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CREDIT OPINION
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McLennan (County of) TX

Update to credit analysis

Summary

The credit profile of McLennan County, TX (GOLT Aa1) is solid. The tax base is large, and anchored by Baylor University and two hospitals; over the near-term, assessed values will increase due to ongoing residential and commercial development. The county has a healthy financial position after a period of surpluses, with another addition to fund balance expected in fiscal 2019. Resident income indices are below average, in part due to the student population. McLennan has manageable direct debt and pension burdens, with contributions favorably above tread water.

Credit strengths

» Strong operating trends; healthy reserves

» Stable tax base with institutional presence

» Manageable direct debt burden

Credit challenges

» Below average wealth indices

Rating outlook

Moody's typically does not assign outlooks to local governments with this amount of debt outstanding.

Factors that could lead to an upgrade

» Significant tax base expansion

» Improvement in resident wealth levels

Factors that could lead to a downgrade

» Sustained tax base contraction

» Trend of operating deficits that narrows reserves

» Material increase to the debt burden

Key indicators

Exhibit 1

McLennan County, TX	2014	2015	2016	2017	2018
Economy/Tax Base					
Total Full Value ($000)	$11,341,984	$12,166,663	$12,868,540	$13,882,215	$15,028,018
Population	239,717	241,505	243,394	245,720	245,720
Full Value Per Capita	$47,314	$50,379	$52,871	$56,496	$61,159
Median Family Income (% of US Median)	81.9%	82.4%	83.3%	83.4%	83.4%
Finances					
Operating Revenue ($000)	$91,939	$96,941	$101,144	$105,899	$113,343
Fund Balance ($000)	$37,527	$51,267	$53,219	$58,353	$62,398
Cash Balance ($000)	$38,541	$52,441	$54,488	$61,163	$66,394
Fund Balance as a % of Revenues	40.8%	52.9%	52.6%	55.1%	55.1%
Cash Balance as a % of Revenues	41.9%	54.1%	53.9%	57.8%	58.6%
Debt/Pensions					
Net Direct Debt ($000)	$67,179	$65,322	$64,635	$69,365	$64,680
3-Year Average of Moody's ANPL ($000)	$122,848	$135,413	$144,744	$169,216	$182,812
Net Direct Debt / Full Value (%)	0.6%	0.5%	0.5%	0.5%	0.4%
Net Direct Debt / Operating Revenues (x)	0.7x	0.7x	0.6x	0.7x	0.6x
Moody's - adjusted Net Pension Liability (3-yr average) to Full Value (%)	1.1%	1.1%	1.1%	1.2%	1.2%
Moody's - adjusted Net Pension Liability (3-yr average) to Revenues (x)	1.3x	1.4x	1.4x	1.6x	1.6x

Source: County's audits; Moody's; US Census (MFI)

Profile

McLennan County, TX is located between the Dallas-Fort Worth and Austin metropolitan areas and is anchored by Baylor University. The county seat is Waco, TX. The county's population is around 245,000.

Detailed credit considerations

Economy and tax base: large and growing tax base encompassing Waco MSA; Baylor University anchors base

The county's tax base is anchored by institutions of higher education and healthcare, which stabilize the local economy, as well as make it a desireable place for residential and commercial investment. McLennan County is located mid-way between the Dallas-Fort Worth metro area and the Austin metro area off the I-35 corridor. The county includes the city of Waco (Aa1 stable) as well as Baylor University, which currently enrolls nearly 17,000 students (around 7% of the population) and employs another 3,100. In addition, two large hospitals, Providence and Baylor Scott, employ over 4,000. The county actively recruits businesses to the area, and in the next 12 to 24 months, hopes to bring over 2,000 highly skilled jobs to Waco. Further, another 1,300 hotel rooms are expected to be added, which will allow the county to host conventions and other events that will translate to increased sales tax collections.

Resident income is below average in the county with median family income of 83.4% of the US (2017 ACS). Wealth indices likely experience some drag given the large student population. However, the labor market remains tight evidenced by a low 2.7% unemployment rate as of April 2019.

The county's fiscal 2019 net assessed value (AV) is large at $16.9 billion, which is net of the value associated with a tax increment reinvestment zone valued at $507 million. With the presence of Baylor University, a significant portion of the county's tax base is exempt from taxation and the estimated full market value of the county is much larger at $25.6 billion. Assessed value growth over the past five years has been strong averaging 7.7% annually. The county expects AV growth of around 6.3% in fiscal 2020. Going forward, officials are conservatively projecting AV expansion of anywhere between 2% to 6% per year. The tax base exhibits a very low level of taxpayer concentration with the top ten accounting for 5.8% of AV.

Financial operations and reserves: county's reserve position is expected to remain healthy

The county's financial position is strong after a period of surpluses. We expect this trend to continue given conservative budgeting, as well as management's commitment to maintain reserve levels. Fiscal 2018 ended with a $2.2 million surplus, increasing general fund balance to $54.6 million, or a healthy 51% of revenues. Property and sales taxes account for the majority of revenues (around 83%), with charges for services making up the remainder. Expenditures are typical of a Texas county, with McLennan making annual transfers out to support its Detention Fund (around 7.5% of the budget). Operating fund balance, including the general fund and debt service fund, had an ending balance of $63.4 million, or 56% of revenues.

Based on performance through June, the county is anticipating ending fiscal 2019 (September 30) with another addition to fund balance. The budget anticipated an unassigned general fund balance of $34 million, but the county is on target to realize an unassigned balance of $43 million. Officials report that fines and fees were up $1.4 million relative to budget, sales taxes were up $700,000, and expenditures were down.

The county is in process of preparing its fiscal 2020 budget, which will be adopted by end of August. Officials expect the fiscal 2020 budget to look similar to prior year's; there are no plans to utilize reserves for recurring or one-time costs.

LIQUIDITY

The county's cash position is healthy, and in line with fund balance. At fiscal 2018 year-end, the county had $57.7 million in general fund cash, or a healthy 53.9% of revenues. Operating cash, including the general fund and debt service fund, is $66.4 million, or 58.6% of revenues.

Debt and pensions: manageable debt and pension burden

The county's debt burden is expected to remain around current levels given future borrowing plans, which will be offset with anticipated tax base growth. At 0.5% of AV, the county's debt burden is manageable and in line with US medians. Included in the debt burden is $41 million in sales tax revenue bonds of the public facility corporation (component unit). Net of that, the county's GO burden is a low 0.3% of AV. The county does not have any immediate capital needs, but will likely issue in the next 18 to 24 months for emergency service upgrades.

DEBT STRUCTURE

All of the county's debt is fixed rate. Principal amortization is below average with 61.5% retired within ten years.

DEBT-RELATED DERIVATIVES

The county is not a party to any derivative agreements.

PENSIONS AND OPEB

The county participates in the Texas County and District Retirement System (TCDRS), an independently administered multi-employer, agent plan. The county has consistently fully funded its annual required contributions. However, Moody's notes that TCDRS' discount rate remains very high at 8.1%, which is much higher than most large US public pension systems, and highlights the system's vulnerability to pension asset volatility.

Moody's adjusted net pension liability (ANPL) for the county, under our methodology for adjusting reported pension data, which uses a more conservative discount rate, is $199.6 million for fiscal 2018. This liability is equal to a moderate 1.76 times annual operating revenues. The three-year average of the county's ANPL to operating revenues is 1.61 times.

Positively, the county's contributions are greater than tread water. In fiscal 2018, actual contributions of $8.9 million were above tread water of $6 million. The “tread water” indicator measures the annual government contribution required to prevent the reported net pension liability from growing under reported liabilities, and for the county, the “tread water” indicator is understated given the plan's discount rate remains so high. Contributions above this level cover all net pension liability interest plus reduce some principal. This is stronger from a credit perspective compared to contributions below this level. Ratios comparing government contributions to the “tread water” level and “tread water” costs to government revenues shed light on budgetary fixed cost burdens.

Further, the county has a recent history of making additional contributions to the plan in both fiscal 2016 and fiscal 2017, totaling $5 million. This demonstrates a willingness on part of management to address the county's long-term liability.

In fiscal 2018, total fixed costs, including debt service, pensions, and OPEBs, were a manageable 14.6% of operating revenues. Fixed costs will likely remain around current levels given relatively flat debt service coupled with revenue growth.

Management and governance: strong management team

The county exhibits conservative fiscal management evidenced by its formal fund policy to maintain unassigned general fund reserves at 33% of general fund expenditures. We also note management has utilized excess reserves in fiscal 2016 and fiscal 2017 to offset its pension liabilities, which we view positively.

Texas Counties have an Institutional Framework score of "Aaa", which is very strong. The sector's major revenue sources are subject to a cap, which cannot be overridden. However, the cap of $8 per $1,000 of assessed values, with no more than $4 allocated for debt service, still allows for significant revenue-raising ability. Unpredictable revenue fluctuations tend to be minor, or under 5% annually. Across the sector, fixed and mandated costs are generally less than 25% of expenditures. Unpredictable expenditure fluctuations tend to be minor, under 5% annually.

Rating methodology and scorecard factors

The US Local Government General Obligation Debt methodology includes a scorecard, a tool providing a composite score of a local government's credit profile based on the weighted factors we consider most important, universal and measurable, as well as possible notching factors dependent on individual credit strengths and weaknesses. Its purpose is not to determine the final rating, but rather to provide a standard platform from which to analyze and compare local government credits.

Exhibit 2

McLennan County, TX

Rating Factors	Measure	Score
Economy/Tax Base (30%) [1]		
Tax Base Size: Full Value (in 000s)	$16,440,957	Aaa
Full Value Per Capita	$66,909	Aa
Median Family Income (% of US Median)	83.4%	A
Notching Factors:[2]		
Institutional Presence		Up
Regional Economic Center		
Economic Concentration		
Outsized Unemployment or Poverty Levels		
Other Analyst Adjustment to Economy/Taxbase Factor:		
Standardized Adjustments [3]: N/A		
Finances (30%)		
Fund Balance as a % of Revenues	55.1%	Aaa
5-Year Dollar Change in Fund Balance as % of Revenues	28.0%	Aaa
Cash Balance as a % of Revenues	58.6%	Aaa
5-Year Dollar Change in Cash Balance as % of Revenues	30.7%	Aaa
Notching Factors:[2]		
Outsized Enterprise or Contingent Liabliity Risk		
Unusually volatile revenue structure		
Other Analyst Adjustment to Finances Factor:		
Management (20%)		
Institutional Framework	Aaa	Aaa
Operating History: 5-Year Average of Operating Revenues / Operating Expenditures (x)	1.1x	Aaa
Notching Factors:[2]		
State Oversight or Support		
Unusually Strong or Weak Budgetary Management and Planning		
Other Analyst Adjustment to Management Factor (specify):		
Standardized Adjustments [3]: N/A		
Debt and Pensions (20%)		
Net Direct Debt / Full Value (%)	0.5%	Aaa
Net Direct Debt / Operating Revenues (x)	0.7x	A
3-Year Average of Moody's Adjusted Net Pension Liability / Full Value (%)	1.1%	Aa
3-Year Average of Moody's Adjusted Net Pension Liability / Operating Revenues (x)	1.6x	A
Notching Factors:[2]		
Unusually Strong or Weak Security Features		Up
Unusual Risk Posed by Debt Structure		
History of Missed Debt Service Payments		
Other Analyst Adjustment to Debt and Pensions Factor (specify):		
Standardized Adjustments [3]: Secured by statute		
Other		
Credit Event/Trend Not Yet Reflected in Existing Data Sets:		
	Scorecard-Indicated Outcome	Aaa
	Assigned Rating	Aa1

(1) Economy measures are based on data from the most recent year available.
(2) Notching Factors are specifically defined in the US Local Government General Obligation Debt methodology dated December 16, 2016.
(3) Standardized adjustments are outlined in the GO Methodology Scorecard Inputs Updated for 2019 publication.
Source: Sources: US Census Bureau, Moody's Investors Service

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