city.

KEY RATING DRIVERS
STRONG FINANCIAL FLEXIBILITY: The system's well-managed financial operations have consistently yielded high debt service coverage (DSC) and ample liquidity. The system's current strong financial position provides room to address significant capital needs.
CAPITAL NEEDS DRIVE EXPECTED INCREASE IN LEVERAGE: Capital spending has increased as the city focuses on addressing core issues related to flood control, including sea level rise, water quality, regulatory compliance, and operations and maintenance. Although the system currently has a low debt profile, capital funding will primarily come from additional debt, raising the system's leverage.
STABLE REVENUE BASE: Storm water fees are based on an equivalent residential unit's impervious surface area, resulting in a very stable revenue stream. Additionally, the fees are collected as part of the city's water and sewer bill, with a history of strong collections.
SOMEWHAT ELEVATED FEES: A history of steady rate increases results in monthly charges that, when combined with the city's water and sewer average residential bill, are slightly elevated as a percent of median household income (MHI). Rates will likely remain elevated as the city continues to adopt rate increase to help support capital needs.

RATING SENSITIVITIES

MAINTENANCE OF FINANCIAL MARGINS: Maintenance of the Virginia Beach storm water system's rating will be driven largely by the ability to maintain stable financial performance amidst growing capital needs associated with flood control, water quality and regulatory compliance, and operations and maintenance. A prolonged increase in capital needs and debt without offsetting increases in user fees or other revenue sources could strain the system's financial margins and pressure the rating.

CREDIT PROFILE

The system serves the entire incorporated city limits, covering approximately 450,000 residents and approximately 131,961 customer accounts in 2018. 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. The secondary system conveys storm water to the primary drainage system.

STRONG FINANCIAL PROFILE

Consistent, historical rate increases have helped produce robust operating margins and financial results. Fitch calculated DSC has averaged an exceptionally high 7.4x over the past five fiscal years, and days cash on hand (DCOH) has averaged 485 days over the same timeframe. In fiscal 2018, Fitch calculated DSC was 7.7x and DCOH was 515 days. The strong results in fiscal 2018 were bolstered by a $5.3 million one-time federal government capital contribution, as well as a $5.4 million transfer from the general fund that represents the one cent real estate tax dedicated to storm water capital projects. The city is projecting the real estate tax to increase to $6.2 million by fiscal 2023, and is an important source of funding for the capital improvement plan (CIP).

Management's current financial forecast indicates that DSC may decline to as low as 1.9x by fiscal 2023. This coverage figure may be conservative as it includes maximum issuance of additional debt to meet capital spending needs. However, management indicated that debt issuance tends to lag projections due to the ability to cash-fund a large number of projects combined with delays in project schedules.

STABLE REVENUE BASE, FULL RATE RAISING AUTHORITY

Storm water fees are set by city council, and the storm water fee is included with the customer's water and sewer utility bill, 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 storm water fee totals $13.93 per month (unchanged from fiscal 2018). When combined with the city's water and sewer average residential bill (including the Hampton Roads Sanitation District wastewater treatment fee), the total bill is slightly over 2% of MHI. This contributes to the system being able to generate substantial excess cash flow that provides resources to fund historically aggressive capital spending, while maintaining low leverage. Since fiscal 2008, the city has funded capital needs well in excess of the rate of annual depreciation. Rates are currently budgeted to increase by 2.5 cents annually through fiscal 2023.

GROWTH IN CAPITAL SPENDING

The city's fiscal 2019-2024 capital improvement plan (CIP) totals approximately $280 million (an average of $47 million annually). Roughly 66% of funding is forecast to come from debt issuance, with remaining funds primarily coming from the dedicated real estate tax and excess annual FCF generated by the system. The current CIP is roughly double the size of the fiscal 2017-2022 CIP.

The current increased CIP is within the scope of what Fitch anticipated in its last review, and is necessary in order for the city to address flooding in certain targeted areas and to meet new and expanded compliance requirements associated with the Municipal Separate Storm Sewer System (MS4) Program, which is a requirement for the MS4 permit.

EXCEPTIONALLY LOW LEVERAGE EXPECTED TO RISE

The system's low leverage has been a major credit strength to date, and positions the system well for new debt issuance. As of fiscal 2018, outstanding debt equated to a low 11% of system assets and debt per customer was just $324. Annual debt service carrying costs represented a small 8% of total gross revenues and total debt to funds available for debt service (FADS) was a low 1.6x.

Fitch expects the system's leverage profile to evolve concurrently with the implementation of its CIP and the proposed new debt issuance. Material new debt without offsetting increases in user fees or other revenue sources could compress financial margins and result in a debt profile less consistent with the 'AAA' medians. Management's ability to implement a financial strategy that supports strong financial margins will be key to maintaining rating stability.

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A January 2018 district court ruling that dismissed claims regarding payment of Puerto Rico Highways and Transportation Authority debt has raised questions about the scope of protections provided by Chapter 9 of the U.S. bankruptcy code to bonds secured by pledged special revenues. Fitch's rating criteria treat special revenue obligations as independent from the related municipality's general credit quality. The outcome of the litigation could result in modifications to Fitch's approach. For more information, see "What Investors Want to Know: The Impact of the Puerto Rico Ruling on Special Revenue Debt" available at www.fitchratings.com.

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

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Additional information is available on www.fitchratings.com

Applicable Criteria
Rating Criteria for Public-Sector, Revenue-Supported Debt (pub. 26 Feb 2018)
https://www.fitchratings.com/site/re/10020113
U.S. Water and Sewer Rating Criteria (pub. 29 Nov 2018)
https://www.fitchratings.com/site/re/10049877