

RatingsDirect®

Summary:

Oro Valley, Arizona; Miscellaneous Tax

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Credit Profile		
Oro Vy excise tax rev obligs (CREBs) <i>Long Term Rating</i>	AA+/Stable	Upgraded

Rationale

S&P Global Ratings raised its long-term rating to 'AA+' from 'AA-' on Oro Valley, Ariz.'s excise tax revenue bonds, series 2010 and 2012. The outlook is stable.

The 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 town the obligor. In addition, the raised rating reflects the town's strong pledged revenue growth and extraordinarily strong coverage on all parity obligations.

Credit Overview

A first-lien pledge of the town's excise taxes secures the bonds. Oro Valley's excise taxes consist of town sales and franchise taxes (64% of pledged revenue in fiscal 2018), state-shared income tax (16%), state-shared sales tax (12%), licenses and permits (8%), and fines. The state-shared tax revenue is allocated to cities and towns based on each's share of all incorporated cities and towns in the state.

Oro Valley's excise tax revenue bond credit profile reflects its location as a suburban town within the broad and diverse Tucson, Ariz., metropolitan statistical area (MSA). The town is a popular location for retirees, second homeowners, and residents who work in the higher education, aerospace and defense, and other industries in Tucson and other parts of the MSA. With a pledged revenue stream that has demonstrated moderate-to-low historic volatility, the town has consistently produced extraordinarily strong maximum annual debt service (MADS) coverage on its excise tax revenue bonds and parity private placements. Given a very strong additional bonds test (ABT) that requires historic revenue produce no less than 2.0x MADS coverage and the town's reliance on the pledged revenue stream to fund its operations, we expect coverage will remain at levels we consider extraordinarily strong.

Key credit considerations include:

- Oro Valley's very strong economic fundamentals, given its high income levels and location within a broad and diverse MSA;
- The excise tax revenue bonds' very strong coverage and liquidity assessment, supported by a very strong 2.0x ABT and extraordinarily strong MADS coverage;
- The moderate-to-low volatility of the pledged revenue stream; and
- Our view that the town's general creditworthiness does not constrain the rating on its excise tax bonds.

The series 2010 and 2012 excise tax revenue bonds are parity obligations with the town's 2013, 2015, 2016, 2017, and 2018 private placements. Though each of the private placement obligations is secured by excise tax revenue, the town reports the 2013 and 2018 private placements as obligations of its water fund, and the town pays those two obligations with water net revenue.

At fiscal year-end 2019, the town had approximately \$18.2 million in outstanding debt secured by excise tax revenue. This includes approximately \$10.1 million in private placement obligations secured by excise taxes but paid by water revenue.

Economic fundamentals: Strong

The town, with a 2018 population of 44,295, is located in Pima County, 12 miles north of downtown Tucson and just west of the Santa Catalina Mountains. The town is a largely residential community and is popular home for retirees and second homeowners, many of whom relocate to the area during the winter months to take advantage of the desert climate. Local residents benefit from access to the broad and diverse Tucson MSA, which is home to the University of Arizona and several employers in the aerospace and defense industries. Town-level per capita effective buying income levels are high, at 144% of the national level in 2018, while the unemployment rate (4.3% in 2018) in Pima County trends just above the national level (3.9%).

Reflecting its popularity among retirees attracted to the warmer weather, golf courses, and other local amenities, the town's population skews much older than the national population. Town residents aged 65 and older represent 32.1% of the total town population, 102.2% greater than the proportion residents in that age range represent of the national population. In addition to the high dependent population, the exposure of the town's economy to seasonality tempers the economic fundamentals assessment. We consider the economic base subject to a moderate degree of seasonality, given the region's exposure to extreme summer temperatures and its relatively high level of second homeowners who relocate to the town in the more temperate shoulder seasons and winter months.

The local tax base is somewhat concentrated, with the top 10 sales taxpayers accounting for about 45% of fiscal 2019 local sales tax collections. In recent years, the top 10 taxpayers have accounted for around 25% of total pledged revenue.

Coverage and liquidity: Very strong

We evaluate Oro Valley's excise tax revenue bond coverage both including and excluding the 2013 and 2018 obligations that the city reports as obligations of its water fund but are secured by excise tax revenue on par with the bonds that we rate and other parity private placements. Though we emphasize coverage metrics inclusive of the 2013 and 2018 obligations, reflecting the obligations' legal security, we note that coverage is extraordinarily strong in either case. Furthermore, we note that water net revenue is consistently more than sufficient to cover the water fund's obligations, including the 2013 and 2018 obligations.

The town's \$34.8 million in pledged revenue produced 13.1x MADS coverage in fiscal 2018 on all excise tax obligations, and 33.2x MADS coverage excluding the obligations paid by water net revenue. The town's estimated \$35.5 million in fiscal 2019 pledged revenue produced 13.4x all-in MADS coverage on all excise tax-secured obligations. We note that pledged revenue would have to decline by 70% below the figure estimated for fiscal 2019 for

all-in MADS coverage to fall below 4.0x. We consider this prospect unlikely, and we note that the city has no current plans to issue additional parity obligations.

Legal provisions for the excise tax revenue bonds include an ABT that requires that pledged revenue collected during the most recent fiscal year produce no less than 2.0x MADS coverage on existing and proposed parity obligations. We believe the town is unlikely to bond down to the level of the ABT, given its reliance on the pledged revenue stream to fund operations. In fiscal 2018, pledged revenue equaled 62% of total governmental fund revenue, and a substantial majority of general fund revenue.

Given the strength of current and historic MADS coverage, the 2.0x ABT, and the town's reliance on pledged revenue to fund operations, we expect coverage metrics will remain at levels we consider extraordinarily strong.

The bonds have a springing debt service reserve (DSR) requirement, whereby the DSR must be funded if coverage on all parity obligations falls below 2.5x, a prospect we consider unlikely for the reasons described above. 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 sales taxes represent a majority of Oro Valley's 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 Oro Valley's pledged revenue stream has demonstrated moderate-to-low historic volatility. Though the presence of state-shared income and sales tax revenue within the excise tax pledge adds a degree of stability compared to a pledge of strictly locally-levied taxes, the town's pledged revenue stream has demonstrated somewhat greater historic volatility than sales taxes nationally. Pledged revenue declined by 32.4% over a three-year period from fiscal 2008-2011, during and in the immediate aftermath of the Great Recession. Pledged revenue growth has been strong since then, recovering to surpass the pre-recession peak by fiscal 2017, six years after hitting the nadir.

Obligor linkage: Close

We believe the priority lien of pledged revenue provides some protection from operating risk. However, because taxes are collected monthly by the town, which then transfers them to the trustee, we consider the flow of pledged revenue to be within the town's direct control. Under 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 Oro Valley's General Creditworthiness

We assess the town'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. Supporting the town's general creditworthiness is its favorable wealth and income levels, positive property value and population growth trends. We consider the city's finances well-managed, and we note as additional credit positives the city's high available fund balances and liquidity, and manageable overall debt burden. Based on our analysis and per our criteria, the city's general creditworthiness does not constrain the rating on its excise tax revenue bonds.

Outlook

The stable outlook reflects our expectation that Oro Valley's strong economy, very strong ABT, and reliance on pledged revenue to fund operations will enable it to continue producing extraordinarily strong MADS coverage. It indicates that we do not expect to change the rating during our two-year outlook horizon.

Upside scenario

We could raise the rating if we observe material improvement in the town's already strong economic fundamentals.

Downside scenario

Although unexpected, we could lower the rating if the town's economic fundamentals unexpectedly worsen or if a combination of substantial additional debt issuance and declining pledged revenue materially suppresses all-in MADS coverage.

Related Research

- U.S. State And Local Government Credit Conditions Forecast, Oct. 24, 2018
- Alternative Financing: Disclosure Is Critical To Credit Analysis In Public Finance, Feb. 18, 2014

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