

MOODY'S

INVESTORS SERVICE

New Issue: Moody's assigns Aa2 to the City of Lawrence's, KS \$9.73M Water & Sewage System Rev. Ref. Bonds

Global Credit Research - 09 Jul 2015

LAWRENCE (CITY OF) KS
Cities (including Towns, Villages and Townships)
KS

Moody's Rating

ISSUE	RATING
Water and Sewage System Refunding Revenue Bonds, Series 2015-B	Aa2
Sale Amount	\$9,730,000
Expected Sale Date	07/14/15
Rating Description	Revenue: Government Enterprise

Moody's Outlook NOO

NEW YORK, July 09, 2015 --Moody's Investors Service has assigned an Aa2 rating to the City of Lawrence, KS \$9.73 million Water and Sewage System Refunding Revenue Bonds, Series 2015-B. Moody's maintains a rating of Aa2 on the system's \$134.7 million of parity debt outstanding.

SUMMARY RATING RATIONALE

The Aa2 rating reflects the system's stability, which is provided in part by its largest customer, the University of Kansas, solid financial operations and a history of annual rate increases that supports the ongoing capital improvement plan. Also considered is the history of healthy debt service coverage expected to continue despite plans to issue additional debt over the next five years, and adequate legal covenants.

OUTLOOK

Outlooks are generally not applicable for local government with this amount of debt outstanding.

WHAT COULD MAKE THE RATING GO UP

- Significant increase in annual debt service coverage
- Expansion of customer base

WHAT COULD MAKE THE RATING GO DOWN

- Trend of declining liquidity
- Trend of narrowing debt service coverage levels

STRENGTHS

- Stable system anchored by the University of Kansas (Aa2 stable)
- History of strong system liquidity and debt service coverage
- Strong management evidenced by ongoing capital improvement plan and supporting annual rate increases

CHALLENGES

- Capital improvement plan expected to increase debt burden in the near term

RECENT DEVELOPMENTS

Recent developments are incorporated in the Detailed Rating Rationale.

DETAILED RATING RATIONALE

SERVICE AREA AND CUSTOMER BASE: STABLE SERVICE BASE AREA ANCHORED BY UNIVERSITY OF KANSAS; ADEQUATE WATER SUPPLY AND SYSTEM CAPACITY

The city of Lawrence (Aa1) is located in northeastern Kansas, approximately 28 miles east of Topeka (Aa3) and 40 miles west of Kansas City, MO (Aa2 stable), and is the home of the University of Kansas. The city's population is currently about 95,000, which is up from 80,000 as of the 2000 census. The housing sector has shown some movement in the city and permit levels on the residential and commercial have been steady over the past five years. Calendar year 2015 new construction permit data through May 31 includes 59 residential permits and 10 commercial permits, which is just over half volume issued for calendar year 2014. More importantly, growth in the employment base, and above-average wage increases are supporting economic strength and expansion. Of note, the healthcare sector is in a growth mode locally, and the city reports it opened its first new industrial park in the past year. With the completion of the K-10 highway, which now connects with Interstate 70, city officials believe the opening of this transportation corridor will be a major growth driver going forward. In addition, the University of Kansas, a research institution and anchor to the Lawrence community, has been growing in its national research profile. Most notably, the university is now allowed to bid on classified contracts with federal agencies and has been receiving grant money for defense related research. The KU Medical Center has been on a similar track, and recently received \$10 million in federal money to conduct an obesity study. Currently student enrollment is approximately 25,000.

The city's water and sewage system serves approximately 33,000 customers, and provides wholesale treated water and wastewater treatment to six rural water districts and the city of Baldwin. Water is sourced through the Kansas River and the Clinton Reservoir, and is treated via two water treatment plants that each can handle average daily volume for the city of 10.2 mgd with some margin. Peak water usage is 24.6 mgd, which can be easily handled by both treatment plants simultaneously given the combined capacity of 36 mgd. The sewage system currently includes one treatment facility, although the current financing will fund a portion of the cost of an additional facility to accommodate future growth. The current facility can treat up to 12.5 mgd (dry) and 25 mgd (wet), as compared to average daily use of 8.9 mgd. The treatment plant can accommodate an additional 40 mgd during peak wet weather flow. The top ten taxpayers represent 22% of water pumped, with the University of Kansas representing the largest revenue-generator and user of the system, at 4.8% of water revenues and 7.6% of water volume.

DEBT SERVICE COVERAGE AND NET WORKING CAPITAL: ADEQUATE COVERAGE EXPECTED TO CONTINUE SUPPORTED BY ANNUAL RATE INCREASES

The City Council has demonstrated a long history of willingness to increase rates to maintain solid total debt service coverage levels and we expect this trend to continue as the system moves forward with its large scale capital plans. Both water and sewer rates for retail service (which represents over the majority of system revenues) increased by 6% in 2014 and are set to increase 6.5% in 2016 and 8% in 2017. The city reports that rate increases have taken place annually since 2004 in order to support the capital needs of the system. Moody's believes the city's trend of raising rates is a favorable credit factor and prudent given the utility's increasing expenditure requirements.

In fiscal 2014, net revenues available for debt service totaled \$14.8 million, which covered total debt service requirements of \$7.2 million by 2.04x, with senior lien coverage totally over 3.4x. In April 2015 the city refunded notes outstanding and issued additional new money debt totaling \$90.7 million. Including the note take-out and additional new money debt coming on in fiscal 2015, senior lien debt service coverage is projected to be 1.95x based on expected fiscal 2015 operating results and average annual debt service of \$7.4 million. The city officials have a goal to maintain fiscal year-end maximum debt service coverage of 1.5 times. The target is used for budgeting purposes in order to account for any reductions in water revenues and still sufficiently meet the rate covenant and additional bonds test.

Liquidity and Net Working Capital

The operating revenue of the system has been relatively stable over the past five years and stood at \$34.4 million as of fiscal 2014. The operating ratio has remained stable over the period at about 57-59%. The city has

maintained a strong liquidity position of the system over the past few years, keeping an excess of 350 days of cash on hand. As of fiscal 2014, total cash and investments equaled \$19.7 million, representing a healthy 373 days of operating expenses.

DEBT AND LEGAL COVENANTS: CAPITAL EXPENDITURES BOLSTERED BY REPLACING AGING SYSTEM INFRASTRUCTURE AND PREPARING FOR GROWTH; ADEQUATE LEGAL STRUCTURE

Moody's believe the systems' debt ratio will remain elevated in the near term given additional borrowing plans for the water and sewer system. The fiscal 2013 debt ratio remains elevated at 54.8% or 3.7 times 2014 operating revenues, which is above the medians for similarly rated credits. The city has been undertaking a robust capital improvement plan for the system to replace aging infrastructure and expand the system to accommodate growth. The plan calls for an additional \$58 million in funding through 2020, approximately \$54 million of which will be funded with debt and the remaining \$4 million through system revenues.

Debt Structure

The system's overall revenue bond debt structure includes more front-loaded amortization with annual debt service tapering lower over time. Including the 2015 Bonds, MADs of about \$9.6 million occurs in 2016, while average annual debt service is about \$7.4 million. Approximately 48% of principal will amortize within 10 years. Total parity debt outstanding will include \$134.7 million with a final maturity of 2040. All of the system's debt is fixed rate.

Debt-Related Derivatives

The city does not have any derivative agreements.

Legal Covenants

Legal provisions provide adequate bondholder security. The rate covenant requires net revenues to produce 1.20 times average annual debt service. Reserves are set at the least of the standard IRS three-prong test by series, and the additional bonds test is 1.20 times average annual debt service. All of the debt service reserves have been cash funded. Finally, the Bond Ordinance requires equal monthly installments for the next payment of principal and interest due.

MANAGEMENT AND GOVERNANCE: STRONG MANAGEMENT WITH DEMONSTRATED WILLINGNESS TO IMPLEMENT TIMELY RATE INCREASES

Management of the Lawrence Water and Sewage System provide departmental administration within the framework of the city's commissioner-manager form of government. Management of the system has been strong, evidenced by a the history of strong system liquidity, and a capital improvement plan that replaces aging infrastructure, plans for future growth, and stays ahead of environmental regulations.

KEY STATISTICS

- Asset condition (remaining useful life): 30 years
- System size (O&M): \$18.9 million
- Service area wealth: 104% of US
- Annual debt service coverage (fiscal 2014): 1.74x MADs
- Debt to Operating Revenues (fiscal 2014 inclusive of 2015 and 2015-B issues): 3.7x
- Rate covenant: 1.20x (senior)
- Debt service reserve requirement: Least of IRS three-prong test

OBLIGOR PROFILE

The City of Lawrence Water and Sewage System serves approximately 33,000 retail accounts within the city of Lawrence (Aa1) and provides wholesale water and wastewater treatment to six rural water districts and the city of Baldwin.

LEGAL SECURITY

The Series 2015-B Bonds are secured by a first lien on the net revenues of the system.

USE OF PROCEEDS

Proceeds of the 2015-B Bonds will be used to refund the Series 2005 Bonds for debt service savings. Annual savings, projected to be approximately \$100,000, will be applied to the city's capital improvement plan.

PRINCIPAL METHODOLOGY

The principal methodology used in this rating was US Municipal Utility Revenue Debt published in December 2014. Please see the Credit Policy page on www.moody.com for a copy of this methodology.

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