S&P Global Ratings

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Summary:
Friendswood, Texas; General Obligation

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Credit Profile		
US$9.62 mil GO imp & rfdg bnds ser 2020 dtd 06/01/2020 due 03/01/2050		
Long Term Rating	AA+/Stable	New

Rating Action

S&P Global Ratings assigned its 'AA+' long-term rating to Friendswood, Texas' approximately $9.6 million series 2020 general obligation (GO) improvement and refunding bonds. At the same time, S&P Global Ratings affirmed its 'AA+' long-term ratings on the city's existing GO debt. The outlook is stable.

Friendswood's GO bonds constitute direct obligations of the city, payable from the proceeds of a continuing, direct annual ad valorem tax, within the limits prescribed by law, on all taxable property within its borders. The maximum allowable ad valorem tax rate in Texas is $2.50 per $100 of assessed value (AV) for all purposes, with the portion dedicated to debt service limited to $1.50. The city's total tax rate is well below the maximum, at 52.14 cents, 8.93 cents of which is dedicated to debt service. Based on the application of our criteria, titled "Issue Credit Ratings Linked To U.S. Public Finance Obligors' Creditworthiness" (published Nov. 20, 2019), we view the limited-tax GO debt pledge on par with the city's general creditworthiness. The ad valorem taxes are not levied on a narrower or distinctly different tax base, and there are no limitations on the fungibility of resources available for the payment of debt service.

Proceeds of the series 2020 bonds will be used to fund drainage improvement projects and renovations to the public works facility. In addition, a portion of the proceeds will be used to refund the series 2010A and 2010B permanent improvement bonds for debt service savings.

Credit overview

Friendswood is a residential community located southeast of downtown Houston, where robust residential growth and construction have fueled tax-base expansion and a growing demand for services and infrastructure investment. Over the short term, we expect that growth trends could moderate in line with the slowdown in the greater U.S. economy. Through a combination of proactive budget management and stable revenue growth, Friendswood maintains fiscal balance while maintaining very strong reserves to cushion against unforeseen expenditures or revenue shortfalls. Its reserve position remains a key strength and source of near-term stability, particularly given possible revenue interruptions associated with the COVID-19 pandemic and protective social distancing guidelines. Over the next few years, the debt burden will likely remain adequate to weak, driven by additional debt issuance to fund voter-approved projects from the November 2019 bond election. The largest project authorization is for drainage improvements, and investment in this area remains key for the city given its proximity to the coast and exposure to weather-related event risk. Generally our rating outlook timeframe is up to two years. Given the current uncertainty around the pandemic, our view of the credit risks to the city are centered on the more immediate budget effects in 2020.

The rating reflects our opinion of the following credit factors:

- Very strong economy, with access to a broad and diverse metropolitan statistical area (MSA);
- Very strong management, with strong financial policies and practices under our Financial Management Assessment (FMA) methodology;
- Adequate budgetary performance, with a slight operating deficit in the general fund but break-even operating results at the total governmental fund level in fiscal 2019;
- Very strong budgetary flexibility, with an available fund balance in fiscal 2019 of 44% of operating expenditures;
- Very strong liquidity, with total government available cash at 78.4% of total governmental fund expenditures and 8.3x governmental debt service, and access to external liquidity we consider strong;
- Adequate debt and contingent liability profile, with debt service carrying charges at 9.4% of expenditures and net direct debt that is 101.0% of total governmental fund revenue, as well as rapid amortization, with 69.2% of debt scheduled to be retired in 10 years; and
- Strong institutional framework score.

Stable Outlook

Downside scenario

We would likely lower the rating if budgetary performance weakens resulting in a material decline in available reserves.

Upside scenario

Although unlikely over the near term, a higher rating would likely follow an expansion of the economy, which improves the city's wealth and incomes to levels more commensurate with those of higher-rated peers.

Credit opinion

Very strong economy

We consider Friendswood's economy very strong. The city, with an estimated population of 41,003, is located in Galveston and Harris counties in the Houston-The Woodlands-Sugar Land, TX MSA, which we consider to be broad and diverse. The city has a projected per capita effective buying income of 180% of the national level and per capita market value of $90,008. Overall, the city's market value grew by 9.4% over the past year to $3.7 billion in 2020. The weighted-average unemployment rate of the counties was 4.5% in 2018.

Friendswood is a primarily residential community located approximately 20 miles southeast of downtown Houston in the northeast corner of Galveston County. The city benefits from the expanding Houston metropolitan area, where residents commute for employment. Since the 2010 census, the city's estimated population increased 12%. While residents can commute to Houston and throughout Galveston County for employment, the leading employers locally are Friendswood Independent School District (750 employees), H-E-B (376), Kroger (315), the city (243), and Clear Creek Independent School District (215).

Before the recent slowdown in global economic activity caused by the COVID-19 outbreak, Friendswood experienced a multiyear period of robust economic growth largely fueled by residential development. Between tax years 2014 and 2019, the tax based increased about 7% annually. In aggregate, it expanded by $1 billion or 40% during that time frame. The tax base remains very diverse, with the leading taxpayers comprising just 3.3% of assessed value. According to city officials, the current development pipeline remains largely residential, supplemented by modest growth in the retail and medical sectors. Over the near term, we expect economic growth in the city will moderate somewhat in line with the near-term contraction in the U.S. economy. However, we do not expect the city's underlying economic fundamentals will fall below what we consider very strong.

Very strong management

We view the city's management as very strong, with strong financial policies and practices under our FMA methodology, indicating financial practices are strong, well embedded, and likely sustainable.

The city uses historical trends to obtain growth projections, which are used to develop both revenue and expenditure assumptions for the budget. It tends to make conservative revenue assumptions and slightly overestimate expenditures. A Municipal Cost Index is used to account for inflationary growth in projecting expenditures. In addition, the city works closely with the central appraisal district for property tax trends. Officials provide revenue and expenditure reports to the council monthly and amendments are generally made quarterly.

Friendswood prepares a long-term financial plan for budgeting purposes, using conservative estimates that look five years out for revenue growth projections. It makes multiyear expenditure projections that are updated annually and presented to the council as part of the budget process. There is a written five-year capital improvement plan in place, which was adopted by the council, with funding for capital projects identified and reviewed annually. The city has its own formal investment policy in place, providing quarterly reports to officials; the policy is reviewed annually. It has a comprehensive debt management plan that includes provisions for refunding debt, which must have a savings of at least 3%. The policy outlines what types of projects can be funded with debt and identifies amortization targets, affordability targets, and debt refunding procedures. The city has a formal reserve policy that requires it to maintain at least 90 days of operating reserves. This was developed to allow the city to maintain operations in an emergency situation.

Adequate budgetary performance

Friendswood's budgetary performance is adequate in our opinion. The city had slight deficit operating results in the general fund of 1.0% of expenditures, but a balanced result across all governmental funds of negative 0.5% in fiscal 2019.

Our ratios have incorporated recurring transfers into the general fund from the water and sewer fund while excluding nonrecurring capital costs funded with debt and insurance proceeds.

Our view of adequate budgetary performance reflects a recent track record of breakeven to surplus results in the general fund driven by modest revenue growth. Surplus revenues in excess of budget have allowed Friendswood to fund additional capital expenditures within the operating budget supplemented by debt and insurance proceeds. The primary sources of general fund revenue include property taxes (54%), sales taxes (22%), franchise taxes (7%), and fines and forfeitures (6%).

For fiscal 2019, audited results reflect a modest $61,000 use of reserves. Revenues were $1.3 million or 5% higher than budgeted. Departmental spending was largely under budget; however, the city used the excess revenue collections and departmental savings to fund an additional $1.7 million in capital expenditures compared with the original budget.

The fiscal 2020 budget is balanced. Although revenues were on track to exceed the original budget estimates through March, we expect that these trends could moderate because of possible short-term revenue interruptions during the COVID-19-driven recession. At this time, city officials expect revenues to meet or fall slightly below original projections, which should be supplemented by departmental expenditure savings to hit the established fiscal targets.

Very strong budgetary flexibility

Friendswood's budgetary flexibility is very strong, in our view, with an available fund balance in fiscal 2019 of 44% of operating expenditures, or $13.1 million. We expect available fund balance to remain above 30% of expenditures for the current and next fiscal years, which we view as a positive credit factor. In the past three years, the total available fund balance has remained at a consistent level overall, totaling 44% of expenditures in 2018 and 45% in 2017.

Friendswood maintains very strong available reserves that have been more than 40% of expenditures in the past three fiscal years. The formal policy requires the maintenance of reserves equal to at least 90 days' worth of operating expenditures. According to city officials, there are no near-term plans to reduce available reserves. In the near term, we expect available reserves will remain very strong, supporting the city's operating profile to provide security if revenues fall short of budget.

Very strong liquidity

In our opinion, Friendswood's liquidity is very strong, with total government available cash at 78.4% of total governmental fund expenditures and 8.3x governmental debt service in 2019. In our view, the city has strong access to external liquidity if necessary.

Friendswood has historically maintained a very strong liquidity position, and given management's demonstrated ability to maintain balanced operations; we do not believe liquidity will worsen in the near term. The city's strong access to external liquidity is demonstrated through access to the market over the past two decades to issue GO-backed bonds and utility revenue bonds. Currently, all of Friendswood's investments comply with Texas statutes and the city's internal investment policy. As of Sept. 30, 2019, investments included government securities and local government investment pools, which we do not consider aggressive. Friendswood does not have any current contingent liabilities that could lead to an unexpected deterioration from its currently very strong levels.

Adequate debt and contingent liability profile

In our view, Friendswood's debt and contingent liability profile is adequate. Total governmental fund debt service is 9.4% of total governmental fund expenditures, and net direct debt is 101.0% of total governmental fund revenue. Approximately 69.2% of the direct debt is scheduled to be repaid within 10 years, which is in our view a positive credit factor.

The city does not have swaps or variable-rate debt outstanding. Our ratios are based on $81.7 million of total direct debt outstanding including $56.9 million of tax-backed GO bonds. We have adjusted ratios to recognize the portion of tax-backed debt supported by the city's enterprise water and sewer fund. In the November 2019 bond election, voters authorized $52.1 million in bonds to fund projects for public works, public safety, and drainage. Approximately $8 million of the series 2020 bonds represents the first issuance of this authorization. Preliminary debt plans over the next two years include approximately $9.1 million in 2021 for the public safety improvement project and $5 million in 2022 for drainage. The debt score could weaken if additional debt were to lower the 10-year principal amortization below 65%.

Friendswood's combined required pension and actual other postemployment benefits (OPEB) contributions totaled 7.0% of total governmental fund expenditures in 2019. The city made its full annual required pension contribution in 2019.

We do not view pension and OPEB liabilities as an immediate credit risk for the city. Despite a somewhat extended amortization, the city's pension plan is adequately funded with actuarially determined contribution amounts. In addition, the city's very healthy reserves offset the risk of significant financial deterioration tied to potential near-term cost escalations.

Friendswood participates in the following plans as of Dec. 31, 2018 (latest measurement date):

- Texas Municipal Retirement System (TMRS), 81.84% funded with a net pension liability equal to $14.4 million. Contributions are actuarially determined, and the city has historically fully funded its annual required costs. Actuarial assumptions include a 6.75% discount rate and 27-year closed amortization period.
- Supplemental Death Benefits Fund (SDBF), which provides group-term life insurance benefits to active and retired members of the TMRS pension plan. The plan is funded on a pay-as-you-go basis, and the city's total OPEB liability for SDBF was $614,614. In 2019, benefit payments were $5,859.
- The City of Friendswood Retiree Health Care Plan, which provides an implicit health care premium subsidy to retirees. The plan is funded on a pay-as-you-go basis, and the total OPEB liability was $981,758.

Strong institutional framework

The institutional framework score for Texas municipalities is strong.

Related Research

- Criteria Guidance: Assessing U.S. Public Finance Pension And Other Postemployment Obligations For GO Debt, Local Government GO Ratings, And State Ratings, Oct. 7, 2019
- S&P Public Finance Local GO Criteria: How We Adjust Data For Analytic Consistency, Sept. 12, 2013

Ratings Detail (As Of April 24, 2020)		
Friendswood GO		
Long Term Rating	AA+/Stable	Affirmed
Friendswood GO perm imp and rfdg bnds		
Long Term Rating	AA+/Stable	Affirmed
Friendswood GO (AGM)		
Unenhanced Rating	AA+(SPUR)/Stable	Affirmed

Many issues are enhanced by bond insurance.