

CREDIT OPINION

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Harris County M.U.D. No. 538, TX

Update to credit analysis

Summary

[Harris County Municipal Utility District No. 538, TX's](#) (Baa3 stable) credit profile is supported by a small yet rapidly growing tax base with ongoing residential development driven by its advantageous location outside of [Houston](#) (Aa3 stable). Reserves relative to revenue continue to improve, yet remain below the median for the rating category and are nominally small. However, these characteristics are moderated by the district's limited enterprise risk as [Harris County MUD 495, TX](#) (A3 stable) provides water and wastewater treatment services to the district on a contractual basis. The debt burden is elevated and will remain so as infrastructure outlays continue over the medium term, though this is offset to some degree by the lack of pension and OPEB liabilities.

Credit strengths

- » Rapidly growing tax base
- » Strong resident incomes
- » No pension or OPEB liabilities

Credit challenges

- » Modestly sized tax base
- » Reserves are small on a dollar basis
- » High debt burden, slow principal amortization, and additional borrowing plans

Rating outlook

The stable outlook reflects the expectation that construction of single-family homes will continue to support tax base growth and reserves will improve and align with peers. Additionally, the outlook reflects the expectation that additional debt issuances will occur in conjunction with taxable value growth, keeping the debt burden stable.

Factors that could lead to an upgrade

- » Continued increase in taxable values
- » Significant moderation of the debt burden
- » Surplus financial operations leading to materially higher reserves

Factors that could lead to a downgrade

- » Trend of tax base decline
- » Reduction of reserves
- » Increased debt burden

Key indicators

Exhibit 1

Harris County M.U.D. No. 538, TX	2018	2019	2020	2021	2022
Economy/Tax Base					
Total Full Value (\$000)	\$56	\$4,608	\$12,179	\$30,502	\$91,048
Population	-	-	845	845	1,166
Full Value Per Capita	N/A	N/A	\$14,413	\$36,097	\$78,086
Median Family Income (% of US Median)	0.0%	148.6%	142.9%	135.2%	135.2%
Finances					
Operating Revenue (\$000)	\$395	\$578	\$635	\$904	\$1,853
Fund Balance (\$000)	(\$27)	\$185	\$342	\$461	\$1,391
Cash Balance (\$000)	\$2	\$135	\$359	\$567	\$1,778
Fund Balance as a % of Revenues	-6.8%	32.0%	53.8%	50.9%	75.1%
Cash Balance as a % of Revenues	0.4%	23.4%	56.5%	62.7%	95.9%
Debt/Pensions					
Net Direct Debt (\$000)	\$0	\$0	\$0	\$0	\$5,500
3-Year Average of Moody's ANPL (\$000)	\$0	\$0	\$0	\$0	\$0
Net Direct Debt / Full Value (%)	0.0%	0.0%	0.0%	0.0%	6.0%
Net Direct Debt / Operating Revenues (x)	0.0x	0.0x	0.0x	0.0x	3.0x
Moody's - adjusted Net Pension Liability (3-yr average) to Full Value (%)	0.0%	0.0%	0.0%	0.0%	0.0%
Moody's - adjusted Net Pension Liability (3-yr average) to Revenues (x)	0.0x	0.0x	0.0x	0.0x	0.0x

Source: US Census Bureau, Harris County M.u.d. No. 538, Tx's financial statements and Moody's Investors Service

Profile

Harris County Municipal Utility District No. 538 encompasses roughly 550 acres just north of the [City of Katy](#) (Aa1) and west of the Grand Parkway. The growing district has an estimated population of 1,430.

Detailed credit considerations

Economy and tax base: growing tax base in Houston metro area

The district's tax base will continue to expand in the next few years from ongoing single family residential development. Assessed valuation (AV) has grown significantly over the past several years, but the size of the tax base is small relative to the Baa3 median. On average, full values grew 378.7% annually over the last five years reaching \$139.9 million in fiscal 2023. Estimated AV as of Feb. 15, 2023 is \$185 million, which is in line with the median for the rating category and reflects ongoing development within the district.

Currently, the district encompasses 550 total acres. As of Feb. 15, 2023 there were 408 completed single family homes, 46 homes under construction, and 45 developed vacant lots ready for new home construction on 165 acres. There are roughly 188 acres of developable land remaining. Top taxpayers account for a moderate 15.2% of fiscal 2023 FV. Resident incomes, using Katy ISD as a proxy, are favorable with median family income estimated at 135.2% of the US.

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[Harris County MUD 495, TX](#) (A3 stable) provides water and wastewater treatment services to the district on a contractual basis. Per an agreement between the district and Harris MUD 495, Harris MUD 495 has allocated capacity within its water and wastewater systems to serve roughly 1,050 equivalent single-family connections (ESFCs) within the district. The district anticipates seeking additional capacity from Harris 495, as needed, to accommodate future growth within the district.

Financial operations and reserves: improving but below median fund balance levels with budgeted surplus operations

Reserves will continue to improve and align with peers over the next couple of years from favorable property tax revenue performance due to assessed value growth and the district's limited scope of operations. In fiscal 2022 (Feb. 28 year-end), the general fund realized a \$765,000 operating surplus and increased the available general fund balance to \$1.2 million 78.5% of general fund revenue. Although the available general fund balance is nominally small, this is moderated by the district's low enterprise risk since water supply and wastewater treatment is provided by Harris County MUD 495. Including the debt service fund, the available operating fund balance improved to \$1.4 million and 75.1% of combined revenue. Unaudited fiscal 2023 results through Jan. 31, 2023 indicate a \$1.2 million surplus in the general fund, which is expected to increase the available general fund balance to \$2.3 million and an improved 122% of year-to-date general fund revenue, which is on par with Baa3 peers. The fiscal 2023 budget is balanced and reflects a \$791,000 surplus in the general fund. If realized, the available general fund balance will grow to \$2.3 million and represent 161% of budgeted general fund revenue.

The district levied a total tax rate of \$13.75 per \$1,000 of AV for fiscal 2023, which is high relative to other Texas MUDs, and includes \$6.50 for debt service and \$7.25 for operations. The voter approved maximum tax rate for maintenance and operations is \$15.00 per \$1,000 of AV while the debt service rate is unlimited.

Liquidity

Liquidity will continue to align with peers, moving in tandem with operating performance and fund balance. At year-end 2022, cash and investments in the general fund were \$1.3 million and 83.5% of general fund revenue. Including the debt service fund, liquidity in the operating fund improved to \$1.8 million or 95.9% of combined revenue.

Debt and pensions: high debt burden; no pensions or OPEBs

The debt burden will remain elevated given slow principal amortization and plans for additional near term borrowing to reimburse developers, constraining the credit profile. Including the Series 2023 bonds, the district has \$23.2 million in outstanding debt, which represents a high 16.6% of fiscal 2023 full valuation (FV) and 13.7 times fiscal 2022 operating revenue. The debt burden falls to 12.5% of estimated full value as of Feb. 15, 2023. When including debt issued by overlapping entities, the overlapping debt burden is a significant 21% of fiscal 2023 FV and 15.9% of estimated FV.

After this issuance, the district owes \$10.9 million to reimburse developers for previously completed capital outlay. The district anticipates issuing additional general obligation unlimited tax (GOULT) debt to fund these reimbursements. Future debt will occur in tandem with AV growth, keeping the debt burden relatively stable.

Legal security

The Series 2023 bonds are payable from an annual ad valorem tax, unlimited as to rate or amount, levied against all taxable property within the district.

Debt structure

All debt is fixed rate and amortizes over the long term (final maturity in fiscal year 2049). Principal amortization is slow with 28.1% retired in 10 years.

Debt-related derivatives

The district is not party to any debt related derivative agreements.

Pensions and OPEB

The district does not have any employees and does not provide pension or other post-employment benefits (OPEB). As such, the district does not have pension or OPEB liabilities.

ESG considerations

Environmental

The local government sector generally has low exposure to environmental risks. However, environmental risks are material to the district's credit profile because its proximity to the Gulf Coast and increased susceptibility to property damage from hurricanes and excessive rainfall.

While no facilities or homes had been built before Hurricane Harvey, according to the district's engineer, Tropical Storm Imelda did not cause damage to the district's water, sanitary sewer, or drainage facilities, and there was no interruption of water and sewer service in the district. Further, according to the developer and the engineer, no homes in the district experienced structural flooding or other material damage as a result of Tropical Storm Imelda. According to the FEMA Flood Insurance Rate Map ("FIRM") dated Nov. 15, 2019, approximately 39 acres within the district are located in the 100-year flood plain and are not considered to be developable. A portion of the remaining acreage in the flood plain will be filled in connection with future development, and a Letter of Map Revision will be filed to remove it from the flood plain. This exposure is moderated by various flood control projects undertaken by the [Harris County Flood Control District](#) (Aaa stable), as well as investments from the state and federal governments.

Social

Although the district is largely residential and exposed to social challenges posed by demographic, housing, and income trends, but its proximity to a major metropolitan area (Houston, TX) supports stability. The population will continue to grow as the district develops. Income levels in the area, using Katy ISD as a proxy, are above average with a median family income equal to 135.2% of the US (2020 American Community Survey).

Governance

The district is governed by a board consisting of five directors elected to staggered four-year terms. Similar to other MUDs, the district's utility operations, financial services, and tax assessments and collections, and legal services are provided by a third party via a service contract.

Texas MUDs have an Institutional Framework score of Aa, which is strong compared to the nation. Property taxes, one of the sector's major revenue sources, are not subject to any caps for debt service. MUDs that are considered over 95% developed, are subject to a property tax cap of 3.5% for maintenance and operations. Unpredictable revenue fluctuations tend to be minor, or under 5% annually. Across the sector, fixed and mandated costs specifically for debt service are generally greater than 25% of expenditures. MUDs have no full time employees. Unpredictable expenditure fluctuations tend to be minor, under 5% annually.

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