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Ratings

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Summary:

Sales Tax Securitization Corporation of Chicago; Sales Tax

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US$550.85 mil sales tax securitization bnds (Taxable) ser 2019A due 01/01/2048		
Long Term Rating	AA-/Stable	New

Rationale

S&P Global Ratings has assigned its 'AA-' long-term rating to the Sales Tax Securitization Corporation (the corporation), Ill.'s taxable series 2019A sales tax securitization bonds issued for the city of Chicago. The outlook is stable.

The series 2019A bonds will refinance certain city of Chicago general obligation (GO) bonds. The GO bonds had a final maturity date in 2042, and the refunding bonds extend the final maturity six years to 2048.

We also discontinued our rating on the taxable series 2018D sales tax securitization bonds because the bonds did not sell.

The rating reflects our application of our "Priority Lien" criteria (published Oct. 22, 2018, on RatingsDirect), which factors in both the strength and stability of the pledged revenues, as well as the general credit quality of the municipality where taxes are distributed and/or collected (the obligor's creditworthiness [OC]). The priority-lien rating on these bonds is limited by our view of Chicago's creditworthiness (BBB+/Stable) and is constrained from going higher unless there is an improvement in the OC. We believe risk of non-payment is more tied to the city's fiscal condition than the state's.

In our view, the intended true sale provides a degree of separation between the city and the pledged revenues wherein they are neither legally nor practically available for operations. Prior to the payment of debt service, the sales tax revenues are separated from the city's cash flow and operations, which, in our view, significantly lessens the risk that the revenues could be diverted to address the city's ongoing budgetary challenges. However, we believe that dependence and linkage cannot be entirely overcome through the overlay of a legal structure supporting the bonds. Despite strong coverage and legal provisions, we expect that Chicago's high fixed costs tied to its liabilities and its need to identify how it will fund looming pension contribution increases beyond 2020 will continue to weigh down the rating.

Other key credit considerations include:

- The city and the state's broad and diverse tax bases, which we anticipate will continue to support strong debt service coverage (DSC);
- Strong coverage of maximum annual debt service (MADS) of 4x, and our anticipation that the corporation will bond

down to its additional bonds test (ABT) of 4x;

- Our view that nationwide, Illinois and Chicago's sales taxes have historically demonstrated low volatility,
- The special-purpose entity nature of the corporation; and
- An intended true sale of the pledged revenues which renders them unavailable to fund operations, as well as other securitization features that segregate tax collections pledged from the city's other revenue and cash balances prior to the payment of debt service, so we view the pledged revenues as less likely to be affected by any city budgetary pressures.

Offsetting factors include:

- Below-average economic growth projected for the city of Chicago and surrounding metropolitan statistical area (MSA), coupled with weaker trends in the U.S. retail sector;
- The potential for late or reduced payments from the state of Illinois (BBB-/Stable) related to appropriation risk (12.8% of the sales tax revenue) or its liquidity pressures, which could reduce DSC, although we note that home rule sales taxes alone provide strong coverage, and there is also statutory state non-impairment language; and
- The unique municipal context in which the corporation was formed and will operate, which, in our view, necessitates linkage to the city's general creditworthiness.

Public Act 100-0023 authorizes home rule municipalities to sell their interest in revenues or taxes received from the state of Illinois to special-purpose entities. The statute authorizing the structure separates the pledged revenues from other municipality revenues by making the sale absolute once done, and ensuring that revenues from the home rule and local share sales and use taxes, which are collected by the Illinois Department of Revenue are then passed directly to the corporation or its bond trustee. The statute further grants a statutory lien on all corporation revenues.

The corporation is pledging the expected flow of state-collected sales tax revenues as source of repayment on the outstanding sales tax securitization bonds. Chicago and the corporation irrevocably directed the state to pay all sales tax revenues directly to the trustee on closing of the series 2017 bonds.

Pledged revenues consist of sales taxes collected by the state that are owed to the city of Chicago. The seller collects all taxes at the time of sale and must file and remit payments to the Illinois Department of Revenue. Sales and use tax revenues are remitted monthly to Illinois municipalities. On the 25th day of each month, the Department of Revenue prepares and certifies to the state comptroller the disbursement of amounts due to each municipality. Within ten days after the comptroller receives the disbursement certification, the state comptroller causes orders to be drawn to disburse the funds. The pledged revenues broadly consist of two categories: home rule sales taxes and local-share sales taxes. The city is not pledging its other home rule sales taxes it collects, which include the use tax on nontitled personal property and the municipal use tax on titled personal property that amount to about $50 million per year.

Economic fundamentals: Very strong

Because 56% of pledged revenues are derived from a statewide base, we have assessed the economic fundamentals primarily of Illinois; however, our view of the credit's underlying economic fundamentals also reflects the city of Chicago (44% of pledged revenues) and its greater metropolitan area. Illinois has a population of 12.8 million, and its effective buying income is 103% of the national level.

As with the U.S. more broadly, Illinois' economy continues to expand. Although growth in Illinois has lagged that of the nation--which itself has been sluggish throughout much of the nine-plus years of expansion--recent data point to an acceleration. For 2018, we forecast that the U.S. economic output will expand by 3.0%. While Illinois' GDP growth will lag this, at 2.5%, even that marks a notable improvement from 2017, when the state's economy expanded by just 1.2%. We anticipate that after 2018, the Illinois economy will continue to expand, albeit at slower rates as the state deals with macroeconomic conditions that affect its manufacturing sector, namely low commodity prices, a strong dollar, and challenging demographic trends.

Statewide employment growth has been a muted 1.07% year over year through July. From 2014 through 2017, the compound average growth of the state's nonfarm payroll jobs was a lackluster 1.03%, ranking it 35th in the nation during that period. The service sector accounts for a majority of employment, anchored by education and health services (15.4%), professional and business services (16.0%), and leisure and hospitality (9.9%). The other significant anchor to the economy is trade and transportation (19.7%), reflecting Chicago's role as a transportation hub for the region. The NAFTA countries--Canada and Mexico--are the state's largest international trading partners and accounted for a combined 42.3% of the state's exports in 2017, according to Census Bureau data. The recent breakthrough in negotiations to update NAFTA (or USMCA) is favorable, as it should avoid a trade war-induced contraction in exports. Unemployment in Illinois declined to 5.0% in 2017 from 5.8% in 2016. The state's jobless rate has continued to fall and as of September 2018 stood at 4.1% (preliminary).

Chicago's growth trends have been in line with Illinois, reflecting that the Chicago MSA's real gross product accounts for more than 82% of Illinois' gross state product (GSP). We anticipate that the city will continue to experience positive economic growth over the medium term, albeit slower compared with the nation. The Chicago-Naperville-Elgin MSA real gross metro product grew 1.5% compared with U.S. GDP growth of 2.1% in 2017, and IHS Markit projects that over 2018-2021, its real gross metro product is expected to grow at an average annual rate of 1.7% compared with the U.S. at 2.4%. Its lagging growth rate is largely attributable to weaker demographics, particularly slow population growth. Total employment growth has also been slower, increasing 0.9% compared with the U.S. at 1.7% in 2017. IHS attributes much of the MSA's slow growth to a contraction in retail employment—tied both to an increase in online competition and its declining population. The construction sector has contributed to faster growth in 2018, particularly residential construction geared toward highly paid professionals wishing to live in the city itself. However, much of Chicago's stronger growth prospects stem from a stronger national forecast. Weaker demographic trends explain, in part, Chicago's slower growth prospects. For the fourth consecutive year, its population declined in 2017 by 13,426 residents, or 0.5%.While better employment opportunities or lower cost of living account for some of the population trend, it is also partly due to lower international in-migration, which had helped to offset population losses in past years. Although weaker population trends will likely hamper economic growth, we still anticipate tax base growth, albeit slow. We do not anticipate significant flight in the future given the strengths of the overall Chicago economy.

Chicago, with a population of 2.7 million, is the nation's third-largest city, has a very diverse economy, and is a global business center and transport hub. Its per capita effective buying income is 97% of the national level. The city and its surrounding MSA has a more educated population than the nation (45.3% with some higher education compared with 39.6% for the U.S.) and also it is home to a larger-than-average population aged 25-34 (15.1% compared with 13.8% for the U.S.). It is repeatedly named a top MSA for corporate relocation, and boasts significant cultural attractions, with

54 million visitors in 2016. However, the Chicago MSA's economic growth has been tepid relative to the U.S. and comparable metropolitan areas, and although it remains an economic powerhouse, it is not without challenges.

Coverage and liquidity: Very strong

Current and projected strong coverage levels mitigate slower economic growth trends for Chicago and softening in the U.S. retail industry. Using fiscal 2017 revenues, and provided projected MADS of $166.5 million, coverage of all parity bonds is 3.97x. After the issuance of these bonds, the corporation will have exhausted its $3 billion bond authorization. The indenture allows for additional bonds provided that pledged sales tax revenues for the most recently completed fiscal year provide at least 4x MADS coverage. We understand that final debt service will be sized to comply with the ABT using 2018 revenues.

Chicago and the corporation irrevocably directed the state to pay all sales tax revenues directly to the trustee. After corporation operating expenses are met, 100% of annual principal and interest requirements are on deposit with the trustee and any reserve, and subordinated indebtedness, Chicago will receive residual revenues, which are not pledged to the bonds. There is no debt service reserve fund requirement for the outstanding bonds.

Volatility: Low

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. Based on the variance of national economic activity that we believe most closely represents the taxing base over multiple economic cycles, it is used to inform our opinion on expectations of future volatility. 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 1993-2014.

On a macro level, we consider sales tax revenues to have a low historical volatility assessment. Looking specifically at the pledged revenue history, overall they have stayed in line with national economic cycles. During the Great Recession, pledged revenues decreased 4% in 2008 and 10.1% in 2009. They have increased consistently since 2010, but recent numbers indicate softer trends. Over the past five years, average annual growth has been 3.9%, although in 2017, the most recent full year of collection data, pledged revenues grew 0.4%. Through Nov. 30, 2018, total pledged revenue collections were $627.5 million, compared with total collections of $661.6 million in 2017.

Growth trends of the state levied sales tax revenue remain positive but subdued. Statewide, fiscal 2018 (June 30) sales tax collections were approximately $8.74 billion, up 2.6% from the prior year. Chicago's local share of state revenues increased 1.4% in fiscal 2017 (Dec. 31). The local share of revenues have demonstrated more stability than the home rule share, decreasing only once (8.9% in 2009) out of the past 10 years.

Recently, growth in home rule taxes has been slower than the local share, decreasing 0.8% compared with an increase of 1.4% in 2017. Softer home rule collection growth partly reflects trends in online sales. The state collects sales taxes attributed to online retailers, but the home rule tax does not apply to online sales. The combined sales tax rate for Chicago is 10.25%, among the highest in the U.S., which, in our view, could provide a challenge to potential future rate increases.

Softer performance in U.S. retail sales in 2017 may signal slower growth in overall sales tax revenues. Not all stress

reflects e-commerce. For many U.S. consumers, discretionary income has not been growing due to stagnant wages and higher costs of living. As a result, consumers are shifting their habits, seeking value and convenience, and are allotting more of their discretionary spending to autos (even as auto sales slow from record levels), technology, experiences such as travel and dining, and insurance and health care. The growing use of e-commerce and recent store closures reflect the effects of these underlying causes. Chicago's large, diverse tax base and strong DSC support our view that the credit quality of these bonds will remain relatively stable. However, it's possible that diminished collections could weaken sales tax revenues.

Revenue-sharing entity risk: State of Illinois

While the sale of the pledged revenues from the city to the corporation pursuant to the sale agreement significantly affects our view of the separateness of the flow and ownership of pledged revenues from the city, it does not eliminate the role of the state as collection and disbursement agent of the revenues. Regarding the city's home rule sales taxes, the role of the state is to simply collect and distribute the revenues, and the state has no interest in the sales taxes. However, we note that the state assesses a 2% service fee for the collection and remittance of home rule municipal use sales tax revenue owed to local governments. Effective June 2018, the state also assesses a 0.5% fee on collections of the home rule municipal retailers' occupation tax and the home rule service occupation tax. Assuming bonding down to the 4x ABT, home rule sales taxes alone would cover MADS by 1.76x. However, approximately 56% of pledged sales tax revenues are Chicago's statutory local share of state sales taxes, of which the rate and proportion are determined by the state. Additionally 12.8% of pledged revenues are subject to state annual appropriation, and these taxes were delayed for three months during the state's fiscal 2016 budget impasse. While unlikely, in our view, it is possible that that the state's weak financial position could lead to impairment of the local share taxes. In our view, the coverage by home rule sales taxes largely mitigates the state risk.

The state non-impairment language in the legislation decreases the likelihood that the state would disrupt the pledged revenue stream; this is a reason why we consider the city of Chicago as the OC for the priority-lien rating, although the pledged revenues do flow through the state of Illinois. Public Act 100-0023 provides state non-impairment language intended to mitigate the potential of state action that could be adverse to bondholders. In the act, the state pledges and agrees that it will not impair the terms of any contract, including any assignment agreement, made by the transferring entity with the issuing entity with the respect to the issuance of bonds until all debt service is repaid. The state also pledges to and agrees with each transferring unit and each issuing entity that it will not limit or alter the basis on which the transferring unit's share or percentage of transferred receipts is derived, or the use of such funds, to impair the terms of any such contract.

Currently, we do not anticipate that the state would revise or change Public Act 100-0023 or otherwise attempt to interfere with the assignment agreement or any contract executed by the issuing entity, such as the trust indenture, in connection with the series 2017 bonds or future parity debt. However, in our opinion, the legislation leaves open to interpretation what constitutes "impair" and that the state still could make some legislative changes to the sales tax revenues or base. We do not anticipate that the state would first look to local share sales tax revenue reductions or violations of state law in times of liquidity distress. However, we have seen the state violate the law in other instances, such as delaying payments to the pension system, which, in our opinion, supports the view that Illinois could possibly delay or reduce payments. Given the state's current credit rating of 'BBB-', we cannot rule out the possibility that it

might interfere with the pledged receipts.

Obligor linkage: Remote

Under our criteria, the legal structure distances the linkage between the priority-lien pledge and the OC, lessening the degree of exposure of the pledged revenue stream to operating risks of the OC. In our view, the true sale and statutory lien provisions provide a degree of separation between the city and the pledged revenues wherein they are neither legally nor practically available for operations. Prior to the payment of debt service, the sales tax revenues are separated from the city's cash flow and operations, which, in our view, significantly lessens the risk that the revenues could be diverted to address the city's ongoing budgetary challenges. We also note that the language provided in state statute reduces the likelihood that a bankruptcy court could rule that the pledged revenues are property of the city. The corporation also exists as a separate entity under state statutes, and, as a not-for-profit, it is unlikely, in our view, that it could be consolidated with the city. That said, we believe the structure securing the bonds cannot completely isolate bondholders from the city's financial and economic condition.

Chicago has created the corporation as a not-for-profit corporation for the limited purpose of issuing bonds for the benefit of the city. It is managed by a board of directors and must maintain a separate office, records, and financial statements from the city. The corporation board has the power to approve bond issuances provided that city council has adopted an ordinance approving the issuance. The corporation is governed by five voting directors, which include Chicago's CFO, budget director, comptroller, chair of the council committee on finance, and chair of the council committee on budget or their designees with mayoral approval. In the event of an action that would constitute a specified vote (meaning any vote to file for bankruptcy, launch a proceeding to liquidate, or cease operations), the mayor would appoint an independent director, with the approval of city council, as a sixth member. When considering a specified vote, the board will consider the interests of the creditors of the corporation. Board members are prohibited from having any conflicts of interest, with city employment not considered such a conflict (except for the case of the independent director).

While the corporation has similar features to special-purpose entities we see in structured finance transactions, we have also taken into consideration the governmental context in which this corporation exists. Municipalities, like the city in this case, have responsibilities that include providing essential services and protecting public safety and welfare. We believe these unique responsibilities introduce considerations around the bankruptcy remoteness of the special-purpose entities that they create. With respect to the corporation, we understand that any vote that would be adverse to bondholders would require an affirmative vote of all six board members, including the independent director. While, in our view, this provides a layer of protection regarding a potential bankruptcy filing or the institution of changes to provisions in the bylaws, we cannot rule out the possibility that the corporation would voluntarily file for bankruptcy relief or make revisions such that pledged revenues would flow to the city if the city were to experience significant financial distress. We view this risk as elevated by the fact that five members of the board have direct linkages to the city and that the independent director is appointed by the mayor and approved by council. In addition, we believe there is insufficient municipal bankruptcy case law to confirm the correctness of the analysis that a court would not order the substantive consolidation of the assets and liabilities of the corporation with those of the city. However, given the current financial position and trajectory of the city, we currently view this possibility as remote.

The legal structure creates significant separation between the city and pledged revenues. In our view, the Assignment,

Purchase and Sale Agreement, pursuant to which the city irrevocably conveys all right, title, and interest of the city of sales taxes collected by the state (including home rule and state sales taxes) to the corporation until the date on which there are no secured obligations outstanding, significantly reduces the likelihood that the city's financial operations could impair the flow of pledged revenues to the bonds.

According to the agreement, the conveyance is a "true sale." The city is thus divested of all rights to receive sales tax revenues, and it is the recipient only of any residual revenues. The city has also acknowledged in the agreement that the corporation assigned all sales tax revenues to the trustee for the benefit of bondholders.

Chicago has covenanted in the agreement that it will take no action that would in any way materially impair the corporation's right to receive the sales tax revenues or limit or alter the rights vested in the corporation to fulfill the terms of its agreements with the secured obligation holders or impair their rights and remedies. The city also has covenanted to pursue any action legally available to it such that sales tax revenues would cover no less than 100% of annual debt service requirements.

In addition to the agreement, the authorizing act provides that the assignment constitutes an absolute conveyance of all right, title, and interest in the revenues and that it would be valid, binding, and enforceable. The act states that the transferred sales taxes are property of the issuing entity to the extent necessary to pay the obligations issued by the issuing entity for the benefit of the transferring unit.

We have also received a legal opinion that once sales taxes are sold, they are no longer property of the city and would not be treated as such in a case under the bankruptcy code. It opines that in the event of a city bankruptcy, a plan of adjustment that contradicts this right and determination by the state would violate state law and thus should not be confirmable.

Rating linkage to Chicago

We assess Chicago'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. Recent examples of fiscal distress illustrate municipalities can and have taken actions that contravene provisions in bond documents and/or applicable law that are adverse to bondholders. While we view the risk of the city being in such a distressed situation as remote, the risk, in our view, cannot be disregarded.

Chicago has made significant progress toward stabilizing its financial position—whether through increasing pension contributions and statutory requirements to fund pensions on an actuarial basis, eliminating the practice of pushing out debt payments into the future through "scoop and toss," and reducing reliance on nonrecurring revenues with a commitment to eliminating the structural deficit by 2019. That said, its high fixed costs tied to its liabilities, significant public safety expenses, and distressed overlapping governments will likely continue to challenge its fiscal sustainability. The city's $10,092 per capita net pension liability and 26% overall weighted plan funded ratio will continue to place a weight on it for decades. Even as Chicago executes its pension plan, liabilities will continue to grow, as payments are not set to pay down any unfunded principal for many years–known as negative amortization. However, in our view, growth in funding forestalls plan insolvency and eliminates a contribution spike that would otherwise occur at the time of plan insolvency, as Chicago would be required to pay out benefits entirely from its budget, not from plan assets. The fiscal 2019 budget is largely a status-quo spending plan and furthers the city's efforts

toward structural balance. Outside of continued significant underfunding of pension actuarially determined contributions, the budget is largely structurally balanced. For further discussion of the city's fiscal 2019 budget, please refer to "Fiscal 2020 Pressures Cast A Shadow Over Chicago's Proposed 2019 Budget" (published Oct. 18, 2018, on RatingsDirect).

Our 'BBB+' GO rating and stable outlook on Chicago assume it will maintain its current course of emphasizing structural solutions to address budget gaps and growing liabilities. However, while prior decisions had set up fiscal 2019 to be an easier budget, the fiscal 2020 budget will be significantly more challenging. The city has yet to identify funding sources for a large increase in police and fire pension contributions in 2020, and we anticipate that new police and fire labor contracts will grow wage expenses beyond base-line assumptions presented in the city's annual financial analysis. We still view structural solutions to close the fiscal 2020 gap as feasible, but a change in political will (particularly uncertain in light of pending administration changes) and further increases to the budget gap, including escalation of pension costs, could change our view.

For further detail on our GO rating, please refer to our full analysis on Chicago, published Feb. 9, 2018.

Outlook

The stable outlook reflects the likelihood that coverage will remain very strong. The broad nature of the pledged receipts and the deep, diverse tax base will likely continue to support long-term revenue growth. The outlook also reflects our expectation that Chicago's budgetary pressures will not significantly worsen over the two-year outlook horizon given its recent measures to address its pension liabilities. It additionally reflects the state's near-term fiscal stability, which, in our view, strengthens the adequacy of its resources to reliably cover its priority obligations.

Downside scenario

Should the city's budgetary pressures worsen in such a way that we believe weakens its OC, we could lower the rating. In addition, a significant decline in sales tax revenues or weaker economic trends could lead us to lower the rating. We could also do so if the state's fiscal position weakens, giving us additional concern that Illinois may withhold sales tax distributions to local governments.

Upside scenario

Upward rating action would likely hinge on improvement in Chicago's OC, which currently limits the rating. It would also likely depend on no significant further deterioration of the state's liquidity position, which, in our view, would lessen the risk that the state could disrupt pledged revenues.

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.

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