

CREDIT OPINION

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New Issue

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South Padre Island (City of), TX

New Issue: Moody's assigns Aa2 to South Padre Island, TX's \$3.9M Tax Notes, Series 2016

Summary Rating Rationale

Moody's Investors Service has assigned a Aa2 rating to the city of South Padre Island, TX's \$3.87 million Tax Notes, Series 2016. Moody's maintains a Aa2 on \$9.5 million in parity general obligation limited tax debt, inclusive of the current sale. The Aa2 reflects the city's moderately sized tax base, strong financial performance, healthy reserves, and modest debt burden. The city's solid financial management and formal reserve policy mitigate risks associated with possible severe weather and an overall economic reliance on tourism.

Credit Strengths

- » Strong financial performance and management
- » Healthy reserve position bolstered by strong policy
- » Modest debt burden

Credit Challenges

- » Reliance on tourism industry
- » Recent declines in taxable values
- » Exposure to severe weather

Rating Outlook

Moody's does not usually assign outlooks to local government credits with this amount of debt outstanding.

Factors that Could Lead to an Upgrade

- » Significant tax base expansion

Factors that Could Lead to a Downgrade

- » Trend of significant tax base contraction
- » Deterioration of reserves

Key Indicators

Exhibit 1

| South Padre Island (Town of) TX | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|--------------|--------------|--------------|--------------|--------------|
| Economy/Tax Base | | | | | |
| Total Full Value (\$000) | \$ 2,579,977 | \$ 2,621,959 | \$ 2,607,485 | \$ 2,583,563 | \$ 2,516,387 |
| Full Value Per Capita | \$ 437,284 | \$ 444,400 | \$ 441,947 | \$ 437,892 | \$ 426,506 |
| Median Family Income (% of US Median) | 133.3% | 132.0% | 132.0% | 132.0% | 132.0% |
| Finances | | | | | |
| Operating Revenue (\$000) | \$ 11,878 | \$ 11,036 | \$ 11,818 | \$ 11,936 | \$ 11,740 |
| Fund Balance as a % of Revenues | 56.2% | 60.1% | 54.7% | 60.3% | 61.5% |
| Cash Balance as a % of Revenues | 54.7% | 62.8% | 55.9% | 64.6% | 63.6% |
| Debt/Pensions | | | | | |
| Net Direct Debt (\$000) | \$ 9,410 | \$ 8,727 | \$ 8,991 | \$ 8,295 | \$ 14,647 |
| Net Direct Debt / Operating Revenues (x) | 0.8x | 0.8x | 0.8x | 0.7x | 1.2x |
| Net Direct Debt / Full Value (%) | 0.4% | 0.3% | 0.3% | 0.3% | 0.6% |
| Moody's - adjusted Net Pension Liability (3-yr average) to Revenues (x) | N/A | 0.6x | 0.8x | 0.8x | 1.1x |
| Moody's - adjusted Net Pension Liability (3-yr average) to Full Value (%) | N/A | 0.3% | 0.3% | 0.4% | 0.5% |

Source: South Padre Island CAFRs, Moody's Investors Service

Recent Developments

Since the June 2015 report, the city has provided fiscal year 2016 tax base information and audited fiscal year 2015 results. The tax base declined modestly for the fourth consecutive year to a still moderately sized \$2.48 billion. Fiscal year 2015 results indicate a modest General Fund deficit attributed to capital outlay. Reserves remain strong and above the city's six month policy. With the current issuance, the city's debt burden increases marginally to a still modest 0.6% of full value. These updates have been incorporated in the detailed rating considerations.

Detailed Rating Considerations

Economy and Tax Base: Beach Destination Remains Stable Despite Modest Tax Base Declines

Despite slight recent declines in the tax base, the moderately sized base will remain stable with possibilities for modest growth moving forward. Located in Cameron County (Aa3), the southernmost county in Texas, the city is primarily a beach destination and its economy is driven by tourism, receiving over one million visitors annually. Following four years of modest annual decline, the city's tax base is moderately sized at \$2.48 billion which is consistent with peers in the rating category. Officials attribute recent declines to aging structures but anticipate that strong permitting trends in recent years will eventually offset depreciation. Recent and ongoing development within the city includes two hotels, numerous condominiums, redevelopment of an older building, improvements at the multimodal transportation hub, and expansions or investments at several tourist attractions.

The city's socioeconomic profile is above average though affected by the modest population. The full value per capita exceeds \$400,000 resulting from a concentration of tourism related commercial properties, vacation rental properties and modest population estimated at 5,900. The wealth indicators are above average as per capita income and median family income are estimated at 157.5% and 137% of the US respectively.

Financial Operations and Reserves: Solid Reserves Bolstered By Strong Performance and Policies

South Padre Island continues to maintain very healthy reserves exceeding a strong formal policy. Per the city charter, the city must maintain six months of operations in reserves, a threshold that the city consistently exceeds. Conservative budgeting, frequent monitoring, and long term planning have enabled the city to realize surpluses in three of the past five years. Despite a modest deficit driven by nearly \$1 million in capital outlay, the available General Fund balance as of fiscal year 2015 totaled \$6.8 million, a healthy

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61.3% of general fund revenues. Incorporating the debt service fund, operating reserves are \$7.2 million, a healthy 61.5% of 2015 revenues in all operating funds.

Tourism trends are strong in the current year. Officials report revenue and expenditure trends are consistent with budget for 2016 but anticipate using approximately \$500,000 of reserves for capital improvements. Despite the anticipated draw for one time capital improvements, the city will continue to maintain healthy reserves in line with policies, mitigating, to some extent, risks associated with exposure to severe weather and the overall economic reliance on tourism.

LIQUIDITY

The city's reserves are highly liquid with cash balances slightly exceeding overall fund balance. At fiscal year end 2015, the city's General Fund held \$7.1 million in cash and investments, a strong 63.4% of revenues. Including a modest \$383,000 held in the debt service fund, the operating funds have a combined cash position of \$7.5 million or 63.6% of operating revenues.

Debt and Pensions: Modest Debt and Pension Liabilities

The city's debt burden is modest compared to peers. Post sale, the city will have \$13.4 million in general obligation limited tax debt and \$954,000 in capital leases resulting in a modest debt burden of 0.6% of full value. There are no near term plans for additional debt. Future capital needs include various infrastructure improvements, particularly to streets, sidewalks, streetlights, and drainage systems. The council dedicated \$5 million of reserves outside the General Fund for convention center improvements which are continuing in the current year. Over the next five to ten years, city officials report possible investment in various tourist amenities including a convention center annex, amphitheater for SpaceX viewings and other events, and an indoor dining and recreation center. These projects would likely be funded with hotel/motel tax revenues.

DEBT STRUCTURE

All of the city's debt is fixed rate. The Series 2015 and 2016 tax notes are scheduled to be repaid within seven years. Overall, an above average 88% of GOLT principal is due within 10 years.

DEBT-RELATED DERIVATIVES

The city is not party to any interest rate derivative agreements.

PENSIONS AND OPEB

The city has a manageable pension liability from its participation in the Texas Municipal Retirement System (TMRS), a multi-employer defined benefit agent plan. The annual contribution of around \$927,000 in 2015 was a manageable 8% of operating expenditures. Moody's fiscal year 2015 combined adjusted net pension liability (ANPL) for the city, under our methodology for adjusting reported data, is about \$18 million or a moderate 1.5 times operating revenues. The three year average of ANPL to operating revenues is 1.1 times. Moody's ANPL reflects certain adjustments we make to improve comparability of reported pension liabilities. The adjustments are not intended to replace the city's reported liability information, but to improve comparability with other rated entities.

Management and Governance

Texas cities have an institutional framework score of "Aa," or strong. Cities rely on stable property taxes for 30% -40% of their operating revenues, while 25%-35% comes from economically sensitive sales taxes, resulting in moderate predictability overall. Cities maintain moderate flexibility under the state-mandated cap (\$25 per \$1,000 of AV, with no more than \$15 for debt) to raise property taxes as most cities are well below the cap. Expenditures primarily consist of personnel costs, which are highly predictable. Cities have high flexibility to reduce expenditures given no union presence.

The city operates under the council/manager form of government. The council is comprised of the mayor and five council members elected to staggered three year terms.

Legal Security

The notes are secured by the levy of a direct and continuing ad valorem tax, within the limits prescribed by law, on all taxable property within the city.

Use of Proceeds

The proceeds of the Series 2016 notes will be used for improvements to Padre Boulevard and various other improvements.

Obligor Profile

South Padre Island is a tourist destination located on the Gulf of Mexico in the southernmost county in Texas about 25 miles northeast of Brownsville (Aa3). The city's population is estimated at 5,900 people.

Methodology

The principal methodology used in this rating was US Local Government General Obligation Debt published in January 2014. Please see the Ratings Methodologies page on www.moodys.com for a copy of this methodology.

Ratings

Exhibit 2

SOUTH PADRE ISLAND (CITY OF) TX

| Issue | Rating |
|------------------------|-----------------------------------|
| Tax Notes, Series 2016 | Aa2 |
| Rating Type | Underlying LT |
| Sale Amount | \$3,870,000 |
| Expected Sale Date | 04/05/2016 |
| Rating Description | General Obligation Limited Tax |

Source: Moody's Investors Service

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