S&P Global Ratings

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Summary:

Sales Tax Securitization Corp. of Chicago; Sales Tax

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Summary:

Sales Tax Securitization Corp. of Chicago; Sales Tax

Credit Profile		
US$759.66 mil second lien sales tax securitization bnds ser 2019A due 01/01/2039		
Long Term Rating	AA-/Stable	New
US$192.795 mil second lien sales tax securitization bnds (forward delivery) ser 2020A due 01/01/2034		
Long Term Rating	AA-/Stable	New
US$71.069 mil second lien sales tax securitization bnds taxable ser 2019B due 01/01/2024		
Long Term Rating	AA-/Stable	New

Rationale

S&P Global Ratings has assigned its 'AA-' long-term rating to the Sales Tax Securitization Corp. of Chicago (STSC or the corporation), Ill.'s second-lien tax-exempt series 2019A and forward delivery series 2020A bonds, and taxable series 2019B sales tax securitization bonds issued for the City of Chicago. S&P Global Ratings also affirmed its 'AA-' long-term rating on the corporation's first-lien bonds outstanding. The outlook on both the first- and second-lien bonds is stable.

The bonds will refinance certain City of Chicago general obligation (GO) bonds, motor fuel tax bonds and various notes. None of the three series of refunding bonds has a final maturity beyond 2039 and therefore does not exceed the life of the refunded bonds.

The rating reflects our application of our "Priority Lien" 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/or 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 non-payment is more tied to the city's fiscal condition than the state's. 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.

This is the first issuance of second-lien debt for the corporation and the legal structure is comparable with that of the first-lien bonds. In our view, the intended true sale provides a degree of separation between the city and the pledged revenues wherein they are neither legally nor practically available for operations. Prior to the payment of debt service, the sales tax revenues are separated from the city's cash flow and operations, which, in our view, significantly lessens the risk that the revenues could be diverted to address the city's ongoing budgetary challenges. However, we believe that dependence and linkage cannot be entirely overcome through the overlay of a legal structure supporting the bonds. Despite the bonds' good coverage and legal provisions, we expect that Chicago's high fixed costs tied to its

liabilities, and its need to identify how it will fund looming pension contribution increases beyond 2020, will continue to weigh down the rating.

Other key credit considerations include:

- The city and the state's broad and diverse tax bases, which we anticipate will continue to support strong DSC;
- Good 2.33x all-in coverage of maximum annual debt service (MADS) for the second-lien bonds, and strong 4.03x coverage of first-lien debt;
- A 1.75x ABT for second-lien debt, and our expectation that the corporation will bond down to that level to take advantage of the lower cost of capital this structure provides;
- Our view that nationwide, Illinois and Chicago's sales taxes have historically demonstrated low volatility;
- The special-purpose entity nature of the corporation; and
- An intended true sale of the pledged revenues 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, so we view the pledged revenues as less likely to be affected by any city budgetary pressures.

Offsetting factors include:

- Below-average economic growth projected for Chicago and the surrounding metropolitan statistical area (MSA);
- A recent history of population losses at both the state and city level that have weakened the sales tax base, although we acknowledge city and state efforts to reduce this trajectory;
- The potential for late or reduced payments from the State of Illinois (BBB-/Stable) related to appropriation risk (13.5% of the sales tax revenue) or its liquidity pressures, which could reduce DSC, although there is statutory state non-impairment language; and
- The unique municipal context in which the corporation was formed and will operate, which, in our view, necessitates linkage to the city's general creditworthiness.

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

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

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 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.

Economic fundamentals: Very strong

Because 56% of pledged revenues are derived from a statewide base, we have assessed the economic fundamentals primarily of Illinois; however, our view of the issuer's underlying economic fundamentals also reflects Chicago (44% of pledged revenues) and its MSA.

Illinois' economy boasts several key advantages, including that it is well diversified and centrally located within the U.S., and benefits from a well-educated workforce and an expansive transportation infrastructure. The state (population 12.7 million) is the fifth-largest economy in the U.S. and 18th-largest worldwide. Illinois' income levels are above the national average, with 2018 per capita personal income of $56,933, equal to 106% of the national level, according to the U.S. Commerce Department's Bureau of Economic Analysis. Per capita GDP also exceeds the nation at 108% (2018). Nevertheless, the state's GDP growth rates have trailed the U.S. rates during the past year and, on average, in the past five and 10 years. We anticipate the Illinois economy will continue to expand, albeit at slow rates as the state deals with macroeconomic conditions that affect its manufacturing sector, namely low commodity prices, a strong dollar, and challenging demographic trends. IHS Markit projects Illinois' gross state product growth will be 2.12%, below the U.S. GDP at 2.67%, and that the state's growth will slow to 1.76% in 2020 and 1.31% in 2021. For additional information on the regional economic picture, please see "Credit Conditions: In The Mist Of Mixed Economic Signals, U.S. State And Local Credit Quality Remains Strong," published Oct. 29, 2019.

Illinois' unemployment rate gradually declined throughout the recovery from its peak at 10.4% in 2010, and in 2018 fell to 4.3%, lower than its pre-recession annual rate of 5.1% in 2007. Unemployment has been largely stable throughout 2019, but fell to 3.9% (preliminary) in October 2019. The service sector accounts for a majority of employment and is anchored by education and health services (15.3%), professional and business services (15.6%), and leisure and hospitality (10.1%). The other significant anchor to the economy is trade and transportation (19.9%), reflecting Chicago's role as a transportation hub for the region. Through August 2019, Illinois' payroll growth has slightly lagged the U.S., primarily due to a contraction in retail employment. The state's manufacturing and services sectors experienced year-over-year growth over the same period, although the manufacturing sector declined in the second quarter of 2019 and will likely continue to shrink over the next year. New developments, though, promise additional jobs in the coming years, including Salesforce, which is planning to add 1,000 more jobs over the next five years. The state's $45 billion six-year infrastructure bill will likely boost construction sector jobs and provide infrastructure improvements that should help the state's economy.

Chicago, with a population of 2.7 million, is the nation's third-largest city, has a very diverse economy, and is a global business center and transport hub. Its projected per capita effective buying income is 103% of the national level. The city and its surrounding MSA have a more educated population than the nation (46.0% with some higher education compared with 39.2% for the U.S.) and also are home to a larger-than-average population aged 25-34 (15.1% compared with 13.9% for the U.S.). It is repeatedly named a top MSA for corporate relocation, boasts significant

cultural attractions, and has been named the No. 1 U.S. city for foreign direct investment for the past seven years. However, the Chicago MSA's economic growth has been tepid relative to that of the U.S. and comparable metropolitan areas, and although the MSA remains an economic powerhouse, it is not without challenges.

Coverage and liquidity: Very strong

Using fiscal 2018 revenues of $687.4 million and provided projected all-in MADS of $295.4 million, coverage of all first- and second-lien debt is 2.33x. Coverage of the first-lien bonds is higher at 4.03x. The corporation can issue up to $3 billion in senior-lien bonds and currently has $2.6 billion outstanding. 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 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 corporation irrevocably directed the state to pay all sales tax revenues directly to the trustee. After corporation operating expenses are met, 100% of annual principal and interest requirements are on deposit with the trustee and any reserve, and subordinated indebtedness, Chicago will receive residual revenues, which are not pledged to the bonds. There is no debt service reserve fund requirement for 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.

On a macro level, we consider sales tax revenues to have a low historical volatility assessment. Looking specifically at the pledged revenue history, overall they have stayed in line with national economic cycles. During the Great Recession, pledged revenues decreased 4% in 2008 and 10.1% in 2009. They have increased consistently since 2010, but recent numbers indicate softer trends. Over the past five years, average annual growth has been 3.6%, although in 2016 and 2017 pledged revenues rose only 2.1% and 0.4%, respectively. Collections for 2018 were stronger, with annual growth of 3.9%, rising to $687.4 million.

Growth trends of the state-levied sales tax revenue remain positive but subdued. Statewide, fiscal 2019 (June 30) sales tax collections were approximately $8.4 billion, up 7.7% from the prior year. Chicago's local share of state revenues increased 4.7% in fiscal 2018 (Dec. 31). The local share of revenues has demonstrated more stability than the home rule share, decreasing only once (8.9% in 2009) in the past 11 years. Between 2008 and 2018, the average growth rate for home rule sales tax was 2.4% whereas local share sales tax revenues grew an average of 3.4%. Softer home rule collection growth partly may reflect trends in online sales; the state collects sales taxes attributed to online retailers, but the home rule tax does not apply to online sales. The combined sales tax rate for Chicago is 10.25%, among the highest in the U.S., which, in our view, could provide a challenge to potential future rate increases.

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. Home rule sales taxes alone would cover MADS by 1.02x. In addition, 13.5% 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, 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.

Public Act 100-0023 provides state non-impairment language intended to mitigate the potential of state action that could be adverse to bondholders. In the act, the state pledges and agrees that it will not impair the terms of any contract, including any assignment agreement, made by the transferring entity with the issuing entity with the respect to the issuance of bonds until all debt service is repaid. The state also pledges to and agrees with each transferring unit and each issuing entity that it will not limit or alter the basis on which the transferring unit's share or percentage of transferred receipts is derived, or the use of such funds, to impair the terms of any such contract.

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

Obligor linkage: Remote

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

Chicago has created the corporation as a not-for-profit corporation for the limited purpose of issuing bonds for the benefit of the city. 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 city council has adopted an ordinance approving the issuance. The corporation is governed by five voting directors: 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. 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 city were to experience significant financial distress. We view this risk as elevated by the fact that five members of the board have direct linkages to the city and that the independent director is appointed by the mayor and approved by council. In addition, we believe there is insufficient municipal bankruptcy case law to confirm the correctness of the analysis that a court would not order the substantive consolidation of the assets and liabilities of the corporation with those of the city. However, given the current financial position and trajectory of the city, we currently view this possibility as remote.

The legal structure creates significant separation between the city and pledged revenues. In our view, the assignment, purchase and sale agreement, pursuant to which the city irrevocably conveyed all right, title, and interest of the city of sales taxes collected by the state (including home rule and state sales taxes) to the corporation until the date on which there are no secured obligations outstanding, significantly reduces the likelihood that the city's financial operations could impair the flow of pledged revenues to the bonds.

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

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

annual debt service requirements.

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

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

Rating linkage to Chicago

We assess Chicago's general operations because we view overall creditworthiness as a key determinant of an obligor's ability to pay all of its obligations, including bonds secured by a special tax. Recent examples of fiscal distress illustrate municipalities can and have taken actions that contravene provisions in bond documents and/or applicable law that are adverse to bondholders. While we view the risk of the city being in such a distressed situation as remote, the risk, in our view, cannot be disregarded.

Chicago has made significant progress toward stabilizing its financial position, through increasing pension contributions and statutory requirements to fund pensions on an actuarial basis, eliminating the practice of pushing out debt payments into the future through "scoop and toss," and reducing reliance on nonrecurring revenues with a commitment to eliminating the structural deficit and ramping up to full actuarial pension contributions by 2022. That said, its high fixed costs tied to its liabilities, significant public safety expenses, and distressed overlapping governments will likely continue to challenge its fiscal sustainability. The city's $11,171 per capita net pension liability and 23% overall weighted plan funded ratio will continue to place a weight on it for decades. Even as Chicago executes its pension plan, liabilities will continue to grow, as payments are not set to pay down any unfunded principal for some time–known as negative amortization. However, in our view, growth in funding forestalls plan insolvency and eliminates a contribution spike that would otherwise occur at the time of plan insolvency, as Chicago would be required to pay out benefits entirely from its budget, not from plan assets.

For additional information on Chicago and its current financial position, please see our GO analysis published Nov. 26, 2019.

Outlook

The stable outlook reflects the likelihood that coverage will remain very strong. The broad nature of the pledged receipts and the deep, diverse tax base will likely continue to support long-term revenue growth. The outlook also reflects our expectation that Chicago's budgetary pressures will not significantly worsen over the two-year outlook horizon given the city's recent measures to address its pension liabilities and achieve structural balance by 2022. The outlook additionally reflects the state's near-term fiscal stability, which, in our view, strengthens the adequacy of its resources to reliably cover its priority obligations.

Downside scenario

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

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.

Ratings Detail (As Of November 26, 2019)		
Sales Tax Securitization Corporation of Chicago sales tax securitization bnds (Taxable)		
Long Term Rating	AA-/Stable	Affirmed
Sales Tax Securitization Corporation of Chicago sales tax (BAM) (SEC MKT)		
Unenhanced Rating	AA-(SPUR)/Stable	Affirmed
Sales Tax Securitization Corp sales tax		
Long Term Rating	AA-/Stable	Affirmed
Sales Tax Securitization Corp sales tax		
Long Term Rating	AA-/Stable	Affirmed
Sales Tax Securitization Corp sales tax		
Long Term Rating	AA-/Stable	Affirmed
Sales Tax Securitization Corp sales tax (BAM) (SECMKT)		
Unenhanced Rating	AA-(SPUR)/Stable	Affirmed

Many issues are enhanced by bond insurance.

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