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Summary:

Surprise, Arizona; General Obligation

Primary Credit Analyst:
David Mares, Centennial + 1 (303) 721 4700; david.mares@spglobal.com

Secondary Contact:
Alyssa B Farrell, Centennial (1) 303-721-4184; alyssa.farrell@spglobal.com

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Summary:

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Credit Profile		
US$17.485 mil GO bnds ser 2020 dtd 09/30/2020 due 07/01/2028		
Long Term Rating	AA/Stable	New
Surprise GO bnds		
Long Term Rating	AA/Stable	Affirmed
Surprise ICR		
Long Term Rating	AA/Stable	Affirmed

Rating Action

S&P Global Ratings assigned its 'AA' long-term rating to Surprise, Ariz.'s anticipated $17.485 million series 2020 general obligation (GO) bonds. At the same time, S&P Global Ratings affirmed its 'AA' long-term rating on the city's GO debt outstanding and its 'AA' issuer credit rating (ICR) on the city. The outlook is stable.

The city's unlimited ad valorem property tax pledge secures the GO bonds. Proceeds from the series 2020 GO bonds will finance facilities improvements including a fire station, an evidence and readiness center, and traffic mitigation efforts to a local road.

Credit overview

The rating reflects the city's participation in the broad and diverse Phoenix economic area, as well as trend of strong financial performance and very strong available reserves. The stable outlook reflects our expectation the city will be able to maintain very strong available reserves despite a potentially challenged revenue environment. Our outlook period is generally two years, but we see significant risks because of the COVID-19 pandemic and U.S. recession over the next six to 12 months.

We will continue to monitor economic conditions, particularly uncertainty related to COVID-19 and budgetary pressures. For more information on the coronavirus' effect on U.S. public finance, see the reports "The COVID-19 Outbreak Weakens U.S. State And Local Government Credit Conditions," published April 2, 2020, and "The U.S. Faces A Longer And Slower Climb From The Bottom," published June 25, 2020, on RatingsDirect.

The rating further reflects our view of the city's

- Strong economy, with 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 a slight operating surplus in the general fund and an operating surplus at the total governmental fund level in fiscal 2019;
- Very strong budgetary flexibility, with an available fund balance in fiscal 2019 of 34% of operating expenditures;

- Very strong liquidity, with total government available cash at 101.8% of total governmental fund expenditures and 18.1x governmental debt service, and access to external liquidity we consider strong;
- Strong debt and contingent liability profile, with debt service carrying charges at 5.6% of expenditures and net direct debt that is 48.8% of total governmental fund revenue, as well as low overall net debt at less than 3% of market value and rapid amortization, with 67.4% of debt scheduled to be retired in 10 years, but a large pension and other postemployment benefit (OPEB) obligation; and
- Strong institutional framework score.

Environmental, social, and governance (ESG) factors

We analyzed Surprise's ESG risks relative to its economy, financial measures, and debt profile. We believe that the city's governance risk factors are in line with our view of the sector as a whole. Our rating incorporates our view regarding the health and safety risks posed by the COVID-19 pandemic, albeit temporary. Absent the implications of COVID-19, we consider the city's social risk to be in line with our view of the sector standard.

Stable Outlook

Downside scenario

Should recessionary pressure have a materially negative impact on the city's economy, and subsequently affect city finances, we could lower the rating.

Upside scenario

Although unlikely given the uncertainty around the economic and financial pressures because of the pandemic, we could raise the rating if the city exhibits financial resiliency through the recessionary pressures, strengthening its underlying credit quality.

Credit Opinion

Strong economy

We consider Surprise's economy strong. The city, with an estimated population of 148,246, is located in Maricopa County in the Phoenix-Mesa-Scottsdale, Ariz., MSA, which we consider broad and diverse. The city has a projected per capita effective buying income of 87.5% of the national level and per capita market value of $96,395. The city's market value grew by 12.7% over the past year to $14.3 billion in 2021. The county unemployment rate was 4.0% in 2019.

Surprise is located approximately 22 miles northwest of Phoenix. The city has experienced both population and economic growth over the last 10 years, resulting in a cumulative market growth of 20.3% since 2018 to $14.3 billion in 2020.

The current economic recession is likely to limit growth in the city's local economy going forward, though city management has indicated housing demand has remained stable, and commercial and mixed-use developments are still on schedule. We note that the effects of the recession will not be reflected in the city's tax base until fiscal 2022 assessed value figures are available.

The county unemployment rate was 4.0% in 2019. Despite this very low figure, rapidly evolving economic conditions due to the pandemic have already affected the labor market (see "U.S. Biweekly Economic Roundup: The Jobs Recovery Loses Momentum" published Aug. 7, 2020). High unemployment, particularly if it exceeds 10%, is a risk. We will monitor the long-term effects of the current downturn on the labor market and the economy overall.

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.

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, with funding sources identified for the current fiscal year's projects. The city has a formal investment policy that reflects state guidelines and 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. 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

Due to the sudden rapid national economic deterioration, we have revised our budgetary performance assessment to adequate from strong. This assessment incorporates heightened near-term uncertainty that exists due to the recessionary pressures related to the COVID-19 pandemic and resulting financial pressures. The city had slight surplus operating results in the general fund of 0.7% of expenditures, and surplus results across all governmental funds of 11.1% in fiscal 2019.

We have adjusted the city's operating revenues and expenditures to account for recurring transfers into 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 five audited fiscal years, and results have consistently been better than budgeted at year-end.

The city's governmental fund revenues rely primarily on sales taxes (33%) and state-shared revenues (19%), with property taxes accounting for 9% of revenues. City officials have noted that despite the pandemic, overall sales tax collections are higher in fiscal 2020 than in the previous year. Management anticipates a positive result in fiscal 2020 and has budgeted for a surplus in fiscal 2021. However, officials note the uncertainty of the pandemic, and should the local economy and revenue streams be disrupted, management could reduce expenditures or roll back transfers to the capital projects fund to balance operations.

Very strong budgetary flexibility

Surprise's budgetary flexibility is very strong, in our view, with an available fund balance in fiscal 2019 of 34% of operating expenditures, or $42.6 million.

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 a very strong level in the near term.

Very strong liquidity

In our opinion, Surprise's liquidity is very strong, with total government available cash at 101.8% of total governmental fund expenditures and 18.1x governmental debt service in 2019. 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 very strong. Total governmental fund debt service is 5.6% of total governmental fund expenditures, and net direct debt is 48.8% of total governmental fund revenue. Overall net debt is low at 1.5% of market value, and approximately 67.4% of the direct debt is scheduled to be repaid within 10 years, which are in our view positive credit factors.

At this time, the city does not have additional GO debt plans after this issuance 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.

Pensions and other postemployment benefits (OPEBs)

- In our opinion, a credit weakness is the city's large pension and OPEB obligation.
- The pension plans that the city participates in are relatively underfunded, and we believe this could lead to cost pressures in the future, even as the city consistently fully funds its required contributions.
- While we note the city is currently exploring options to mitigate rising pension rates, no plans have been finalized.
- City employees participate in a cost-sharing multiple-employer defined benefit health insurance premium benefit plan and long-term disability plan (OPEB), which the city funds on a pay-as-you-go basis.

The city participates in the following plans funded as of June 30, 2019:

- Arizona State Retirement System (ASRS), a cost-sharing multiple-employer defined benefit plan: $53.8 million in net pension liability, and 73.2% funded;

- Public Safety Personnel Retirement System (PSPRS) - Police, an agent multiple-employer plan: $23.9 million in net pension liability, and 60.4% funded;
- PSPRS - Fire, an agent multiple-employer plan: $12.6 million in net pension liability, and 67.8% funded; and
- PSPRS Police OPEB: $44,000 in net OPEB liabilities, and 96.2% funded.

The city's combined required pension and actual other postemployment benefits (OPEB) contributions totaled 7.7% of total governmental fund expenditures in 2019. The city's 2019 actuarially determined contributions for ASRS fell short of static funding and minimum funding progress, indicating that the liability is increasing annually, while its contribution to the largest PSPRS plan exceeded static funding progress. The discount rate used for most of the city's pension liabilities is between 7.3% and 7.5%, which adds to our view of contribution volatility going forward.

Strong institutional framework

The institutional framework score for all Arizona municipalities with a single audit requirement is strong.

Related Research

- Through The ESG Lens 2.0: A Deeper Dive Into U.S. Public Finance Credit Factors, April 28, 2020
- 2019 Update Of Institutional Framework For U.S. Local Governments