FitchRatings

Galveston, Texas

Ratings

Long-Term Issuer Default Rating	AA

New Issue

$32,050,000 Public Improvement Bonds, Series 2019	AA

Outstanding Debt

Combination Tax and Revenue Certificates of Obligation	AA
General Obligation Bonds	AA
Public Improvement Bonds	AA
Hotel Occupancy Tax Revenue Refunding Bonds	AA

Rating Outlook

Stable

Related Research and Criteria

Fitch Rates Galveston, TX's $32MM PIBs 'AA'; Outlook Stable (October 2019)

U.S. Public Finance Tax-Supported Rating Criteria (April 2018)

New Issue Summary

Sale Date: Week of Oct. 7 via negotiation.
Series: $32,050,000 Public Improvement Bonds, Series 2019.
Purpose: Street, bridge and drainage improvements.
Security: Annual property tax levy limited to $0.70 per $100 of taxable assessed valuation (TAV).

The 'AA' Issuer Default Rating (IDR) and rating on the GOs, COs and PIBs reflect the city's healthy operating cushion, solid expenditure flexibility and moderate long-term liability burden. The 'AA' rating on the HOT bonds reflects strong pledged revenue growth prospects and a sound resilience cushion, as well as a significant concentration of top taxpayers.

Economic Resource Base: The city Galveston is located on Galveston Island, approximately 45 miles southeast of Houston. With a 2018 population of approximately 50,500, the city is the seat of Galveston County (rated AA+/Stable by Fitch Ratings). The local economy is dominated by tourism, healthcare and maritime industries.

Key Rating Drivers

Revenue Framework: 'aa': The assessment is driven by the city's solid revenue growth prospects and satisfactory independent legal ability to increase operating revenues.

Expenditure Framework: 'aa': Fitch expects the city's natural pace of spending to grow in line with revenues, with expenditure flexibility derived from the city's discretion with respect to staffing and workforce costs. Fitch expects carrying costs to remain moderate, despite public safety pension contribution increases.

Long-Term Liability Burden: 'aa': Galveston's long-term liabilities are a moderate burden on the resource base and expected to remain so through the completion of the 2017 bond program.

Operating Performance: 'aaa': Fitch expects Galveston to demonstrate strong financial resilience during a moderate economic downturn. The city's budget management has been characterized recently by public safety pension contributions below actuarially determined levels, but recent reforms to both the firefighter and police plans should satisfactorily address this issue.

Rating Sensitivities

Sound Operating Cushion: The 'AA' IDR and bond rating are sensitive to maintenance of reserves consistent with the current operating performance assessment, particularly given the reliance on economically sensitive tourism revenue and the city's exposure to hurricanes.

Coverage Cushion: The 'AA' rating on the HOT bonds is sensitive to maintenance of a strong resilience cushion.

Credit Profile

Galveston benefits from its participation in the diversified and growing Houston-area economy, with the city's local economy centered in the tourism, healthcare and maritime industries. The Port of Galveston is home to four year-round home-ported cruise ships, contributing to the port's ranking as the nation's fourth busiest by embarkations. Passenger embarkations neared one million in 2018, and planned pier redevelopment will expand cruise

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ship volume in the coming years. In addition, ongoing beachfront and other commercial improvements (e.g. hotel and motel construction) further contribute to the growing tourism trade. The University of Texas Medical Branch (UTMB) anchors the city's health and education service sector, and serves as a teaching hospital and hub for medical research.

The Port of Galveston and nearby Pelican Island support expanding industrial operations, cargo transportation and petroleum support services. Recent and near-term infrastructure improvements bode well for growth in the island's maritime and industrial sectors.

Revenue Framework

The city's general fund revenue stream consists of property taxes (48% of fiscal 2018 revenues), sales taxes (31%), franchise and other taxes, charges for services, and fees. Other dedicated funding sources such as the city's hotel occupancy taxes provide additional funds to mitigate operating and capital pressure on the general and debt service funds. The city's ad valorem tax base — now more than $6 billion — performed well during the last recession, as rebuilding subsequent to the devastation of Hurricane Ike in September 2008 offset the recession's impact on the local housing market. Sales tax revenues also fared well during the economic downturn, with just a single year of revenue decline associated with the aftermath of Hurricane Ike. The general fund portion of sales tax receipts totaled $16.6 million in fiscal 2018, up more than 3% from the prior year.

The city's general fund revenues realized a compound annual growth rate (CAGR; adjusted for tax rate changes) of 1.8% for the 10 years ended Sept. 30, 2018, below the U.S. GDP growth rate over the same period but better than inflation. This result was materially affected by the 10% drop in fiscal 2010 revenues as the city continued to contend with the financial repercussions of Hurricane Ike. Fitch believes that development underway and planned in Galveston will support ongoing solid revenue growth, while acknowledging the inherent risk of periodic hurricanes that can disrupt economic activity and revenue trends.

Galveston's fiscal 2020 total ad valorem tax rate of $0.5799 per $100 of TAV provides ample capacity below the city charter tax rate cap of $0.70. However, the Texas Legislature recently approved, and the governor signed into law, Senate Bill 2 (SB2), which makes a number of changes to local governments' property tax rate-setting process starting in fiscal 2021. Most notably, SB2 will reduce the rollback tax rate (now the "voter approval tax rate") from 8% to 3.5% for most local taxing units and require a ratification election (replacing the current petition process) if any local taxing unit exceeds its voter approval rate. The tax rate limitation in SB2 excludes new additions to tax rolls and allows for banking of unused margin for up to three years.

This new law lowers the assessment of Galveston's independent legal revenue-raising ability compared to Fitch's last review. However, the city's remaining control over other local revenues, such as fines, fees and charges for services, is sufficient to generate satisfactory revenue-raising flexibility relative to Fitch's assessment of expected modest revenue volatility in a typical downturn. The revenue cap does not apply to debt service tax levies.

Expenditure Framework

The city's operating cost structure is focused on public safety (2/3 of fiscal 2018 general fund spending), and the annual budget includes a charter-designated amount for infrastructure capital spending and/or debt service support.

Fitch expects the city's natural pace of spending to be generally in line with, to marginally higher than, expected solid revenue growth. Additional service demands from a moderately expanding population should be manageable.

The city maintains solid expenditure flexibility, as upward pressure from salaries and healthcare benefits are managed through periodic departmental spending reductions. Carrying costs consumed a moderate 12% of the city's fiscal 2018 governmental spending, reflecting in part a large amount of self-supporting debt. Carrying costs will trend higher due to increased contributions to the city's three employee pension plans, but should remain in the moderate range. Management reports no tax-supported debt issuance plans for the next two to three years (following this sale).

Rating History (IDR)

Rating	Action	Outlook/ Watch	Date
AA	Affirmed	Stable	10/04/19
AA	Upgraded	Stable	1/12/17
AA-	Affirmed	Positive	1/05/16
AA-	Assigned	Stable	10/02/12

Long-Term Liability Burden

Galveston's long-term liabilities (overall debt and adjusted net pension liability) are moderate at slightly more than 12% of estimated personal income. Fitch expects the direct debt component of the city's long-term liabilities (about 16% of the total) to remain relatively stable as it completes the 2017 GO authorization with this sale. Proceeds from this offering will finance street, bridge and drainage improvements.

The city sponsors three single-employer defined benefit pension plans: the Employees' Retirement Plan for City Employees (ERP), the Employees Retirement Plan for Police (PRP) and the Firefighters' Pension Plan (GPFP). Under GASB 67 and 68, the city reported a Sept. 30, 2017 aggregate net pension liability (NPL) of $64.3 million, with fiduciary assets covering nearly 65% of total pension liabilities. The Fitch adjusted NPL, estimated for an assumed investment return of 6% compared to the plans' higher assumptions, is $97 million with assets covering nearly 55% of total liabilities.

Total contributions to all three plans have fallen short of actuarially determined amounts in recent years. The city began making the full actuarially determined contribution to the ERP in fiscal 2016, and management and the GPFP board recently agreed to a set of plan reforms and contribution increases for the firefighter plan that has reduced a previously infinite amortization period to roughly 25 years. City contributions to the GPFP increased from 14% of pay to 17%, and employee contributions increased from 16% to 18%.

Negotiations between the city and the PRP board regarding reforms and contribution levels produced an agreement in early-2019, which was memorialized in legislation approved by both Texas houses in May and subsequently signed into law. The reform package highlights include:

-- an increase in city contribution from 14.83% of salary to 18%; employee contributions remain at 12%;

-- an increase in benefit eligibility age for newly hired officers;

-- any required increases in contribution amounts in the future will be split equally between the city and employees;

-- governance changes that alter the pension board composition from the 4-3 split between retirees/employees and the city to a 4-4 split, with any major plan changes requiring a six-vote supermajority;

-- a reduction in the investment return assumption from 7.5% to 7%.

The reforms in the legislation produce a projection NPL amortization period of 22 years, down from nearly 50 years previously.

Operating Performance

Fitch expects Galveston to maintain a high level of financial flexibility during a moderate economic downturn based on its satisfactory independent revenue-raising capacity, solid expenditure flexibility and healthy reserve position. For details, see Scenario Analysis, page 6.

Galveston budgets conservatively, restores its financial cushion during times of economic recovery and maintains an infrastructure and debt service set aside fund to address repair and replacement needs. General fund transfers to the infrastructure and debt service fund are scheduled for $4.6 million (8% of the general fund budget) in fiscal 2020, as required by the city charter. As stated above, the city has restored full actuarially determined contributions to the ERP and recently agreed to significant reforms for both the GPFP and the PRP that will amortize NPLs in both plans in less than 30 years.

Fiscal 2018 general fund results featured a surplus after transfers of roughly $2 million and corresponding gain in reserves to $19.7 million, or nearly 38% of spending and transfers out. The results improved budget projections and were due to both revenues and expenditures outperforming budget.

Fiscal 2019 general fund results will be affected by a recent court decision that requires the city to pay a contracting firm $13.5 million in damages. The firm had been engaged to oversee post-Ike federal housing recovery work in the city but was later fired; the firm subsequently sued the city. A portion of the payment ($6.1 million) will come from general fund reserves and spending adjustments; the remainder will come from excess internal service fund reserves. Management currently anticipates a year-end general fund balance of roughly $15 million after this payment, as revenue gains and departmental savings are expected to offset to a degree the impact from the settlement payment. This reserve cushion would still be consistent with a 'aaa' financial resilience assessment.

The fiscal 2020 proposed general fund budget is balanced and includes a nearly 5% increase in revenues, pay increases for employees, and additional spending for health benefits, police pension contributions and infrastructure. General fund spending is budgeted for a 6% increase from the adopted fiscal 2019 budget to $59.4 million.

Dedicated Tax Key Rating Drivers

Revenue Growth Prospects: Revenues that back the outstanding HOT bonds are economically sensitive and expected to register strong growth over the near term given recent performance and continued healthy economic prospects for the city and regional economies.

Sensitivity and Resilience: The pledged revenues generate a sufficiently strong debt service cushion to handily withstand a moderate economic decline scenario, while also incorporating a significant level of taxpayer concentration.

Dedicated Tax Credit Profile

The city imposes a hotel occupancy tax at a rate equal to 2%, less costs of collection as pledged to the payment of the series 2012A bonds (under Chapter 351 of the local government code - the net city HOT proceeds). The city imposes a separate hotel occupancy tax pursuant to Chapter 334 of the local code at a rate of 2%, less costs of collection, applicable to the series 2012B bonds (net venue HOT proceeds).

The city's top HOT contributors have remained relatively stable and accounted for an elevated 40%-plus of fiscal 2018 HOT collections, down from 62% in fiscal 2012 as the city's hotel stock and short-term rental business continues to expand. HOT collections realized a CAGR of more than 6% for the 10 years ended Sept. 30, 2018. Fiscal 2018 pledged revenues totaled $4.15 million for each 2% tax, up 12% from the prior year. Each tax generated a healthy debt service cushion of nearly 4.0x MADS in fiscal 2018. The city's historical and projected use of surplus HOT revenues support a variety of city operating and tourism-related uses.

HOT pledged revenues realized a strong 6% CAGR for the 10 years ended fiscal 2018. Preliminary fiscal 2019 results suggest a modest dip in HOT revenues, which management attributes to an unusually wet summer tourism season. Growth prospects remain strong given tourism trends, hotel construction and permitting activity, and an expanding short-term rental sector.

To evaluate the sensitivity of the dedicated revenue stream to a cyclical decline, Fitch considers both a revenue sensitivity scenario (using a 1% decline in national GDP scenario) and the largest decline in revenues over the period covered by the revenue sensitivity analysis. Based on the city's HOT revenue history, Fitch's analytical sensitivity tool (FAST) generates a 5% scenario decline in pledged revenues. A 21% drop in revenues during 2009 represents the largest cumulative decline and was the result of Hurricane Ike in 2008.

Assuming issuance to 3.0x MADS coverage (anticipating a moderate additional amount of borrowing), debt service would be covered with a 67% revenue decline, 13.0x the scenario results and 3.1x the largest actual revenue decline. This level of resilience is consistent with a 'aaa' assessment and contributes to the 'AA' rating, which also incorporates elevated taxpayer concentration as well as the possibility of additional leveraging (the five-year CIP currently contains no additional HOT debt). Assuming issuance up to the 1.5x ABT, well below actual current coverage and Fitch's expectation of possible additional leveraging, debt service for each series would be covered with a 33% drop in revenues, 6.6x the scenario results and 1.5x the largest actual revenue decline in the review period.

The HOT bond rating incorporates an elevated concentration in top taxpayers, which Fitch views as an asymmetric risk (particularly given the city's exposure to hurricanes). Consequently, the rating is at a level below what the growth and sensitivity assessments would otherwise suggest.

Exposure to Issuer Operations

The pledged revenues currently meet the requirements set out in Fitch criteria for treatment as "pledged special revenues" under section 902(2)(B) of the U.S. bankruptcy code.

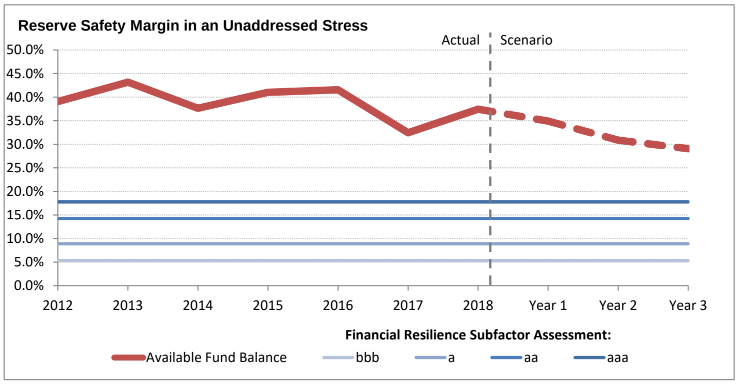
ESG Considerations

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of 3. ESG issues are credit neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity.

For more information on our ESG Relevance Scores, visit www.fitchratings.com/esg.

Galveston (TX)

Scenario Analysis



Analyst Interpretation of Scenario Results:

Fitch expects Galveston to maintain a high level of financial flexibility during a moderate economic downturn based on its satisfactory independent revenue-raising capacity, solid expenditure flexibility and healthy reserve position. Galveston has demonstrated its willingness to cut expenditures in order to maintain a sound financial position. Fitch expects the city to maintain a healthy financial cushion consistent with its 90-day policy goal, comfortably above the minimum reserve safety margin associated with an 'aaa' financial resilience assessment.

Scenario Parameters:	Year 1	Year 2	Year 3
GDP Assumption (% Change)	(1.0%)	0.5%	2.0%
Expenditure Assumption (% Change)	2.0%	2.0%	2.0%
Revenue Output (% Change)	(3.6%)	0.4%	4.3%
Inherent Budget Flexibility		Midrange	

Revenues, Expenditures, and Fund Balance	Actuals							Scenario Output		
	2012	2013	2014	2015	2016	2017	2018	Year 1	Year 2	Year 3
Total Revenues	42,607	43,315	45,305	45,664	50,800	50,944	51,935	50,087	50,268	52,420
% Change in Revenues	-	1.7%	4.6%	0.8%	11.2%	0.3%	1.9%	(3.6%)	0.4%	4.3%
Total Expenditures	41,574	42,344	44,687	43,257	45,814	48,539	46,927	47,865	48,823	49,799
% Change in Expenditures	-	1.9%	5.5%	(3.2%)	5.9%	5.9%	(3.3%)	2.0%	2.0%	2.0%
Transfers In and Other Sources	5,610	1,103	1,761	872	675	736	2,774	2,675	2,685	2,800
Transfers Out and Other Uses	307	115	1,230	1,988	3,659	6,013	5,747	5,862	5,979	6,099
Net Transfers	5,303	988	531	(1,116)	(2,984)	(5,277)	(2,973)	(3,187)	(3,294)	(3,299)
Bond Proceeds and Other One-Time Uses	-	-	-	-	-	-	-	-	-	-
Net Operating Surplus(+)/Deficit(-) After Transfers	6,336	1,959	1,149	1,291	2,002	(2,872)	2,034	(966)	(1,849)	(678)
Net Operating Surplus(+)/Deficit(-) (% of Expend. and Transfers Out)	15.1%	4.6%	2.5%	2.9%	4.0%	(5.3%)	3.9%	(1.8%)	(3.4%)	(1.2%)
Unrestricted/Unreserved Fund Balance (General Fund)	16,365	18,326	17,281	18,565	20,571	17,708	19,730	18,764	16,915	16,238
Other Available Funds (GF + Non-GF)	-	-	-	-	-	-	-	-	-	-
Combined Available Funds Balance (GF + Other Available Funds)	16,365	18,326	17,281	18,565	20,571	17,708	19,730	18,764	16,915	16,238
Combined Available Fund Bal. (% of Expend. and Transfers Out)	39.1%	43.2%	37.6%	41.0%	41.6%	32.5%	37.5%	34.9%	30.9%	29.0%

Reserve Safety Margins	Inherent Budget Flexibility				
	Minimal	Limited	Midrange	High	Superior
Reserve Safety Margin (aaa)	56.9%	28.5%	17.8%	10.7%	7.1%
Reserve Safety Margin (aa)	42.7%	21.3%	14.2%	8.9%	5.3%
Reserve Safety Margin (a)	28.5%	14.2%	8.9%	5.3%	3.6%
Reserve Safety Margin (bbb)	10.7%	7.1%	5.3%	3.6%	2.0%

Notes: Scenario analysis represents an unaddressed stress on issuer finances. Fitch's downturn scenario assumes a -1.0% GDP decline in the first year, followed by 0.5% and 2.0% GDP growth in Years 2 and 3, respectively. Expenditures are assumed to grow at a 2.0% rate of inflation. Inherent budget flexibility is the analyst's assessment of the issuer's ability to deal with fiscal stress through tax and spending policy choices, and determines the multiples used to calculate the reserve safety margin. For further details, please see Fitch's US Tax-Supported Rating Criteria.

The ratings above were solicited and assigned or maintained at the request of the rated entity/issuer or a related third party. Any exceptions follow below.