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Ratings

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Summary:

Surprise, Arizona; Miscellaneous Tax

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Summary:

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Credit Profile		
Surprise MISCTAX		
Long Term Rating	AA+/Stable	Upgraded

Rationale

S&P Global Ratings raised its long-term rating to 'AA+' from 'AA' on Surprise, Ariz.'s series 2015 pledged revenue and revenue refunding obligations. The outlook is stable.

The raised rating action reflects the application of our "Priority-Lien Tax Revenue Debt" criteria, published Oct. 22, 2018, on RatingsDirect, which factors in both the strength and stability of the pledged revenue, as well as the general credit quality of the obligor. In this case, we consider the city the obligor.

Credit Overview

A first-lien pledge of the city's excise taxes and state-shared revenue secures the bonds. The city's locally levied sales tax accounts for nearly half (48% in fiscal 2018) of pledged revenue, followed by charges for services (16%), state-shared income taxes (15%), state-shared sales taxes (12%), and other taxes and fees. The state-shared tax revenue is allocated to cities and towns based on each's share of the total population of all incorporated cities and towns in the state.

The credit profile of Surprise's pledged revenue bonds reflects the economic strength and breadth of the city's taxing base, which benefits from its location within the broad, diverse, and rapidly growing Phoenix-Mesa-Scottsdale metropolitan statistical area (MSA). Although the city's pledged revenue stream has demonstrated somewhat greater volatility than sales and use taxes nationally, in part due to the relatively severe local economic downturn during the Great Recession, we understand that the city continues to experience economic development and diversification. We believe this will continue to support a pledged revenue stream that consistently produces extraordinarily strong debt service coverage (DSC), which is further aided by a very strong 3.0x maximum annual debt service (MADS) additional bonds test (ABT) as well as the city's reliance on the pledged revenue stream to fund operations.

Key credit considerations include:

- Surprise's strong economic fundamentals, reflecting its rapidly growing population of nearly 150,000 (in 2018), per capita effective buying income (EBI) of 85% of the national level, and the economic strength and diversity stemming from the city's location within the broad and diverse MSA;
- Our view that pledged revenue obligations' will continue to attain extraordinarily strong MADS coverage levels, supported by a very strong 3.0x ABT and the city's reliance on pledged revenue to fund general operations;
- The moderate-to-low volatility of the pledged revenue stream; and
- Our view that the city's general creditworthiness does not constrain the rating on its pledged revenue obligations.

At fiscal year-end 2018, the city had approximately $28.3 million in series 2015 pledged revenue and revenue refunding obligations outstanding. The city has no parity debt outstanding.

Economic fundamentals: Strong

Surprise, with a 2018 population of approximately 148,500, is located approximately 20 miles northwest of downtown Phoenix. Since emerging from the Great Recession, the city's economic base has grown and diversified, following with the very strong growth across the MSA. Surprise's population growth rate has outpaced even that of Maricopa County, which is growing at a rate more than double the national growth rate. Surprise's population increased 13.2% from 2013-2018, outpacing the county (10.2%), state (7.5%), and more than tripling the national growth rate (3.7%).

The city has a large amount of developable land, and many residential subdivisions have popped up in recent years in the suburban community. The city's warm temperatures and golf courses are one factor that has attracted a relatively large number of retirees. As a result, the city's population skews older than average, with residents aged 65 or higher, at 22.1%, comprising a 39.2% greater share of the city's population than of the nation as a whole. The city's plentiful housing, economic diversification, and proximity a multitude of job opportunities elsewhere in the MSA also make it attractive to families with young children, who also comprise greater shares of the local population than of the nation as a whole.

The city's per capita EBI was 85% of the national level in 2018, supporting the strong economic fundamentals assessment.

Coverage and liquidity: Very strong

Surprise's $109.3 million in pledged revenue produced 25.8x MADS coverage in fiscal 2018, a level we consider extraordinarily strong. The series 2015 bonds follow level amortization, with approximately $4.2 million in annual debt service requirements, through fiscal 2024. Annual debt service requirements step down by 62.6% in fiscal 2025, and the bonds mature in fiscal 2030. We understand the city has no plans to issue additional debt secured by the pledged revenue.

Combined, the various components of the pledged revenue stream accounted for 94% of the city's general fund revenue and 74% of its total governmental fund revenue in fiscal 2018. In our view, the city's reliance on the pledged revenue stream to fund its general government operations lessens the likelihood that it would incur additional leverage to an extent that would materially dilute coverage. In addition, the ABT requires that the city's pledged revenue collected in the most recently completed fiscal year produce MADS coverage of at least 3.0x on existing and proposed parity bonds. Together, these factors inform our expectation that the city will maintain extraordinarily strong coverage metrics.

The city is required to fund a debt service reserve if coverage falls below 3.0x. We consider springing DSR's weaker from a credit perspective than DSR's funded at the point of issuance, though we consider it unlikely that coverage metrics would fall near the level that would trigger the springing reserve in this case. Furthermore, given our coverage and volatility assessments, we do not apply a liquidity factor adjustment to the coverage and liquidity assessment for the excise tax revenue bonds.

Volatility: Moderate-to-low

We assess the volatility of pledged revenue to evaluate the likely availability of revenue across different economic cycles. We have two levels of volatility assessment: macro and micro. Our macro volatility assessment begins with an assessment of the historical volatility of the economic activity being taxed, and includes an analysis of societal, demographic, political, and other factors that could affect these activities. We use the variance of national economic activity that we believe most closely represents the taxing base over multiple economic cycles to inform our expectations of volatility.

Because locally levied sales taxes represent nearly a majority of Surprise's total pledged revenue, we select national sales tax revenue as the baseline for our macro volatility assessment. To determine our view of the volatility of sales taxes, we used total retail food and service sales data from the U.S. Census Bureau for the period 1993 to 2014. On a macro level, we assess the revenue volatility of sales taxes as low.

On a micro level, we observe that Surprise's pledged revenue stream has demonstrated moderate-to-low historic volatility. Though the presence of state-shared income and sales tax revenue within the overall revenue pledge adds a degree of stability compared to a pledge of strictly locally-levied taxes, the city's pledged revenue stream has demonstrated greater historic volatility than sales taxes nationally. Pledged revenue declined by 26% from fiscal 2007 through fiscal 2011, during and in the immediate aftermath of the Great Recession. After four years of declines, pledged revenue surpassed the pre-recession peak within four years of hitting its nadir. Growth in recent years has been very strong.

Obligor linkage: Close

We believe the priority lien of pledged revenue provides some protection from operating risk. The state department of revenue collects the pledged tax revenue and remits it monthly to the city. As such, we consider the flow of pledged revenue to be within the city's direct control. Per our criteria and given the flow of funds, we consider the linkage between the priority-lien revenue pledge and the obligor's general creditworthiness close.

Rating linkage to Surprise's General Creditworthiness

We assess the city's general operations, because we view overall creditworthiness as a key determinant of an obligor's ability to pay all of its obligations, including bonds secured by a special tax. The city's general creditworthiness reflects its strong overall financial position, supported by what we consider to be its very strong budgetary flexibility and liquidity, and strong debt and contingent liability position. We consider the city's financial management strong. For more on our view of the city's general credit quality, please see our report published April 3, 2018.

Outlook

The stable outlook reflects our expectation that Surprise will maintain MADS coverage metrics we consider extraordinarily strong, given the city's very strong 3.0x ABT and reliance on pledged revenue to fund governmental operations. We do not expect to change the rating during our two-year outlook horizon.

Upside scenario

We could raise the rating if the city's steady population and assessed value growth leads to improvement in the city's general creditworthiness, and if the pledged revenue stream demonstrates materially greater stability and/or the economic base materially strengthens.

Downside scenario

We could lower the rating if coverage metrics materially decline, due to the unexpected issuance of a substantial amount of additional parity debt.