S&P Global Ratings

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Summary:

Mesa, Arizona; General Obligation

Primary Credit Analyst:
Alyssa B Farrell, Centennial (1) 303-721-4184; alyssa.farrell@spglobal.com

Secondary Contact:
James M Breeding, Dallas (1) 214-871-1407; james.breeding@spglobal.com

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Credit Profile		
US$33.065 mil GO bnds ser 2019 dtd 05/23/2019 due 07/01/2039		
Long Term Rating	AA/Stable	New
Mesa GO		
Unenhanced Rating	AA(SPUR)/Stable	Upgraded

Rationale

S&P Global Ratings raised its long-term rating and underlying rating (SPUR) to 'AA' from 'AA-' on Mesa, Ariz.'s existing general obligation (GO) bonds. At the same time, S&P Global Ratings assigned its 'AA' long-term rating to the city's series 2019 GO bonds. The outlook is stable.

The raised ratings reflect our view of the city's strong tax base growth over the last five years, driven by ongoing development and steady economic recovery. While wealth and income indicators trail behind those of peers within the country and have not fully rebounded, significant economic development in the pipeline will likely contribute to continued strong property value growth in the near term. The city's stable financial profile, as evidenced by consistent operating surpluses over the last five years and maintenance of a very strong fund balance position, supports our view of the city's creditworthiness, reinforced by what we consider very strong financial management policies and practices. While we note that rising long-term liabilities could result in some budgetary pressure in the medium term, the city has begun adjusting its budgets and building up reserves to help absorb the costs. Overall, we anticipate these credit factors will remain consistent for the foreseeable future.

Security and purpose

Unlimited ad valorem taxes, levied on taxable property in the city, secure the GO bonds. The series 2019 bonds will be issued in a par amount of approximately $33.1 million, and proceeds will finance the acquisition and construction of certain public safety, parks and recreation, and streets improvements.

Credit fundamentals

The ratings reflect our view of the city's:

- Adequate 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 27% of operating expenditures;
- Very strong liquidity, with total government available cash at 78.8% of total governmental fund expenditures and

8.6x governmental debt service, and access to external liquidity we consider exceptional;

- Very weak debt and contingent liability position, with debt service carrying charges at 9.2% of expenditures and net direct debt at 97.6% of total governmental fund revenue, a large pension and other postemployment benefit (OPEB) obligation and the lack of a plan to sufficiently address it, and low overall net debt at less than 3% of market value; and
- Strong institutional framework score.

Adequate economy

We consider Mesa's economy adequate. The city, with an estimated population of 488,925, is located in Maricopa County about 16 miles east of downtown Phoenix and participates in the Phoenix-Mesa-Scottsdale, Ariz., MSA, which we consider to be broad and diverse. Major local employers within Mesa include Banner Health Systems, Mesa Public Schools, Boeing Co., the city of Mesa, and several retailers. The city has a projected per capita effective buying income of 87.4% of the national level and per capita market value of $77,475. The county unemployment rate was 4.2% in 2017.

Over the last five years, the city has demonstrated strong market value growth as the tax base has steadily recovered from the recession. Most recently, the city's market value grew by 9.1% over the past year to $37.9 billion in 2019, which we note is about 97% of the prerecession peak. Net limited assessed value (AV) has followed a similar trend, growing by about 28% between 2014 and 2019 to $3.3 billion in 2019. The city's tax base deteriorated substantially during the recession, with the formerly used secondary AV declining by a cumulative 47% between 2009 and 2014. Although the recent growth has been strong, the city's property values have not yet recovered to the prerecession peak--but we note that the state's change to the net limited AV in 2016 may dampen the subsequent values slightly. This statewide change limited annual growth in taxable AV, which we believe will contribute to greater tax base stability by moderating the effect on taxable value of rapid boom-and-bust cycles. We understand that there is significant development ongoing within the city, including the expansion of the Light Rail east of downtown, which has encouraged new development and business growth.

Very strong management

We view the city's management as very strong, with strong financial policies and practices under our FMA methodology, indicating financial practices are strong, well embedded, and likely sustainable.

Highlights of key financial management policies and practices include the city's conservative budget forecasts based on historical trend analysis and the maintenance of a formal five-year financial projection. The city also maintains an annually updated five-year capital improvement plan, which includes cost estimates and funding sources for projects. The governing body reviews budget statements monthly, with quarterly budget-to-actual updates. The city has adopted basic debt management policies and a detailed investment management policy, and investment performance is reported to the city council at least quarterly. In addition, the city adheres to its formal reserve policy requiring an unrestricted fund balance of at least 8%-10% of operating expenditures for cash flow purposes. In fiscal 2018, the city adopted additional reserve requirements for its pension reserve and economic correction stabilization reserve, both of which are included in the general fund.

Strong budgetary performance

Mesa's budgetary performance is strong, in our opinion. The city had operating surpluses of 3.6% of expenditures in the general fund and of 7.7% across all governmental funds in fiscal 2018. The city's general fund operating results have been stable over the last three years, at 4.4% in 2017 and 4.3% in 2016.

Our calculation for budgetary performance reflects adjustments for capital outlay funded by bond proceeds, recurring transfers considered ongoing revenues and expenditures, and the inclusion of the city's quality of life fund, which receives revenues from voter-approved sales taxes, and funds about 120 police officers and 65 firefighters annually. The city has historically funded its public safety expenses from utility rate increases regularly transferred to the general fund from the enterprise fund. In fiscal 2017, these transfers totaled about $110.4 million.

Mesa relies heavily on sales and other cyclical tax revenues, which can be volatile, in our opinion; however, we believe the city's very strong reserves and financial management practices mitigate the risk that volatility will result in significant budgetary pressure. The city's sales taxes and state-shared revenues have shown strong growth over the last five fiscal years, and management projects continued growth in the near term. For fiscal 2019, the city has budgeted for a general fund deficit of about 9.1% of expenditures, which includes several one-time projects and set-asides. However, management anticipates ending the year better than budgeted, as it has historically.

Very strong budgetary flexibility

Mesa's budgetary flexibility is very strong, in our view, with an available fund balance in fiscal 2018 of 27% of operating expenditures, or $119.7 million.

Inclusive of the city's quality of life fund, the city has maintained a very strong available fund balance position in excess of 20% of expenditures over the last several years. The city's available general fund reserve includes recently established set-asides for pension contributions and economic correction to offset rising pension costs and to insulate the city from potential economic slowdown. Management indicated that, while the current multiyear forecasts conservatively project drawdowns on reserves, it expects prudent management of expenditures to minimize the use of the reserves, with no established plans to diminish the available fund balance in the near term. While the city's charter limits the ability to raise sales tax revenues without voter approval, we note that the electorate has approved such increases in the past, including a 0.25% sales tax increase in 2018 for public safety purposes, and we do not believe this significantly hinders the city's financial flexibility.

Very strong liquidity

In our opinion, Mesa's liquidity is very strong, with total government available cash at 78.8% of total governmental fund expenditures and 8.6x governmental debt service in 2018. In our view, the city has exceptional access to external liquidity if necessary.

The city's nearly annual GO bond and utility revenue bond issuances over the last 15 years reinforce our view of its strong access to external liquidity, and we have no reason to believe that its access to markets will diminish. In addition, Arizona statutes permit cities to invest public funds in ways we consider permissive and potentially risky. The city reports nearly $58 million (13%) of its portfolio is invested in corporate debt that we rate 'A' or better. The vast majority of the remaining portfolio balance is invested in U.S. securities, and we do not consider the portfolio to pose a liquidity risk. Finally, we have confirmed that the city does not have any direct purchase or variable-rate debt outstanding.

Very weak debt and contingent liability profile

In our view, Mesa's debt and contingent liability profile is very weak. Total governmental fund debt service is 9.2% of total governmental fund expenditures, and net direct debt is 97.6% of total governmental fund revenue. Overall net debt is low at 2.3% of market value, which we view as a positive credit factor. Inclusive of the current issuance, the city's direct debt totals $505 million, including $28.8 million in special assessment debt paid for by the community facility districts within the city. We understand that the city intends to issue $155 million in additional GO bonds over the next three years, with installments ranging from $45 million to $55 million annually.

In our opinion, a credit weakness is Mesa's large pension and OPEB obligation, without a plan in place that we think will sufficiently address the obligation, although the city has begun taking steps to offset the budgetary impact. Mesa's combined required pension and actual OPEB contributions totaled 10.6% of total governmental fund expenditures in 2018. The funded ratio of the largest pension plan (the Arizona State Retirement System, or ASRS) is 73.4%. The city contributes to ASRS, the Elected Officials Retirement Plan, and the Public Safety Personnel Retirement System (PSPRS) and had consistently funded its annual required contributions. However, the city made 82% of its annual required pension contribution in 2018, as it received a credit from PSPRS for the one-time refund made by the city to employees for excess member contributions as a result of a recent lawsuit settlement.

Public safety employees participate in the PSPRS, which is an agent multiple-employer statewide retirement system. The plan fiduciary net position as a percentage of total pension liability as of June 30, 2018, was 48.4% for fire and 45.6% for police. The city's net pension liability is $193.9 million for the fire plan and $377.9 million for police. In light of the low funded ratio for the police plan, we expect the city's contributions will increase in future years, which could result in some budgetary pressure in the medium term.

We understand the city is actively adjusting its budget to account for rising costs and has incorporated its expected increases in pension contributions into its financial forecasts. We also understand that the city has opted to extend amortization rates to 30 from 20 years, as offered by the pension plan. Despite the extension in the amortization, city officials note it is the city's intention to budget for and make higher payments toward the plan in coming years to pay down the liability in 25 years. Additionally, as of fiscal 2018, the city has adopted a formal policy of funding a $10 million pension reserve over the next four years to help mitigate future rate increases, which will help the city adjust to higher pension carrying charges but not be considered an actuarial asset. The city set aside $4 million in fiscal 2018 and plans to set aside an additional $2 million annually for the next three years to meet the $10 million. However, management indicated that the $2 million contribution has been budgeted in perpetuity and could continue in the long term for additional flexibility.

As of a July 1, 2017 valuation date, the unfunded actuarial accrued OPEB liability was $705.7 million. Although we recognize this is a large liability, we believe the city's general fund budget has the flexibility to absorb the OPEB pay-as-you-go costs in the medium term. From 2001 to 2006, the city increased its requirements for workers to receive OPEBs twice: Mesa increased its minimum years of service to 15 from 10 years before raising it again to 20 years. In fiscal 2009, the city stopped offering OPEBs for new hires altogether.

Strong institutional framework

The institutional framework score for all Arizona municipalities with a single audit requirement is strong.

Outlook

The stable outlook reflects our view of the strong economic activity within the tax base, which has improved property tax values to levels closer to the prerecessionary values and driven consistent revenue growth. The outlook further reflects our expectation that the city's stable budgetary performance and strong budgetary flexibility will continue in the near term, supported by what we consider very strong management. We do not expect to change the ratings within the two-year outlook horizon.

Upside scenario

Additional rating improvement is dependent upon continued growth in the economic indicators to levels commensurate with those of higher-rated peers, and a moderation in the debt levels, particularly in regards to its large pension liability.

Downside scenario

We could lower the ratings if the city experiences sustained operational imbalance, resulting in a deterioration in budgetary flexibility and budgetary performance to levels that we consider below those of similarly rated peers.

Related Research

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

Ratings Detail (As Of April 18, 2019)		
Mesa GO bnds		
Long Term Rating	AA/Stable	Upgraded
Mesa GO (AGM)		
Unenhanced Rating	AA(SPUR)/Stable	Upgraded
Mesa GO		
Unenhanced Rating	AA(SPUR)/Stable	Upgraded

Many issues are enhanced by bond insurance.