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Ratings

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Summary:
Queen Creek, Arizona; General Obligation

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Long Term Rating	AA/Stable	Upgraded

Rationale

S&P Global Ratings raised its issuer credit rating (ICR) to 'AA' from 'AA-' on Queen Creek, Ariz. The outlook is stable.

The raised rating reflects our view of the town's rapid economic expansion, which has moderated the taxpayer concentration and improved wealth and income indicators to levels we consider strong. The rating action further reflects the town's very strong financial management policies and practices, which have supported our view of strong budgetary performance and very strong flexibility. While the town maintains a large direct debt burden due to its growth-related infrastructure needs, it has made efforts in recent years to pay down debt early with funds on hand, and annual debt service carrying charges remain moderate and are further offset by our view of manageable pension contributions, which we believe limit the budgetary pressure from long-term obligations. Overall, we expect these credit factors will remain consistent throughout the near-term horizon.

Credit overview

The rating further reflects our view of the town's:

- Strong economy, with access to a broad and diverse metropolitan statistical area (MSA);
- Very strong management, with strong financial policies and practices under our Financial Management Assessment (FMA) methodology;
- Strong budgetary performance, with operating surpluses in the general fund and at the total governmental fund level in fiscal 2018;
- Very strong budgetary flexibility, with an available fund balance in fiscal 2018 of 39% of operating expenditures;
- Very strong liquidity, with total government available cash at 90.4% of total governmental fund expenditures and 8.5x governmental debt service, and access to external liquidity we consider strong;
- Weak debt and contingent liability profile, with debt service carrying charges at 10.6% of expenditures and net direct debt that is 226.5% of total governmental fund revenue, but rapid amortization, with 65.3% of debt scheduled to be retired in 10 years; and
- Adequate institutional framework score.

Strong economy

We consider Queen Creek's economy strong. The town, with an estimated population of 52,405, encompasses an annexed area of 39 square miles and is located in Maricopa and Pinal counties in the Phoenix-Mesa-Scottsdale, Ariz., MSA, which we consider broad and diverse. Located about 38 miles southeast of Phoenix, residents have access to employment opportunities throughout the broader MSA. The population has nearly doubled since the 2010 census, reflective of the town's rapid development and significant annexation. Since 2017, the town has annexed approximately 9.9 square miles to its boundaries (an increase of about 34%) and currently has approximately 1,607 acres in additional annexation pending. Significant population growth is expected in coming years, and management anticipates the town's population to reach 88,000 by 2028. The town has a projected per capita effective buying income of 98.5% of the national level and per capita market value of $98,713. The weighted-average unemployment rate of the counties was 4.1% in 2018.

The town's local economy, which was formerly dominated by agriculture, has experienced continuous expansion, with industrial, commercial, and residential development contributing to strong property value growth in recent years. Following a 45% decline in estimated net full cash value (market value) between 2009 and 2014, the town's market value has grown at an average annual rate of nearly 20% since 2015, surpassing the prerecession peak. Overall, the town's market value grew by 21.8% over the past year to $5.2 billion in 2020. Net limited assessed value (AV), which is now used for setting the tax rate, followed a similar trend and has grown by an average annual rate of 14% over the last five years to $425.4 million in 2020. Management indicated that there is ongoing commercial and residential construction occurring within the town, including the expansion and development of the Town Center area; various grocery, restaurant, and retail developments; and over 2,000 new single-family homes, all of which is expected to be completed within the next 24 months. Previously, roughly 50% of the town's AV was owned by developers, resulting in a very concentrated taxpayer base, in our view. However, ongoing development and the sale of property to individual owners has resulted in a significant moderation of concentration, with the 10 largest taxpayers accounting for 6.8% of net limited AV in 2019.

The Mountain region of the U.S. continues to lead the country in net migration from other states, and we expect most of these new residents to find work, with nonfarm employment growth expanding through 2021. As many of these new residents come with coastal-level buying power, we anticipate that median home price growth will give developers incentive to build in a region with plenty of land. However, projections for demand are not being reflected in housing starts, and projections show that in 2019 every state but Arizona--which we anticipate will squeak in with 0.2% growth--will see declines. Further, we see the region's diverse portfolio of leading industries--professional services, natural resources and mining, and leisure and hospitality--and attractiveness to interstate migrants for its quality of life as helping it capture a portion of the growth that would otherwise flow to high-paying but even higher-costing metropolitan areas in the Pacific states. For more information, please see our report "U.S. State And Local Governments Will Need To Keep Their Hands On The Wheel," published July 31, 2019.

Very strong management

We revised our view of the town's management to very strong from strong, with strong financial policies and practices under our FMA methodology, indicating financial practices are strong, well embedded, and likely sustainable. The revision reflects our view of the town's comprehensive long-term operating and capital plans, which have been utilized over the last several years.

Highlights of policies and practices include the town's conservative budgeting practices based on an internal analysis of extensive historical trends and economic conditions, as well as information from various outside sources. The town maintains an annually updated five-year financial forecast for each of its nonenterprise operating funds, as well as an annually updated capital improvement plan covering fiscal years 2020 through 2024 that identifies estimated costs and funding sources. Management actively reviews its forecasts and provides budget-to-actual reports to the governing body on a monthly basis. The governing body has formally adopted comprehensive investment and debt policies, and investment performance is reported to the council at least annually, and management performs additional review of the portfolio with the investment advisor monthly. The town also adheres to a formal fund balance policy requiring a fund balance of at least 25% of next year's general fund revenue, with additional targets for its committed pension reserve, as imposed by its formal pension funding policy.

Strong budgetary performance

Queen Creek's budgetary performance is strong, in our opinion. The town had operating surpluses of 37% of expenditures in the general fund and of 7.8% across all governmental funds in fiscal 2018. Our assessment accounts for various adjustments to exclude certain one-time expenditures and general fund transfers, as well as the inclusion of recurring transfers in and out of the general fund as ongoing revenues and expenditures. The town's positive operating performance was bolstered by the ongoing development, driving continued growth in operating revenue, including an 11% increase in sales and property tax revenue and a 22% increase in building revenue. While we note that Queen Creek relies heavily on volatile revenue such as sales and other cyclical tax revenue, we believe that potential correlated budgetary pressures are somewhat alleviated by the town's maintenance of its very strong fund balance position and very strong financial management.

Looking ahead, the town's unaudited actuals show a small addition to the fund balance at fiscal year-end 2019, which management attributed primarily to strong revenue growth. The town's fiscal 2020 budget projects a general fund drawdown after transfers for one-time capital outlay. However, we note that the town's year-end actuals have historically outperformed the adopted budgets due to its conservative assumptions. While we expect the town will maintain its strong financial position in the near term after accounting for various one-time items, our assessment accounts for our expectation that budgetary results could deteriorate somewhat from the very strong 2018 operating results.

Very strong budgetary flexibility

Queen Creek's budgetary flexibility is very strong, in our view, with an available fund balance in fiscal 2018 of 39% of adjusted operating expenditures, or $14.2 million. We expect the available fund balance will remain above 30% of expenditures for the current and next fiscal years, which we view as a positive credit factor.

The town's general fund also includes a committed fund balance of $22.3 million as of fiscal year-end 2018 for its unfunded pension liability, which management indicated could be used for operations if needed, which would increase the available fund balance to nearly 100% of adjusted operating expenditures. We understand that the town intends to maintain its fund balances at a very strong level throughout the near term, continuing to use excess revenue to build its internal pension reserve and to fund pay-as-you-go capital outlay.

Very strong liquidity

In our opinion, Queen Creek's liquidity is very strong, with total government available cash at 90.4% of total governmental fund expenditures and 8.5x governmental debt service in 2018. In our view, the town has strong access to external liquidity if necessary. Queen Creek has issued various forms of long-term debt over the last 15 years, including excise tax revenue bonds and several types of enterprise debt, and we have no reason to believe that the town's access to markets has diminished. Additionally, as the majority of investments are in government investments, we do not consider the portfolio to pose a liquidity risk. We expect that liquidity levels will not materially change in the next few years.

The town has entered into several privately placed obligations, including its 2016 special assessment revenue refunding bonds and 2019 excise tax revenue bank loan. The 2019 refunding was privately placed with CoBiz Financial in the par amount of $18.4 million to refinance the privately owned portion of the improvement district's debt. The 2019 bank loan was issued in the par amount of $49.5 million with Bank of America N.A. and is variable rate, with interest calculated using 80% of LIBOR plus 49 basis points and a final maturity of Feb. 20, 2020. The loan is secured by a subordinate-lien on the town's excise tax revenue. We have reviewed the documents associated with these agreements, and while the bank loan includes a cross-default provision where a default on senior debt will trigger an event of default on the loan, we view associated covenants as standard and the events of default as unlikely, and we do not believe these agreements pose a contingent liquidity risk.

Weak debt and contingent liability profile

In our view, Queen Creek's debt and contingent liability profile is weak. As of fiscal year-end 2019, the town has approximately $173 million in direct debt outstanding. Total governmental fund debt service is 10.6% of total governmental fund expenditures, and net direct debt is 226.5% of total governmental fund revenue. Of the town's direct debt, excise tax revenue bonds accounts for $160 million. While they are not legally pledged, the town utilizes other sources of funds, such as impact fee revenue, to support the excise tax debt. Approximately 65.3% of the direct debt is scheduled to be repaid within 10 years, which is in our view a positive credit factor, including the scheduled payoff of the 2019 interim financing with Bank of America. We understand that town intends to refinance the loan prior to February 2020 with a long-term debt issuance backed by utility revenue, extending the maturity. The town also intends to issue $22 million in excise tax revenue debt for road projects and an estimated $20 million in utility revenue bonds for water rights in the summer of 2020.

The town participates in two pension plans for its personnel: the Arizona State Retirement System (ASRS), and the Public Safety Personnel Retirement System (PSPRS). ASRS, the largest plan, administers a cost-sharing, multiple-employer defined benefit pension plan, which maintained a plan fiduciary net position as a percentage of total pension liability of 73.4% as of June 30, 2018, and the town's proportionate share of the net pension liability was $21.1 million. Public safety employees participate in the PSPRS, which is an agent multiple-employer retirement system, maintained a funded ratio of 89.1% for the fire plan, and the town's net pension liability is $907,944. Additionally, the town's estimated share of the unfunded liability of the police plan under PSPRS was $20.9 million in 2019, according to the town's pension funding policy. Queen Creek's combined required pension and actual other postemployment benefit contributions totaled 3.4% of total governmental fund expenditures in 2018.

In an effort to reduce its unfunded pension liabilities, the town implemented a policy to make excess contributions toward its plan and committed pension reserves, and as a result, the town made 129% of its annual required pension contribution in 2018. The town's pension funding policy includes conservative calculations of its unfunded liabilities based on the greater of the figures presented by either the actuary report or the annual GASB report, which typically vary due to the smoothing of amounts in the actuary calculation. As previously noted, the town maintains a committed general fund balance for its unfunded pension liabilities, which, as of fiscal-year end 2018, maintained a balance of $19.7 million for the police plan, $2.4 million for ASRS, and $239,454 for the fire plan. As of fiscal 2019, the town had fully funded its fire and police plan liabilities in its internal pension reserve and all excess funds will now be applied toward its ASRS internal reserve.

Adequate institutional framework

We consider the institutional framework score for Arizona towns not subject to a single audit requirement adequate.

Outlook

The stable outlook reflects our expectation that the rapid economic growth will continue to support wealth and income indicators that we consider strong and generate continual growth in related operating revenue, driving our view of the town's strong budgetary performance. The outlook additionally reflects our view of the town's very strong reserve position, further bolstered by its committed fund balances, which illustrate the town's very strong financial management policies and practices and notable efforts to pay down its long-term liabilities. While we note that the expected economic expansion could require additional debt issuances, likely maintaining a high debt burden, we believe the town has capacity to absorb expected costs while maintaining its budgetary performance at a level we consider strong during our outlook window. As a result, we do not anticipate changing the rating during the two-year outlook period.

Upside scenario

Should ongoing growth strengthen economic indicators to levels we consider commensurate with those of higher-rated peers and we believe the level of growth is sustainable, while the town maintains its very strong reserves and a stable debt profile, we could raise the rating.

Downside scenario

We could lower the rating if the town were to underperform its current projections, resulting in a sustained operational imbalance and a depletion of reserves to a level we no longer consider strong.

Related Research

2018 Update Of Institutional Framework For U.S. Local Governments