

RatingsDirect®

Summary:

Palacios, Texas; General Obligation

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Credit Profile

US\$2.16 mil GO rfdg bnds ser 2020 dtd 10/01/2020 due 08/15/2031

Long Term Rating A+/Stable New

Palacios GO (AGM)

Unenhanced Rating A+(SPUR)/Stable Affirmed

Many issues are enhanced by bond insurance.

Rating Action

S&P Global Ratings assigned its 'A+' long-term rating to Palacios, Texas' anticipated \$2.16 million general obligation (GO) refunding bonds, series 2020. At the same time, we affirmed our 'A+' rating on the city's GO debt outstanding. The outlook is stable.

The bonds are payable from revenue from a direct and continuing ad valorem tax levied, within the limits prescribed by law, on all taxable property within the city. Texas statutes limit the ad valorem tax rate for home rule cities to \$2.50 per \$100 of taxable assessed valuation (AV) for all city purposes. Administratively, the state attorney general will permit the allocation of \$1.50 of the tax rate for ad valorem tax debt service. We rate the bonds on par with our view of the city's general creditworthiness, as the tax base supporting the obligations is coterminous with the city, and we see no unusual risks regarding the fungibility of resources or the city's willingness to support the debt.

Proceeds from the sale of bonds will refund certain maturities of debt for net present value savings.

Credit overview

The city's credit metrics remain stable overall. Although susceptible to hurricane and weather events along the Texas Gulf Coast, Palacios' market value has grown modestly with few fluctuations over the past two decades. Stable fiscal performance has resulted in increased reserves, which are ample when compared to the city's budget, but relatively modest on a dollar basis. While unemployment has spiked in the county, the city's major revenue streams have not been significantly affected by the COVID-19 pandemic to date. Long-term effects of the pandemic will depend on the severity of the recession. (For more information, see "U.S. Economic Update: A Recovery At Risk As COVID-19 Surges," published July 22, 2020, on RatingsDirect.) Future credit reviews will focus on what influence the current situation has on the city as well as its ability to respond in a timely and appropriate fashion to ensure maintenance of stable key credit metrics.

The rating also reflects our view of the city's:

- Very weak economy, with market value per capita of \$45,314 and projected per capita effective buying income at 57.5% of the national level;
- Adequate management, with standard financial policies and practices under our Financial Management Assessment

(FMA) methodology;

- Adequate budgetary performance, with operating results that we expect could deteriorate in the near term relative to fiscal 2019, which closed with operating surpluses in the general fund and at the total governmental fund level;
- Very strong budgetary flexibility, with an available fund balance in fiscal 2019 of 55% of operating expenditures;
- Very strong liquidity, with total government available cash at 67.1% of total governmental fund expenditures and 18.0x governmental debt service, and access to external liquidity we consider strong;
- Very strong debt and contingent liability profile, with debt service carrying charges at 3.7% of expenditures and net direct debt that is 76.3% of total governmental fund revenue, as well as low overall net debt at less than 3% of market value and rapid amortization, with 92.3% of debt scheduled to be retired in 10 years; and
- Strong institutional framework score.

Environmental, social, and governance factors

Our analysis of these risks encompasses our review of current environmental, social, and governance risks. We acknowledge the ongoing pandemic and potential negative impacts it might have on various aspects of the city's creditworthiness. Absent COVID-19, we believe the social risks to be in line with the sector standard. We have also analyzed the governance risks and have determined that they are in line with our view of the sector standard. We do note the city's position along the Gulf Coast makes it more susceptible to hurricane and related weather events. We believe Palacios will maintain very strong reserves, which minimizes risks associated with near-term liquidity pressures and heightened expenditures directly after a storm, as well as ongoing infrastructure improvements that acknowledge the risks associated with hurricanes.

Stable Outlook

Downside scenario

A significant reduction of general fund reserves below what we would consider low nominal at \$500,000 or significant debt issuance without commensurate market value growth could lead to a downgrade.

Upside scenario

While unlikely, we could raise the rating if Palacios' economic indicators improve and all other factors remain stable.

Credit Opinion

Very weak economy

We consider Palacios' economy very weak. The city, with an estimated population of 4,633, is located in Matagorda County. The city has a projected per capita effective buying income of 57.5% of the national level and per capita market value of \$45,314. Overall, its market value grew by 5.9% over the past year to \$209.9 million in 2021. The county unemployment rate was 5.7% in 2019.

Palacios is approximately equidistant between Corpus Christi and Houston. Its economy is fueled by the maritime and tourism industries along Matagorda Bay, in addition to mineral production and agriculture. The South Texas Nuclear

Project site is located 13 miles away and is a major regional employer. The city's market value continues to grow modestly on an annual basis. The tax base mainly consists of single-family residential properties (65% of the total tax base), commercial properties (13%), and vacant lots (10%). The top 10 taxpayers are stable, make up a small 6.0% of the total tax base, and include a utility, marina, retail space, a bank, and rental housing community. City officials note some modest developments occurring in and around the city including the opening of shops and restaurants. The onset of the pandemic has not significantly affected the city or its businesses. Although there were disruptions, the vast majority of businesses remain open and are operating. The unemployment rate did spike in June to 11.2%, up from 6% in June 2019. Our view of the economy incorporates residents' below-average wealth indices. While near-term market value growth is likely limited, we expect property values and key economic indicators will remain stable in the near term.

Adequate management

We view the city's management as adequate, with standard financial policies and practices under our FMA methodology, indicating the finance department maintains adequate policies in some but not all key areas.

At least three years of historical data are used when building revenue and expenditure assumptions. Outside sources to monitor major revenues and economic trends are also used. The city monitors budget to actual performance through quarterly reports to the city council. It can amend the budget as needed throughout the year. Palacios does not maintain a long-term financial forecast. It does have a long-range vehicle and equipment replacement plan and improvement plan for utility infrastructure. The city adheres to an investment policy and provides updates to council on holdings and earnings quarterly. It has no debt policy but follows a reserve policy to hold 15% to 20% of expenditures in reserve, which it currently exceeds given the need for cash to offset risks associated with emergencies or weather events such as hurricanes.

Adequate budgetary performance

Palacios' budgetary performance is adequate in our opinion. The city had operating surpluses of 14.6% of expenditures in the general fund and of 15.6% across all governmental funds in fiscal 2019. Our assessment accounts for the fact that we expect budgetary results could be pressured as a result of the ongoing pandemic.

Historically, the city has maintained stable budgetary performance. In fiscal 2019, general fund revenues of \$3.2 million outpaced expenditures of \$2.6 million. Following transfers in and out, the general fund received a \$402,961 addition to fund balance at fiscal year-end (Sept. 30). For fiscal 2019, property taxes comprised 47% of the budget and sales taxes, franchise taxes, and mixed beverage taxes made up a smaller 15% of revenues combined. Officials report stable revenue performance in 2020 despite the onset of the pandemic. Sales tax collections are trending up slightly ahead of 2019 with only modest negative variations in April and May. Expenditures are trending to budget and officials anticipate a surplus at fiscal year-end. Heading into 2021, the city does not expect any change in the tax rate and anticipates remaining conservative with expenditures.

Very strong budgetary flexibility

Palacios' budgetary flexibility is very strong, in our view, with an available fund balance in fiscal 2019 of 55% of operating expenditures, or \$1.5 million. We expect the available fund balance to remain above 30% of expenditures for the current and next fiscal years, which we view as a positive credit factor.

Despite its relatively small dollar amount at \$1.5 million, the city's reserves represent a solid 54.6% of expenditures. Given positive year-to-date fiscal performance trends, we expect the city will maintain very strong reserves over the medium term.

Very strong liquidity

In our opinion, Palacios' liquidity is very strong, with total government available cash at 67.1% of total governmental fund expenditures and 18.0x governmental debt service in 2019. In our view, the city has strong access to external liquidity if necessary.

The city has demonstrated strong access to capital markets, with several GO-supported debt issues in the past 20 years. We do not expect deterioration in its liquidity profile. Palacios has \$416,000 in outstanding tax notes that were issued in 2017 and privately placed. The notes do not contain permissive events of default, cross-default provisions, or acceleration. We do not believe they put any near-term pressure on the city's liquidity.

Very strong debt and contingent liability profile

In our view, Palacios' debt and contingent liability profile is very strong. Total governmental fund debt service is 3.7% of total governmental fund expenditures, and net direct debt is 76.3% of total governmental fund revenue. Overall net debt is low at 1.7% of market value, and approximately 92.3% of direct debt is scheduled to be repaid within 10 years, which are in our view positive credit factors.

The city has no near-term debt plans and we do not expect the debt profile will change significantly in the near term.

Palacios' combined required pension and actual other postemployment benefits (OPEB) contributions totaled 8.3% of total governmental fund expenditures in 2019. The city made its full annual required pension contribution in 2019.

Pension and other postemployment benefits

Pension and OPEB costs are not a source of immediate credit pressure, given that they represent 8.3% of the city's budget. Recent volatility in the markets and the amortization and payroll growth assumptions will likely lead to increased costs in the future. However, we believe Palacios has sufficient budgetary flexibility and liquidity to address these costs. The OPEB obligation is funded on a pay-as-you-go basis.

The city participates in the following plans:

- Texas Municipal Retirement System (TMRS): 75.3% funded, with a net pension liability of \$1.5 million, and
- OPEB plan: 0% funded, with net liability of \$127,419.

Palacios provides pension benefits for all of its full-time employees through the TMRS, a multiple-employer, defined-benefit pension plan. Actuarially determined contributions fell slightly short of our minimum funding progress (MFP) metric. The MFP metric assesses whether the most recent employer and employee contributions cover total service cost, plus unfunded interest cost, plus one-30th of the principal. When MFP is achieved, it indicates that an issuer has strong funding discipline that aims to ensure timely progress on reducing plan liabilities. Actuarial assumptions include a discount rate of 6.75% and a 30-year closed amortization period. The plan's assumed discount rate is not aggressive, in our opinion, although we consider the closed amortization period of 30 years extended, leaving greater potential for costs to rise based on actual performance. Lastly, contributions are likely to increase,

given the level percent of payroll funding method, as opposed to level-dollar contributions, which would result in consistent payments.

OPEB includes a supplemental death benefit, which we view as modest.

Strong institutional framework

The institutional framework score for Texas municipalities is strong.

Related Research

- Through The ESG Lens 2.0: A Deeper Dive Into U.S. Public Finance Credit Factors, April 28, 2020

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