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Ratings

Research

Summary:

Sales Tax Securitization Corp. of Chicago; Sales Tax

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Table Of Contents

Rating Action

Stable Outlook

Credit Opinion

Related Research

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Credit Profile		
US$263.425 mil second sale tax securitization bonds ser 2021A due 01/01/2024		
Long Term Rating	AA-/Stable	New
US$157.06 mil second sale tax securitization bonds ser 2021B due 01/01/2024		
Long Term Rating	AA-/Stable	New
Sales Tax Securitization Corporation sales tax (BAM) (SECMKT)		
Unenhanced Rating	AA-(SPUR)/Stable	Outlook Revised

Rating Action

S&P Global Ratings has revised the rating outlook on the Sales Tax Securitization Corp. of Chicago (STSC or the corporation), Ill.'s series 2021 A&B second-lien bonds to stable from negative. At the same time, we have assigned our 'AA-' long-term rating and underlying rating (SPUR) to the series 2021 A&B second-lien bonds and affirmed our 'AA-' rating on the city's first- and second-lien bonds outstanding. The outlook revision reflects the recent outlook change on the City of Chicago.

The bonds will refinance certain City of Chicago general obligation (GO) bonds, motor fuel tax bonds, a Transportation Infrastructure Finance and Innovation Act (TIFIA) loan and STSC debt outstanding. Neither series of refunding bonds has a final maturity beyond 2042 and therefore does not exceed the final maturity of the refunded bonds. The bonds are secured by a pledge of, and security in, the trust estate, which includes all right, title, and interest of the STSC in the sales tax revenues. The lien on the second-lien bonds is subordinate to the lien on the first-lien bonds.

The rating and outlook change 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+/Stable) 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) levels 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.

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 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

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overcome through the overlay of a legal structure.

Credit overview

During the pandemic, sales tax collections in Chicago and the State of Illinois slipped, pushing coverage on the first- and second-lien bonds down. Sales tax revenues pledged to the bonds fell by 10.5% during 2020, slightly more than the 10.1% drop between 2008 and 2009 during the Great Recession. Projections for 2021 indicate a rebound of 16%, taking collections to over $746 million, the highest point to date. According to projections from IHS Markit, retail sales in Illinois are expected to increase 17% in 2021, putting Illinois in the top 18 states for sales tax growth this year.

Chicago continues to use STSC bonds, its most cost-effective borrowing option, to refund GO debt outstanding for savings. Prior to the pandemic, the city planned to cease these GO refundings using the STSC pledge, but is doing another round to free up budget space for 2022 and 2023. There are currently no plans to issue additional STSC new-money debt. Despite being a major source of operating revenue for Chicago, segregating the sales tax revenues to pay STSC debt service first has not caused cash flow pressures for the city.

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 all-in coverage of maximum annual debt service (MADS) for the second-lien bonds, and strong 3.74x coverage of first-lien debt using 2020 revenues of $638.7 million, with coverage in 2021 expected to increase following a post-pandemic increase in sales tax 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 provides, but in order to do so, revenue collections will need to rebound from 2020 levels;
- 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+/Stable), 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;
- 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 of Illinois (BBB/Stable) related to appropriation risk (the state's use and service use taxes, which made up 20.5% of 2020's total sales tax revenues) or its liquidity pressures, which could reduce DSC, although there is statutory state nonimpairment language.

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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.

We revised the outlook on the city of Chicago to stable from negative, reflecting a return to greater stability following pressures created by the COVID-19 pandemic.

Environmental, social, and governance (ESG) factors

In our view, 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 the shift is not expected to be permanent. Despite these social risks, we believe the long-term trajectory of the economic fundamentals remains very strong.

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.

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 rising water levels in Lake Michigan, we don't think pledged revenues will be affected by outsized physical risks.

Stable Outlook

Downside scenario

We could downgrade the STSC bonds if there is a downgrade on the OC (our rating on Chicago's GO debt), or if there is notable deterioration in coverage provided by the sales taxes pledged to the bonds.

Upside scenario

An upgrade to the bonds would likely hinge on improvement in Chicago's OC, which is currently a limiting factor. 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.

Credit Opinion

Economic fundamentals: Very strong

Because 59% of 2020'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

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Chicago (41% 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 the revenue structure or expenditure trajectory. Illinois' unemployment rate peaked at 17.2% in April 2020, then fell but remained elevated, at 7.0% in August 2021. As the economy continues to adjust to pandemic effects, we expect the unemployment rate will continue to decline. S&P Global Economics is projecting 5.7% national GDP growth in 2021 and 4.1% growth in 2022. Although state experiences will vary, this demonstrates the strength of the economic recovery we are considering in our assessments. For more information on the economic forecast, see "Economic Outlook U.S. Q4 2021: The Rocket Is Leveling Off," published Sept. 23, 2021, on RatingsDirect.

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 a projected per capita effective buying income of 100.5% of the national level and per capita market value of $120,136. The county unemployment rate was more than 10% in 2020, which we consider high, but rates have since come down. Cook County's most recent unemployment rate was 8.2% in August 2021. Chicago continues to focus on its growth prospects and attractiveness to business. The city has also aggressively marketed its post-COVID-19 reopening to residents and visitors, claiming the title of the largest U.S. city to reopen completely.

Coverage and liquidity: Very strong

Using fiscal 2020 revenues of $638.7 million and all-in MADS of $262.4 million, coverage of all first- and second-lien debt is 1.75x. Coverage of the first-lien bonds is higher at 3.74x. 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. Given lower collections in 2020, to issue additional debt, revenues will have to increase in order to meet the 1.75x ABT; 2021 collection projections show 16.8% growth over 2020 actuals. Projections for 2022 are for 16.5% growth from 2021 expectations.

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 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 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 1993-2014.

Total collections of $638.7 million were $75 million (10.5%) lower than 2019's collections of $713.8 million. The

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amount of revenues attributed to the local share of state sales taxes versus home rule has also been changing over time, going to 41% home rule and 59% local share in 2020, from 44% and 56% in 2018, respectively. While we do not view this change as a negative credit factor, should the trend persist beyond the pandemic, it could alter our view of how much dependency the rating has on the state.

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 by 4% in 2008 and 10.1% in 2009. Before 2020, they had increased consistently since 2010, but recent numbers indicate softer trends.

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 2020, 39% ($251 million) of sales taxes pledged to the bonds were the city's home rule taxes and the remaining 61% ($388 million) came from Chicago's share of state sales tax collections. Of the $388 million that flows through the state, $131 million (20.5%) of pledged revenues were subject to state annual appropriation, up from 15% in 2019. During the pandemic, collections of state-wide sales and use taxes remained more stable than Chicago's home-rule collections, pushing the appropriated share of revenues closer to 30% of total collections for several months. Since that time, the share has fallen back down closer to 15%. While unlikely, the state's weak financial position could lead to impairment of the local share taxes appropriation and distribution, as happened for three months during the state's fiscal 2016 budget impasse.

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. 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. The corporation 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.

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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.

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.

Chicago has made significant progress toward stabilizing its financial position, through increasing pension contributions via a ramp-up to an actuarial basis, eliminating the practice of pushing out debt payments into the future through scoop-and-toss refundings, and reducing reliance on nonrecurring revenues. While the pandemic pushed the expectation of achieving full structural balance off by one year to 2023, federal stimulus dollars have helped the city manage through revenue shortfalls caused by COVID-19. However, even with additional federal support, the high fixed costs tied to pension, OPEB, and debt payments (37% in 2020), coupled with very low pension funding levels (23.5% funded across all four plans), the city will continue to be challenged to find fiscal sustainability.

For additional information on Chicago and its current financial position, please see our GO analysis published Nov. 3, 2021, on RatingsDirect. For additional information on the STSC structure, please see our analysis published Nov. 26, 2019.

Related Research

- Through The ESG Lens 2.0: A Deeper Dive Into U.S. Public Finance Credit Factors, April 28, 2020

Ratings Detail (As Of November 3, 2021)		
Sales Tax Securitization Corporation sales tax		
Long Term Rating	AA-/Stable	Outlook Revised
Sales Tax Securitization Corporation sales tax		
Long Term Rating	AA-/Stable	Outlook Revised
Sales Tax Securitization Corporation sales tax		
Long Term Rating	AA-/Stable	Outlook Revised
Sales Tax Securitization Corporation sales tax		
Long Term Rating	AA-/Stable	Outlook Revised

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Ratings Detail (As Of November 3, 2021) (cont.)		
Sales Tax Securitization Corporation sales tax		
Long Term Rating	AA-/Stable	Outlook Revised
Sales Tax Securitization Corporation sales tax		
Long Term Rating	AA-/Stable	Outlook Revised
Sales Tax Securitization Corporation sales tax (BAM) (SECMKT)		
Unenhanced Rating	AA-(SPUR)/Stable	Outlook Revised
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Unenhanced Rating	AA-(SPUR)/Stable	Outlook Revised
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Unenhanced Rating	AA-(SPUR)/Stable	Outlook Revised
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Unenhanced Rating	AA-(SPUR)/Stable	Outlook Revised
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Unenhanced Rating	AA-(SPUR)/Stable	Outlook Revised
Sales Tax Securitization Corporation sales tax (BAM) (SECMKT)		
Long Term Rating	AA-/Stable	Outlook Revised
Sales Tax Securitization Corporation sales tax (BAM) (SECMKT)		
Unenhanced Rating	AA-(SPUR)/Stable	Outlook Revised
Sales Tax Securitization Corporation sales tax (BAM) (SECMKT)		
Unenhanced Rating	AA-(SPUR)/Stable	Outlook Revised
Sales Tax Securitization Corporation sales tax (BAM) (SECMKT)		
Unenhanced Rating	AA-(SPUR)/Stable	Outlook Revised
Sales Tax Securitization Corporation sales tax (BAM) (SEC MKT)		
Unenhanced Rating	AA-(SPUR)/Stable	Outlook Revised
Sales Tax Securitization Corporation sales tax (BAM) (SEC MKT)		
Unenhanced Rating	AA-(SPUR)/Stable	Outlook Revised

Many issues are enhanced by bond insurance.

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