

Summary:

Southlake, Texas; General Obligation

Primary Credit Analyst:

Chase C Ashworth, Centennial + 1 (303) 721 4289; chase.ashworth@spglobal.com

Secondary Contact:

Andy A Hobbs, Dallas + 1 (972) 367 3345; Andy.Hobbs@spglobal.com

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Credit Profile

US\$17.69 mil GO rfdg bn ds ser 2019 dtd 05/01/2019 due 02/15/2030

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|-------------------------|------------|----------|
| <i>Long Term Rating</i> | AAA/Stable | New |
| Southlake GO | | |
| <i>Long Term Rating</i> | AAA/Stable | Affirmed |
| Southlake GO | | |
| <i>Long Term Rating</i> | AAA/Stable | Affirmed |
| Southlake GO | | |
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| Southlake GO | | |
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Rationale

S&P Global Ratings assigned its 'AAA' long-term rating to Southlake, Texas' series 2019 general obligation (GO) refunding bonds. At the same time, S&P Global Ratings affirmed its 'AAA' long-term rating and underlying rating (SPUR) on the city's previously issued GO debt. The outlook is stable.

The bonds and the city's parity debt is payable from a direct and continuing ad valorem tax levied, within the limits prescribed by law, on all taxable property within the city. 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. Based on the application of our "Issue Credit Ratings Linked To U.S. Public Finance Obligors' Creditworthiness" criteria (published Jan. 22, 2018), we view the limited-tax GO debt pledge to be on par with the issuer credit rating, which reflects the city's general creditworthiness. Texas statutes provide for a maximum ad valorem tax rate of \$2.50 per \$100 of taxable assessed valuation (AV) for all purposes, including a maximum of \$1.50 of the \$2.50 for all ad valorem tax obligation debt service. In fiscal 2019, the city's levy is well below the maximum at 44.7 cents per \$100 of AV, 9 cents of which is dedicated to debt service.

The bond proceeds will refund a portion of the city's GO debt outstanding to achieve debt service savings.

Southlake's 'AAA' rated bonds are eligible to be rated above the sovereign, because we believe the city can maintain better credit characteristics than the U.S. in a stress scenario. Under our criteria "Ratings Above The Sovereign: Corporate And Government Ratings—Methodology And Assumptions," published Nov. 19, 2013, U.S. local governments are considered to have moderate sensitivity to country risk. The city's locally derived property taxes secure the bonds, and the institutional framework in the U.S. is predictable with significant U.S. local government autonomy. In a potential sovereign default scenario, U.S. local governments should maintain financial flexibility through the ability to continue collecting locally derived revenues and U.S. local governments have independent

treasury management.

Southlake is an extremely wealthy, primarily residential, community that benefits from its location and access within the Dallas-Fort Worth-Arlington MSA. The city continues to experience economic growth, in line with much of the Dallas Metroplex, which is likely to continue due to ongoing commercial and residential development. The city's strong financial performance allows it to use excess revenues to cash fund capital projects, assisting with the expenditures associated with economic growth. While the city's debt burden is elevated, in our view, we do not anticipate it will affect its budgetary performance, and expect financial operations to remain sound.

The 'AAA' rating reflects our view of the city's 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;
- Very strong budgetary performance, with operating surpluses in the general fund and at the total governmental fund level in fiscal 2018;
- Very strong budgetary flexibility, with an available fund balance in fiscal 2018 of 68% of operating expenditures;
- Very strong liquidity, with total government available cash at 86.3% of total governmental fund expenditures and 4.6x governmental debt service, and access to external liquidity that we consider exceptional;
- Weak debt and contingent liability profile, with debt service carrying charges at 18.9% of expenditures and net direct debt that is 99.3% of total governmental fund revenue, but rapid amortization, with 74.1% of debt scheduled to be retired in 10 years; and
- Strong institutional framework score.

Very strong economy

We consider Southlake's economy very strong. The city, with an estimated population of 29,173, is located in Denton and Tarrant counties in the Dallas-Fort Worth-Arlington, TX MSA, which we consider to be broad and diverse. The city has a projected per capita effective buying income of 248% of the national level, which we view as extremely high and a positive credit factor and per capita market value of \$259,211. Overall, the city's market value grew 7.5% over the past year to \$7.6 billion in 2019. The counties' weight-averaged unemployment rate was 3.7% in 2017.

Southlake spans approximately 23 square miles, located just over 25 miles northwest of downtown Dallas, and 10 miles from the Dallas-Fort Worth (DFW) International Airport. In our view, the city continues to benefit from its favorable location in the DFW Metroplex and close proximity to the airport. The city is primarily residential, characterized by extremely high income levels, with many residents commuting to Dallas for employment opportunities. In addition, property values have historically been very strong and continue to improve, demonstrated by a 30% increase over the past five years, since fiscal 2014. Management projects a very conservative 2%-4% annual growth rate in AV, but it expects to exceed this rate based on trends and ongoing economic development.

While residential property taxes compose the majority (nearly 75%) of Southlake's AV, it also has a large commercial presence. Most of the city's commercial properties consist of retail and office space. The Southlake Town Square is a

large mixed-use development that offers high-end shopping, drawing shoppers from the surrounding areas. The Square also contains office space, a movie theatre, and a Hilton hotel. In addition to ongoing commercial economic development, the city has several residential developments that it expects to come online over the next few years. Therefore, we anticipate the city will continue to experience economic expansion over at least the next few fiscal years.

Very strong management

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

When drafting the budget, management uses historical trends and statistical information to forecast revenue and expenditures, as well as working closely with department heads during the budget process to identify departmental needs. Officials monitor the budget monthly and adjustments are typically made at midyear, although management has the flexibility to make amendments throughout the fiscal year. The city has a comprehensive formal long-term financial plan and a formal long-term capital improvement plan, with identified funding sources. The city has a written, in-depth, and conservative investment policy, and gives monthly updates regarding holdings and earnings to the governing body. It also has a formal debt management policy that it has historically adhered to, identifying targets for refunding parameters and types of debt that are acceptable for issuance. Finally, the city has a formal reserve policy that targets reserves of at least 25% of operating expenditures for emergencies, which it has historically maintained above this target.

Very strong budgetary performance

Southlake's budgetary performance is very strong in our opinion. The city had operating surpluses of 21% of expenditures in the general fund and of 3.3% across all governmental funds in fiscal 2018. When assessing the city's budgetary performance, we have adjusted for recurring operating transfers and one-time capital expenditures.

City officials attribute fiscal 2018's strong operating surplus primarily to growth in property and sales tax revenues, coupled with conservative spending. In line with the city's economic expansion, property tax revenues increased nearly 6% from fiscal 2017, while municipal sales and mixed beverage taxes grew by almost 3%. Overall, we believe the city's operating revenue streams are diverse, with property tax revenues accounting for just over half of general fund revenues, while sales tax revenues account for approximately 30%.

The city budgeted for another operating surplus for fiscal 2019, inclusive of a \$7.5 million transfer to the capital projects fund, consistent with previous years' transfers for capital projects. Management notes the budget is tracking well, and the city anticipates another operating surplus. Therefore, we believe the city's budgetary performance will remain very strong over the next few years.

Very strong budgetary flexibility

Southlake's budgetary flexibility is very strong, in our view, with an available fund balance in fiscal 2018 of 68% of operating expenditures, or \$26.9 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. Over the past three years, the total available fund balance has remained at a consistent level overall, totaling 67% of expenditures in 2017 and 65% in

2016.

Due to its history of balanced and positive budgetary performance, the city has maintained a very strong reserve position. While management has no material plans to draw on reserves, the city transfers excess revenues and reserves in excess of its fund balance policy to its strategic initiatives fund, which is included in our analysis of the city's available fund balance. Management uses the strategic initiatives fund for one-time high-impact projects involving infrastructure maintenance, community enhancement, and capital acquisition, limiting the amounts needed for future debt issuance. Based on our expectations for fiscal 2019, we do not anticipate the city's reserve position will deteriorate over the next two years.

Very strong liquidity

In our opinion, Southlake's liquidity is very strong, with total government available cash at 86.3% of total governmental fund expenditures and 4.6x governmental debt service in 2018. In our view, the city has exceptional access to external liquidity if necessary.

Southlake's exceptional access to external liquidity is demonstrated by its issuance of GO and revenue debt over the past 15 years. We do not view the city's investments as risky, given they are held in state investment pools, commercial paper, and government agency securities. Furthermore, we do not believe the city has any contingent liabilities that we view as a risk to its liquidity profile. Therefore, we expect the city's liquidity position to remain very strong over the next two years.

Weak debt and contingent liability profile

In our view, Southlake's debt and contingent liability profile is weak. Total governmental fund debt service is 18.9% of total governmental fund expenditures, and net direct debt is 99.3% of total governmental fund revenue. Approximately 74.1% of the direct debt is scheduled to be repaid within 10 years, which is in our view a positive credit factor.

We note the city's high overall net debt is driven in large part by significant overlapping debt of Carroll Independent School District. After the issuance of the 2019 bonds, the city will have approximately \$88.3 million in GO debt outstanding, much of which is considered self-supporting. Southlake plans to issue approximately \$3 million-\$5 million in additional debt annually over the next few years, in line with its CIP. Therefore, we believe the city will continue to have an elevated debt burden. In addition, if the city's 10-year amortization schedule were to fall below 65%, due to future debt issuances, we would have a weakened view of the city's debt profile.

Southlake's combined required pension and actual other postemployment benefits (OPEB) contributions totaled 3.6% of total governmental fund expenditures in 2018. The city made 102% of its annual required pension contribution in 2018. Southlake participates in the Texas Municipal Retirement System (TMRS), which is an agent multiple-employer hybrid pension plan administered by the State of Texas and it the city's largest plan. The required pension contribution is the city's actuarially determined contribution (ADC), which is calculated at the state level. Using reporting standards in accordance with Governmental Accounting Standards Board (GASB), the city's net pension liability (measured as of Dec. 31, 2017) was \$7.2 million (improved from \$11.9 million the previous year due to strong investment earnings), and its GASB funded ratio was 92.4%. TMRS calculates the ADC using a level percent of payroll amortization, assuming 3.0% annual growth, which adds risk, given that contributions are deferred with the idea that growth will enhance affordability. TMRS also amortizes using a layered 25-year offsetting approach. This means that each year

there is a loss, a new base is created to be amortized over 25 years, which we consider long. However, each year there is a gain, the largest loss is essentially reduced, decreasing overall contribution volatility. TMRS lists an equivalent single amortization period for the city of 28 years for fiscal 2018.

Southlake also provides OPEB in the form of health care; the city subsidizes medical, vision, dental, and life insurance coverage costs incurred by retirees and their dependents. Contributions are made on a pay-as-you-go basis, and totaled \$116,779 in fiscal 2017. Group-term life insurance is also provided through the Supplemental Death Benefits Fund operated by TMRS; the city paid its annual required contribution in fiscal 2018, equal to \$2,376.

Strong institutional framework

The institutional framework score for Texas municipalities is strong.

Outlook

The stable outlook reflects our opinion that Southlake will continue to maintain its very strong budgetary performance, allowing it to maintain its reserve and liquidity positions, which we view as very strong. In addition, we believe the city will continue to experience economic expansion, benefiting from its participation in the DFW MSA. Therefore, we do not anticipate changing the rating over the two-year outlook.

Downside scenario

Although unlikely, we could lower the rating if the city's budgetary performance significantly weakens to levels that we consider structurally imbalanced, causing the city to draw down its reserves to levels that we no longer consider very strong. In addition, we could lower the rating if Southlake's debt profile notably increases, causing material budgetary pressures.

Related Research

- 2018 Update Of Institutional Framework For U.S. Local Governments

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.

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