Topeka (City of) KS Combined Utility Ent.

Update to credit analysis

Summary

The Topeka Combined Utility Enterprise (Aa3 stable) benefits from a large and stable service area, adequate system capacity and healthy system liquidity that is expected to remain strong. While the system’s debt service coverage has improved, intermittent rate increases, weather patterns and increasing expenses have narrowed debt service coverage overall. However, the city is committed to increase rates over the near term to support a robust capital improvement plan. The debt burden is moderate and expected to increase, though remain manageable given forward planning by the system’s management team.

Credit strengths

» Stable service area encompassing the Kansas (Aa2 stable) state capital of Topeka (Aa3)

» Healthy system liquidity

Credit challenges

» Narrowed debt service coverage based on senior and subordinate debt service

» Moderate leverage and manageable future debt plans

Rating outlook

The stable outlook reflects the expectation that the system’s credit fundamentals will remain stable over the near term despite planned future debt issuances due to the city’s long range planning, conservative fiscal management and the governing body’s willingness to adjust revenues as needed to support operations and capital improvements.

Factors that could lead to an upgrade

» Sustained increases to debt service coverage including senior and subordinate lien debt

» Maintenance of liquidity above the median level for similarly rated systems

» Moderated debt burden

Factors that could lead to a downgrade

» Trend of declining debt service coverage

» Material and sustained declines in system liquidity
Key indicators

Exhibit 1

Topeka (City of) Combined Utility Enterprise, KS

System Characteristics

| Asset Condition (Net Fixed Assets / Annual Depreciation) | 24 years |
| System Size - O&M ($000) | $42,040 |
| Service Area Wealth: MFI % of US median | 85.70% |

Legal Provisions

| Rate Covenant (x) | 1.25x |
| Debt Service Reserve Requirement | DSIF funded at the lesser of the standard 3-prong test (Aa) |

Management

| Rate Management | Aa |
| Regulatory Compliance and Capital Planning | Aa |

Financial Strength

<table>
<thead>
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<th>2013</th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
<th>2017</th>
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<tr>
<td>Operating Revenue ($000)</td>
<td>$60,508</td>
<td>$63,138</td>
<td>$63,416</td>
<td>$65,888</td>
<td>$68,447</td>
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<tr>
<td>System Size - O&amp;M ($000)</td>
<td>$40,019</td>
<td>$42,159</td>
<td>$43,723</td>
<td>$43,430</td>
<td>$42,040</td>
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<tr>
<td>Net Revenues ($000)</td>
<td>$21,053</td>
<td>$21,520</td>
<td>$20,575</td>
<td>$23,062</td>
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<tr>
<td>Net Funded Debt ($000)</td>
<td>$176,302</td>
<td>$165,507</td>
<td>$174,183</td>
<td>$184,280</td>
<td>$190,134</td>
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<tr>
<td>Annual Debt Service ($000)</td>
<td>$17,075</td>
<td>$16,901</td>
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<td>$16,516</td>
<td>$17,594</td>
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<tr>
<td>Annual Debt Service Coverage (x)</td>
<td>1.2x</td>
<td>1.3x</td>
<td>1.3x</td>
<td>1.4x</td>
<td>1.5x</td>
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<tr>
<td>Cash on Hand</td>
<td>221 days</td>
<td>202 days</td>
<td>462 days</td>
<td>487 days</td>
<td>633 days</td>
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<tr>
<td>Debt to Operating Revenues (x)</td>
<td>2.9x</td>
<td>2.6x</td>
<td>2.7x</td>
<td>2.8x</td>
<td>2.8x</td>
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</tbody>
</table>

Source: Moody’s Investors Service, City of Topeka annual audited financial reports, bond legal documents associated with the outstanding revenue bonds.

Profile

The combined utility system provides water (wholesale and retail), wastewater and stormwater services to the city of Topeka, KS and surrounding areas, including six rural water districts and the airport. The combined utilities serve a population of approximately 165,000.

Detailed credit considerations

Service area and customer base: stable service area in state capital

The service area will remain stable given the City of Topeka’s role as state capital and positive developments in the private sector. Government related employment, including federal, state, local and military, represented approximately 41% of jobs in Shawnee County (Aa1) as of 2016 data from the Bureau of Economic Analysis. Two large medical centers in the city provide additional employment stability. While the region has not seen its labor force recover to pre-recession levels, the area has been experiencing growth in food manufacturing due to its proximity to agricultural inputs and strong transportation infrastructure that benefits manufacturing and distribution.

The combined utility system includes the water, wastewater and stormwater utilities. The water system possesses five senior water rights to the Kansas River granted by the Kansas Department of Agriculture’s Water Office. The system provides water treatment and distribution to approximately 57,000 customers, and sewer and stormwater services to approximately 47,000 customers. The enterprises have more than sufficient capacity to address the system’s demand. Among the water system’s largest customers are several rural water districts that receive raw water via long-term contracts. The top retail customers are relatively diverse, representing a variety of industries, including manufacturing, government, service and healthcare.

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Debt service coverage and net working capital: slightly improved coverage and healthy system liquidity
The system’s operating results and debt service coverage improved in fiscal years 2016 and 2017 and will remain stable, albeit slightly narrow, due to an expectation that the city council will continue to support multi-year rate increases as needed to fund the long range capital improvement plan. Moody’s calculation of the system’s debt service coverage considers both senior and subordinate debt, as well as subordinate payments in lieu of taxes (PILOT) to the general fund. Following narrow debt service coverage hovering around the 1.25 times range from fiscal 2013-2015, rate increases implemented over the past few years have aided in coverage increasing annually, up to 1.5 times in 2017. While the city council adopted annual rate increases of approximately 5% through fiscal 2020, increases to the debt service schedule from new revenue bonds is expected to keep debt service coverage stable. Year to date in fiscal 2018, the city reports revenues and expenses are generally tracking with the budget.

Debt service coverage improves when netting out the PILOTs from the system to the general fund, which is legally subordinate to the payment of debt. In fiscal 2017, $7 million of the system’s $42 million in operating expenses (net of depreciation) was attributable to PILOTs. Discounting PILOTs from the coverage calculation, debt service coverage on the aggregate senior state revolving fund (SRF) loans and subordinate revenue bonds increases to 1.9 times.

LIQUIDITY
The system’s cash position has increased annually over the past three years, up to $72.9 million as of fiscal 2017, representing an above-median (for similarly rated systems) 633 days of operating expenses. The cash position is partially tempered by a note outstanding in the par amount of $36.3 million. Further, the city expects to draw down a small portion of cash to support capital projects over the near term, but maintain cash above the policy of 180 days of expenses. Net working capital increased by $2.6 million in fiscal 2017, bringing it to $53.4 million, or 127% of operating expenses.

Debt and legal covenants: manageable debt burden; adequate albeit weaker legal covenants
Topeka's combined utility enterprise debt burden will remain manageable but increase in the near term due to capital projects that are planned over the next several years. As of fiscal 2017, the enterprise’s debt to revenues ratio was moderate at 2.8 times, and included $40.8 million in senior SRF loans, and $154 million in subordinate revenue bonds.

The combined utility's five year capital improvement plan calls for $217.5 million in investment from 2019 through 2023, which the city plans to largely debt finance. Annual rate increases are expected to support debt service, though absent commensurate revenue growth, the debt to revenues ratio is expected to materially increase. The city has indicated that future borrowings would be on parity with or subordinate to the junior lien, and does not intend to issue additional SRF debt.

Of the city's fiscal 2017 reported $93.6 million net pension liability, the combined utility system is responsible for approximately $4.7 million, or 5.1% of the total report unfunded liability. Moody’s adjusted net pension liability (ANPL) for the city as of 2017 was $276.8 million, which results in an ANPL of the system of $14 million, representing a small 0.3 times 2017 revenues.

DEBT STRUCTURE
All of the system’s debt is fixed rate. The senior SRF loans mature in 2029 while the junior lien revenue bonds mature in 2048. Revenue bond debt tends to be structured with level annual payments over thirty years; approximately half of the subordinate debt retires in ten years.

DEBT-RELATED DERIVATIVES
The system is not a party to any derivative agreements.

LEGAL COVENANTS
The system’s revenue debt maintains adequate, albeit slightly weaker legal covenants relative to typical covenants in the sector. The bonds are secured by a junior lien on system net revenues from the combined utility. Per the bond resolution, net revenues available to pay debt service on the revenue bonds are defined as gross revenues less operations and maintenance expenses net of payments in lieu of taxes (PILOTs), and debt service payments on outstanding state revolving fund loans (SRF). While the SRF loans are considered an expense under the bond resolution, they are ultimately loans and may be accelerated in an event of default, with consent of the bond insurer. The SRF loans do carry bond insurance.
The legal covenants require net revenues (as defined in the resolution) to provide 1.25 times coverage on annual junior lien parity debt service and an additional bonds test of 1.25 times maximum annual debt service. The coverage test for purposes of setting rates and issuing additional bonds is based on the bond resolution. Positively, the bonds are additionally secured by a cash debt service reserve fund that is equal to the least of the standard three-prong test and based on total parity revenue bond debt.

Management and governance
Management of the combined utilities falls under the utilities division directors, who report to the deputy city manager and finally the city manager. The city council approves budgets and policies and the city manager carries out the policies established through city departments, including the utilities department. The council and city staff have generally shown a willingness and ability to adjust rates as necessary to accommodate operations and reinvestment in the combined utilities system, including recent adoption of three years of rate increases. Recently, the city has bolstered capital planning for the combined utility, moving to a formal ten year capital improvement plan.
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