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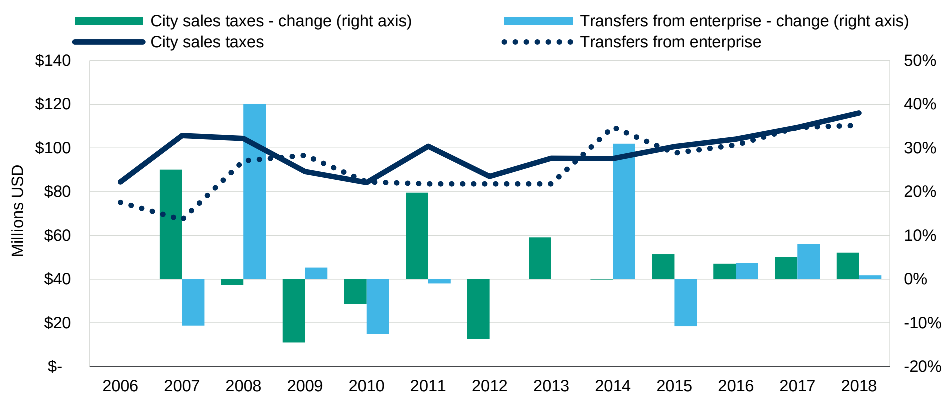
# Mesa, AZ

Update to credit analysis

## Summary


Mesa, Arizona (Aa2 stable) is supported by a very large and growing $40-billion tax base anchored by a diverse set of economic drivers and moderate resident wealth measures. Mesa's otherwise stable financial profile, with healthy if somewhat below-average fund balance, is constrained by the large share of revenues from volatile sales tax revenues and substantial transfers from the city's combined utility system. Already-elevated pension liabilities are increasing, and climbing contribution requirements will further pressure expenditures, though the city is proactively building reserves to help manage future cost increases.


Exhibit 1
**Sales tax revenues and transfers from enterprise are volatile revenue sources**




*Source: Moody's Investors Service*

## Credit strengths

- Large and diverse local economy within the Phoenix area continues to expand and diversify
- An affordable cost of living will fuel population gains while low business costs will continue to attract new employers
- Experienced management has maintained balanced operations through timely budget adjustments and proactive planning

## Credit challenges

» Reserves remain somewhat below national levels and below many peers in Arizona

» Modest socioeconomic profile

» Revenues are highly dependent on sales taxes, state shared sales taxes, and transfers from the city's combined enterprise

» Pension liabilities and costs, already elevated, will continue to grow without stronger contributions

## Rating outlook

The stable outlook reflects our expectation that economic growth will continue to provide additional revenue to support the growing pension liabilities and contribution requirements, and that the city's strong management team will continue to make timely budgetary adjustments, as necessary, to preserve financial flexibility.

## Factors that could lead to an upgrade

» Sustained tax base growth and improved socioeconomic measures

» Material decrease in pension liabilities and reduced budgetary pressure from growing contribution requirements

» Reserves that grow to levels held by similar Arizona cities with high exposure to potentially volatile revenue sources, or reduced reliance on those revenue sources

## Factors that could lead to a downgrade

» Economic contraction resulting in significant revenue declines and inability to bring about fiscal balance

» Demonstrated unwillingness to make budgetary adjustments as necessary to maintain reserves

» Additional growth in pension liabilities and costs, which are already somewhat elevated

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## Key indicators

Exhibit 2

| Mesa (City of) AZ | 2014 | 2015 | 2016 | 2017 | 2018 |
|---|---|---|---|---|---|
| Economy/Tax Base | | | | | |
| Total Full Value ($000) | $20,977,492 | $22,538,782 | $27,641,432 | $31,023,572 | $33,281,283 |
| Population | 452,091 | 458,860 | 470,456 | 479,317 | 501,137 |
| Full Value Per Capita | $46,401 | $49,119 | $58,755 | $64,725 | $66,412 |
| Median Family Income (% of US Median) | 89.2% | 90.0% | 89.0% | 88.9% | 88.9% |
| Finances | | | | | |
| Operating Revenue ($000) | $584,122 | $593,450 | $637,964 | $661,072 | $680,736 |
| Fund Balance ($000) | $229,795 | $233,373 | $171,936 | $196,024 | $208,904 |
| Cash Balance ($000) | $270,183 | $342,244 | $273,109 | $292,066 | $319,126 |
| Fund Balance as a % of Revenues | 39.3% | 39.3% | 27.0% | 29.7% | 30.7% |
| Cash Balance as a % of Revenues | 46.3% | 57.7% | 42.8% | 44.2% | 46.9% |
| Debt/Pensions | | | | | |
| Net Direct Debt ($000) | $539,728 | $529,114 | $465,245 | $480,262 | $472,193 |
| 3-Year Average of Moody's ANPL ($000) | N/A | $1,227,281 | $1,283,713 | $1,402,877 | $1,549,809 |
| Net Direct Debt / Full Value (%) | 2.6% | 2.3% | 1.7% | 1.5% | 1.4% |
| Net Direct Debt / Operating Revenues (x) | 0.9x | 0.9x | 0.7x | 0.7x | 0.7x |
| Moody's - adjusted Net Pension Liability (3-yr average) to Full Value (%) | N/A | 5.4% | 4.6% | 4.5% | 4.7% |
| Moody's - adjusted Net Pension Liability (3-yr average) to Revenues (x) | N/A | 2.1x | 2.0x | 2.1x | 2.3x |

*Source: Moody's Investors Service*

## Profile

Mesa, Arizona is a large, full-service city covering 133 square-miles in southeast Maricopa County (Aaa stable), with a 2018 population estimated at 501,137. The city operates under a charter form of government, with a mayor and six city councilmembers who appoint a city manager, who is responsible for appointing department heads and carrying out the administration of the city.

## Detailed credit considerations

### Economy and tax base: large, diverse tax base east of Phoenix; strong growth trends continue

Mesa's tax base and local economy continue to grow nearly a decade after the last recession, and diverse economic drivers including health care, tourism, construction, and manufacturing growth will support sustained improvement over the next few years. The city's investment in transit, transit-oriented development, and higher education will provide further gains in the local economic base, and may increase Mesa's socioeconomic metrics, which lag national medians.

Full value will continue to grow as new construction and increasing property values drive sustainable growth. At $40.3 billion in fiscal 2020, the city's estimated net full cash value (our proxy for full value) remains large compared to peers, and exceeds the pre-recession peak (2009) for the first time. Full value per capita is notably below the median for peer cities nationally at $80,469 (using 2020 FV). Resident income levels are also relatively weak, with median family income that is 89% of the national measure as of 2017 American Community Survey data; per capita income is similarly low at 85% of the national measure. Median household income is slightly better compared to the national measure at 91%, using 2016 American Community Survey data.

Mesa's economy will benefit from numerous and varied economic projects, driven in part by city investment in infrastructure. The city's access to multiple freeways and overall low cost of doing business will attract continued commercial interest while the light rail extension further into downtown Mesa, which will open to public service in the next few months, will help support the proposed Arizona State University (ASU, Aa2 stable) expansion into the downtown. Additionally, the city has supported the development of a campus of Benedictine University in downtown Mesa, which now enrolls 500 students.

Eastern Mesa's available land and the city's overall low cost of doing business will promote strong growth in residential construction and sales, particularly in the Eastmark community. In addition, the city continues to expand its already notable presence in the aerospace manufacturing and health care device sectors. Additionally, the city has been working with private partners to create SkyBridge Arizona, which is the first international air cargo hub in the United State to house both US and Mexican customs, to ease international trade. The expected impacts on the $230 million, 360-acre commercial development include warehouse space, office space, cargo operations, a 242-bed hotel, and retail and restaurants.

### Financial operations and reserves: stable financial operations; reserves healthy but remain below national and state averages

Mesa's financial operations are stable and largely healthy, despite the heavy reliance on sales tax revenues and transfers from the city's combined enterprise (Aa2 stable), which is a longstanding practice. However, the city will be challenged to offset increasing pension costs and increasing service demands from a growing resident population given Mesa's primary operating revenues are primarily derived from economically sensitive sources and other revenues with somewhat limited flexibility.

Reserves will continue to be sufficient, if somewhat below national averages. Reserves grew in fiscal 2018 to $208.9 million, or 30.7% of revenues in the city's operating funds, which we define as the General, Internal Service, Environmental Compliance, Grants and Special Programs, Highway User Revenue, Quality of Life Sales Tax, Street Sales Tax, and Debt Service funds. This is somewhat below higher reserves in fiscal 2015, however the city paid off $77.8 million in Highway Project Advancement Notes in fiscal 2016, accounting for the decline.

In the General Fund alone, reserves will continue to grow modestly, which is positive for the city's overall stability. Available fund balance in fiscal 2018 is $128 million, or 30% of revenues (including transfers). While this is below similarly rated cities in the state and nationally, this level of reserves has improved from a recent low in 2013, when reserves were $51.6 million or 15.6% of revenues.

Operating funds revenues will continue to be derived primarily from state-shared revenues (28% of revenues in 2018), sales taxes (25%), and transfers in (12%) with smaller contributions from charges for services and fines (10%) and property taxes (5%). This composition has not varied significantly from previous years. Of those revenue sources, sales taxes are particularly sensitive to economic conditions, and a portion of state shared revenues are also derived from statewide sales taxes, which can be similarly volatile.

Transfers from the city's enterprises will remain a substantial component of revenues, at $81.5 million in fiscal 2018 (12% of operating funds revenues). The city does not levy a property tax for general operations, and the utility transfers help to reduce overall revenue volatility somewhat. The city's policy is to increase the size of the transfers predictably, though the size of the transfers has exceeded the rate of inflation in the past. Positively, the city maintains the ability to adjust utility rates without regulatory oversight, providing a measure of flexibility in this revenue source. Relative to a property tax for operations, however, the utility transfers are a credit weakness due the potential for volatility in enterprise operations and that the transfers are dependent on the utility having sufficient revenue for operations, debt service and capital reinvestment. Considering the decades-long history of stable transfers, the credit weakness is a relatively minor one in the city's overall profile.

Expenditures are primarily for public safety (40%), general government (14%), community environment (8%) and recreation and culture (7%). Cost pressures in the form of increased contribution requirements for the Public Safety Personnel Retirement System (PSPRS) are expected to continue. City management expects to meet increased contribution requirements through the use of reserves or the reduction of other expenses. An increase to the city's sales tax rate of 0.25% was approved by the city's voters in November 2018, which will be positive for public safety funding.

We note that the city has historically outperformed budgeted expectations and strong, stable management contributes to overall stability in the city's financial operations. Increased revenues from sales taxes and state shared revenues are expected to continue as long as the local economy remains healthy, and the city has a demonstrated history of reducing expenditures mid-year and across fiscal years when the economy contracts and economically sensitive revenues decline.

#### LIQUIDITY

Net cash is healthy and is strong compared to national peers across the operating funds. In the General Fund alone, net cash is $120.3 million, or 28% of revenues. Across the operating funds, net cash is stronger at $319 million, or a very healthy 47% of operating revenues.

### Debt and pensions: debt manageable; pension burden high and growing; OPEBs liabilities also very high

Debt liabilities are declining for the city's general credit, as previous debt for investments in infrastructure and economic development projects are paid. With total general government debt of $542 million, debt represents a low 1.4% of 2020 full value, and a modest 0.8-times 2018 operating revenues. General obligation debt is expected to total approximately $399 million after a small $33 million new sale in May 2019.

In additional to GO debt, the city has $76.6 million in Highway User Revenue Bonds outstanding, which are secured by various vehicle-related taxes distributed by the state, and an additional $66 million in excise tax obligations. Additionally, the city's combined enterprise debt is elevated, at $1.3 billion in May 2018, though the enterprise is remarkably strong despite the leverage with strong coverage and growing liquidity.

City voters approved $196 million in GO bonds in November 2018; $111 million for parks and culture, and $85 million for public safety. After the upcoming 2019 bond issuance, the city will have approximately $240.7 million in additional authorized but unissued GO bonds, with the purpose distributed between library, parks and recreation ($103 million), public safety ($83 million), streets ($20 million), and small amounts (less than $10 million each) for other purposes.

#### DEBT STRUCTURE

All of Mesa's debt is fixed rate. Debt service on the city's GO debt is highest in fiscal 2020 at $49 million, before declining to between $32 million and $33 million from 2020 to 2029, with further declines in debt service until final maturity in 2039.

#### DEBT-RELATED DERIVATIVES

The city is not a party to any debt-related derivatives.

#### PENSIONS AND OPEB

Mesa's pension liabilities will continue to increase, and the city has focused more on contribution flexibility instead of faster reduction in their liability. This has led to growing liabilities, which will lead to higher total contributions over the medium- to long-term. In fiscal 2018, the city made payouts to retirees due to the resolution of prior lawsuits, and was allowed to count the payouts as part of their contributions to PSPRS (the public safety system). This reduced their contributions to PSPRS by approximately $11 million, representing 26% of their Actuarially Determined Contribution (ADC) to PSPRS.

Additionally, in June 2017, the city extended the amortization of their PSPRS liabilities to 30 years. The extended amortization will reduce annual contribution requirements to PSPRS plans (compared to a shorter amortization schedule), but will extend the time it takes for the city to fully fund the unfunded liability of the system. The city reports that it will be contributing to PSPRS on a 25-year amortization schedule, under a Council-approved policy, and will also be holding in reserve the additional funds the city would have contributed if it was using the 20-year amortization schedule. Those reserves are expected to be used only for pension contributions in future years, if contribution requirements rise suddenly in the future.

Mesa's pension burden is elevated, and Adjusted Net Pension Liabilities (ANPL) were $1.7 billion in fiscal 2018, net of enterprise support. Positively, this was essentially flat from the prior year. The growth has been driven in large part from growing ANPL from the city's participation in the Public Safety Retirement System (PSPRS), which grew 4% year-over-year to $1.2 billion in fiscal 2018 alone, one of the slowest years of liability growth. ANPL attributed to the Arizona State Retirement System (ASRS), a multi-agent employer plan, has generally grown slower than the PSPRS liability, and actually shrank 8% in fiscal 2018 to $469 million.

Three-year average of ANPL is $1.6 billion, or an elevated 2.3-times 2018 operating revenues and an elevated 3.8% of 2020 full value. Moody's ANPL reflects certain adjustments we make to improve comparability of reported pension liabilities. The adjustments are not intended to replace the city's reported liability information, but to improve comparability with other rated entities.

Mesa's pension contributions were below their "tread water" requirement in fiscal 2017, the most recent year for which complete data is available, with a tread-water gap of 2.5% as a percent of revenues. This indicator measures the annual government contribution required to prevent the reported net pension liability from growing, under reported assumptions. Contributions above this level cover all net pension liability interest plus the pay down of some principal; this is stronger from a credit perspective compared to contributions below this level, which indicates the city is not making contributions large enough to reduce their net liabilities even under reported plan assumptions. A long-term tread-water gap may indicate structural imbalance, with growing liabilities not offset by growing assets.

Additionally, Mesa's finances will be further strained by high liabilities and growing contribution requirements associated with their Other Post-Employment Obligation (OPEB) plan. The city had OPEB liabilities of $650.2 million (under Moody's adjustments), and made an issuer contribution of $22 million, or 3% of operating revenues. This has increased 40% since fiscal 2012, and the city has no assets for the OPEB as it is a pay-go plan. Positively, the city has more legal options to close or end their OPEB plan than they do for their pension plans.

### Management and governance: Strong institutional framework

Arizona Cities have an Institutional Framework score of Aa, which is high. Institutional Framework scores measure a sector's legal ability to increase revenues and decrease expenditures. Typically, cities have an above average reliance on economically sensitive revenues, comprised of local sales and state-shared taxes, and only a small number of cities have the legal ability to adjust these taxes. Cities do have the ability to increase operating property tax revenues by 2% annually per statute. Unpredictable revenue fluctuations tend to be moderate, or between 5-10% annually. Across the sector, fixed and mandated costs are generally greater than 25% of expenditures. Arizona is a Right to Work state, providing significant expenditure-cutting ability. Unpredictable expenditure fluctuations tend to be minor, under 5% annually.

Mesa operates under a charter form of government, with a mayor elected at-large and six city councilmembers elected by geographic district. The mayor and city council set policy and appoint the City Manager, who is responsible for the appointment of department heads and oversees all operations of the city.

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