

RatingsDirect®

Summary:

Azusa, California; General Obligation

Primary Credit Analyst:

Andrew Bredeson, Centennial + 1 (303) 721 4825; andrew.bredeson@spglobal.com

Secondary Contact:

Michael Parker, Centennial + 1 (303) 721 4701; michael.parker@spglobal.com

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Credit Profile

US\$70.165 mil taxable pension oblig bnds ser 2020 due 08/01/2040

Long Term Rating

AA-/Stable

New

Rating Action

S&P Global Ratings assigned its 'AA-' long-term rating to Azusa, Calif.'s anticipated \$70.2 million series 2020 taxable pension obligation bonds (POBs). The outlook is stable.

The POBs are obligations of the city and are payable from any source of legally available funds of the city. We rate the city's POBs on par with its general creditworthiness due to our view that the city's ability to pay the obligation is closely tied to its operations, and the revenue used to secure its POBs is not limited in scope and not distinct and separate from its general fund. The city will use the bond proceeds, along with \$10.7 million in available cash, to prepay all of its currently existing net pension liability for the miscellaneous and safety defined benefit plans administered by CalPERS. The city is issuing the POBs to provide anticipated budgetary relief through interest cost savings over the life of the unfunded pension liability.

Credit overview

In recent years, the city's credit profile has reflected its steadily growing local economy and improved management practices and policies. Management has been engaged in identifying and implementing measures to address an emerging budget gap related to recent increases in public safety and employee benefit expenditures. We view positively the city's recent actions to increase required reserve levels, the city's very strong fund balance position, and ongoing pre-pandemic economic growth. In addition, we note the city's 2020 passage of Measure Z, a 0.75% increase to the city's sales tax levy as a credit positive, particularly as we believe management's efforts to realize a sustainable structural budget balance will be complicated by the COVID-19 pandemic and related economic recession.

The stable outlook reflects our view that the city's very strong reserves and management's focus on working toward sustainable budgetary balance will enable the city to maintain the current rating, even as it faces near-term challenges related to public safety expenditure increases and the ongoing pandemic and recession. It further reflects our view of the city's fixed obligations, as although the city is fully funding its defined benefit pension obligations with the series 2020 POBs and use of cash, we consider the credit benefits offset by a corresponding increase in debt and the possibility that pension funding requirements may increase in the future. Though our outlook is generally for up to two years, we see the potential for downside risk to emerge within the next six to 12 months.

For more information on the coronavirus' effect on U.S. public finance, see our reports "The U.S. Faces A Longer And Slower Climb From The Bottom," published June 25, 2020, and "Economic Research: U.S. Real-Time Economic Data Continues To Paint A Mixed Picture," published Aug. 14, 2020.

The rating reflects our view of the city's:

- Adequate economy, with market value per capita of \$96,916 and projected per capita effective buying income at 69.5%, but that is benefitting from access to a broad and diverse metropolitan statistical area (MSA);
- Strong management, with "good" financial policies and practices under our Financial Management Assessment methodology;
- Adequate budgetary performance, with operating results that we expect could deteriorate in the near term relative to fiscal 2019, which closed with operating surpluses in the general fund and at the total governmental fund level;
- Very strong budgetary flexibility, with an available fund balance in fiscal 2019 of 43% of operating expenditures;
- Very strong liquidity, with total government available cash at 1.9x total governmental fund expenditures and 19.5x governmental debt service, and access to external liquidity we consider strong;
- Very weak debt and contingent liability position, with pro forma debt service carrying charges at 9.9% of expenditures and pro forma net direct debt that is 205.2% of total governmental fund revenue, inclusive of the series 2020 POBs; and
- Strong institutional framework score.

Environmental, social, and governance (ESG) factors

We analyzed the city's ESG risks relative to its economy, management, financial measures, and debt and liability profile. Our rating incorporates our view of the health and safety social risks related to COVID-19, which we expect may pose downside pressure on the city's economic and budgetary performance in the near- to medium-term. We consider the city exposed to heightened environmental risks, such as wildfires and earthquakes, though the city has taken action to manage these risks such as through adoption of its wildfire mitigation plan, and by completing a project to bury electric utility lines. We consider the city's governance risks in line with the sector standard.

Stable Outlook

Downside scenario

If the city's operating results fall materially short of those indicated by its five-year financial forecast, and if the city is unable to achieve and maintain structural budgetary balance, whether due to expenditure increases or tax revenue declines driven by the recession, we could lower the rating.

Upside scenario

Although unexpected due to the ongoing pandemic and recession, we could raise the rating if the city's economic metrics materially improve while the city demonstrates sustained structural budgetary balance.

Credit Opinion

Adequate economy

Azusa, with an estimated population of 53,510, is located 24 miles northeast of downtown Los Angeles. The city's economy benefits from its location within the broad and diverse Los Angeles-Long Beach-Anaheim, Calif. MSA. The

city has a projected per capita effective buying income of 69.5% of the national level and per capita market value of \$96,916. Overall, the city's market value grew by 7.8% over the past year to \$5.2 billion in 2020. The county's unemployment rate was 4.4% in 2019.

The city's tax base is diverse, with the top 10 property taxpayers accounting for just 7.5% of total assessed value (AV). The city's top employer is Azusa Pacific University (9.2% of total employment), with the local school district and city joining aerospace and defense company Northrop Grumman and a Costco store in rounding out the top five employers.

County-level unemployment rose substantially to 20.4% in April 2020, due to the onset of the COVID-19 pandemic and related economic recession. City-level unemployment has continued to trend marginally better than the county rate, consistent with pre-pandemic local unemployment rate. According to the Bureau of Labor Statistics, the city's unemployment rate was 16.0% for June 2020, compared to 18.2% for Los Angeles County, and 11.2% for the nation.

Property values have grown at a strong rate in recent years, rising 7.8% for 2020 after increasing 6.6% for 2019. However, we believe the rate of growth will likely slow due to the recession, with tempered AV growth, or possibly a decline, for fiscal 2022, depending on the extent to which the current recession flows through to local property values.

Strong management

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

- Line-item budgeting that incorporates several years of historic trend analysis as well as property and sales tax revenue projections from an external consultant;
- Quarterly budget-to-actual financial reporting to city council, with budget revisions typically adopted mid-year;
- An annually updated five-year financial forecast that incorporates basic revenue and expenditure growth assumptions, and is used by management in accordance with the city's financial sustainability policy as a tool to identify potential budgetary challenges beyond the next budgeted fiscal year;
- An annually updated five-year capital improvement plan that identifies planned projects and funding sources;
- An investment policy that aligns with state statute and guidelines, and monthly reporting on investments to city council;
- The city has a formal debt management policy, which provides guidelines surrounding debt issuance purpose, types of debt, debt limits, and minimum savings for refunding; and
- A formal policy requiring maintenance of reserves of at least 20% of budgeted expenditures for the general fund (increased from 15% for fiscal 2021 budget year), with other required amounts for certain other funds.

Adequate budgetary performance

Azusa's budgetary performance is adequate in our opinion. The city had operating surpluses of 11.8% of expenditures in the general fund and of 13.4% across all governmental funds in fiscal 2019. Our assessment accounts for the fact that we expect budgetary results could deteriorate somewhat from 2019 results in the near term. In addition, we

believe the city will likely face budgetary challenges related to the pandemic and current recession of the pandemic and economic challenges stemming from the current recession.

By our calculations, after adjusting for recurring transfers and removing the revenue associated with a one-time asset sale in fiscal 2018, we calculate general fund operating results ranging from a very strong 11.8% surplus in fiscal 2019, to a 10.9% deficit for fiscal 2018, and a 4.6% surplus for fiscal 2017. Management's estimates for fiscal 2020 indicated a \$1.7 million operating deficit (-4.4%). Management's fiscal 2021 budget indicates a \$2.1 million (-5.0%) operating deficit, with the final CalPERS pension payment before the POB issuance and the final year of its series 2003 certificates of participation more than outweighing the revenue benefit of the new Measure Z sales tax.

While general property and sales tax revenue growth supported the surplus results posted for fiscal years 2017 and 2019, the fiscal 2018 deficit was primarily driven by a large (17.2%) increase in public safety expenditures, which constitute the city's largest operating expenditure category by more than double the second-largest category each year. Management indicates that several public safety personnel retirements in fiscal 2018 led to a spike in employee benefit payments, such as those related to payouts of accumulated compensated absences. In addition, higher overtime expenditures for the remaining public safety staff, and management's actions to limit future spikes in public safety benefit expenditures contributed to the increase. Public safety expenditures fell 5.0% in fiscal 2019, but remained significantly higher than prior years.

Longer term, the city's current five-year forecast projects operating surpluses in each of fiscal years 2022 through 2025. The projected improvement in operating results is driven by a combination of assumed property and sales tax revenue growth, based on consultant HdL's forecasts, an increase in the city's hazardous waste tax that took effect July 1, 2020, which is projected to more than outweigh higher labor costs related to new contracts with the city's various bargaining groups. In an effort to forecast conservatively, management has not included the projected savings resulting from the POB issuance and retirement of the city's share of the CalPERS unfunded liability in its current forecast, nor has it included tax revenue growth associated with anticipated economic development projects the city expect to be complete within the next few years.

Very strong budgetary flexibility

Azusa's budgetary flexibility is very strong, in our view, with an available fund balance in fiscal 2019 of 43% of operating expenditures, or \$18.0 million. The general fund deficit in fiscal 2018 contributed to a 22% decline in available fund balances, though they remained very strong at 18.2% of operating expenditures.

The city revised its fund balance policy in 2020, increasing the required amount of available general fund balance to 20% from 15% of expenditures. Despite the deficits estimated for fiscal 2020 and budgeted for fiscal 2021, we anticipate the city's available reserves will remain very strong and not less than the 20% required by the revised policy. Supporting the city's ability to maintain very strong reserves in recent years has been management's ability to limit capital expenditures to other governmental funds, with marginal capital outlays funded through the general fund.

Very strong liquidity

We consider Azusa's liquidity is very strong, with \$96.6 million in total government available cash equal to 1.9x total governmental fund expenditures and 19.5x governmental debt service in 2019. In our view, the city has strong access to external liquidity, if necessary.

The city primarily invests its cash in the state's Local Agency Investment Fund and federal government securities.

Very weak debt and contingent liability profile

In our view, Azusa's debt and contingent liability profile is very weak. Inclusive of the planned series 2020 POB issuance and refinancing of the city's unfunded CalPERS pension liabilities, total governmental fund debt service is 9.9% of total governmental fund expenditures, and net direct debt is 205.2% of total governmental fund revenue. POB debt service begins in fiscal 2022, with level debt service requirements of about \$4.98 million per year through fiscal 2041.

The POBs will constitute the city's only governmental funds debt outstanding after its one outstanding capital lease matures in fiscal 2021. Our debt calculations include the redevelopment agency's tax increment debt. Management indicates the city has no current plans to issue additional debt.

Pension and OPEB highlights:

- We do not view pension and OPEB liabilities as an immediate source of credit pressure for the city, given that the POB will refinance nearly all the city's pension liabilities into a fixed-debt obligation to recognize interest cost savings. Furthermore, the city's POBs are anticipated to shorten the term of its current pension liabilities by about four years. However, if poor investment performance or other changes generate new liabilities that are greater than previously projected--particularly if this occurs earlier in the amortization period--the city risks having to pay both the debt service costs on the bonds and higher-than-expected pension contributions, which would reduce potential payment savings from the transaction.
- The issuance of the POBs is expected to reduce the city's annual pension costs for the CalPERS plans it participates in, and the city expects to recognize savings of an average \$1.1 million annually over the 25-year POB amortization period. Including the city's planned use of \$10.7 million in cash from the utility enterprises to pay down a portion of its utilities' unfunded pension liability, total estimated savings of \$54.1 million equate to about \$2.2 million on average through fiscal 2046.
- The city funds OPEBs on a pay-go basis and posted a \$48.5 million OPEB liability at fiscal year-end 2019. To manage OPEB costs and limit future liability growth, the city plans to establish an OPEB trust account and replaced the lifetime medical benefit previously offered with a health reimbursement agreement.

Azusa participates in the CalPERS miscellaneous and safety pension plans. As of a June 30, 2019 measurement date, the miscellaneous plan is 73.4% funded with a city net liability of \$42.9 million, and the safety plan is 70.2% funded with a city net liability of \$40.7 million.

The city made its full annual required pension contribution in 2019. The pension contributions and funded ratios used in our analysis reflect pro forma figures following the issuance of the POBs. We have adjusted pension contributions downward to reflect elimination of the required payment toward unfunded liability, resulting in the pro forma pension carrying charge of 2.2% of total governmental fund expenditures; on this same basis, Azusa's combined required pension and actual OPEB contributions would be 3.5% of total governmental fund expenditures. In addition, on a pro forma basis, the pension funded ratios reflecting the city's share of both plans' liabilities would be 100%. For more on our view of POBs, please see our report "Pension Obligation Bonds' Credit Impact On U.S. State And Local

Government Issuers," published Dec. 6, 2017.

In our view, a discount rate of 7.15% (on a GASB basis) for the miscellaneous plan could lead to contribution volatility. While CalPERS' recent adoption of a 20-year, level dollar amortization approach for new gains and losses will lead to more rapid contribution increases and increased payment volatility, a shorter amortization period will provide a faster recovery to plan funding following years of poor investment performance or upward revisions to the pension liability, which we view favorably from a credit perspective.

The city's 2018 actuarially determined contributions for both CalPERS plans fell short of both static funding and minimum funding progress, indicating no funding progress was made and liabilities increased. While CalPERS' recent adoption of a 20-year, level-dollar amortization approach for new gains and losses will lead to more rapid contribution increases, a shorter amortization period will provide a faster recovery to plan funding, following years of poor investment performance, or upward revisions to the pension liability, which we view favorably. Although we believe costs will increase for the next several years to retire existing unfunded liability, much of these are amortized over 30-year periods using a level percent of payroll approach. In our view, the discount rate of 7.15% contributes to contribution volatility.

Related Research

- S&P Public Finance Local GO Criteria: How We Adjust Data For Analytic Consistency, Sept. 12, 2013
- Criteria Guidance: Assessing U.S. Public Finance Pension And Other Postemployment Obligations For GO Debt, Local Government GO Ratings, And State Ratings, Oct. 7, 2019
- Through The ESG Lens 2.0: A Deeper Dive Into U.S. Public Finance Credit Factors, April 28, 2020

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