S&P Global Ratings

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Summary:

Surprise, Arizona; General Obligation

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Table Of Contents

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Credit Profile		
US$39.5 mil GO bnds ser 2018 due 07/01/2038		
Long Term Rating	AA/Stable	New
Surprise ICR		
Long Term Rating	AA/Stable	Upgraded

Rationale

S&P Global Ratings raised its issuer credit rating to 'AA' from 'AA-' on Surprise, Ariz. At the same time, S&P Global Ratings assigned its 'AA' long-term rating to the city's series 2018 general obligation (GO) bonds. The outlook is stable.

The raised rating reflects our opinion of the city's improved budgetary performance on an audited basis, with stable operating surpluses in each of the last three audited fiscal years, in conjunction with stability in the city's local economy and a very strong reserve position.

The city's unlimited ad valorem property tax pledge secures the GO bonds. Proceeds from the series 2018 GO bonds will finance certain facilities improvements including a fire station, an evidence and readiness center, a public works operations facility, and various road improvements.

The ratings further reflect our view of the city's:

- Adequate economy, with projected per capita effective buying income at 83.4% and market value per capita of $73,611, though that is advantageously gaining from access to a broad and diverse metropolitan statistical area (MSA);
- Strong management, with good financial policies and practices under our Financial Management Assessment (FMA) methodology;
- Adequate budgetary performance, with operating results that we expect could deteriorate in the near term relative to fiscal 2017, which closed with a slight operating surplus in the general fund and break-even operating results at the total governmental fund level;
- Very strong budgetary flexibility, with an available fund balance in fiscal 2017 of 36% of operating expenditures;
- Very strong liquidity, with total government available cash at 75.7% of total governmental fund expenditures and 24.6x governmental debt service, and access to external liquidity we consider strong;
- Strong debt and contingent liability position, with debt service carrying charges at 3.1% of expenditures and net direct debt that is 57.6% of total governmental fund revenue, as well as low overall net debt at less than 3% of market value, but a large pension and other postemployment benefit (OPEB) obligation; and
- Strong institutional framework score.

Adequate economy

We consider Surprise's economy adequate, with a projected per capita effective buying income of 83.4% of the national level and per capita market value of $73,611. The city, with an estimated population of 144,500, is located in northwestern Maricopa County, about 20 miles northwest of downtown Phoenix. Surprise participates in the Phoenix-Mesa-Scottsdale, Ariz., MSA, which we consider broad and diverse. The county unemployment rate, which we believe is representative of the city, was 4.5% in 2016.

Prior to the recent recession, the city experienced a period of rapid growth given its abundant vacant and affordable land and proximity to Phoenix and other major employment centers, although the economic downturn significantly slowed development within the city. The rebounding local economy in recent years stimulated new development within the city, and the city's market value grew by 36.9% since 2015 to $10.6 billion in 2018. Management anticipates continued growth in coming years as a result of ongoing commercial and residential development within the city, including development around a newly completed six-lane freeway through the city and several mixed-use development areas, which brought health care and higher education jobs to the economic base.

Proposition 117, approved by voters in 2012, changed the state assessed value (AV) system. Beginning in fiscal 2016, the amendment caps AV at no greater than 5% of the previous year, plus new construction. The amendment also moved to a single AV as part of the implementation (previously, primary and secondary AV were distinct mechanisms). The amendment does not impose new limits at which property taxes may be assessed. In fiscal 2018, the city's net limited AV increased by 5.5% to $978.04 million. Surprise's taxpayer base is very diverse, in our view, with the 10 largest taxpayers, a mix of public utility, commercial, and residential developments, accounting for about 5.8% of AV in 2018.

Strong management

We view the city's management as strong, with good financial policies and practices under our FMA methodology, indicating financial practices exist in most areas, but that governance officials might not formalize or monitor all of them on a regular basis.

The city bases its revenue and expenditure assumptions on extensive historical lookback and information compiled from several outside sources including regional economic data. City council reviews budget-to-actuals on a monthly basis, and has the ability to adjust the budget in a timely manner in compliance with its formal budget amendment policy. The city maintains a comprehensive five-year financial forecast for its general fund and several other governmental funds, which the city council reviews annually as part of the budget process, as well as a five-year capital improvement plan that identifies funding sources for the current fiscal year's projects. The city has a formal investment policy that reflects state guidelines, and it contracts with an external investment manager who presents quarterly investment holdings and earnings reports to the council. The city also has a basic debt management policy in place and is in the process of implementing a more robust policy for debt issuances. Finally, the city has implemented a well-defined minimum fund balance policy, with a three-part reserve requirement for the general fund and additional guidance for various other funds. The general fund policy requires an emergency reserve of 1.67%, an operating reserve of 10%, and a budget stabilization reserve of 5% of the average of budgeted personnel, supplies, and services expenses over a two-month period for that year's adopted budget for the general fund and the Highway User Revenue Fund.

Adequate budgetary performance

Surprise's budgetary performance is adequate in our opinion. The city had slight surplus operating results in the general fund of 0.9% of expenditures, and balanced results across all governmental funds of negative 0.3% in fiscal 2017. Our assessment accounts for the fact that we expect budgetary results could deteriorate somewhat from 2017 results in the near term.

We have adjusted the city's operating revenues and expenditures to account for recurring transfers in and out of the general fund, including regular transfers out of the general fund for debt service and various capital needs such as asset replacement. The city has reported general fund surpluses in the last three audited fiscal years, and results have consistently been better than budgeted at year-end. Prior to fiscal 2016, the city made many necessary expenditure cuts, such as staff reductions and deferring capital outlay, in an effort to restore fund balance levels to comply with its internal policies. With the improved financial position in recent years, the city began increasing staff and working on delayed capital projects, increasing transfers out of the general fund to the capital fund to nearly $6 million in each of the last two audited fiscal years for various one-time items. The uptick in capital outlay has contributed to a drawdown on fund balance in the other governmental funds in fiscals 2016 and 2017 as the city intentionally spends down previously built-up reserves, though the drawdown has been modest, at less than 1% of expenditures in each year.

Looking ahead, the city has budgeted for a drawdown on general fund reserves in fiscal 2018 of approximately 8% of expenditures, as the city continues to expend previously built-up reserves in excess of its fund balance policy. The fiscal 2018 budget includes an increase in transfers out of the general fund of about $15 million for an intentional one-time use of fund balance for asset replacements. We note that the city has historically outperformed its budget at year-end and anticipates similar results in the current fiscal year, with an expected operating surplus.

Multiyear forecasts project additional drawdowns in fiscals 2019 through 2022, with the upcoming fiscal 2019 result primarily attributed to a one-time reimbursement of pension contributions to sworn public safety employees as part of a recent statewide litigation settlement and an increase in reimbursements of local sales tax due to existing development agreements. Despite the projected one-time expenditures, management intends to increase its reserves annually as expenditures grow to remain in compliance with the minimum fund balance policies. Expected deficits are projected to decline annually, with near-balanced operations in fiscal 2022, according to the multiyear plan, and we expect management to continue to adjust its budget as needed. The city's governmental fund revenues rely primarily on sales taxes (33%) and state-shared revenues (21%), with property taxes accounting for 7% of revenues. Current projections assume continued stable growth in each of the major revenue streams over the next five fiscal years, which we believe to be reasonable considering recent trends and ongoing retail development.

Very strong budgetary flexibility

Surprise's budgetary flexibility is very strong, in our view, with an available fund balance in fiscal 2017 of 36% of operating expenditures, or $38.8 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.

Our calculation of available fund balance combines assigned and unassigned portions of the general fund balance. The city has added to its fund balance year over year as expenditures continue to grow, maintaining reserves above 30% of expenditures. Given the city's commitment to maintain its reserves in compliance with its formal reserve policies, we do not expect fund balances to fall below very strong levels in the near term.

Very strong liquidity

In our opinion, Surprise's liquidity is very strong, with total government available cash at 75.7% of total governmental fund expenditures and 24.6x governmental debt service in 2017. In our view, the city has strong access to external liquidity if necessary.

In our view, the city's liquidity is reinforced by its strong access to external liquidity, with the city having issued GO bonds and various revenue bonds over the past 15 years, and we have no reason to believe that its access to markets has diminished. City management reports that it has no exposure to direct purchase debt or instrument provisions that might increase liquidity risk. We believe the city does not have aggressive investments, as the majority of investments are in mutual funds and government investments.

Strong debt and contingent liability profile

In our view, Surprise's debt and contingent liability profile is strong. Total governmental fund debt service is 3.1% of total governmental fund expenditures, and net direct debt is 57.6% of total governmental fund revenue. Overall net debt is low at 1.9% of market value, which is in our view a positive credit factor. At this time, the city does not have additional GO debt plans for the near term. However, we understand that the city is evaluating refunding options for existing revenue bonds and may issue additional debt in the near term to be funded with utility system revenues for the acquisition of a water company.

In our opinion, a credit weakness is Surprise's large pension and OPEB obligation. Surprise's combined required pension and actual OPEB contributions totaled 6.3% of total governmental fund expenditures in 2017. The city made its full annual required pension contribution in 2017. The city participates in three defined-benefit pension plans for its personnel: the Arizona State Retirement System (ASRS), the Public Safety Personnel Retirement System (PSPRS), and the Elected Officials Retirement Plan (EORP).

The PSPRS plan fiduciary net position as a percentage of total pension liability as of June 30, 2017, was 54.3% for police and 66.4% for fire. For ASRS, the plan fiduciary net position as of June 30, 2017, was reported as 67% of the total liability, while the EORP's plan fiduciary net position was 23.4% for the same period. In light of the low funded ratio for the plans, we expect the city's contributions to increase in future years, which could result in some budgetary pressure in the medium term. We understand that the city continues to include expected contribution increases into its multiyear budgets and intends to contribute its statutorily required contributions at the beginning of each fiscal year based on budgeted amounts in an effort to maximize asset balance and interest revenue.

Strong institutional framework

The institutional framework score for Arizona municipalities subject to a federal single audit requirement is strong.

Outlook

The stable outlook reflects our view of the city's maintenance of its very strong budgetary flexibility and stable performance, supported by what we consider prudent management policies and practices. The outlook further reflects our anticipation that the city's local economy will remain at least stable over the next two years, in line with regional economic trends. We do not expect to change the ratings during our two-year outlook horizon.

Upside scenario

We could raise the ratings if the city were to sustain positive balances across all governmental funds, and if its economic base were to expand to very strong levels.

Downside scenario

Should the city's budgetary performance and flexibility positions deteriorate as a result of increasing pension contributions or sustained operational imbalance, we could lower the ratings.

Related Research

- S&P Public Finance Local GO Criteria: How We Adjust Data For Analytic Consistency, Sept. 12, 2013
- Incorporating GASB 67 And 68: Evaluating Pension/OPEB Obligations Under Standard & Poor's U.S. Local Government GO Criteria, Sept. 2, 2015
- 2017 Update Of Institutional Framework For U.S. Local Governments