Fitch Rates Eastern Municipal Water District, CA's Revenue Bonds 'AA+'; Outlook Stable

Fitch Ratings-San Francisco-04 September 2018: Fitch Ratings has assigned a 'AA+' rating to the following Eastern Municipal Water District, CA (the district) debt:

--$94.2 million subordinate lien refunding water and wastewater revenue bonds series 2018A and related bank bonds;
--$53.5 million subordinate lien refunding water and wastewater revenue bonds series 2018B;
--$47.7 million subordinate lien refunding water and wastewater revenue bonds series 2018C.

The 2018A bonds, which are variable rate demand obligations (VRDOs), are scheduled to sell via negotiation on or about Sept. 27, 2018. A standby bond purchase agreement from Bank of America N.A. (rated 'AA-/Stable) will provide liquidity support for the purchase of tendered bonds in the event of a failed remarketing. Fitch expects to assign a short-term rating to the bonds that will reflect Bank of America's support. The long-term and bank bond ratings assigned above reflect the underlying credit quality of the district. The 2018B and 2018C bonds are floating rate notes (FRNs). They are scheduled to sell via negotiation on or about Sept. 13, 2018.

The proceeds will be used to refund the district's outstanding 2017E and 2017F private placements for debt service savings and to pay cost of issuance.

In addition, Fitch affirms the following ratings:

--$9.2 million senior water and sewer revenue bonds at 'AAA';
--$993.9 million subordinate water and sewer revenue bonds and associated bank bonds at 'AA+';
--$32.5 million Western Riverside Water and Wastewater Financing Authority revenue bonds (Eastern Municipal Water District improvement district general obligation (GO) bond financing) at 'AA+'.

SECURITY
The senior lien revenue bonds are secured by a first lien on net water and sewer revenues. The senior lien is effectively closed and all outstanding senior bonds will be repaid over the next four years. The subordinate working lien bonds are payable from a second lien on net revenues.

The GO bonds are payable from net system revenues after payment of all revenue bonds (senior and subordinate lien) and COPs, from available reserves and from ad valorem property taxes. The bonds are rated to the water and sewer revenue pledge.

KEY RATING DRIVERS
STRONG REVENUE DEFENSIBILITY: EMWD provides essential retail water and sewer services to a large and diverse suburban service area in western Riverside County. Operating revenues have held up well in the face of variable demand for water due to disciplined rate increases, the district's budget-based water rate structure, and very stable sewer and property tax revenues. The utility remains exposed to economically sensitive connection fee revenues, but overall financial performance has remained strong even during downturns in new home construction.

MANAGEABLE OPERATING RISKS: Operating risks are manageable with water supply variability and growth pressures as the primary risks. Water supply risks relate to the variability of imported water provided by the Metropolitan Water District of Southern California (Metropolitan,
rated 'AA+/Stable) and to cost pressures due to the wholesaler's significant capital needs. The district's sewer enterprise is subject to less operating risk. Managing growth is the primary challenge facing the sewer enterprise. Debt levels are above average but expected to decline gradually over the next five years as the district focuses on pay-go funding of capital.

FINANCIAL PERFORMANCE REMAINS STRONG: The utility's financial performance has remained strong through periods of extreme drought and deep recession. All-in debt service coverage (DSC) has averaged a very strong 2.6x over the past three fiscal years. Liquidity remains very healthy with 431 days unrestricted cash and investments on hand on June 30, 2017. Leverage remains elevated with debt to funds available for debt service at 8.8x, but leverage is expected to decline over the next five years amid rapid revenue growth and relatively flat debt levels.

RATING SENSITIVITIES
LEVERAGE TO DRIVE RATING: Management has shifted to greater use of pay-go funding of capital in recent years. The ratings could come under downward pressure if the district's financial strategy shifted, increasing reliance on debt-funding of capital again. The rating could also come under downward pressure if policymakers fail to set rates sufficient to provide continued strong financial performance.

CREDIT PROFILE
Eastern Municipal Water District's service area covers 550 square miles and includes the cities of Temecula, Murrieta, Moreno Valley, Hemet, San Jacinto and Perris, as well as unincorporated areas. The formerly agricultural region suburbanized rapidly in recent decades and is close to both Orange and San Diego Counties.

STRONG REVENUE DEFENSIBILITY
The suburban residential service area is diverse in terms of payers and has sound economic underpinnings. Median household income is solid at about 90% of the state level and 104% of the national level. The top 10 water and sewer customers provide a moderate 8% of operating revenues. The region's economy is performing strongly again with rapid residential development underway after deep downturn in the local housing market during the Great Recession. Despite the recession, Riverside County's strong population growth has outpaced both the state and the nation for many years. The region's growth is driven by an affordability advantage over nearby coastal regions and the availability of undeveloped land within commuting distance a major Southern California employment centers. Job growth has significantly outpaced the nation for the past seven years, and the unemployment rate, which trends higher than the national average, was low at 4.8% in June 2018.

The district's relatively diverse revenue mix yields a high degree of baseline revenue stability and solid coverage of debt service and operating expenses across business cycles, while volatile connection fee revenues provide significant excess funding for capital and reserve building in periods of strong growth. Very stable property taxes and fixed water and sewer fees averaged about 48% of total revenues over the past five years through 2018. Volatile connection fees averaged 12% of revenues over the period. Volumetric water charges provided about 31% of revenues. The district's allocation-based rate structure increases the average cost of water as sales fall during droughts by pushing usage into more expensive tiers, reducing volume risk. The district also benefits from reductions in water purchases as demand declines, offsetting lost revenues. Water purchases averaged about 35% of operating costs (excluding depreciation) over the past five years.

The district's board has the independent authority to raise water and sewer rates without outside regulatory approval. Rate payers can reject rate increases if a majority of customers submit written protests, but such challenges are rare and have not impeded rate increases. The district's elected board has raised rates as needed to maintain solid financial performance. Combined water and
sewer rates were affordable at about 1.6% of Riverside County's median household income for a customer paying Fitch's typical household wastewater charge and using 10 hundred cubic feet (HCF) of water in 2017. Actual water usage is significantly higher in this arid, suburban service area, suggesting somewhat less rate flexibility than Fitch's affordability measure suggests. But even with average use of 18 HCF of water per month, combined bills remain moderate. Rates also compare favorably to other local jurisdictions.

MANAGEABLE OPERATING RISKS
Operating risks are manageable with water supply variability, growth pressures and an elevated debt/fixted cost burden as the primary risks. Supply risks relate to the variability of imported supplies provided by Metropolitan and to cost pressures due to the wholesaler's significant capital needs. Metropolitan plans to fund a significant portion of the $17 billion (2017$) California WaterFix, pushing up EMWD's imported water costs and somewhat reducing rate flexibility.

The district's supply portfolio has diversified over the years, but EMWD remains dependent on imported supplies because of limited local rainfall. Metropolitan and EMWD have managed the supply variability well, storing large volumes of water in wet years for use in dry years and conserving deeply in droughts. EMWD has also invested heavily in local supplies. It has long recycled most of its wastewater flows, providing a highly reliable source of irrigation water that is not subject to interruptions due to weather variability and shifting environmental regulations that constrain imports. The district has also invested heavily in groundwater production, including desalination of brackish groundwater.

The district's sewer enterprise is subject to less operating risk. Managing growth, which affects both business lines, is the primary challenge facing the sewer enterprise. The district aims to deliver additional wastewater treatment capacity in small increments as needed by its rapidly growing population and currently has adequate capacity. Sewer flows equaled 63% of capacity in 2017, and the district is currently expanding capacity in the fast-growing Temecula wine country. The district has set aside a large amount of capital reserves to meet future growth needs and benefits from increased connection fee revenues in periods of high growth, somewhat offsetting growth pressures.

The district's $397.1 million fiscal 2019-2023 capital improvement plan (CIP) focuses on water-supply reliability, water recycling and energy independence with 61% of the funds spend on water. The district plans to fund about a third of the CIP with the proceeds of prior bonds and about two-thirds on a pay-go basis. The physical plant appears well maintained. The district has invested consistently to maintain and expand its infrastructure with capital expenditures to depreciation averaging 114% over the five years ended 2017. Financial average age of plant is below average at 12 years.

The district's debt burden is above average but expected to decline. Its roughly $1 billion debt burden at the end of fiscal 2017 was about 130% of the median for 'AA' category water and sewer utilities at $2,594 per customer. The district has no significant debt plans over the next five years, and debt is projected to decline slowly to about $2,226 per customer in 2022, which is in line with the projected debt median for the 'AA' category.

The district's debt portfolio is more complex than the typical municipal water and sewer utility with variable rate debt equaling about 35% of the portfolio and 28% unhedged. The current bond issues will refund outstanding variable rate debt. The 2018A bonds will be sold as VRDOs in daily mode. The 2018B bonds are FRNs indexed to the one month LIBOR, and the 2018C bonds are FRNs indexed to SIFMA. Both FRN series have a mandatory tender in September 2021, ahead of LIBOR's discontinuation.

FINANCIAL PERFORMANCE REMAINS STRONG
The utility performed well in very difficult operating environments in recent years, including periods of surging imported water costs, extreme drought and very weak connection fee revenues. Fitch calculated all-in DSC, which includes the district's general obligation bond revenues and debt service, was strong at 3x in fiscal 2016 and 2.6x in fiscal 2017. A reasonably conservative district forecast shows coverage remaining near 2017 levels across the forecast horizon. All-in coverage excluding connection fees has averaged a solid 1.5x over the five fiscal years ended 2017 and has been on a generally increasing trend with the district's efforts to generate more pay-go funding for capital.

The senior lien bonds are rated a notch above the subordinate working lien debt due to the additional bondholder protection provided by priority of payment and higher debt service coverage. Senior lien DSC was very strong at 5.6x in fiscal 2016 and rose to 7.4x in fiscal 2017. Senior lien coverage is expected to rise dramatically over the next four years, reflecting the rapid runoff of the lien's bonds.

Leverage remains elevated with debt to funds available for debt service at 8.8x, but leverage is expected to decline over the next five years amid rapid revenue growth and relatively flat debt levels.

Free cash to depreciation, a key measure of the utility's ability to maintain its existing assets from revenues, averaged a modest 60% over the five year period ended in fiscal 2017 but has been increasing gradually. The measure rose to 88% in fiscal 2016 and fell back to 75% in 2017. Fitch expects the ratio to continue to improve over the next several years.

While the district's connection fee revenues yield a degree of cyclicality in coverage, they have remained a significant source of revenues even in downturns, and Fitch does not expect them to decline to zero in a typical economic downturn. During the Great Recession, a particularly severe downturn, the pace of home construction decreased sharply in fast-growing Riverside County, but the district continued to see an average of 3,400 new connections a year during the period of relative weakness from 2009 to 2012. The number of new connections rose to 6,801 in fiscal 2018.

The utility's very strong financial reserves mitigate concerns about revenue volatility in the near term. Unrestricted cash and investments equaled $231.3 million, or 431 days of operating expenses, at the end of fiscal 2017.

Contact:

Primary Analyst
Andrew Ward
Director
+1-415-732-5617
Fitch Ratings, Inc.
650 California Street
San Francisco, CA 94103

Secondary Analyst
Shannon Groff
Director
+1-415-732-5628

Committee Chairperson
Douglas Scott
Managing Director
In addition to the sources of information identified in Fitch's Revenue-Supported Rating Criteria, this action was additionally informed by information from Lumesis.

Media Relations: Sandro Scenga, New York. Tel: +1 212 908 0278. Email: sandro.scenga@fitchratings.com.

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. 30 Nov 2017)
https://www.fitchratings.com/site/re/10010508

ALL FITCH CREDIT RATINGS ARE SUBJECT TO CERTAIN LIMITATIONS AND DISCLAIMERS. PLEASE READ THESE LIMITATIONS AND DISCLAIMERS BY FOLLOWING THIS LINK: HTTPS://WWW.FITCHRATINGS.COM/UNDERSTANDINGCREDITRATINGS. IN ADDITION, RATING DEFINITIONS AND THE TERMS OF USE OF SUCH RATINGS ARE AVAILABLE ON THE AGENCY'S PUBLIC WEB SITE AT WWW.FITCHRATINGS.COM. PUBLISHED RATINGS, CRITERIA, AND METHODOLOGIES ARE AVAILABLE FROM THIS SITE AT ALL TIMES. FITCH'S CODE OF CONDUCT, CONFIDENTIALITY, CONFLICTS OF INTEREST, AFFILIATE FIREWALL, COMPLIANCE, AND OTHER RELEVANT POLICIES AND PROCEDURES ARE ALSO AVAILABLE FROM THE CODE OF CONDUCT SECTION OF THIS SITE. DIRECTORS AND SHAREHOLDERS RELEVANT INTERESTS ARE AVAILABLE AT HTTPS://WWW.FITCHRATINGS.COM/SITE/REGULATORY. FITCH MAY HAVE PROVIDED ANOTHER PERMISSIBLE SERVICE TO THE RATED ENTITY OR ITS RELATED THIRD PARTIES. DETAILS OF THIS SERVICE FOR RATINGS FOR WHICH THE LEAD ANALYST IS BASED IN AN EU-REGISTERED ENTITY CAN BE FOUND ON THE ENTITY SUMMARY PAGE FOR THIS ISSUER ON THE FITCH WEBSITE.

Copyright © 2018 by Fitch Ratings, Inc., Fitch Ratings Ltd. and its subsidiaries. 33 Whitehall Street, NY, NY 10004. Telephone: 1-800-753-4824, (212) 908-0500. Fax: (212) 480-4435. Reproduction or retransmission in whole or in part is prohibited except by permission. All rights reserved. In issuing and maintaining its ratings and in making other reports (including forecast information), Fitch relieves on factual information it receives from issuers and underwriters and from other sources Fitch believes to be credible. Fitch conducts a reasonable investigation of the factual information relied upon by it in accordance with its ratings methodology, and obtains reasonable verification of that information from independent sources, to the extent such sources are available for a given security or in a given jurisdiction. The manner of Fitch's factual investigation and the scope of the third-party verification it obtains will vary depending on the nature of the rated security and its issuer, the requirements and practices in the jurisdiction in which the rated security is offered and sold and/or the issuer is located, the availability and nature of relevant public information, access to the management of the issuer and its advisers, the availability of pre-existing third-party verifications such as audit reports, agreed-upon procedures letters, appraisals, actuarial reports, engineering reports, legal opinions and other reports provided by third parties, the availability of independent and competent third- party verification sources with respect to the particular security or in the particular jurisdiction of the issuer, and a variety of other factors. Users of Fitch's ratings and reports should understand that neither an enhanced factual investigation nor any third-party verification can ensure that all of the information Fitch relies on in connection with a rating or a report will be accurate and complete. Ultimately, the issuer and its advisers are responsible for the accuracy of the information they provide to Fitch and to the market in offering documents and other reports. In issuing its ratings and its reports, Fitch must rely on the work of experts, including independent auditors with respect to financial statements and attorneys with respect to legal and tax matters. Further, ratings and forecasts of financial and other information are inherently forward-looking and embody assumptions and predictions about future events that by their nature cannot be verified as facts. As a result, despite any verification of current facts, ratings and forecasts can be affected by future events or conditions that were not anticipated at the time a rating or forecast was issued or affirmed.

The information in this report is provided "as is" without any representation or warranty of any kind, and Fitch does not represent or warrant that the report or any of its contents will meet any of the requirements of a recipient of the report. A Fitch rating is an opinion as to the creditworthiness of a security. This opinion and reports made by Fitch are based on established criteria and methodologies that Fitch is continuously evaluating and updating. Therefore, ratings and reports are the collective work product of Fitch and no individual, or group of individuals, is solely responsible for a rating or a report. The rating does not address the risk of loss due to risks other than credit risk, unless such risk is specifically mentioned. Fitch is not engaged in the offer or sale of any security. All Fitch reports have shared authorship. Individuals identified in a Fitch report were involved in, but are not solely responsible for, the opinions stated therein. The individuals are named for contact purposes only. A report providing a Fitch rating is neither a prospectus nor a substitute for the information assembled, verified and presented to investors by the issuer and its agents in connection with the sale of the securities. Ratings may be changed or withdrawn at any time for any reason in the sole discretion of Fitch. Fitch does not provide investment advice of any sort. Ratings are not a recommendation to buy, sell, or hold any security. Ratings do not comment on the adequacy of market price, the suitability of any security for a particular investor, or the tax-exempt nature or taxability of payments made in respect to any security. Fitch receives fees from issuers, insurers, guarantors, other obligors, and underwriters for rating securities. Such fees generally vary from US$1,000 to US$750,000 (or the applicable currency equivalent) per issue. In certain cases, Fitch will rate all or a number of issues issued by a particular issuer, or insured or guaranteed by a particular insurer or guarantor, for a single annual fee. Such fees are expected to vary from US$10,000 to US$1,000,000 (or the applicable currency equivalent). The assignment, publication, or dissemination of a rating by Fitch shall not constitute a consent by Fitch to use its name as an expert in connection with any registration statement filed under the United States securities laws, the Financial Services and Markets Act of 2000 of the United Kingdom, or the securities laws of any particular jurisdiction. Due to the relative efficiency of electronic publishing and distribution, Fitch research may be available to electronic subscribers up to three days earlier than to print subscribers.

For Australia, New Zealand, Taiwan and South Korea only: Fitch Australia Pty Ltd holds an Australian financial services license (AFS license no. 337123) which authorizes it to provide credit ratings to wholesale clients only. Credit ratings information published by Fitch is not intended to be used by persons who are retail clients within the meaning of the Corporations Act 2001.

Fitch Ratings, Inc. is registered with the U.S. Securities and Exchange Commission as a Nationally Recognized Statistical Rating Organization (the "NRSRO"). While certain of the NRSRO's credit rating subsidiaries are listed on Item 3 of Form NRSRO and as such are authorized to issue credit ratings on behalf of the NRSRO (see https://www.fitchratings.com/site/regulatory), other credit rating subsidiaries are not listed on Form NRSRO (the "non-NRSROs") and therefore credit ratings issued by those subsidiaries are not issued on behalf of the NRSRO. However, non-NRSRO personnel may participate in determining credit ratings issued by or on behalf of the NRSRO.