

FITCH AFFIRMS HERNANDO COUNTY, FL'S WATER & SEWER REVS AT 'AA-'; OUTLOOK STABLE

Fitch Ratings-New York-06 May 2015: Fitch Ratings affirms the 'AA-' rating on the following Hernando County, FL (the county) revenue bonds:

--Approximately \$34 million water and sewer revenue refunding bonds, series 2013A.

The Rating Outlook is Stable.

SECURITY

The bonds are payable from a senior lien pledge of the net revenues of the county's water and sewer system (the system), and legally available connection fees.

KEY RATING DRIVERS

IMPROVED FINANCIAL PROFILE: Financial metrics have improved and stabilized over the past few years due to the implementation of rate increases and cost controls. Continued rate increases planned over the next five years are forecast to produce all-in debt service coverage (DSC) of 1.6x, which is adequate for the rating.

LOW DEBT BURDEN: Debt metrics compare positively to Fitch's 'AA' medians and are expected to stay favorable even as management borrows around \$38 million in additional subordinate state revolving fund (SRF) loans to support capital needs over the next five years.

RATES AFFORDABLE: The combined monthly residential bill of roughly \$53 is affordable at 1.5% of median household income (MHI). Continued rate increases will support additional debt requirements but charges should remain affordable.

MANAGEABLE CAPITAL NEEDS: The system's medium-range capital needs have stayed stable over the cycle and focus on expanding a wastewater treatment plant and other infrastructure improvements.

LIMITED LOCAL ECONOMY: The economy remains limited, concentrated mostly in agriculture, manufacturing, mining, and distribution. Wealth levels are low and low-wage employment dominates the local economy. Tampa is within commuting distance to parts of the county, which provides additional employment options.

RATING SENSITIVITIES

CONTINUATION OF SOLID FINANCIAL PERFORMANCE: A sustained trend of strong financial results similar to fiscals 2013 and 2014, low debt levels and manageable capital needs could result in upward rating action.

CREDIT PROFILE

Hernando County is located in west central Florida, along the Gulf of Mexico, approximately 50 miles north of the city of Tampa. The system provides retail service to approximately 57,000 water and 27,000 sewer accounts. The system is fragmented, serving various small and geographically

dispersed unincorporated areas of the county. Operating and regulatory concerns are heightened with the large number of facilities - 28 water treatment plants and six sewer treatment plants. The customer base is predominantly residential and there is no customer concentration.

RATE SETTING IMPROVES FINANCES

Financial results have improved significantly in recent years. Due to a series of rate increases and lowered operating expenses beginning in 2011, senior lien DSC has averaged 2.7x and with the onset of subordinate SRF loan repayments that year all-in DSC has averaged a solid 2.1x. Net recurring revenues yielded a strong senior lien DSC level of 3.5x in fiscal 2014, in part due to a decline in senior annual debt service (ADS) that year, and coverage of all debt was also strong at 2.3x.

A revenue sufficiency study conducted in May 2014 by an engineering consultant recommends continued rate increases through the forecast period (fiscal 2019) to meet system operational and debt service obligations. Based on these increases, net revenues are forecast to decline from 2014 levels as a result of additional debt but should remain at or above 2.4x senior lien DSC and 1.6x all-in DSC over the five year period.

Liquidity is strong. The system ended fiscal 2014 with \$16.3 million in unrestricted cash and investments, which combined with renewal and replacement (R&R) fund balances was equivalent to 382 days cash on hand. Available free cash relative to the annual rate of depreciation has been somewhat weak over time however, and a projected continuation of this trend into the forecast supports the system's need for additional debt, namely the SRF loans, to fund capital needs. Fitch views the system's currently low debt levels and ample rate-raising flexibility as important mitigating factors to support continued financial flexibility.

MANAGEABLE CAPITAL PLAN

Capital spending has been strong in recent years but has primarily been supported by debt. The annual capital spending rate as a percentage of depreciation has averaged a strong 142% over the past five years and the capital program is set to continue this trend over the ensuing five year forecast. The county's current \$83 million five year fiscal 2015-2019 capital improvement plan (CIP) appears manageable and will be 45% funded by additional SRF loans with the remaining 55% projected to come from ongoing revenues and reserves.

The primary goals of the CIP are to further system regionalization and interconnectedness in order to continue to reduce operating costs and improve service reliability, bolster the reclaimed water system's ability to offset potable water usage, and to expand wastewater treatment capacity. The largest single project remains the expansion of the Airport Road wastewater treatment plant, for which the CIP has about \$30 million budgeted.

One of the system's primary credit strengths is its low debt burden relative to the rating category. Current debt represents only 27% of net plant and debt per customer is a low \$715 compared to the 'AA' medians of 50% and \$1,934 respectively. Annual carrying costs in fiscal 2014 were only 13% for senior lien debt and 20% for all-in debt, compared to the corresponding 13% and 23% 'AA' medians. Current pro forma projections incorporating the onset of SRF loan repayments in fiscal 2017 indicate that these debt burden metrics should remain favorable.

FLEXIBLE AND AFFORDABLE RATES

Rates are structured with a base charge and inclining block consumption charges designed to promote conservation. The base rate is roughly 38% of the total bill, which is viewed favorably as the system is somewhat less dependent upon potentially variable flows. Rates are very affordable and compare favorably to other systems. At roughly \$53 for combined service in fiscal 2014, the average monthly

bill assuming 8,000 gallons of water use is just 1.5% of median household income (MHI), indicating significant additional rate raising flexibility.

In accordance with a multi-year rate plan approved by the county in 2010, water rates were increased by 4% in fiscal 2013 and by another 5% in fiscal 2014. Sewer rates were increased by 8% and 10% in fiscals 2013 and 2014, respectively. Going forward, management expects to implement additional rate increases as recommended by a third party rate consultant, and when combined, the increases range from 4% to 5% annually through fiscal 2019. While additional rate increases will push rates higher, the monthly bill is expected to remain competitive and affordable.

LIMITED LOCAL ECONOMY; ACCESS TO TAMPA MSA

The county experienced rapid population growth of nearly 30% from 2000 to 2010, and has a current estimated population of 176,000. Growth was driven by proximity to employment opportunities and commercial air service in Tampa, affordable housing, coastal access and recreational activities. Some residents commute to the Tampa metropolitan area, which serves as the economic anchor of Florida's Gulf Coast.

Local employment options remain limited with major industries including limestone mining, cement production, dairy and cattle production, construction, and manufacturing. The county also has an active tourism and retiree base. Employment growth over the past few years has helped lower the county's previously very high unemployment rate to a somewhat elevated 6.9% in December 2014.

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In addition to the sources of information identified in Fitch's Revenue-Supported Rating Criteria, this action was additionally informed by information from Creditscope.

Applicable Criteria and Related Research:
--'Revenue-Supported Rating Criteria' (June 2014);

- 'U.S. Water and Sewer Revenue Bond Rating Criteria' (July 2013);
- '2015 Water and Sewer Medians' (December 2014);
- '2015 Outlook: Water and Sewer Sector' (December 2014).

Applicable Criteria and Related Research:

Revenue-Supported Rating Criteria

http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=750012

U.S. Water and Sewer Revenue Bond Rating Criteria

http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=715275

2015 Water and Sewer Medians

http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=818409

2015 Outlook: Water and Sewer Sector

http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=818410

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