# FITCH RATES RALEIGH, NC REVS 'AAA'; OUTLOOK STABLE

Fitch Ratings-New York-23 October 2019: Fitch Ratings has assigned a 'AAA' rating to the following Raleigh, NC (the city) revenue bonds:

--$171.1 million combined enterprise system revenue refunding bonds series 2019.

The series 2019 bonds are scheduled to sell via negotiation the week of November 4. Proceeds will be used to refund outstanding bonds and to pay issuance costs.

In addition, Fitch has affirmed the 'AAA' rating on the following bonds (pre-refunding):

--$673.8 million water and sewer revenue and revenue refunding bonds.

The Rating Outlook is Stable.

SECURITY

The bonds are payable from net revenues of the city's water and sewer system (the system).

KEY RATING DRIVERS

SOLID FINANCIAL PROFILE: System net revenues generate debt service coverage (DSC) well above 2.0x of total annual debt service. Ample liquidity and affordable rates provide further financial flexibility and a financial forecast indicates these strong trends should continue despite the prospect for additional debt.

ELEVATED LEVERAGE: Leverage metrics have historically exceeded Fitch's 'AAA' medians. However, debt levels have remained stable, consistent with city policy and practice, and associated annual debt service costs (ADS) have been ably supported by recurring revenues.

INCREASED, MANAGEABLE CAPITAL PROGRAM: Capital spending has grown in recent years to accommodate economic growth and expansion, as well as ongoing renewal and replacement of aging infrastructure. Positively, capital needs are not driven by capacity restraints or regulatory compliance, affording some greater discretion in execution over time.

SOLID SERVICE AREA: The city of Raleigh, Issuer Default Rating (IDR) AAA/Stable, is located adjacent to the Research Triangle Park (RTP), a regional economic engine. Economic indicators are strong, including low unemployment, above-average income levels and a highly educated labor force.

RATING SENSITIVITIES

MAINTENANCE OF STRONG CREDIT FUNDAMENTALS: Fitch expects that the strong credit fundamentals supporting the city of Raleigh's combined enterprise system, including robust coverage and liquidity and a well-managed capital and debt program, will preserve rating stability. An adverse departure from management's current financial forecast could potentially exert downward pressure on the rating.

CREDIT PROFILE

The city owns and operates a potable water distribution and wastewater collection, treatment and disposal system and a reuse water component. The service territory includes the city of Raleigh, several communities adjacent to the city, and portions of Wake County (IDR AAA/Stable). The system's customer base is stable and 94% residential.

## WELL-MANAGED FINANCIAL PROFILE

The system's adherence to (and consistent exceedance of) prudent financial policies has resulted in ongoing financial flexibility, including robust liquidity, strong coverage margins and a manageable (albeit high) debt burden. Examples of policies include a minimum 2.0x senior lien DSC requirement, a fund balance of no less than 100% of the operating expense budget, and a 50% cash-funded capital improvement program (CIP).

Improved system revenues driven by continued rate increases has resulted in solid senior lien DSC exceeding 2.0x since 2012. Fiscal 2018 Fitch-calculated senior lien DSC was 2.8x and all-in DSC, including debt service for subordinate lien state revolving fund (SRF) loans, was 2.5x. The city's financial forecast, prepared by a third party rate consultant, shows senior lien and all-in DSC no lower than 2.4x and 2.1x, respectively, through fiscal 2024. Unrestricted fiscal 2018 cash was a robust $360 million, providing the equivalent of nearly three and a half years' of cash on hand. The system's liquidity position serves as an important offset to an otherwise high and steadily growing debt burden.

## AFFORDABLE RATES

An affordable rate structure further enhances financial flexibility. Rates consist of fixed monthly service and infrastructure replacement fees, plus a variable inclining block volumetric charge, which has helped buffer against the impact of a statewide water consumption decline. Customers pay about $90 per month for a combined water and sewer bill (based on Fitch's standard 7,500 gallons of water per month [gpm] and 6,000 gpm of sewer), over a third of which is a fixed cost that provides guaranteed revenue to support asset renewal and replacement. The bill equates to an affordable 1.7% of median household income (MHI), below Fitch's 2% threshold.

Rates have increased substantially since 2008 yet remain objectively affordable relative to MHI. As a result, management retains substantial rate-raising flexibility and, with the consent of an amenable city council, intends to continue rate increases by between 1.3% and 3.1% annually through fiscal 2024.

## ELEVATED, ALBEIT MANAGEABLE LEVERAGE

Leverage metrics exceed those of other Fitch 'AAA' rated utility systems, due in part to debt issued over the past decade to keep pace of rapid growth and expansion. This concern is somewhat offset by adherence to internal policies that dictate additional leveraging, set minimum cash balances, and limit the amount of variable rate debt and the use of swaps.

In fiscal 2018, debt equated to $2,126 per customer, debt to plant was a high 55%, and total debt carrying costs (senior and subordinate lien annual debt service) comprised a 24% of gross revenues, each more than double Fitch's 'AAA' medians of $1,037 and 26% and 13% respectively. However, total debt relative to funds available for debt service (FADS) was only a moderate 6.4x, or a low 3.0x when offsetting debt with the system's ample unrestricted cash.

Additional revenue bonds of around $523 million and $67.5 million in low-interest SRF loans are expected to be issued to support around half of the system's $1.1 billion CIP. This amount is subject to change based on annually generated cash flows, but currently reflects management's standard 50%-debt funded CIP practice. Accordingly, debt metrics are expected to continue to increase moderately on a per-customer basis and relative to net fixed assets, but remain manageable relative to the system's overall operating profile. Moreover, the combination of existing principal amortization, the current refunding savings, and steady customer growth should keep metrics consistent with historical norms.

SIGNIFICANT CAPITAL INVESTMENT SUPPORTS STRONG SYSTEM CAPACITY

The system's five-year, fiscal 2020-2024 CIP totals $1.1 billion and focuses on growth, rehabilitation, and maintaining regulatory compliance. Capex priorities have shifted over time based on consumption and economic growth demand changes, as well as from the guidance of an extensive asset management and renewal and replacement program that targets aging infrastructure and sanitary sewer overflow reductions. Several notable, near-term spending items include a multi-year expansion and rehabilitation of the system's largest water treatment plant as well as the replacement of near-failing large-diameter sewer interceptors.

Water supply is derived primarily from Falls Lake, a multipurpose reservoir owned by the Army Corps of Engineers and to a lesser extent, Wheeler and Benson lakes. The system's two water treatment facilities have a combined capacity to treat nearly twice the average daily demand, and well in excess of typical peak usage. The wastewater treatment plants are capable of meeting current customer demands with expansion being added that will ensure capacity for the foreseeable future.

ROBUST ECONOMIC UNDERPINNINGS

Raleigh, the county seat of Wake County and the capital of North Carolina, is located in the north central part of the state adjacent to the RTP, which serves as an economic engine to the region's 1.8 million residents.

The city's economy boasts a skilled labor force and an employment base concentrated in service sector jobs related to government, education, technology, health care, and other professional services. Employment growth trends following the recession have accelerated over the past several years resulting in an unemployment rate for the city of just 4% in August 2019. Wealth and income levels are consistently above the state average and approximate the national average.

ESG CONSIDERATIONS

Unless otherwise disclosed in this section, the highest level of Environmental, Social and Governance (ESG) credit relevance is a score of 3. This signals that 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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In addition to the sources of information identified in Fitch's Public Sector, Revenue-Supported Entities Rating Criteria, this action was additionally informed by information from Lumesis.

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Additional information is available on www.fitchratings.com

Applicable Criteria
Public Sector, Revenue-Supported Entities Rating Criteria (pub. 28 May 2019)
https://www.fitchratings.com/site/re/10064680
U.S. Water and Sewer Rating Criteria (pub. 29 Nov 2018)
https://www.fitchratings.com/site/re/10049877