FitchRatings

RATING ACTION COMMENTARY

Fitch Upgrades Chicago, IL's GO Bonds to 'BBB' and Rates $757MM GO Bonds 'BBB'; Outlook Positive

Fri 21 Oct, 2022 - 2:38 PM ET

Fitch Ratings - New York - 21 Oct 2022: Fitch Ratings has assigned a rating of 'BBB' to the following GO bonds to be issued by Chicago, IL:

--Approximately $638.2 million GO bonds, series 2022A (Chicago Works);

--Approximately $76.9 million GO bonds, series 2022B (Chicago Recovery Plan);

--Approximately $42.3 million GO bonds, series 2022C (Chicago Recovery Plan - Taxable).

Proceeds are expected to fund various capital improvement projects in the city and price via negotiation the week of Nov. 28.

Additionally, Fitch has upgraded the following Chicago ratings:

--Issuer Default Rating (IDR) to 'BBB' from 'BBB-';

--GO bonds to 'BBB' from 'BBB-';

--Sales Tax Securitization Corporation's (STSC) sales tax securitization bonds to 'AA' from 'AA-'.

The Rating Outlook for above ratings is Positive.

Fitch has also affirmed the 'AA-' rating on the STSC second lien sales tax securitization bonds with a Stable Outlook.

SECURITY

The GO bonds are payable from the city's full faith and credit and its ad valorem tax, without limitation as to rate or amount. The sales tax securitization bonds have a lien on the state-collected portion of the city's home rule sales and use taxes and the local share of the state-wide sales and use taxes; the second lien bonds are secured by a lien that is subject to and subordinate to the first priority lien securing the first lien bonds issued and to be issued by the corporation.

ANALYTICAL CONCLUSION

The upgrade to 'BBB' of the IDR and GO bonds rating reflects Chicago's improving pension funding practices, its commitment to maintaining a sound reserve position, and ability to institute structural budget measures that improve its capacity to respond to future cyclical challenges. The 'BBB' rating remains well below the sector median, incorporating several key risks including Chicago's constrained expenditure profile given the heavily unionized nature of its workforce and exceptionally high carrying costs for debt and pensions, a history of sizable budget gaps and dependence on one-time gap closing measures, and a revenue base highly sensitive to economic setbacks. Rating strengths center on the city's role as the economic hub for the Midwestern region of the U.S. and its broad revenue raising authority, which underpins a midrange level of inherent budget flexibility.

The Positive Outlook on the IDR and GO bonds signals the potential for additional positive rating action over a one- to two-year period conditioned on the city's ability to maintain its recent fiscal and budgetary progress against headwinds associated with expectations for slowed economic growth, inflation.

The upgrade and Positive Outlook on the STSC sales tax securitization bonds (senior lien) is based on the rating action taken on the city's IDR. The bankruptcy-remote, statutorily defined nature of the STSC and a bond structure involving a true sale of the pledged sales tax revenues lead Fitch to assign a bond rating at the maximum permitted by criteria of six notches above the city's IDR. The STSC ratings reflect the 'aa' growth prospects of the pledged revenue stream. The STSC revenue bonds' rating distinction reflects the resilience assessments of 'aaa' and 'aa' for the senior and second lien bonds, respectively.

Economic Resource Base

Chicago acts as the economic engine for the Midwestern region of the U.S. and offers abundant and diverse employment opportunities. The city also benefits from an extensive infrastructure network which supports expectations for long-term economic growth and resilience. The employment base is represented by all major sectors including trade, professional and business services and financial sectors, with no one sector dominating. Socioeconomic indicators are mixed as is typical for an urbanized area, with above-average per capita income and educational levels but also elevated individual poverty rates.

KEY RATING DRIVERS

Revenue Framework: 'aa'

Fitch expects continued solid revenue growth driven by the strength and resilience of the city's economy, excluding the effect of new or raised taxes and fees. The city's home rule status affords it access to a wide variety of revenue-raising options, many of which are legally unlimited.

Expenditure Framework: 'bb'

Carrying costs for debt service and retiree benefits equal a substantial portion of operating resources. Public safety, which is fairly inflexible as a practical matter, comprises a majority of general fund spending, further constraining expenditure flexibility. Pension costs are subject to volatility inherent in the performance of investment returns and other actuarial assumptions, likely necessitating ongoing revenue-raising measures and careful expenditure control.

Long-Term Liability Burden: 'bbb'

The long-term liability burden has moderated in recent years primarily due to growth in the city's economic resource base but will remain a credit challenge going forward as unfunded pension liabilities are expected to remain high notwithstanding funding at the full statutory level.

Operating Performance: 'a'

The city's ability to close recessionary revenue gaps is strong and is a function of its high revenue raising flexibility and long-term reserves that are available to offset the expected level of revenue volatility in a downturn. Sustained improvement in Chicago's budget management practices are likely to support gains in financial flexibility.

RATING SENSITIVITIES

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

--Ongoing commitment to structural budget solutions and pension funding at or above the statutory level, lower out-year gaps and maintenance of high reserves at or above current levels relative to spending;

--Long-term liabilities sustained below 40% of personal income;

--For the STSC senior lien bonds, positive rating action on the city's IDR; positive rating action on the subordinate lien bonds is not anticipated due to weaker leverage protections and resilience to sales tax declines.

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

--Material reliance on non-structural fiscal measures or aggressive budget assumptions;

--Failure to fund the full statutory pension contribution;

--Weakening of the city's reserve position and overall financial resilience;

--For the STSC bonds, negative rating action on the city's IDR and/or additional large declines in sales tax revenue.

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

Financial Resilience Remains Strong

Chicago concluded 2021 (Dec. 31 fiscal year-end) with a large general fund surplus of $313.8 million, which was equivalent to 6.3% of total operating expenditures and transfers out. Year-end results reflect the collection of $221.6 million in revenue above budget, expenditures $107.2 million less than budgeted amounts and $782.2 million of American Rescue Plan Act (ARPA) revenue replacement. The use of ARPA funds for revenue replacement positioned the city to redirect corporate fund resources for other uses, which allowed the city to cancel the previously planned scoop and toss restructuring to achieve $501 million in budget relief for 2021.Unrestricted general fund reserves registered $641.5 million or 12.9% of total spending. Fitch's view of the city's financial resilience also considers reserves from prior asset sales/leases totaling $685.3 million, resulting in a combined available fund balance of $1.33 billion or 26.6% of spending at 2021 YE.

Pensions Improved but Remain a Rating Constraint

Pension contributions will remain exceptionally high relative to governmental spending but yoy increases should prove more manageable going forward. The city increased its pension contributions from $848.5 million in 2016 to nearly $2.28 billion in 2022 as part of a five-year plan to reach the full statutorily-required pension contribution to the four single-employer pension funds covering municipal employees (MEABF), laborers (LABF), police (PABF) and firefighters (FABF). The depletion dates for the municipal plan was eliminated and the other three plans' depletion dates were extended to 2074 or later as a result of the pension contribution ramp-up.

The proposed 2023 budget includes $2.39 billion in pension contributions (excluding a planned $242 million advance or supplemental payment, see below for more information), representing an increase of $92.3 million over the 2022 budget. The city forecasts pension contribution rising less than $50 million per annum through 2027, if actuarial assumptions, including for investment performance are met.

The statutory pension contributions are based on an amount that targets a 90% funding ratio by 2058 for all plans rather than full prefunding which Fitch continues to view as an underfunding of pension contributions. The statutory funding amount combined with a 30-year open amortization are likely to produce little funding progress absent sustained supplemental contributions by the city or the plans' consistently exceeding their 6.75% to 7.25% investment return targets (which Fitch views as unlikely).

Improved Budgetary Outlook

As of the mayor's executive budget plan released earlier this month, the city is projecting a surplus totaling $134 million in 2022 with year-end revenue estimated at $5.0 billion or $84.5 million above budget largely driven by favorable transaction and personal property replacement tax trends. The city intends to allocate the surplus to address future years' budget gaps.

Overall, the mayor's proposed 2023 budget closely aligns one-time resources and spending. The proposed 2023 budget totals $5.4 billion, which is nearly $392 million above the August budget forecast due to $160 million in baseline revenue growth, $56 million in tax increment financing (TIF) surplus and a $40 million initial payment from the city's casino operator, among other factors. These additional resources position the city to close the $127.9 million budget forecast gap and fund the aforementioned supplemental pension payment. While not formally codified or funded, the city plans to budget additional pension advances each year to reduce the negative amortization associated with open amortization schedules and curb growth in the net pension liability (NPL).

The proposed 2023 budget appropriates $152.4 million in ARPA revenue replacement funds (down from $385 million in 2022) in addition to $222.1 million in prior years' surplus/reserves (up from $51.4 million in 2022). Remaining ARPA funds are earmarked to fund $567 million of the $1.2 billion Chicago Recovery Plan (supplementing approximately $660 million in GO bond proceeds).

The city forecasts modestly declining general fund revenue through 2025 incorporating expectations for slowed economic growth, inflationary headwinds and the exhaustion of remaining stimulus funds. Budget gaps, assuming no tax increases and contractually-based wage and benefit increases, are estimated at $474 million in 2024 and $554 million in 2025, without consideration of any potential revenue improvement versus the August budget forecast.

Chicago plans to address the forecasted budget deficits with various plausible gap-closing measures, including the continuation of COLA-based property tax levy increases, additional TIF surpluses and savings from operational efficiencies and bond refinancing. The city reports $1.2 billion in structural budget solutions from 2020-2022, including several revenue enhancements that highlight the broad revenue flexibility of the city. Fitch views this flexibility as an important fiscal tool albeit one subject to considerable political influence. A sustained focus on recurring fiscal solutions to maintain budgetary balance through economic cycles will be a key factor in future rating outcomes.

STSC Analysis

The bankruptcy-remote, statutorily defined nature of the STSC and a bond structure involving a true sale of the pledged sales tax revenues are key credit strengths that lead Fitch to assign a bond rating at the maximum permitted by criteria of six notches above the city's IDR. The city has sold all right, title and interest in the pledged revenues to the corporation, a limited purpose entity. The state directs all pledged sales tax revenues to the trustee for the benefit of bondholders and the residual flows to the city for any lawful purpose.

Pledged revenues include the portions of the city's home rule sales taxes that are collected by the state as well as its local share of state sales taxes. Certain components of the pledged revenue stream subject to annual appropriation by the Illinois General Assembly (the Illinois Use Tax and Illinois Service Use Tax, which represent about 18% of 2021 pledged revenues) are excluded from Fitch's dedicated tax analysis because their value is limited to one notch below the state's IDR (BBB+/Stable).

Sales Tax Rebound Evident

Fitch-adjusted STSC revenue (excluding pledged revenues subject to state appropriation) rebounded 21.3% in 2021 to $615.9 million following a 16.3% decline in 2020. The city projects a nearly 12% increase in YE 2022 sales tax revenues. Fitch considers recent sharp gains anomalous and largely reflective of the sharp nationwide recovery from the pandemic-driven recession in 2020. Historical revenue growth has consistently exceeded inflation, supporting the 'aa' growth prospect assessment. The 10-year CAGR has ranged between 2.0% and 3.8% between 2015 and 2019 and Fitch anticipates revenue growth will revert to a similar long-term trend. Gross revenues, including that portion subject to state appropriation and excluded from Fitch's dedicated tax analysis totaled $747.8 million in 2021, the highest collection amount on record.

Bond Structures Retain Solid Resilience

Fitch's resilience assessments for the senior and subordinate structures are 'aaa' and 'aa', respectively. The resilience assessments anticipate the city will fully leverage the structures up to the additional bonds test minimum maximum annual debt service (MADS) coverage ratio of 4.0x for senior bonds and 1.75x for subordinate bonds, or an effective coverage ratio of 3.3x for the senior lien and 1.4x for the subordinate lien when adjusted to exclude that portion of pledged revenues subject to state appropriation.

Senior lien and all-in MADS is $170.7 million and $340.0 million, respectively. Senior MADS coverage from 2021 STSC revenue on a gross and Fitch-adjusted basis is 4.4x and 3.6x, respectively. All-in coverage was 2.2.x and 1.8x on a gross and Fitch-adjusted basis, respectively.

Assuming leverage to the ABT level, Fitch-adjusted STSC revenues could decline 72% to 1.0x senior lien MADS, whereas the subordinate lien structure could withstand a 31% decline to 1.0x all-in MADS. The coverage cushions are weighed against the Fitch Analytical Stress Test (FAST) model decline of 7.3% under the standard -1% U.S. GDP scenario and the 16.3% decline in 2020 which represents the largest historical decline dating back to 2000. The 72% coverage cushion for the senior lien bonds equates to a 'aaa' resilience assessment (9.9x the FAST decline and 4.4x the largest historical loss).

As a result of the pandemic decline, the 31% coverage cushion for the subordinate lien structure falls below the 'aa' resilience assessment guidance. However, Fitch believes the 2020 decline overstates the sales tax base's sensitivity to typical economic cyclicality. Prior to the pandemic, the largest decline in Fitch-adjusted pledged revenues was an 11.2% drop over a multi-year period spanning 2008 and 2009. Future large declines in STSC revenue could alter our fundamental view of the stability of the sales tax base and pressure the rating on the STSC subordinate lien debt.

CREDIT PROFILE

Chicago is governed by an elected Mayor and City Council and is divided into 50 legislative districts, or wards. Each ward is represented by an alderman who is elected by their constituency to serve coterminous four-year terms.

Proceeds will finance projects outlined in the city's Chicago Works and Chicago Recovery Plan. Chicago Works is a five-year $3.7 billion plan initiated in 2021 to modernize infrastructure and quality of life projects across the city. The $1.2 billion Chicago Recovery Plan is expected to fund a variety of violence prevention, mental health, and affordable housing investments.

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 ⬍
Chicago Sales Tax Securitization Corporation (IL)				
Chicago Sales Tax Securitization Corporation/Sales Tax Revenues/1 LT	LT	AA Rating Outlook Positive	Upgrade	AA- Rating Outlook Stable

Chicago Sales Tax Securitization Corporation (IL) /Sales Tax Revenues - Second Lien/1 LT	LT	AA- Rating Outlook Stable	Affirmed	AA- Rating Outlook Stable
Chicago (IL) [General Government]	LT IDR	BBB Rating Outlook Positive	Upgrade	BBB- Rating Outlook Stable
Chicago (IL) /General Obligation - Unlimited Tax/1 LT	LT	BBB Rating Outlook Positive	Upgrade	BBB- Rating Outlook Stable

VIEW ADDITIONAL RATING DETAILS

FITCH RATINGS ANALYSTS

Michael Rinaldi
Senior Director
Primary Rating Analyst
+1 212 908 0833
michael.rinaldi@fitchratings.com
Fitch Ratings, Inc.
Hearst Tower 300 W. 57th Street New York, NY 10019

Ashlee Gabrysch
Director
Secondary Rating Analyst
+1 312 368 3181
ashlee.gabrysch@fitchratings.com

Eric Kim
Senior Director
Committee Chairperson
+1 212 908 0241
eric.kim@fitchratings.com

MEDIA CONTACTS

Sandro Scenga
New York
+1 212 908 0278
sandro.scenga@thefitchgroup.com

Additional information is available on www.fitchratings.com

PARTICIPATION STATUS

The rated entity (and/or its agents) or, in the case of structured finance, one or more of the transaction parties participated in the rating process except that the following issuer(s), if any, did not participate in the rating process, or provide additional information, beyond the issuer's available public disclosure.

APPLICABLE CRITERIA

U.S. Public Finance Tax-Supported Rating Criteria (pub. 04 May 2021) (including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

FAST Econometric API - Fitch Analytical Stress Test Model, v3.0.0 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Chicago (IL)	EU Endorsed, UK Endorsed
Chicago Sales Tax Securitization Corporation (IL)	EU Endorsed, UK Endorsed

DISCLAIMER & DISCLOSURES

Ratings company (or branch of such a company) can be found on the entity summary page for this issuer on the Fitch Ratings website.

In issuing and maintaining its ratings and in making other reports (including forecast information), Fitch relies on factual information it receives from issuers and underwriters and from other sources Fitch believes to be credible. Fitch conducts a reasonable investigation of the factual information relied upon by it in accordance with its ratings methodology, and obtains reasonable verification of that information from independent sources, to the extent such sources are available for a given security or in a given jurisdiction. The manner of Fitch's factual investigation and the scope of the third-party verification it obtains will vary depending on the nature of the rated security and its issuer, the requirements and practices in the jurisdiction in which the rated security is offered and sold and/or the issuer is located, the availability and nature of relevant public information, access to the management of the issuer and its advisers, the availability of pre-existing third-party verifications such as audit reports, agreed-upon procedures letters, appraisals, actuarial reports, engineering reports, legal opinions and other reports provided by third parties, the availability of independent and competent third- party verification sources with respect to the particular security or in the particular jurisdiction of the issuer, and a variety of other factors. Users of Fitch's ratings and reports should understand that neither an enhanced factual investigation nor any third-party verification can ensure that all of the information Fitch relies on in connection with a rating or a report will be accurate and complete. Ultimately, the issuer and its advisers are responsible for the accuracy of the information they provide to Fitch and to the market in offering documents and other reports. In issuing its ratings and its reports, Fitch must rely on the work of experts, including independent auditors with respect to financial statements and attorneys with respect to legal and tax matters. Further, ratings and forecasts of financial and other information are inherently forward-looking and embody assumptions and predictions about future events that by their nature cannot be verified as facts. As a result, despite any verification of current facts, ratings and forecasts can be affected by future events or conditions that were not anticipated at the time a rating or forecast was issued or affirmed.

The information in this report is provided “as is” without any representation or warranty of any kind, and Fitch does not represent or warrant that the report or any of its contents will meet any of the requirements of a recipient of the report. A Fitch rating is an opinion as to the creditworthiness of a security. This opinion and reports made by Fitch are based on established criteria and methodologies that Fitch is continuously evaluating and updating. Therefore, ratings and reports are the collective work product of Fitch and no individual, or group of individuals, is solely responsible for a rating or a report. The rating does not address the risk of loss due to risks other than credit risk, unless such risk is specifically mentioned. Fitch is not engaged in the offer or sale of any security. All Fitch reports have shared authorship. Individuals identified in a Fitch report were involved in, but are not solely responsible for, the opinions stated therein. The individuals are named for contact purposes only. A report providing a Fitch rating is neither a prospectus nor a substitute for the information assembled, verified and presented to investors by the issuer and its agents in connection with the sale of the securities. Ratings may be changed or withdrawn at any time for any reason in the sole discretion of Fitch. Fitch does not provide investment advice of any sort. Ratings are not a recommendation to buy, sell, or hold any security. Ratings do not comment on the adequacy of market price, the suitability of any security for a particular investor, or the tax-exempt nature or taxability of payments made in respect to any security. Fitch receives fees from issuers, insurers, guarantors, other obligors, and underwriters for rating securities. Such fees generally vary from US$1,000 to US$750,000 (or the applicable 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 by Fitch 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