FitchRatings

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Fitch Upgrades Hernando County's (FL) Water and Sewer Revs to 'AAA'; Outlook Stable

Fitch Ratings - New York - 23 Feb 2023: Fitch Ratings has upgraded to 'AAA' from 'AA+' the following bonds issued by Hernando County, FL (the county) revenue bonds:

--Approximately $59.5 million water and sewer revenue refunding bonds, series 2021A and 2021B.

In addition, Fitch has assessed the Standalone Credit Profile (SCP) of the county's water and sewer system (the system) at 'aaa'. The SCP represents the credit profile of the system on a stand-alone basis irrespective of its relationship with, and the credit quality of, the county.

The Rating Outlook is Stable.

ANALYTICAL CONCLUSION

The upgrade of the bond rating to 'AAA' from 'AA+' reflects the system's sustained declining leverage, measured as net adjusted debt to adjusted funds available for debt service (FADS), in conjunction with expectations that leverage remains exceptionally low below 2.0x in upcoming years. Leverage decreased from 3.4x in fiscal 2017 (FYE September 30) to 0.6x in fiscal 2021 as a result of amortizing debt and steady rate adjustments that have increased FADS by 30% over the five-year period (2018-2021). The expectation of lower leverage over Fitch's scenario analysis is driven by continued FADS growth from additional modest rate increases and expectations of a fully cash- and grant-funded capital improvement program (CIP).

The rating is also supported by very strong revenue defensibility and operating risk profiles, both assessed at 'aa'. The system maintains independent rate-setting autonomy and very strong rate flexibility with favorable service area characteristics. The operating risk assessment reflects a very low operating cost burden with low life cycle investment needs. Additionally, the system experienced no damage as a result of Hurricane Ian in September 2022 or Hurricane Nicole in November 2022.

CREDIT PROFILE

Hernando County is located in west-central Florida along the Gulf of Mexico, approximately 50 miles north of Tampa. The county is home to nearly 201,000 residents with the system providing retail service to a mostly residential customer base of around 64,000 water accounts and 31,000 sewer accounts. The county continues to experience rapid population growth driven primarily by the its proximity to employment opportunities in the Tampa-St. Petersburg-Clearwater metropolitan statistical area, affordable housing, and coastal access.

The system serves the City of Brooksville and the remaining unincorporated portions of the county and thus has a wide operational responsibility that includes a geographically dispersed network of 23 water treatment plants (WTPs). Water is sourced from the Upper Floridan Aquifer. The wastewater system consists of collection, transmission, treatment, and effluent disposal, with three water reclamation facilities

(WRF) and one wastewater treatment plant (WWTP). With many private septic systems, the utility plans further execution of its septic-to-sewer conversion program.

Fitch considers the system to be a related entity to the county given the relationship of the utility system as an enterprise fund of the county. The credit quality of the county does not currently constrain the bond rating. However, as a result of being a related entity, the issue rating could become constrained by a material decline in the county's general credit quality.

KEY RATING DRIVERS

Revenue Defensibility 'aa'

Very Strong Rate Flexibility; Favorable Service Area

The 'aa' assessment reflects the system's monopolistic service lines and favorable demand characteristics. Customer growth remains strong amid midrange median household income (MHI) and unemployment. Combined water and sewer rates are affordable for the vast majority of the population.

Operating Risks 'aa'

Very Low Operating Cost Burden

The system benefits from a very low operating cost burden of around $3,500 per million gallons (mg). The operating risk profile is supported by a low life cycle ratio and moderate investment needs with near-term capital spending expected to keep the ratio low.

Financial Profile 'aaa'

Exceptionally Low Leverage Expected to Continue

The trend of declining leverage continues, registering 0.6x in fiscal 2021. The upgrade is driven by expectations that leverage remains exceptionally low and typically not exceed 2.0x in the upcoming years. The liquidity profile is neutral to the assessment.

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:

--The rating is at the highest level on Fitch's scale and cannot be upgraded.

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

--A material increase in leverage metrics above projections and over 5.0x on a sustained basis, assuming revenue defensibility and operating risk assessments remain unchanged.

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 secured by a senior lien on net system revenues and connection fees.

Revenue Defensibility

Revenue defensibility is very strong, reflected in the 'aa' assessment. All system revenues are derived from monopolistic business lines providing water and sewer services to a steadily growing service area with favorable demographics, including midrange MHI (77%) and unemployment (96%) relative to national levels. With a five-year customer CAGR of 2.1%, the system attributes growth to both new development within the service territory and ongoing septic-to-sewer conversions.

The system maintains the independent legal ability to increase service rates without external approval. Annual rate increases are in place through fiscal 2024 with plans for a future rate study ahead of fiscal 2025. Water rates are set to increase 2.5% in both fiscal 2023 and fiscal 2024 while sewer rates are set to increase by 5% in both fiscal 2023 and fiscal 2024. The system's monthly residential bill for fiscal 2021 totals about $72 and is considered affordable for the vast majority of the population (85%), assuming Fitch's standard measurement of 7,500 gallons per month (gpm) of water and 6,000 gpm of wastewater.

Operating Risks

The system's operating risk profile is assessed at 'aa', which considers its very low operating cost burden and low life cycle ratio. The system's operating cost burden remained fairly steady at around $3,500 per mg for the last several years

The system's life cycle ratio remains low, but has increased marginally in recent years, registering 43% in fiscal 2021, up from 39% in fiscal 2017. Five-year average capital expenditures relative to depreciation reflects sustained investment, historically remaining above 100% before dipping to 90% in fiscal 2021. Planned capital spending should continue to keep pace with or outpace depreciation and keep the life cycle ratio close to the current level and supportive of the current assessment.

The five-year CIP totals $136 million through fiscal 2026, funded by accumulated cash reserves in addition to large amounts of grant and American Rescue Plan Act funding. No additional debt is anticipated through fiscal 2026. Major projects include Phase 1 of the Septic to Sewer Conversion District project, expansions to both the Airport WWTP and the Ridge Manor WRF, and upgrades to the Glen WWTP.

Financial Profile

The financial profile is assessed at 'aaa' with fiscal 2021 leverage registering 0.6x. Leverage has steadily decreased over the previous five years due to sustained revenue growth and accumulation of cash amid no new debt issuances. The system's liquidity profile is neutral to the assessment with 971 current days cash on hand and coverage of full obligations (COFO) of 3.1x at the close of fiscal 2021. Fitch also considers COFO excluding connection fees, which is also sound at 2.0x or higher since fiscal 2017.

Fitch Analytical Stress Test (FAST)

The five-year forward look provided by FAST considers the potential trend of key ratios in a base case and a stress case. The stress case is designed to impose capital costs 10% above expected base case levels and evaluate potential variability in projected key ratios. The FAST is informed by the system's fiscal 2022 unaudited figures, as well as the system's budgeted revenue, expense, and capital forecast assumptions for fiscal 2023 through fiscal 2026. Overall, from fiscal 2022 to 2026, total revenue increases by an average of 2.4% annually while expenses increase by 8.3% on average annually over the same period, which likely reflects conservativism as actual historical revenue CAGRs outpace expense growth.

Under these assumptions the FAST reflects modestly rising leverage as the system finances its $136 million five-year CIP, yet to a level comfortably supported by the current rating. Under the base case, leverage peaks at 1.5x in fiscal 2025 before falling to 1.0x in fiscal 2026 as the system comes out of its peak capital cycle. Under the stress case, leverage peaks at 2.1x in fiscal 2025 before falling to 1.7x in fiscal 2026. Both scenarios are supportive of the rating upgrade and the 'aaa' assessment. The liquidity profile is expected to remain neutral to the assessment with COFO of at least 3.0x and sound days cash annually.

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

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

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Rating Actions

ENTITY/DEBT		RATING		RECOVERY	PRIOR
Hernando County (FL) [Water, Sewer]					
• Hernando County (FL) /Water & Sewer Revenues/1 LT	LT	AAA	Upgrade		AA+

RATINGS KEY	OUTLOOK	WATCH
POSITIVE		
NEGATIVE		
EVOLVING		
STABLE		

Applicable Criteria

Public Sector, Revenue-Supported Entities Rating Criteria (pub.01 Sep 2021) (including rating assumption sensitivity)

U.S. Water and Sewer Rating Criteria (pub.18 Mar 2021) (including rating assumption sensitivity)

Additional Disclosures

Solicitation Status

Endorsement Status

Hernando County (FL)	EU Endorsed, UK Endorsed

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