MEMORANDUM

Date: April 22, 2021

To: The Honorable Chair and Members
Pima County Board of Supervisors

From: C.H. Huckelberry
County Administrator

Re: **Pledged Revenue Obligations Sale**

On March 23, 2021, I issued the attached memorandum regarding the credit rating reviews received by Fitch Ratings and Standard & Poor's (S&P) Global Ratings for our Pledged Revenue Obligations that were being issued to address the unfunded liability in the Public Safety Personnel and Corrections Officer Retirement Plans.

As stated in that memorandum, the two firms spoke highly of the County's fiscal management and the local economy. Here are some of the comments from the ratings reports released in March 2021.

- "Solid revenue growth prospects, strong expenditure controls, a low long-term debt liability burden, and superior operating performance" *(Fitch)*
- "The County has a conservative approach to managing its finances, enabling it to sustain robust financial flexibility through economic cycles" *(Fitch)*
- "Large and diverse economy, in addition to good incomes and an employment base made up of government, defense, tourism, higher education and services" *(S&P)*
- "Good financial management policies and practices" *(S&P)*

The debt was sold earlier this week. Based on the market, our high quality ratings and sound financial practices, the County was able to obtain an overall interest rate of 1.9894% on this issue. The low rate the County will pay on the debt service positions us well to realize significant savings over the next 15 years.

Attachment

c: Jan Lesher, Chief Deputy County Administrator
Michelle Campagne, Director, Finance and Risk Management

MEMORANDUM

Date: March 23, 2021

To: The Honorable Chair and Members
Pima County Board of Supervisors

From: C.H. Huckelberry
County Administrator

Re: **Credit Ratings**

The County has received credit rating reviews by Fitch Ratings (Fitch) and S&P Global Ratings (Standard & Poor's) for the Pledged Revenue Obligations that will be issued in April to address the unfunded liability in the Public Safety Personnel and Corrections Officer Retirement Plans as approved by the Board of Supervisors on February 16, 2021.

Pima County's conservative approach to debt management and aggressive debt retirement has once again been rewarded by strong ratings being issued for the Pledged Revenue Obligations. Below is a recap of the current ratings for Pima County's debt instruments.

Credit Ratings				
	Standard & Poor's		Fitch Ratings	
	Rating	Date	Rating	Date
Certificates of Participation (COPs)	AA-	November-2020	AA	November-2020
General Obligation	AA	November-2020	AAA	November-2020
Pledged Revenue Obligations	AA+	March-2021	AA+	March-2021
Street and Highway Revenue	AA	November-2020	AA	November-2020
Sewer Revenue Obligations	AA	November-2020	AA	November-2020

In their rating reports, the two firms spoke highly of the County's fiscal management and local economy. Here are some of the comments from the ratings reports released in March 2021:

- Fitch Ratings:
  - "Solid revenue growth prospects, strong expenditure controls, a low long-term debt liability burden, and superior operating performance"
  - "The County has a conservative approach to managing its finances, enabling it to sustain robust financial flexibility through economic cycles"
- Standard & Poor's:
  - "Large and diverse economy, in addition to good incomes and an employment base made up of government, defense, tourism, higher education and services."
  - "Good financial management policies and practices"

Attachments

c: Jan Lesher, Chief Deputy County Administrator
Michelle Campagne, Director, Finance and Risk Management

RATING ACTION COMMENTARY

Fitch Rates Pima County, AZ Pledged Revenue Obligations and IDR 'AA+'; Outlook Stable

Mon 22 Mar, 2021 - 11:30 AM ET

Fitch Ratings - Austin - 22 Mar 2021: Fitch Ratings has assigned a 'AA+' rating to the following Pima County, AZ obligations:

--$300 million pledged revenue obligations taxable series 2021.

In addition, Fitch has affirmed Pima County, AZ's Issuer Default Rating (IDR) rating at 'AA+'.

The Rating Outlook is Stable.

The taxable series 2021 pledged revenue obligations are scheduled for a negotiated sale on April 21. Proceeds will be deposited with the Arizona Public Safety Personnel Retirement System (PSPRS) and Corrections Officer Retirement Plan (CORP) in July 2021 to address a portion of the county's unfunded liabilities.

The pledged revenue obligations are backed by a first lien on pledged county excise taxes (various license fees, franchise fees, fines and forfeitures, and other fees), federal payments in lieu of taxes, and state shared sales taxes and vehicle license fees, both collected by the state and returned to the county.

Feedback

DEDICATED TAX ANALYTICAL CONCLUSION

The 'AA+' rating on the pledged revenue obligations reflects the expectation of continued revenue growth and ample resiliency relative to potential cyclicality; the resilience assessment includes the assumption of no additional leveraging.

IDR ANALYTICAL CONCLUSION

The 'AA+' IDR is supported by solid revenue growth prospects, strong expenditure controls, a low long-term debt liability burden, and superior operating performance. The county has a conservative approach to managing its finances, enabling it to sustain robust financial flexibility through economic cycles.

(SEE BELOW FOR IDR ANALYSIS)

ECONOMIC SUMMARY

Pima County has a population of just over 1 million and is home to Tucson, Arizona's second-largest city. The county's diverse economy features higher education, healthcare, government, technology, tourism and manufacturing as primary components. The top 10 taxpayers represent retail, healthcare, utility and mining sectors and comprise a modest 7% of total fiscal 2020 taxable values.

DEDICATED TAX KEY RATING DRIVERS

Strong Growth Prospects for Pledged Revenues: The pledged excise tax revenues that back the obligations are expected to increase modestly over the near term, given recent results for the sources and the general overall health of the state and regional economy.

Sound Resiliency: The 2x ABT provides a solid cushion relative to potential volatility, even before considering Fitch's expectation of no further leveraging. The pledged revenues generate a strong debt service cushion to withstand the current downturn, as well as a severe revenue shock scenario.

Feedback

RATING SENSITIVITIES

IDR

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

--Reduction of carrying costs to levels in line with 10% of expenditures, providing additional expenditure flexibility;

--Sustained revenue growth above the rate of nominal U.S. GDP growth.

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

--While unlikely, increases in carrying costs that consistently exceed 30% of expenditures;

--Failure to implement available policy measures that offset risks associated with a return to economic contraction consistent with Fitch's coronavirus downside scenario, resulting in an erosion of the county's gap-closing capacity.

--More severe economic weakness than envisioned in Fitch's coronavirus downside scenario, without evidence that available measures are adequate to counteract associated budgetary risks.

Pledged Revenue Obligations

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

--An upgrade of the county's IDR, combined with pledged revenue growth performance that further strengthens coverage of MADS.

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

--Consistent erosion of pledged revenues and that weakens the coverage cushion and resilience.

--A downgrade of the county's IDR.

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

The recently enacted American Rescue Plan (ARP) will provide $350 billion in direct aid to state and local governments, transit systems, and school districts (through the states), as well as a significant amount of economic stimulus that should have a positive near-term impact on state and local government revenues. Fitch does not expect the stimulus to alter the long-term credit fundamentals of state and local governments, but should bridge near-term gaps. Fitch's commentary on the ARP, as it relates to state and local governments, is available via the following link: https://www.fitchratings.com/site/pr/10155293.

CORONAVIRUS IMPACT ON PIMA COUNTY, ARIZONA

The county received $87 million in federal Coronavirus Relief Fund grants in calendar 2020, with approximately $42 million expended in fiscal 2020, and the remaining $45 million shifted to fiscal years 2021. Additionally, the county received $48 million more in coronavirus related grants that are being allocated for emergency rental assistance. The grant funds that are being segregated in a special revenue fund and being used for various programs including vaccinations ($21 million), testing and contact tracing, small business grants, childcare organizations, food banks, and homelessness. Under the American Rescue Plan, the county anticipates receiving an estimated $203 million.

For the county's general fund, fiscal 2020 results were positive. Revenues exceeded prior year amounts by $17.7 million, or 3.1%, and were $6.9 million over budgeted amounts. Expenditures were $715,000 over prior year levels; however, $98.3 million under budget due primarily to $42.6 million in unspent contingency funds. Property tax and state shared sales tax revenues performed well due to rising valuations and internet sales, respectively.

Expenditure containment was due to vacant position salary savings and limitations placed on departmental spending. Also, sheriff costs totaling $20.6 million were shifted from the general fund to a pandemic grants fund. With fiscal 2020 budget execution, the unrestricted fund balance ended at $98 million, representing 16.2% of spending for the year.

For the fiscal 2021 budget, the county made expenditure reductions, including eliminating 270 vacant positions and limiting or eliminating spending on categories such as travel, overtime and supplies. The county has also opted to forgo pay-as-you-go capital project funding for one year. The budgeted unrestricted general fund balance is $49 million, which is well above the reserve safety margin requirement for the highest financial resilience assessment by Fitch.

The county's budgets tend to be conservative, and Fitch expects actual fund balance to exceed the amount budgeted. To date, management reports revenues are higher yoy by about $26.6 million mainly due to increased property tax ($5.6 million), state shared sales tax ($23.5 million) and vehicle license tax collections ($4 million). Expenditures are about $9.7 million under budget year-to-date, primarily due to a decrease in mandated payments and election costs following the primary election.

PENSION OBLIGATION BONDS

The county is issuing $300 million in taxable pledged revenue obligations to address a portion of its unfunded liabilities in the PSPRS and CORP pension systems. Currently, the county's funded ratios in the systems are in the low to mid 40%. With this financing, the county is targeting reaching reported funded ratios of 90% in both plans, as well as mitigating rises in future required pension contributions from the general fund. Proceeds from the financing will be deposited with the respective systems.

The issuance follows 2016 state reforms that established a Tier III hybrid benefit structure for new hires, closed Tiers I and II and required the amortization of legacy unfunded liabilities over 20 years, among other changes, which Fitch views as improving the sustainability of the plans over time. The transaction will substitute a lower net pension liability with a higher direct debt burden, resulting in little change to the long-term liability burden upon issuance.

Fitch's metrics will continue to reflect its adjustment to reported pension data to reflect a standard 6% investment return assumption, leaving a larger residual net pension liability. Additionally, pension liabilities and carrying costs could rise further in the future if the statewide plans are unable to achieve their 7.3% investment return target or other actuarial and demographic assumptions.

ECONOMIC RESOURCE BASE

Prior to the pandemic, Pima County's economy was firmly in growth mode with eight consecutive years of gains in countywide market values. Market value increased a solid 6.4% in fiscal 2021 to $89.5 billion and 7.4% in fiscal 2019. Countywide retail sales averaged 4% annual increases since 2013, including a 4.6% gain in 2019 to $9.7 billion. Management expects additional near-term tax base growth based on current residential construction activity and appreciation of existing properties.

New housing starts totaled 4,350 in 2020, up 17% from 2019. Values of new homes were up 5% and existing homes were up 11% for 2020. Employment in the local economy has weakened during the pandemic, with layoffs occurring particularly in the retail, tourism and entertainment sectors. The University of Arizona has had layoffs and non-renewed contracts totaling 251 staff. Unemployment has risen to 7.4% as of December, higher than that of the state and the U.S., at 6.7% and 6.5%, respectively.

Major southern Arizona employers include the University of Arizona, Raytheon Missile Systems, Davis-Monthan Air Force Base, state and local government, Wal-Mart Stores Inc., Tucson Unified School District and Banner Healthcare.

DEDICATED TAX CREDIT PROFILE

Surplus pledged revenues are utilized as sources for general fund operations. Therefore, the pledged revenues do not meet the requirements set out in Fitch criteria for treatment as "pledged special revenues" under section 902(2)(D) of the U.S. bankruptcy code. Fitch treats the debt as related to the operating risk of the entity, due to the nature of the pledged revenues. Therefore, the rating on the dedicated tax bonds is capped at the county's IDR.

The pledged revenue obligations are backed by a first lien on pledged county excise taxes (various license fees, franchise fees, fines and forfeitures, and other fees), federal payments in lieu of taxes, and state shared sales taxes and vehicle license fees, both collected by the state and returned to the county.

Additional leveraging of the pledged revenues is permitted to the extent that they provide at least two times coverage of MADS.

Pledged revenues include local excise taxes such as certain license fees, fines and forfeitures, and franchise fees collected by the county. Also pledged are federal payments in lieu of taxes and state collected taxes, sales and vehicle license, that are remitted to the county. The 10-year CAGR for these sources is 4.4% and is expected to continue given the ongoing economic activity and prospects post-pandemic. In the analysis of the pledged revenue resiliency, Fitch also examined the City of Tucson excise (sales) tax performance over the past 20 years to gauge the sensitivity of local revenue streams to varied economic conditions.

Using fiscal 2020 pledged revenue collections, maximum annual debt service coverage (MADS) is robust at 4.3x. Approximately 56% of pledged revenues stem from state shared sales taxes, traditionally a more economically sensitive revenue stream. The combined remaining pledged revenues provide nearly 1.9x coverage of MADS using fiscal 2020 revenues. Using the largest historical decline in pledged revenues of 18.4%, fiscal 2020 revenues would provide nearly 3.5x MADS coverage.

IDR KEY RATING DRIVERS

Revenue Framework: 'aa'

Pima County's revenue growth prospects are solid, benefitting from a diverse regional economy that continues to perform overall. State law limits the county's ability to raise taxes for operating purposes, but the county retains unused property tax levy that the state allows to be banked and carried forward, and Pima County, like other counties in the state, has the option of imposing a local option sales tax.

Expenditure Framework: 'aa'

Fitch expects the county's pace of spending to remain generally in line with revenue growth. The county's responsiveness and willingness to adjust spending levels provides the capacity to manage cost pressures, including from pension contributions. Carrying costs are within the moderate range and the county operates under a flexible labor framework in which management retains full control over head count and wages.

Long-Term Liability Burden: 'aaa'

The combined burden of debt and net pension liabilities in relation to personal income is low at just under 6%. The assessment reflects the county's above average debt amortization rate (more than 67% retired in 10 years), moderate capital needs, and an elevated net pension liability, a portion of which will be addressed by a pledged revenue obligation bond issue.

Operating Performance: 'aaa'

Pima County has the highest gap-closing capacity with sizable reserves and superior inherent budget flexibility. Conservative budgeting allows the county to adapt to economic conditions and to replenish reserves during periods of recovery.

IDR CREDIT PROFILE

REVENUE FRAMEWORK

The county's operating revenues are a mix of local-generated and state-shared revenues. Property tax revenues contribute about 60% of general fund revenues annually, and intergovernmental revenues are the next largest revenue component at nearly 31% of the total.

The most recent 10-year CAGR for Pima County general fund revenues (adjusted for tax rate changes) was essentially the same as the rate of inflation. Fitch's assessment of sustained revenue growth prospects is based on Pima County's diverse economy, solid population growth, recent solid tax base and retail sales gains, and the expectation for continued economic development in the area. Fitch expects the county's revenue gains to exceed the more modest rate-adjusted growth rate over the past 10 years, which was constrained due to the disproportionately large impact of the Great Recession throughout the state.

Feedback

State law limits the county's ability to make changes to certain revenues. Primary property tax levies, used for operations, are limited to a 2% per annum increase over the maximum allowable levy in the prior year plus taxes on any new construction. Additionally, the state allows the banking and carry forward of the 2% maximum levy increase, to the extent not fully used. Pima County had approximately $95 million of annual unused capacity in this regard in fiscal 2019, equal to nearly 20% of the general fund budget.

The primary tax rate was reduced for the fiscal 2021 budget adoption, which marks the fourth consecutive year of a decrease in this component of the levy. The same declining trend holds true for the total tax rate over the same period.

There is no limitation on annual secondary property tax levies used for voter-approved bonded indebtedness; those levies are not authorized to support operations. The secondary tax rate was also reduced for fiscal 2021, dropping to $1.4304 per $1,000 of assessed value, from $1.6018 in the prior fiscal year.

EXPENDITURE FRAMEWORK

The county's largest general fund expenditure areas are general government (45% of fiscal 2020 outlays), public safety (26%), and health and social services (23%).

Fitch expects the county's pace of spending to generally align with revenue growth over time as continued population gains increase service demands. Annual general fund spending increases over the past several fiscal years has been relatively modest; the slow rate of growth allowed management to both transfer increasing amounts for capital spending and boost operating reserves.

Sound expenditure flexibility is derived primarily from management's strong control over workforce costs. Carrying costs (debt service and retiree benefit outlays) are moderate (13% of fiscal 2020 governmental spending). The carrying cost incorporates an above average debt amortization schedule (more than 67% repaid in 10 years) and recently climbing pension contributions.

Fitch does not anticipate carrying costs to shift materially over the near term due to moderate borrowing plans and the amortization schedule that will accommodate additional debt issues; this combination should offset projected increasing required contributions to county pension plans. The county has demonstrated the ability and willingness to make spending cuts when necessary to retain sound budgetary flexibility.

LONG-TERM LIABILITY BURDEN

Pima County's long-term liability burden, comprised of overall debt and Fitch-adjusted net pension liabilities, is low at slightly under 6% of total personal income. Fitch expects the county's burden to remain affordable based on the above average debt amortization schedule and moderate near-term borrowing plans. Management reports plans to issue $50 million in certificates of participation in the succeeding three fiscal years (2022-2024), with the fiscal 2020 issue for pavement preservation.

The county and its employees participate in six separate pension programs administered by four state-sponsored systems. The three most significant are the Arizona State Retirement System (ASRS), a cost-sharing multiple-employer plan; the PSPRS, an agent multiple-employer (AME) plan; and the CORP, also an AME plan.

Under GASB 67 and 68, the county reported a fiscal 2020 combined net pension liability (NPL) for all plans of $776 million, with fiduciary assets covering 61% of total pension liabilities. Investment return assumptions for the plans vary, with ASRS at 7.5% and PSPRS and CORP at 7.3% as of the plans' fiscal 2020 audits. Using a more conservative standard 6% investment return assumption, the combined NPL increases to $1.12 billion with assets covering 52% of total liabilities.

The county has formulated a pension financing policy through the establishment of a reserve for future unfunded pension liability in the event that plan assumption changes trigger higher contributions. The county also adopted a policy statement that precludes the Board of Supervisors from accepting any grants that provide for personnel costs, except for those that provide solely for overtime payments, which does not create additional pension liability.

OPERATING PERFORMANCE

Fitch expects that Pima County will utilize the highest gap-closing capacity through an economic downturn based on its capacity and willingness to cut spending and manage tax rates as necessary. Conservative budgeting, solid expenditure flexibility and maintenance of healthy reserves position the county to quickly address any budgetary gaps and maintain a high level of financial flexibility.

Fiscal 2020 general fund results included a modest $3.8 million draw on reserves as the county continued its practice of pay/go capital spending; the results exceeded original budget projections. The unrestricted general fund balance at year-end totaled $98.1 million or just over 16% of spending, comfortably above the county's minimum reserve target of 5% of spending. Recent increases in operating reserves (five out of the past six years) were due primarily to better than expected revenue performance and sound expenditure control, which was consistent with the county's plan to build up fund balances to use for pay-as-you-go capital projects.

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

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

RATING ACTIONS

ENTITY/DEBT	RATING			PRIOR
Pima County (AZ) [General Government]	LT IDR	AA+ Rating Outlook Stable	Affirmed	AA+ Rating Outlook Stable
• Pima County (AZ) /Sales Tax Revenues - Excise Taxes/1 LT	LT	AA+ Rating Outlook Stable	New Rating	
• Pima County (AZ) /Issuer Default Rating - General Government/1 LT	LT	AA+ Rating Outlook Stable	Affirmed	AA+ Rating Outlook Stable

VIEW ADDITIONAL RATING DETAILS

FITCH RATINGS ANALYSTS

Jose Hernandez
Director
Primary Rating Analyst
+1 512 215 3727
Fitch Ratings, Inc.
2600 Via Fortuna, Suite 330 Austin, TX 78746

Steve Murray
Senior Director
Secondary Rating Analyst
+1 512 215 3729

Douglas Offerman
Senior Director
Committee Chairperson
+1 212 908 0889

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

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Pima County (AZ)	EU Endorsed, UK Endorsed
Pima County (AZ)	EU Endorsed, UK Endorsed

DISCLAIMER

COPYRIGHT

currency equivalent) per issue. In certain cases, Fitch will rate all or a number of issues issued by a particular issuer, or insured or guaranteed by a particular insurer or guarantor, for a single annual fee. Such fees are expected to vary from US$10,000 to US$1,500,000 (or the applicable currency equivalent). The assignment, publication, or dissemination of a rating by Fitch shall not constitute a consent by Fitch to use its name as an expert in connection with any registration statement filed under the United States securities laws, the Financial Services and Markets Act of 2000 of the United Kingdom, or the securities laws of any particular jurisdiction. Due to the relative efficiency of electronic publishing and distribution, Fitch research may be available to electronic subscribers up to three days earlier than to print subscribers.

For Australia, New Zealand, Taiwan and South Korea only: Fitch Australia Pty Ltd holds an Australian financial services license (AFS license no. 337123) which authorizes it to provide credit ratings to wholesale clients only. Credit ratings information published by Fitch is not intended to be used by persons who are retail clients within the meaning of the Corporations Act 2001

Fitch Ratings, Inc. is registered with the U.S. Securities and Exchange Commission as a Nationally Recognized Statistical Rating Organization (the "NRSRO"). While certain of the NRSRO's credit rating subsidiaries are listed on Item 3 of Form NRSRO and as such are authorized to issue credit ratings on behalf of the NRSRO (see https://www.fitchratings.com/site/regulatory), other credit rating subsidiaries are not listed on Form NRSRO (the "non-NRSROs") and therefore credit ratings issued by those subsidiaries are not issued on behalf of the NRSRO. However, non-NRSRO personnel may participate in determining credit ratings issued by or on behalf of the NRSRO.

READ LESS

SOLICITATION STATUS

The ratings above were solicited and assigned or maintained at the request of the rated entity/issuer or a related third party. Any exceptions follow below.

ENDORSEMENT POLICY

Fitch's international credit ratings produced outside the EU or the UK, as the case may be, are endorsed for use by regulated entities within the EU or the UK, respectively, for regulatory purposes, pursuant to the terms of the EU CRA Regulation or the UK Credit Rating Agencies (Amendment etc.) (EU Exit) Regulations 2019, as the case may be. Fitch's approach to endorsement in the EU and the UK can be found on Fitch's Regulatory Affairs page on Fitch's website. The endorsement status of international credit ratings is provided within the entity summary page for each rated entity and in the transaction detail pages for structured finance transactions on the Fitch website. These disclosures are updated on a daily basis.

US Public Finance   Infrastructure and Project Finance   North America   United States

S&P Global Ratings

RatingsDirect®

Summary:

Pima County, Arizona; Miscellaneous Tax

Primary Credit Analyst:
Tim Tung, San Francisco + 1 (415) 371 5041; tim.tung@spglobal.com

Secondary Contact:
Daniel Golliday, Farmers Branch + 1 (214) 765 5881; daniel.golliday@spglobal.com

Table Of Contents

Summary:

Pima County, Arizona; Miscellaneous Tax

Credit Profile		
US$300.0 mil pledged rev obligations ser 2021 due 05/01/2036		
Long Term Rating	AA+/Stable	New

Rating Action

S&P Global Ratings assigned its 'AA+' long-term rating to Pima County, Ariz.'s $300 million taxable series 2021 pledged revenue obligations. The outlook is stable.

The series 2021 obligations represent an interest in lease payments made by the county pursuant to a lease-purchase agreement. The lease payments are payable from and secured by a first-lien pledge on the county's general excise tax revenue, state-shared sales tax revenue, vehicle license tax revenue, and federal payments in lieu of taxes (PILT) revenue. The lease payments are not subject to appropriation, and there is no existing debt secured by these pledged revenues. The series 2021 obligations will fund a portion of the county's unfunded liabilities with respect to the Arizona Public Safety Personnel Retirement System (PSPRS) and the Correctional Officers Retirement Plan (CORP).

Credit overview

The 'AA+' rating reflects our view that coverage will remain very strong, consistent with the track record of good pledged revenue growth and very strong coverage. Moreover, the rating reflects the large and diverse economy, in addition to good incomes and an employment base made up of government, defense, tourism, higher education, and services.

Given the historical trend of the pledged revenues and the fact that the county relies on the pledged revenues as a substantial source of funding for general operations, we expect coverage on the lien to remain very strong and well above the 2.0x additional bonds test (ABT). Our outlook period is generally two years, but we continue to see some risks over the next six to 12 months because of the COVID-19 pandemic and U.S. recession. While we expect the outlook to remain stable, we will continue to monitor economic conditions, particularly uncertainty related to COVID-19 and budgetary pressures. For more information on our view of the U.S. economy, see the report "Staying Home For The Holidays," published Dec. 2, 2020, on RatingsDirect.

The priority-lien rating on the pledged revenue obligations is not currently constrained by our view of the obligor's creditworthiness (OC).

Key credit considerations include:

- A very strong local economic base with a local population of more than 1 million, along with good incomes within the broad and diverse Tucson metropolitan statistical area;
- Our view that nationwide sales taxes have historically demonstrated low volatility, in addition to our view of

moderate-to-weak volatility of the pledged revenues at the local level; and

- The county's very strong coverage, with pro forma 4.3x maximum annual debt service (MADS) coverage based on audited pledged revenues for fiscal 2020, and pro forma 4.4x MADS coverage based on projected pledged revenues for fiscal 2021.

Environmental, social, and governance (ESG) factors

We analyzed the county's ESG risks relative to its economy, financial measures, and debt profile. We believe that the county'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 county's social risk to be in line with our view of the sector standard. Finally, although the county has elevated exposure to wildfire risk and drought, we believe that these risks have been substantially mitigated by state building codes and the state's efforts to secure water rights from various sources to support its growing population.

Stable Outlook

Downside scenario

Should pledged revenues decline significantly in the near term, resulting in a deterioration in MADS coverage to levels we no longer consider very strong, or should the county's general creditworthiness decline, we could lower the rating.

Upside scenario

We could raise the rating if the county's general creditworthiness improved and we came to view the pledged revenues as no more volatile than nationwide sales taxes.

Credit Opinion

Economic fundamentals: Very strong

Pima County encompasses 9,184 square miles of southern Arizona, and approximately half its population resides in Tucson. Education and health care, defense, and government are the county's primary employment sectors. Raytheon Missile Systems is the leading employer (12,600 estimated employees), followed by The University of Arizona (12,500), Banner Healthcare-UMC (7,500), Davis-Monthan Air Force Base (7,200), and the county (6,900). Davis-Monthan Air Force Base supports a variety of missions; one of the largest plane groups at the base is the A-10. The Pentagon extended funding for the A-10, which had previously been at risk for near-term retirement, which has since been extended until 2022. Management previously reported that the F-35 is a probable replacement, and the base benefits from the competitive advantages provided by the airspace availability and weather. At this time, there are no consolidation concerns for the base. While we consider the regional economic base to be diverse, its reliance on the aerospace, defense, and government sectors contributed to a weaker recovery relative to those of areas that depend less on federal, state, and local government spending.

According to management, residential and commercial development continues to be strong, which we believe will lead to tax base growth and higher sales tax collections in the next several years. The county has experienced four consecutive years of valuation growth, and limited property assessed value (AV) grew 4.7% in fiscal 2021, reaching $9.1 billion. We consider the tax base to be very diverse based on the top 10 taxpayers for the county representing 7.5% of AV in fiscal 2021. The county's income indicators are good, in our view, with per capita effective buying income measuring 86% of the national level. The county's population grew at an average annual rate of 1.6% between 2000 and 2010, and has since slowed to an average rate of about 0.7% from 2010 to 2019.

Volatility: Moderate-low

We assess the volatility of revenue in order to determine the likelihood of the availability of revenue during different economic cycles. We have two levels of volatility assessment: macro and micro.

On a macro level, we consider sales and use tax revenue to have a low historical volatility assessment, based on total retail food and service sales data from the U.S. Census Bureau over the past two decades. 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. Nationwide retail and food service sales have historically fluctuated moderately throughout severe economic downturns and price fluctuations, as sales of nonessential goods are relatively cyclical. However, we expect overall collections will remain relatively stable nationwide, given the relative inelasticity of demand for certain taxable goods and services.

On a micro level, local sales taxes, representing 15% of pledged revenue, have grown by an average annual rate of 4.1% since 2011 following a 17.9% peak-to-trough decline during the Great Recession. In fiscal 2020 alone, local sales tax revenue increased by 19.5%. The county budgeted for a modest increase in local sales tax revenue of 0.7% in fiscal 2021, but current projections indicate that this revenue stream will underperform and experience a 0.3% increase. While we believe that there is some potential for deterioration in pledged revenue collections if there is a resurgence of the pandemic that drives business closures and constrains economic activity, we note that the county's trend has generally been positive historically. In total, pledged revenues increased by 3.4% in fiscal 2020 and are projected to further increase by 2.6% in fiscal 2021.

The inclusion of net state-shared revenue, which accounts for 56% of overall pledged revenue, provides revenue diversity, although we note that this stream has experienced some volatility historically. The state-shared revenue is collected by the state and distributed to counties and municipalities monthly based on a statutory formula. The allocation of revenue to each county is based first on its population relative to the aggregate population of all counties as shown by the latest census, then by the county's relative taxable property valuation and sales tax contribution. Vehicle license tax revenue received from the Arizona Department of Transportation for deposit into the county's general fund experienced an aggregate 14.7% decline between fiscal 2008 and 2011, but surpassed the pre-recession peak by 2017 and has grown steadily during the past seven audited fiscal years. Finally, PILT revenue received from the federal government for its national wildlife land (representing about 3% of the total pledged revenue) has fluctuated over the last decade, but has grown in four of the last five audited fiscal years.

Coverage and liquidity: Very strong

Based on audited collections for fiscal 2020, the county's pledged revenue of $124.5 million provides pro forma MADS coverage of 4.3x, which we consider very strong. While the county conservatively budgeted for a 21% decline in pledged revenue for fiscal 2021, current projections indicate 2.6% growth, which would increase MADS coverage to

4.4x if realized. Overall, we expect coverage to remain very strong throughout the near term.

Bond provisions include an ABT that requires pledged revenue for the preceding fiscal year to cover projected MADS by 2.0x. The county indicated that it does not have additional established debt plans at this time. While the county could leverage the pledged revenues in the future, we believe it unlikely that the county will issue additional debt to the fullest extent permitted under the ABT given the county's reliance on pledged revenues for operations.

There is no debt service reserve fund held for the pledged revenue obligations. With our expectations of at least very strong coverage and a moderate-low volatility assessment based primarily on our view of the dependability of sales and use taxes (the largest revenue stream), there is no downward adjustment to the very strong coverage score that would indicate potential liquidity pressures.

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 county, which then transfers to the trustee, we consider the flow of pledged revenue to be within the county's direct control. Under our criteria, this narrows the linkage between the priority-lien pledge and the OC, as we believe pledged revenue has some degree of exposure to operating risk. We assess the county'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.

Rating linkage to Pima County

In our view, the county's creditworthiness is enhanced by its strong underlying economy and the maintenance of a strong financial position, supported by what we consider good financial management policies and practices. For more information on the county's creditworthiness, see our report published Nov. 6, 2020, on RatingsDirect.

The series 2021 bonds will refinance a majority of the county's pension liability into a fixed-debt obligation to recognize interest cost savings. The bonds are structured to provide near-term savings in fiscal years 2022 and 2023 while also shortening the amortization of this liability by two years to fiscal 2036 from fiscal 2038. However, if poor investment performance or other experience changes generate new liabilities that are greater than previously projected--particularly if it occurs earlier in the amortization period--then the county risks having to pay both the debt service costs on the bonds and higher-than-expected pension contributions, which would result in eliminating potential payment savings from the transaction. The county has generated projections based on rates of return ranging from 4.0% to 7.3%, and we understand that the transaction produces savings in all fiscal years with an assumed rate of return as low as 5.0%.

In fiscal 2020 (prior to the issuance of the series 2021 obligations), the county's combined required pension contributions totaled 6.4% of total governmental fund expenditures. After the issuance of the series 2021 obligations, we calculate that the required pension contribution cost will fall to a projected 4.1% in fiscal 2022, consisting of normal costs and remaining amortization payments for these plans and its other plans. Total governmental fund debt service would increase to 13.3% of total governmental fund expenditures from 10.7%, and net direct debt would rise to 81.9% of total governmental fund revenue from 50.8%. While the funding ratios for the PSPRS and CORP plans will increase to about 90% in fiscal 2022 after depositing the bond proceeds with the pension plans, the combined funded ratio for all plans would increase to 76% from 61%.

We also note that the county has structured the bonds' debt service payments to move from an escalating unfunded actuarially accrued liability (UAAL) payment schedule of $23.5 million (in fiscal 2022) to $37.7 million (in 2036), to a more level debt service payment schedule that averages $26.5 million beginning in fiscal 2024. Relative to the current UAAL schedule, this will result in lower payments throughout the life of the bonds, which is structured to fully amortize two years before the current UAAL schedule. While we generally believe the risk of transactions that seek to refund pension liability for present value savings will often not result in savings due to likelihood that poor investment returns generate a new unfunded accrued liability, we believe the shorter amortization schedule modestly improves the probability that savings are realized.

The bonds lead to an expected budgetary savings of $18 million and $21 million for fiscal years 2022 and 2023, respectively, with savings also realized in the shortening of the amortization schedule by two fiscal years. We understand that the county will be establishing a pension fund reserve in fiscal 2022 pursuant to its adopted pension funding policy and intends to use $25 million of the near-term budgetary savings generated by this financing to fund this reserve. The pension fund reserve will be held as committed fund balance within the county's general fund. For additional information on our view of the added volatility risks, see our article "Pension Obligation Bonds' Credit Impact On U.S. State And Local Government Issuers," published Dec. 6, 2017.

Related Research

Through The ESG Lens 2.0: A Deeper Dive Into U.S. Public Finance Credit Factors, April 28, 2020