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Ratings

Research

Summary:

Sales Tax Securitization Corp. of Chicago; Sales Tax

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Table Of Contents

Credit Highlights

Outlook

Credit Opinion

Related Research

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Summary:

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Credit Profile		
US$563.19 mil taxable tender bnds 2nd lien ser 2023B due 01/01/2041		
Long Term Rating	AA-/Positive	New
US$116.375 mil tax-exempt tender bnds 2nd lien ser 2023A due 01/01/2039		
Long Term Rating	AA-/Positive	New
US$103.645 mil sales tax securitization bnds sr lien ser 2023A due 01/01/2052		
Long Term Rating	AA-/Positive	New
US$52.925 mil sales tax securitization bnds sr lien ser 2023B due 01/01/2043		
Long Term Rating	AA-/Positive	New

Credit Highlights

- S&P Global Ratings assigned its 'AA-' rating to the Sales Tax Securitization Corp. of Chicago (STSC or the corporation), Ill.'s series 2023 first- and second-lien bonds, and affirmed its 'AA-' rating on the corporation's bonds outstanding.
- The outlook on all ratings is positive, based on our outlook revision following the outlook revision on Chicago's general obligation (GO) debt outstanding on Nov. 10, 2022.
- The rating on these bonds is constrained by the rating on Chicago's GO bonds and thus, the STSC ratings can move in tandem with changes in Chicago's general creditworthiness.
- Bond proceeds of the senior-lien series 2023A and 2023B social bonds will be used to fund projects related to the Chicago Recovery Plan, including tree planting and electric vehicles. Proceeds from the second-lien series 2023A and 2023B will be used to tender GO and STSC debt outstanding.

The rating and positive outlook reflect the application of our priority-lien tax revenue debt criteria (published Oct. 22, 2018), 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 collected (the obligor's creditworthiness [OC]). The priority-lien rating on the first-lien bonds is limited by our view of Chicago's creditworthiness (BBB+/Positive) and is constrained from going higher unless there is an improvement in the OC. We believe risk of nonpayment is more tied to the city's fiscal condition than to that of the state. Although the debt service coverage (DSC) and additional bonds test (ABT) are different on the first- and second-lien bonds, the two lien ratings are on parity, given the four-notch limitation above the OC in our priority-lien criteria.

Security

The first- and second-lien bonds have comparable legal structures. In our view, the intended true sale feature of the bonds provides a degree of separation between the city and the pledged revenues wherein they are neither legally nor

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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.

Credit overview

During the COVID-19 pandemic, sales tax collections in Chicago and the State of Illinois slipped but rebounded in 2021, pushing coverage on the first- and second-lien bonds back up. Sales tax revenues pledged to the bonds rose by 17% between 2020 and 2021 after falling 10.5% in 2020, slightly more than the 10.1% drop between 2008 and 2009 during the Great Recession.

Despite the sales tax being a major source of operating revenue for Chicago, segregating sales tax revenues to pay STSC debt service first has not caused cash flow pressures for the city.

Chicago plans to issue a tender for GO and STSC debt outstanding to be refunded with second-lien STSC bonds but the amount of additional debt this will add to STSC's debt burden will not be known until the time of issuance. Debt service coverage levels cited in this analysis are expected to be the maximum amount of new debt that could be issued under each lien while still meeting the 4.0x (senior) and 1.75x (all-in) ABTs. Because neither lien is closed, our rating on the bonds continues to reflect the ABT and thus, bonding down to the ABT does not affect the rating.

Other key credit considerations include:

- The city and state's broad and diverse tax bases, which we anticipate will continue to support DSC;
- Good 1.75x x all-in coverage of maximum annual debt service (MADS) for the second-lien bonds, and strong 4.1 x coverage of first-lien debt using 2021 revenues of $747.8 million. Coverage is expected to increase, given collections in the first three quarters of 2022 are running at 85% of total 2021 collections;
- A very strong 4.0x ABT for first-lien debt and a 1.75x ABT for second-lien debt. We expect that the corporation will bond down to the level of the ABT to take advantage of the lower cost of capital this structure can provide;
- Our view that nationwide, Illinois' and Chicago's sales taxes have historically demonstrated low volatility, including when averaged over the course of the pandemic;
- The special-purpose entity nature of the corporation; and
- An intended true sale of the pledged revenues that 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. Given this, we view the pledged revenues as less likely to be affected by any city budgetary pressures.

Offsetting factors include:

- The credit quality of the City of Chicago (BBB+/Positive), which informs our assessment of the OC under our criteria;
- A recent history of population losses at the state level that could weaken the sales tax base over time; and
- The unique municipal context in which the corporation was formed and will operate, which, in our view,

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necessitates linkage to the city's general creditworthiness.

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. 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 10 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.

Environmental, social, and governance

We view governance as an elevated risk when compared with that of peers, given the close relationship between the STSC board and the city. Composition of the board includes five members who have direct linkages to the city, and while there is the ability to appoint an independent director under certain circumstances, the role is appointed by the mayor and approved by city council. In our view, this makes STSC more a part of Chicago's government than an independent entity.

Health and safety social risks stemming from the pandemic that resulted in high unemployment and social activity restrictions temporarily weakened the economic base on which pledged revenue is generated, but as expected, the shift was not permanent.

Rising water levels in Lake Michigan due to climate change have prompted remediation efforts by the city, primarily via the Chicago Park District and federal authorities. While the area is subject to modest environmental risks from the rising water levels, we don't think pledged revenues will be affected by outsize physical risks.

Outlook

We expect that STSC will continue to bond down to the ABT as tax collections increase, particularly given a history of strong revenue growth over time. Given we rate the senior- and junior-lien bonds based on their ABTs of 4.0x and 1.75x, respectively, we anticipate the rating will be unchanged, even as the debt burden rises, provided collections don't fall significantly and result in markedly lower coverage levels.

Downside scenario

We could revise the outlook to stable on the STSC bonds if there is an outlook revision on the OC (our rating on Chicago's GO debt), if there is notable deterioration in coverage provided by the sales taxes pledged to the bonds, or if there is any interference in the pledged revenue stream coming from the state.

Upside scenario

An upgrade to the bonds hinges on improvement in Chicago's OC. An upgrade 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.

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Credit Opinion

Economic fundamentals: Very strong

Because 58% of 2021's pledged revenues are derived from a statewide base, we primarily assessed the economic fundamentals of Illinois. However, our view of the issuer's underlying economic fundamentals also reflects those of Chicago (42% of pledged revenues) and its metropolitan statistical area.

Illinois' economy retains key strengths, with its largest city, Chicago, serving as the economic engine for the Midwest. However, the state lacks the dynamism required to grow itself out of its structural budget imbalance without changes to its revenue structure or expenditure trajectory. Before the pandemic, demographics were a drag on Illinois' economic performance and could dampen its recovery. The original 2020 census indicated that Illinois' population declined from 2010; in May 2022, the census released a post-enumeration survey (used to measure accuracy of the census and to make adjustments) that shows the state population increased 1.8% between 2010 and 2020 to 13.1 million.

Chicago, with a population of 2.7 million, is the nation's third-largest city. It has a very diverse economy and is a global business center and transportation hub. The city has projected per capita effective buying income of 102.4% of the national level and per capita market value of $130,360. Cook County's unemployment rate was 7.0% in 2021, down from over 10% in 2020. Chicago continues to focus on its growth prospects and attractiveness to business and reports ongoing success in business relocations and expansions within the city.

Coverage and liquidity: Very strong

Using fiscal 2021 revenues of $747.8 million and all-in MADS of $340 million, coverage of all first- and second-lien debt is 1.75x. Coverage of the first-lien bonds is higher at 4.1 x. While coverage increased moderately between 2020 and 2021, revenues rose more than 17% based on very strong tax growth. The jump also follows a drop of 10.5% in 2020, reflecting lower revenue collections during the height of the pandemic. To issue more second-lien bonds, the ABT requires 1.75x historical coverage of the new MADS amount, using sales tax collections for the most recently completed fiscal year. Under the master trust indenture, the ABT for additional senior-lien debt is 4x; supplemental indentures provide that the issuance of any additional senior debt must also meet the 1.75x test for all-in coverage of all debt, preventing coverage dilution on the second-lien bonds.

Chicago and the STSC 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 to satisfy debt service obligations. Chicago will receive residual revenues, which are not pledged to the bonds. There is no debt service reserve fund requirement for either the first- or second-lien 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

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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.

Revenue-sharing entity risk: State of Illinois

Although 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, 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.

In 2021, 42% ($312 million) of sales taxes pledged to the bonds were the city's home rule taxes and the remaining 58% ($435 million) came from Chicago's share of state sales tax collections. Of the $435 million that flows through the state, $132 million (18%) of pledged revenues were subject to state annual appropriation, down from 20% in 2020. While unlikely, a weakened financial position at the state could potentially lead to impairment of the local share taxes appropriation and distribution.

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 pressures. Furthermore, the language provided in state statute reduces the likelihood that a bankruptcy court could rule that the pledged revenues are property of the city. STSC also exists as a separate entity under state statutes, and, as it is a not-for-profit corporation, we view it as unlikely 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 created the not-for-profit corporation for the limited purpose of issuing bonds for the benefit of the city. STSC 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 the city council has adopted an ordinance approving the issuance. The corporation is governed by five voting directors: Chicago's chief financial officer, 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. Although, 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 Chicago experiences significant financial distress.

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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 its obligations, including bonds secured by a special tax. 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 cannot be disregarded.

Over the past four years Chicago made significant strides to achieve financial stability and executed transformative changes that built on the successes of the previous decade. This includes finding new revenue streams, managing through the pandemic without deteriorating financially, and climbing a steep debt and pension ramp, all while finding greater efficiency in government. The city also recently revised its debt policy to require supplemental annual deposits to the pension funds starting in 2023; these contributions will keep the pension funds from experiencing negative amortization and will also address negative fund performance. To that end, the city included $242 million of additional pension fund payments to its 2023 budget, which reflects the difference in the statutorily required contribution of $2.37 billion and $2.61 billion, the amount required to avoid increasing the net pension liability (NPL). By augmenting statutory contributions, Chicago will be able to maintain static funding during a period where statutory funding would otherwise allow the NPL to keep rising. However, despite ongoing efforts to address the pension issues, high fixed costs (pension, other postemployment benefits, and debt payments) remain elevated at 39% in 2021, and are accompanied by very low pension funding levels of 23.4% funded across all four plans.

For additional information on Chicago and its current financial position, please see our GO analysis published Nov. 10, 2022, on RatingsDirect.

Related Research

- Through The ESG Lens 3.0: The Intersection Of ESG Credit Factors And U.S. Public Finance Credit Factors, March 2, 2022

Ratings Detail (As Of December 6, 2022)		
Sales Tax Securitization Corporation sales tax		
Long Term Rating	AA-/Positive	Affirmed
Sales Tax Securitization Corporation sales tax		
Long Term Rating	AA-/Positive	Affirmed
Sales Tax Securitization Corporation sales tax		
Long Term Rating	AA-/Positive	Affirmed
Sales Tax Securitization Corporation sales tax		
Long Term Rating	AA-/Positive	Affirmed
Sales Tax Securitization Corporation sales tax		
Long Term Rating	AA-/Positive	Affirmed
Sales Tax Securitization Corporation sales tax		
Long Term Rating	AA-/Positive	Affirmed
Sales Tax Securitization Corporation sales tax (BAM) (SECMKT)		
Unenhanced Rating	AA-(SPUR)/Positive	Affirmed

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Ratings Detail (As Of December 6, 2022) (cont.)		
Sales Tax Securitization Corporation sales tax (BAM) (SECMKT)		
Unenhanced Rating	AA-(SPUR)/Positive	Affirmed
Sales Tax Securitization Corporation sales tax (BAM) (SECMKT)		
Unenhanced Rating	AA-(SPUR)/Positive	Affirmed
Sales Tax Securitization Corporation sales tax (BAM) (SECMKT)		
Unenhanced Rating	AA-(SPUR)/Positive	Affirmed
Sales Tax Securitization Corporation sales tax (BAM) (SECMKT)		
Unenhanced Rating	AA-(SPUR)/Positive	Affirmed
Sales Tax Securitization Corporation sales tax (BAM) (SECMKT)		
Unenhanced Rating	AA-(SPUR)/Positive	Affirmed
Sales Tax Securitization Corporation sales tax (BAM) (SECMKT)		
Unenhanced Rating	AA-(SPUR)/Positive	Affirmed
Sales Tax Securitization Corporation sales tax (BAM) (SECMKT)		
Long Term Rating	AA-/Positive	Affirmed
Sales Tax Securitization Corporation sales tax (BAM) (SECMKT)		
Unenhanced Rating	AA-(SPUR)/Positive	Affirmed
Sales Tax Securitization Corporation sales tax (BAM) (SECMKT)		
Unenhanced Rating	AA-(SPUR)/Positive	Affirmed
Sales Tax Securitization Corporation sales tax (BAM) (SECMKT)		
Unenhanced Rating	AA-(SPUR)/Positive	Affirmed
Sales Tax Securitization Corporation sales tax (BAM) (SECMKT)		
Unenhanced Rating	AA-(SPUR)/Positive	Affirmed
Sales Tax Securitization Corporation sales tax (BAM) (SECMKT)		
Unenhanced Rating	AA-(SPUR)/Positive	Affirmed
Sales Tax Securitization Corporation sales tax (BAM) (SEC MKT)		
Unenhanced Rating	AA-(SPUR)/Positive	Affirmed
Sales Tax Securitization Corporation sales tax (BAM) (SEC MKT)		
Unenhanced Rating	AA-(SPUR)/Positive	Affirmed

Many issues are enhanced by bond insurance.

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