FitchRatings

RATING ACTION COMMENTARY

Fitch Rates Harris County, TX LT and ULT Bonds 'AAA'; Outlook Stable

Wed 19 Aug, 2020 - 3:55 PM ET

Fitch Ratings - Austin - 19 Aug 2020: Fitch Ratings has assigned a 'AAA' rating to the following Harris County, TX obligations:

--$221.4 million permanent improvement refunding bonds, series 2020A;

--$188.3 million unlimited tax road refunding bonds, series 2020A;

--$187.3 million Harris County Flood Control District (TX) improvement refunding bonds, series 2020A.

The Rating Outlook is Stable.

Bond proceeds will be used to refund outstanding general obligation bonds and commercial paper notes. The permanent improvement and unlimited tax road bonds are scheduled for a negotiated sale during the week of Sept. 7. The flood control district bonds are scheduled for a negotiated sale during the week of Sept. 14.

SECURITY

The permanent improvement refunding bonds are payable from an annual property tax levy limited to $0.80 per $100 assessed valuation (AV) for operations and debt service. The unlimited tax road refunding bonds are payable from an unlimited annual property tax levy. The Harris County Flood Control District (the district) improvement refunding bonds are payable from an annual property tax levy limited to $0.30 per $100 AV for operations and debt service.

ANALYTICAL CONCLUSION

The county's 'AAA' IDR reflects its strong gap-closing capacity in the form of budget controls supplemented by ample reserve funding, a moderate long-term liability burden, and robust economic base and growth prospects. Management's prudent budgeting of its expansive resource base benefits the county's prospects for maintaining structural balance through economic cycles.

Fitch rates the Harris County Flood Control District's (the district) long-term debt 'AAA' based on the tax base's strong revenue growth prospects as well as ample revenue-raising flexibility within the annual property tax revenue limitation, which provide significant cushion against potential tax base declines and offsets any concern about tax base volatility. As the district is a blended component unit of Harris County with limited operations, Fitch believes that operating risk exposure for the bonds is best reflected in the county's IDR of 'AAA'.

ECONOMIC RESOURCE BASE

Harris County is the largest county in Texas and the third largest in the nation, encompassing all but a small portion of the city of Houston, with a population totaling nearly 4.7 million. The county features a large, diverse economy that remains exposed to the energy sector. Expansion of the healthcare, biomedical research, aerospace, port, and petrochemical industries over the past several decades has reduced the historically strong reliance on the energy exploration sector.

KEY RATING DRIVERS

Revenue Framework: 'aaa'

Although the pandemic-induced shutdown and the oil price shock is likely to result in sluggish or negative AV growth in near-term budget cycles, a long-term healthy pace of revenue growth is likely to continue as cyclical contraction within the energy sector is balanced against continued expansion of the county's diverse economy. The impact of recent statewide property tax revenue limitations is mitigated by flexibility in other locally controlled revenues.

Expenditure Framework: 'aa'

The county's expenditure flexibility is aided by prudent budgeting, pay-go capital spending, and lack of collective bargaining agreements with any of its personnel. Fitch expects growth-related spending demands to be matched by revenue gains, keeping their trajectories in line with one another.

Long-Term Liability Burden: 'aa'

The long-term liability burden is moderate relative to personal income and driven primarily by overlapping debt. The county consistently funds its pension at actuarially determined levels and the net pension liability is modest relative to the resource base.

Operating Performance: 'aaa'

The combination of the county's expenditure flexibility and revenue-raising authority, as well as its record of very large reserve funding, should enable maintenance of a high level of financial flexibility during the current and future economic cycles.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

--Not applicable given the current 'AAA' rating.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

--An economic contraction extending well into the second half of 2020 or beyond, consistent with Fitch's coronavirus downside scenario, which triggers sustained and deeper than expected revenue declines and materially erodes the county's gap-closing capacity;

--Although unlikely, a sustained increase in the long-term liability burden above 20% of personal income due to substantially larger debt issuance than expected or large declines in the county's resource base.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit [https://www.fitchratings.com/site/re/10111579].

CURRENT DEVELOPMENTS

Sector-Wide Coronavirus Implications

The ongoing outbreak of coronavirus and related government containment measures worldwide create an uncertain global environment for U.S. state and local governments and related entities in the near term. While the district's most recently available fiscal and economic data may not fully reflect impairment, material changes in revenues and expenditures are occurring across the country and likely to worsen in the coming weeks and months as economic activity suffers and public health spending increases. Fitch's ratings are forward-looking in nature, and Fitch will monitor developments in state and local governments as a result of the virus outbreak as it relates to severity and duration and incorporate revised expectations for future performance and assessment of key risks.

In its baseline scenario, Fitch assumes sharp economic contractions to hit major economies in 1H20 at a speed and depth that is unprecedented since World War II. Sequential recovery is projected to begin from 3Q20 onward as the health crisis subsides after a short but severe global recession. GDP is projected to remain below its 4Q19 level until mid-2022. Additional details, including key assumptions and implications of the baseline scenario and a downside scenario, are described in the report entitled, "Fitch Ratings Coronavirus Scenarios: Baseline and Downside Cases - Update" (https://www.fitchratings.com/site/re/10120570), published April 29, 2020 on www.fitchratings.com.

As is the case with other counties, Harris County has experienced the effects from the spread of the coronavirus. The governor declared a state of disaster for all counties in Texas on March 13, 2020. Subsequently, the governor's executive order, effective March 31 through April 30, directed all Texans to stay at home unless participating in essential services or activities. Large meetings and sporting events were cancelled; elective and/or non-critical hospital surgeries were postponed; essential businesses remain closed or are operating with a remote workforce, and all area K-12 school districts switched to remote learning.

Beginning on May 5, the governor has allowed for phased-in partial restarting of economic activity in the state. However, Fitch believes the reopening of Harris County may be stalled due to the surging number of coronavirus cases in the county. The county currently leads the state in the number of coronavirus cases, leading county management to elevate its assessment of risk to 'Level 1: Severe-Stay Home Work Safe'; however, a county-wide stay at home order has not been issued.

The county entered the pandemic-induced shutdown with a very strong financial position. Unaudited fiscal 2020 results point to further expansion of its fiscal 2019 unrestricted fund balance of $1.3 billion, equal to nearly 59% of spending. The budget for fiscal 2021, which began on March 1, was adopted as balanced but greater than budgeted AV gains are expected to result in additional property tax revenues (which accounted for 81% of general fund revenues in fiscal 2019). Because the county doesn't expect a material near-term impact to property taxes and it does not collect sales taxes, management projects a modest revenue loss of less than 1% for the general fund in fiscal 2021.

Coronavirus-related expenditures totaled $115 million through July and were funded from the county's public improvement contingency (PIC) fund (unaudited fiscal 2020 unrestricted fund balance of $269 million). Reported as part of the general fund group, the PIC fund receives property tax revenues from a dedicated property tax levy. The county expects to utilize its entire $426 million allocation of Coronavirus Recovery and Economic Stabilization (CARES) Act funds to reimburse the PIC fund and pay for related recovery efforts, allowing the fiscal 2021 general operating budget to remain balanced.

The recent oil price shock represents an additional challenge to the local economy. The combined economic setback of the coronavirus and the oil price shock has led to widespread layoffs in the manufacturing, construction/mining, and leisure/hospitality sectors. The larger layoffs include Haliburton Energy Services (3,500), Texas Steel Conversion (491), Four Season Hotel (344), Zachary Industrial (288), UTLX Manufacturing (278) and Baker Hughes (184).

Recovery from these combined economic setbacks may last longer than previous downturns, but Fitch expects economic growth will return to strong pre-pandemic levels. IHS Markit expects a slower than typical recovery in 2021 for the MSA, followed by gradual recovery of the energy sector that will boost overall economic growth in 2022. Compared with the forecast price of $35 per barrel for 2020, Fitch projects the price will increase to $45 and $53 in 2021 and 2022, respectively. During the recovery period, Fitch expects AV will turn sluggish or decline modestly as in past downturns. Continued in-migration and natural population growth will serve to buoy the county's housing market and taxable values over the medium term.

CREDIT PROFILE

The Houston MSA is home to several thousand energy companies, ranging from large multi-national concerns to numerous mid-sized-to-smaller exploration, construction, engineering and service companies. Many of these companies have cut operating costs via layoffs during the current oil bust that coincided with the pandemic-induced downturn.

IHS Markit projects the MSA's total employment will decline by 3% in 2020 and recover gradually by 2022, fueled by a resurgent energy sector. Professional and business services are expected to be the MSA's other leading growth sectors. The trade and transportation sector is projected to benefit from additional activity at the Port of Houston due to the fast-growing export market for US oil, natural gas, and chemicals. The port is ranked first in the U.S. in foreign waterborne commerce and second in total tonnage.

The county experienced a nearly 15% population gain in 2010-2019, the majority of which occurred in the unincorporated areas. Fitch expects the MSA's strong population growth trend to continue. Population gains have helped stabilize the MSA's housing market, allowing median home prices to remain stable during the last energy sector downturn in 2014. More recently, median home values are expected to decline by 1.5% over the next 12 months per Zillow.

REVENUE FRAMEWORK

Property taxes accounted for over 81% of general fund revenues in fiscal 2019. Favorable revenue trends have been aided by steady tax base gains and the county's practice to maintain a level O&M tax rate even during periods of AV growth.

Historical revenue growth has exceeded the level of inflation and U.S. GDP growth which Fitch expects to continue over time as cyclical contraction within the energy sector is balanced against continued expansion of the county's increasingly diverse economy. The county's AV, which grew by a 10-year CAGR of 4.7%, is expected to further expand in fiscal 2021 based on preliminary values which indicate a 4.5% gain. Fitch expects the impact of the current downturn on AV to become evident in the following fiscal period.

Harris County's fiscal 2020 tax rate of approximately $0.41 per $100 of AV provides ample capacity below the statutory cap of $0.80. However, the Texas legislature recently approved and the governor signed into law Senate Bill 2, which makes a number of changes to local governments' property tax rate setting process starting in fiscal 2021. Most notably, SB 2 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. Remaining control over other local revenues such as fines, fees and charges for services is sufficient to generate still ample 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

Typical of municipalities, public safety is the largest expenditure, accounting for approximately 51% of general fund spending in fiscal 2019.

The pace of spending growth absent policy actions is likely to be generally in line with revenue growth. Fitch expects that the rising operating costs associated with an expanding population and growing service delivery needs in the unincorporated portions of the county will be funded with revenue gains from its expanding resource base.

Fitch assesses the county's expenditure flexibility to be solid, aided by the county's strong control over employee headcount, lack of collective bargaining agreements with any of its personnel, and use of pay-go capital funding which can be delayed, reduced or eliminated. The county's fixed cost burden is moderate with carrying costs for debt, pension and OPEB equaling approximately 16% of governmental spending in fiscal 2019. Debt service alone accounts for over 9% of governmental spending as it includes toll road-supported tax bonds and flood control district contract tax bonds.

LONG-TERM LIABILITY BURDEN

The long-term liability burden, including direct and overlapping debt and unfunded pension liabilities, is moderate at approximately 14% of personal income. About 87% of the total liability burden is in the form of overlapping debt. Overall debt levels have risen mostly from substantial debt issuances by the county's approximately 350 overlapping jurisdictions. Continued overlapping debt issuance is likely to be accompanied by steady gains in personal income, leading Fitch to expect the county's long-term liability burden to remain moderate relative to the resource base.

Including a $784 million GO authorization approved by voters in 2015, the county's remaining bond authorization totals approximately $830 million. This amount is equal to almost 44% of outstanding net direct debt -- including the Harris County Flood Control District's contract revenue bonds, which are paid by the county's limited tax. The county plans to issue its remaining authorization over a seven to ten year period. Capital needs, while extensive, appear to be manageable given the county's history of a measured pace of debt issuance and reliance on existing taxable resources using flat or declining tax rates.

To address the damage caused by Hurricane Harvey in 2017, voters approved a $2.5 billion GO bond authorization for the flood control district to finance major flood control improvements. As in past and current projects, Fitch expects planning and capital costs to be shared with the U.S. Army Corp of Engineers. Specifically, $1 billion of the authorization will be used to leverage an estimated $3 billion in federal funds. The balance of the authorization will be used for flood control projects to be prioritized using a "social vulnerability index" that takes into account residents' ability to readily recover from flood events. The flood control district plans to issue its bond authorization over a 10-15 year period and require a modest debt service tax rate increase of $0.03 per $100 AV. Fitch expects the impact of the district's large authorization on the county's long term liability burden will be manageable given the expansive size of the district's tax base and the extended issuance schedule. The district's $2.5 billion authorization is equal to about 1% of personal income.

County employees participate in the Texas County and District Retirement System, a cost-sharing multiple-employer plan. The county consistently funds its pension at the actuarially determined level and the net pension liability totals approximately $2.9 billion, equal to about 1% of personal income based on Fitch's adjusted 6% rate of return.

OPERATING PERFORMANCE

Fitch believes the county's ample revenue-raising capacity, solid expenditure control and large reserves make it exceptionally well-positioned to manage through an economic downturn. The FAST scenario analysis tool, which relates historical tax revenue volatility to GDP to support the assessment of operating performance under Fitch's criteria, has now been adjusted to reflect GDP parameters consistent with Fitch's global coronavirus forecast assumptions. FAST is not a forecast, but it represents Fitch's estimate of possible revenue behavior in a downturn, based on historical revenue performance. Hence, actual revenue declines will vary from FAST results and Fitch expects the county will implement decisive corrective actions to offset them. FAST does provide a relative sense of the risk exposure of a particular local government entity compared with other local government entities.

The county's unaddressed FAST results under both the coronavirus baseline and downside scenarios indicate pressure on the county's financial resilience in the medium-term, absent policy interventions. Fitch anticipates the county will absorb any downward budget pressure by utilizing a combination of expenditure cuts and revenue-raising, and will also have the option to make reserve draws if necessary. Given the array of budgetary solutions available to it, the county will be well positioned to rebuild its financial resilience through the eventual recovery period

Following the Great Recession, significant right-sizing via the elimination of about 1,000 positions (5% of total personnel), with no deferrals of annual pension contributions, led to steady and sustainable additions to financial reserves. Moderate annual pay-go funding provided additional expenditure flexibility. The accumulation of substantial reserves allowed the county to forego its annual tax anticipation notes (TAN) borrowing for interim cash-flow purposes since fiscal 2017.

The fiscal 2019 audit posted an approximate $134 million (5.9% of spending) net general fund surplus, resulting in a very high unrestricted fund balance of over $1.3 billion or almost 59% of spending, well above its 15% fund balance policy. Fiscal 2020 is projected to further boost reserves. The fiscal 2021 budget is balanced, but greater than budgeted AV is likely to result in another net surplus.

DATE OF RELEVANT COMMITTEE

17 July 2020

In addition to the sources of information identified in Fitch's applicable criteria specified below, this action was informed by information from Lumesis.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

The highest level of ESG credit relevance, if present, is a score of 3. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity(ies), either due to their nature or to the way in which they are being managed by the entity(ies). For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

RATING ACTIONS

ENTITY/DEBT	RATING		
Harris County (TX) [General Government]			
• Harris County (TX) /General Obligation - Limited Tax/1 LT	LT	AAA Rating Outlook Stable	Affirmed

VIEW ADDITIONAL RATING DETAILS

FITCH RATINGS ANALYSTS

Jose Acosta
Senior Director
Primary Rating Analyst
+1 512 215 3726
Fitch Ratings, Inc.
111 Congress Avenue Suite 2010 Austin 78701

Rebecca Moses
Director
Secondary Rating Analyst
+1 512 215 3739

Steve Murray
Senior Director
Committee Chairperson
+1 512 215 3729

MEDIA CONTACTS

Sandro Scenga
New York
+1 212 908 0278
sandro.scenga@thefitchgroup.com

Additional information is available on www.fitchratings.com

APPLICABLE CRITERIA

U.S. Public Finance Tax-Supported Rating Criteria (pub. 27 Mar 2020) (including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

FAST States & Locals - Fitch Analytical Stress Test Model, v2.4.0 (1)

ADDITIONAL DISCLOSURES

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Harris County (TX)	EU Endorsed
Harris County Flood Control District (TX)	EU Endorsed

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