FitchRatings

Public Finance
Water & Sewer
U.S.A.

Mesa Water District, California

New Issue Summary

Sale Date: On or around June 2 via negotiated sale
Series: Approximately $56,545,000 Revenue Certificates of Participation (COPs), Series 2020
Purpose: Proceeds will be used to fund various capital improvement projects and pay issuance costs.
Security: The COPs are secured by installment payments made by the district to the Mesa Consolidated Water District Improvement Corporation. The corporation has assigned its right to receive installment payments to the trustee for the benefit of COP holders. Payments from the district are an absolute and unconditional obligation of the district, payable from a pledge of net water system revenues.

The 'AAA' Issuer Default Rating (IDR) reflects the district's very low net leverage, calculated as net adjusted debt/adjusted funds available for debt service (FADS), within a very strong revenue defensibility and low operating risks profile. The district maintains rate setting autonomy and a high degree of rate affordability. The district is embarking on a large, but manageable, capital improvement plan (CIP) primarily to ensure continued reliance on local water supplies and for pipeline repair and replacement. Net leverage is expected to increase with this debt issuance but is expected to remain low and consistent with the 'AAA' IDR.

The outbreak of the coronavirus and related government containment measures worldwide create an uncertain global environment for the water and sewer sector. While the system's performance through most recently available data has not indicated impairment, as there has only been a marginal increase in the number of delinquent accounts reported, material changes in revenue and cost profiles are occurring across the sector and likely to worsen in weeks and months, as economic activity suffers and government restrictions are maintained.

Fitch's ratings are forward-looking in nature, and Fitch will monitor developments in the sector as a result of the coronavirus outbreak, as it relates to severity and duration, and incorporate revised expectations for future performance and assessment of key risks.

Key Rating Drivers

Factors That Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade:

- Not applicable; given the 'AAA' rating, which is the highest Fitch rating, it could not be upgraded.

Factors That Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade:

- Although not expected, a sustained increase in net leverage to greater than 5.0x resulting from higher than expected borrowing and/or a material narrowing of financial margin could pressure the rating.
- A material increase in user charges coupled with moderate deterioration in the service territory economic fundamentals could weaken the revenue defensibility assessment and pressure the rating without improvement in leverage.

Rating

Long Term Issuer Default Rating	AAA

New Issue

$56,545,000 Mesa Water District Revenue COPs, Series 2020	AAA

Outstanding Debt

Mesa Water District Revenue COPs	AAA

Rating Outlook

Stable

Applicable Criteria

U.S. Water and Sewer Rating Criteria (April 2020)

Public Sector, Revenue-Supported Entities Rating Criteria (March 2020)

Related Research

Fitch Rates Mesa Water District, CA's Revenue COPS 'AAA'; Outlook Stable (May 2020)

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Credit Profile

The district serves an affluent service area within 18 square miles that include most of the city of Costa Mesa, parts of Newport Beach and unincorporated areas in Orange County, California. As a built-out community in Orange County, the district's population of about 115,000 is largely residential and stable.

The district benefits from access to an ample supply of ground water, which is managed by the Orange County Water District (OCWD). The district currently operates six clear water wells that produce water at about half the cost of imported water even with a basin equity assessment (BEA) from OCWD and two deep water wells that produce amber water that the district treats at its advanced treatment facility, the Mesa Water Reliability Facility (MWRF). Completion of the MWRF in fiscal 2013 essentially eliminated the district's dependence on costly imported water supplies. While the cost of treating amber water is relatively high compared with the district's traditional clear water treatment, the amber water is plentiful and is not subject to the BEA or the district's groundwater allotment limits from the OCWD. Treatment costs are also expected to be lower than the cost of imported water over time.

Revenue Defensibility

Revenue defensibility is assessed at 'aa'. The utility's revenue source subfactor is assessed at 'aa', which takes into consideration that the utility derives all revenue from water service provided to an affluent service area in Orange County, CA. The customer mix, as a percentage of fiscal 2019 water sales revenue, is diverse with about 64% residential, 24% commercial and 6% governmental. The remaining are irrigation and industrial accounts. Although the top 10 users account for more than 10% of revenues, they are generally stable governmental enterprises. In fiscal 2019, the top 10 customers accounted for 12.3% of water revenues and the city of Costa Mesa was the largest customer, accounting for 2.4% of total water revenues.

Service Area Characteristics

Fitch considers the service area characteristics to be very favorable, consistent with the 'aa' subfactor assessment, implying a high degree of resiliency of demand and collectivity. Customer growth experienced a five-year average annual compound growth rate of 0.7% at FYE 2019. Costa Mesa income levels are considered strong, with area household income at 131% of the national average. The unemployment rate has consistently been lower than state and national levels.

Rate Flexibility

The rate flexibility subfactor is also assessed at 'aa' with utility rates that are affordable for the vast majority of the population. The district has independent legal ability to increase service rates subject to Proposition 218 requirements, and rates are deemed affordable for the vast majority of the population at more than 80%. Fitch measures affordability relative to the most vulnerable customers who are at the lower income brackets of the service territory. The utility's monthly service charges at $53.69 (assuming 7,500 gallons of water and 6,000 gallons of sewer service billed) in fiscal 2019 are considered to be unaffordable to approximately 18 % of customers, as measured against the income levels of the city of Costa Mesa.

The district has diligently implemented annual rate increases since 2013 and has been adopting these rate increases in five-year increments. Most recently, the district adopted a five-year rate plan and rate schedule through a Proposition 218 hearing in November of 2017. The utility implemented a 5% rate increase for fiscal 2020 and has approved additional 5% rate increases through fiscal 2022. Currently, expected rate adjustments are not anticipated to materially change service affordability levels.

No asymmetric rating factor considerations affect the revenue defensibility assessment.

Operating Risks

The utility's operating risks are assessed at 'aa', which takes into consideration a very low operating cost burden and moderate life cycle investment needs supported by adequate capital investment. Operating costs, while trending upward over the last five years, are expected to remain very favorable for the foreseeable future. Capital spending has well-

Rating History (IDR)

Rating	Action	Outlook/ Watch	Date
AAA	Affirmed	Stable	5/12/20
AAA	Review — No Action	Stable	8/26/19
AAA	Review — No Action	Stable	10/12/16
AAA	Assigned	Stable	11/4/10

exceeded depreciation annually over the last five years and is expected to continue as the utility implements the current CIP. Concerns relating to technology and completion risks of the planned capital projects are limited.

Operating Cost Burden

The district's operating cost burden subfactor is assessed at 'aa' with a very low operating cost burden of $5,457 per million gallons of water produced in fiscal 2019. Fitch calculates this as the ratio of total annual operating costs including depreciation to total million gallons of water produced on an average annual basis. Although this is expected to increase over time, the current operating cost burden remains comfortably below the 'aa' threshold of $6,500 per million gallons.

Capital Planning and Management

Fitch assessed the district's capital planning and management subfactor at 'aa'. The district's life cycle ratio is 40%, and capital investment over the last five fiscal years averaged 176% of depreciation. The fiscal years 2020 to 2024 CIP totals $85 million. The series 2020 COPs will be used to fund about 81% of the capital program with the remaining funds from revenues and available reserves. The CIP consists mainly of the construction of two new groundwater production wells to increase clear groundwater production capacity, rehabilitation of two reservoirs, and pipeline replacements. Other projects include the development and construction of a MWRF education center and assessment and rehab or abandonment of existing vaults.

No asymmetric rating factor considerations affect the operating risk assessment.

Financial Profile

The financial profile is assessed at 'aaa'. Fitch's calculated net leverage was less than 1x at FYE 2019, which is well under the assessment range. The liquidity profile is neutral to the rating with coverage of full obligations at 3.3x and a liquidity cushion of 461 days at the close of fiscal 2019.

Fitch's net leverage calculation includes the district's net pension liability, as adjusted upward by Fitch to reflect a 6% discount rate, and is offset by the district's $13.5 million pension trust fund. Overall, the district's net debt in fiscal 2019 was only $3.3 million due to its low debt and large cash reserves. Measured against the district's solid operating results of $14.7 million adjusted FADS for the period, the net leverage is only 0.2x. In the context of the district's 'aa' assessments for both revenue defensibility and operating risks, net leverage of less than 5x suggests a 'AAA' analytical outcome. Including the series 2020 COPs, the Fitch Analytical Stress Test (FAST) tool output reflects our expectation that the district will maintain net leverage consistent with the rating.

The FAST base case utilized the district's operating projections that were most recently adjusted to reflect management's expectation with regard to the coronavirus, which reflects a 7.8% decrease in fiscal 2020 revenue that is somewhat offset by a 6.4% decline in operating expenses. The projections also reflect annual 5% rate increases that were adopted through fiscal 2022 and assume additional 5% rate increases for fiscal years 2023 and 2024, although these are subject to board approval and Proposition 218 hearings.

The base case reflects net leverage rising to 3.9x in fiscal 2020 as a result of the current debt issuance, with swift declines thereafter to under 1x by fiscal 2024. The FAST rating case, which layers an additional 10% in capital spending on the base case, reflects net leverage peaking in 2020 at 4.0x and then continuing a downward trend to 1.2x in fiscal 2024. Fitch also applied additional stresses to revenue in its forward looking assessment related to the effects of the coronavirus and possible lower than planned rate actions. The results increased net leverage marginally but remained supportive of the 'aaa' assessment. The district does not plan to issue additional debt over the next five years.

Asymmetric Additional Risk Considerations

No asymmetric additive risk considerations affected this rating determination.

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, either due to their nature or to 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.

Issuer Summary

($000, Audited Fiscal Years Ended June 30)	2015	2016	2017	2018	2019
Revenue Defensibility					
Service Area Characteristics					
Service Area Population Estimate	112,930	113,092	113,825	113,615	N.A.
Total Customer Count	24,491	24,488	24,477	24,748	24,993
Five-Year Total Customer Count CAGR	**0.4**	**0.4**	**0.3**	**0.5**	**0.7**
Service Area MHI ($)	66,459	70,438	75,109	79,207	N.A.
Service Area MHI/US MHI (%)	**123**	**127**	**130**	**131**	**N.A.**
Service Area Unemployment Rate (%)	4.5	3.5	3.2	2.6	N.A.
Service Area Unemployment Rate/US Unemployment Rate (%)	**85**	**71**	**73**	**67**	**N.A.**
Rate Flexibility					
Total Monthly Bill (7,500 gallons water/6,000 gallons sewer)($)	44.85	46.46	47.81	51.07	53.69
% of Population w/Unaffordable Bill	**18**	**18**	**18**	**18**	**N.A.**
Operating Risks					
Operating Cost Burden ($/mg)	**4,420**	**4,890**	**5,269**	**5,328**	**5,457**
Capital Planning and Management					
Life Cycle Ratio (%)	**37**	**38**	**38**	**39**	**40**
Annual CapEx/Depreciation (%)	68	110	263	230	207
Five-Year Avg Capital Expenditures/Depreciation (%)	**258**	**221**	**125**	**145**	**176**
Financial Profile ($000)					
Total Debt	27,014	24,723	36,806	33,452	30,278
Capitalized Fixed Charges	6,482	2,062	1,357	952	903
Adjusted Net Pension Liability	14,021	15,823	18,504	17,686	17,574
Available Cash	40,148	42,212	51,549	46,926	45,439
Funds Restricted for Debt Service	—	—	—	—	—
Net Adjusted Debt	**7,369**	**395**	**5,118**	**5,164**	**3,317**
Total Operating Revs	33,250	29,295	31,125	35,705	36,168
Purchased Water/Sewer Services	2,646	841	554	388	369
Other Operating Expenses	20,706	20,683	23,016	25,836	24,879
EBITDA	**9,898**	**7,770**	**7,555**	**9,481**	**10,920**
Investment Income/(Loss)	405	681	26	536	1,872
Other Cash Revenues/(Expenses)	10	—	—	17	—
Capital Contributions	1,248	3,257	2,750	412	774
FADS	**11,560**	**11,708**	**10,331**	**10,447**	**13,566**
Fixed Services Expense	926	295	194	136	129
Net Transfers In/(Out)	—	—	—	—	—
Pension Expense	651	434	1,122	1,275	1,009
Adjusted FADS	**13,137**	**12,436**	**11,647**	**11,858**	**14,705**
Net Adjusted Debt to Adjusted FADS (x)	**0.6**	**0.0**	**0.4**	**0.4**	**0.2**
FADS	**11,560**	**11,708**	**10,331**	**10,447**	**13,566**
Fixed Services Expense	926	295	194	136	129
Net Transfers In/(Out)	—	—	—	—	—
Adjusted FADS for COFO	12,486	12,003	10,525	10,583	13,695
Total Annual Debt Service	3,510	3,318	3,544	3,872	4,029
Fixed Services Expense	926	295	194	136	129
Adjusted Debt Service (including fixed services expense)	**4,436**	**3,613**	**3,738**	**4,008**	**4,158**

Issuer Summary

($000, Audited Fiscal Years Ended June 30)	2015	2016	2017	2018	2019
Coverage of Full Obligations (COFO) (x)	**2.81**	**3.32**	**2.82**	**2.64**	**3.29**
COFO exc. connection Fees (x)	**2.53**	**2.42**	**2.08**	**2.54**	**3.11**
Current Days Cash on Hand	**617**	**707**	**690**	**482**	**461**
Liquidity Cushion Ratio (days)	**617**	**707**	**690**	**482**	**461**
All-in DSC (x)	3.29	3.53	2.91	2.70	3.37
Cash and Investments ($000)					
Current Unrestricted Cash/Investments	39,445	41,674	44,567	34,648	31,910
Current Restricted Cash/Invest (Available Liquidity)	—	—	—	—	—
Current Cash Available	**39,445**	**41,674**	**44,567**	**34,648**	**31,910**
Noncurrent Unrestricted Cash/Investments	—	—	—	—	—
Noncurrent Restricted Cash/Invest (Pension Trust Fund)	703	538	6,983	12,278	13,529
Available Cash	**40,148**	**42,212**	**51,549**	**46,926**	**45,439**
Current Restricted Cash/Invest (Debt Service or Debt Service Reserve)	—	—	—	—	—
Noncurrent Restricted Cash/Invest (Debt Service or Debt Service Reserve)	—	—	—	—	—
Funds Restricted for Debt Service	**—**	**—**	**—**	**—**	**—**

N.A. – Not available. Note: Fitch may have reclassified certain financial statement items for analytical purposes.
Source: Fitch Ratings, Fitch Solutions, Mesa Consolidated Water District (CA).

The ratings above were solicited and assigned or maintained at the request of the rated entity/issuer or a related third party. Any exceptions follow below.