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Sales Tax Securitization Corporation, Illinois; Sales Tax

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Sales Tax Securitization Corporation, Illinois; Sales Tax

Credit Profile		
US$664.875 mil sales tax securitization bnds ser 2018C due 01/01/2053		
Long Term Rating	AA/Stable	New
Sales Tax Securitization Corp sales tax		
Long Term Rating	AA/Stable	Affirmed

Rationale

S&P Global Ratings has assigned its 'AA' long-term rating to the Sales Tax Securitization Corporation, Ill.'s (the corporation) series 2018C sales tax securitization bonds issued for the city of Chicago. At the same time, we affirmed our 'AA' long-term rating on the corporation's outstanding sales tax securitization bonds. The outlook is stable.

STSC will convey the proceeds of the series 2018C bonds to the City of Chicago to refund certain outstanding general obligation (GO) bonds.

The 'AA' rating reflects our view of the following credit considerations:

- Strong coverage of maximum annual debt service (MADS) of 5.33x, and our anticipation that the corporation will bond down to its additional bonds test (ABT) of 4x;
- The city and the state's broad and diverse tax bases, which we anticipate will continue to support strong debt service coverage (DSC);
- 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 operating shortfalls or similar pressures;
- The special-purpose entity nature of the corporation; and
- Statutory language in the authorizing act that identifies the conveyance of the pledged revenues to the corporation as a true sale, grants a statutory lien on all corporation revenues, and includes state non-impairment provisions.

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 unique municipal context in which the corporation was formed and will operate, which, in our view, necessitates linkage to the city's general creditworthiness; and
- The potential for late or reduced payments from the state 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.

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 once the bonds are issued.

The corporation is pledging the expected flow of state-collected sales tax revenues as source of repayment on the series 2018C 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. 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 series 2018C bonds.

While the legal structure set up to isolate the sales tax revenues from the city has certain characteristics more commonly seen in structured finance transactions, given the municipal context, our rating primarily reflects the pledged underlying assets, the sales and use tax revenues, and our analysis under our special tax bonds criteria. That analysis is supplemented by the legal structure of the corporation. We also have taken into consideration the municipal context in which the corporation was formed and will operate, and the lack of municipal bankruptcy case law confirming the correctness of the analysis that the transferred revenues would not be considered property of the estate of the city.

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. The ability to levy and collect sales and use taxes depends directly on the underlying economic activity in Chicago and Illinois, which can be affected by the governments' financial conditions, and we believe that dependence and linkage cannot be entirely overcome through the overlay of a legal structure supporting the bonds.

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 $124.2 million, coverage of all parity bonds is 5.33x. Taking into account the corporation's authorization to issue $3 billion in bonds, of which after the close of the 2018C bonds, $911 million is remaining, we anticipate coverage will decline. 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. Assuming that the corporation was to bond down to its ABT, sales tax revenues could decline 75% and still provide 1x coverage.

The municipal context of the corporation and the lack of municipal case law addressing the true sale and statutory lien inform our opinion that despite the strengths of this securitization structure, we cannot rule out the possibility that the city or a bankruptcy court could interfere with payments to bondholders. However, Chicago cannot legally file for bankruptcy relief and we currently see the risk that the city would reach such a level of fiscal insolvency that it would consider such disruption as remote. In our view, recent steps to increase pension contributions, with the help of dedicated revenues, eliminated projected contribution spikes and alleviated near-term credit pressure. Chicago retains substantial liquidity, and its deep and diverse tax base continues to exhibit resilience, and its fiscal path forward will largely be determined by financial management decisions.

Outlook

The stable outlook reflects the likelihood that coverage will remain very strong, even including the likelihood of additional issuance of parity debt. While we have observed a structural shift in the U.S. retail sector which could weaken sales tax revenues, 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 budget enactment, which, in our view, strengthens the adequacy of its resources to reliably cover its priority obligations.

Downside scenario

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 impair sales tax distributions to local governments. In addition, should the city's budgetary pressures worsen in such a way that we believe there would be increased likelihood that the city would attempt to interfere with the pledged revenues, we could lower the rating.

Upside scenario

Upward rating action would likely hinge on improvement in the state's liquidity position, which, in our view, would lessen the risk that the state could disrupt pledged revenues. Further action to correct the city's structural imbalance could also have positive credit implications.

Pledged Revenues

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 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.

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 includes the use tax on nontitled personal property and the municipal use tax on titled personal property that amount to about $50 million per year. 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.

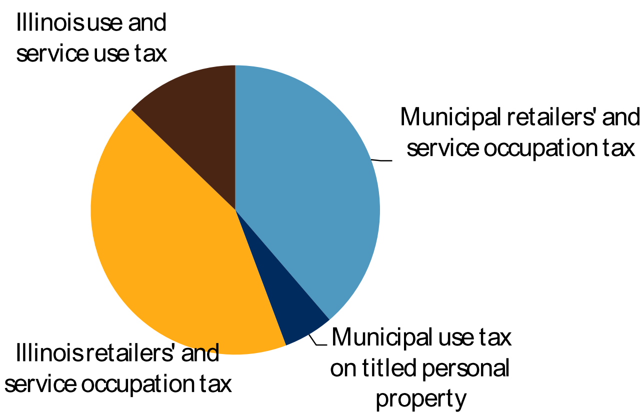
Corporation Sales Tax Rates And Distribution

Table 1

Items taxed	Tax rate	% of net tax collections payable to the corporation	Home rule	Local share	Subject to annual state appropriation
Tax on most tangible personal property items sold by retailers in the city	1.25%	100%	Yes		
Tax imposed on service providers when tangible personal property is transferred within the course of performing a service in the city	1.25%	100%	Yes		
Tax on the privilege of using within the city personal property purchased from a retailer and titled or registered at a location in the city #Collected on sales in Cook County and five adjoining counties	1.25%	100%	Yes		
Tax imposed by the state on most tangible personal property items sold by retailers in the state	6.25%	16%		Yes	
Tax on qualified food, drugs, and medical appliances	1%	100%		Yes	
Tax imposed by the state on service providers when tangible personal property is transferred within the course of performing a service	6.25%	16%		Yes	
Tax on qualified food, drugs, and medical appliances	1%	100%		Yes	
Tax imposed by the state on tangible personal property purchased from a retailer outside the state and titled or registered by a state agency	6.25%	16%		Yes	
Tax imposed by the state on nontitled tangible personal property purchased from a retailer outside the state	6.25%	4%		Yes	Yes
Tax on qualified food, drugs and medical appliances purchased outside of the state	1%	20%		Yes	Yes
Tax imposed by the state on the privilege of using most tangible personal property items acquired because of the purchase of a service from service providers who does not have a physical presence in the state	6.25%	4%		Yes	Yes
Tax on qualified food, drugs, and medical appliances purchased outside of the state	1%	20%		Yes	Yes

Chart 1

Sales Taxes Assigned To The Corporation



Based on 2017 sales tax revenues.

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Pledged Revenue Trends

Overall, pledged revenues have stayed in line with national economic cycles, and 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%. 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. Through Sept. 30, 2018, total pledged revenue collections were $508.4 million.

Chart 2

Total Pledged Revenue

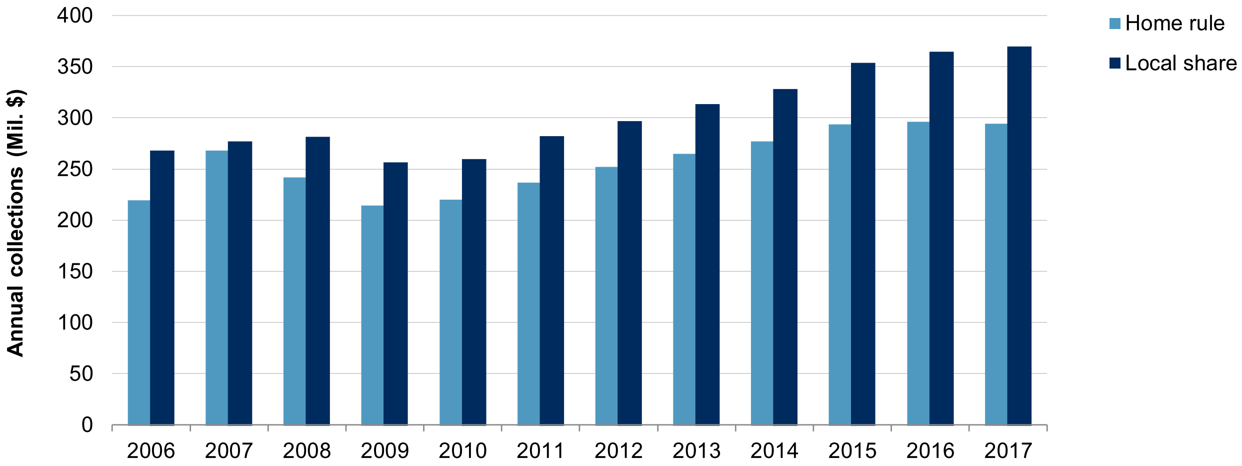

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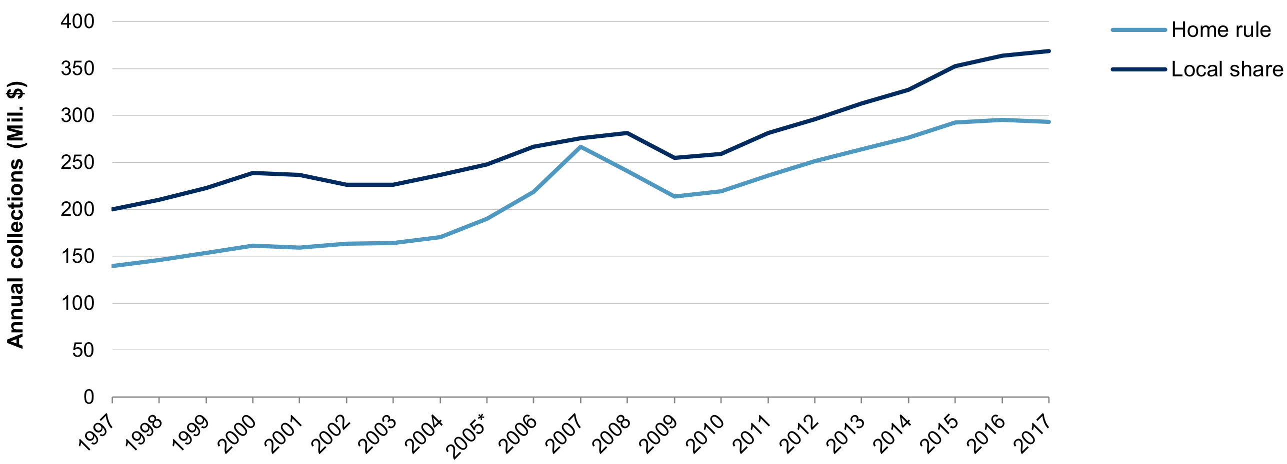
Chart 3

Home Rule Versus Local Share Pledged Revenues



*Chicago's home rule tax rate increased from 1% to 1.25% on July 1, 2005.

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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. For additional insight into our views on credit conditions for this sector, please refer to our commentary "Sea Change In The U.S. Retail Sector Could Shake Up The Long-Term Stability Of Sales Tax Revenue Bonds" (published on Aug. 7, 2017, on RatingsDirect).

Economy

Chicago, the nation's third-largest city, has a very diverse economy and is a global business center and transport hub. 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.

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.

Fiscal uncertainty could weigh on the city's future growth. While the state's near-term fiscal condition shows modest improvement, it still faces significant projected deficits and maintains large unfunded pension liabilities. Chicago Public Schools received financial relief with changes to the state funding formula, but it, too, still faces financial challenges. When assessing the financial needs of overlapping entities, combined with the city's own significant unfunded pension liabilities and high fixed costs, it is likely that that either these entities will need to raise taxes or cut services. However, taxes are just one factor many residents and businesses evaluate when choosing where to locate. For example, Chicago's costs of living and doing business remain lower than other comparable cities, and its diverse, highly educated workforce and transportation infrastructure remain attractive traits. Services and amenities, including quality of schools and public safety, are also considerations, and to the degree that financial challenges weigh on service levels, residents and businesses may consider locating elsewhere.

Table 2

2017 Economic Statistics		
	Chicago	**Illinois**
Population	2.7 million	12.8 million
Population (% change)	(0.5%)	(0.26%)
Per capital retail sales	72%	94
Per capita effective buying income as % of U.S.	97%	101
Unemployment rate	5.20%	5%
Total employment (% change)	0.86%*	0.71%
Real gross metro product/GSP (% change)	1.48%*	1.19%

*Chicago-Naperville-Elgin, IL Metropolitan Statistical Area. GSP--Gross state product.

Illinois' growth trends have been in line with Chicago, reflecting that the Chicago MSA's real gross product accounts for more than 82% of Illinois' gross state product (GSP). 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.

Legal Structure

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 will be a "true sale." The city is thus divested of all rights to receive sales tax revenues, and the city will be the recipient only of any residual revenues. The city has also acknowledged in the agreement that the corporation will assign 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 adversely 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 will be 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.

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.

The corporation as a special-purpose entity and its unique municipal context

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.

State linkages mitigated by home rule coverage

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. Assuming bonding down to the 4x ABT, home rule sales taxes alone would cover MADS by 1.79x. 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. 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 unity 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, support 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.

Ratings Detail (As Of October 15, 2018)		
Sales Tax Securitization Corp sales tax		
Long Term Rating	AA/Stable	Affirmed
Sales Tax Securitization Corp sales tax		
Long Term Rating	AA/Stable	Affirmed

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