S&P Global Ratings

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Summary:

Arizona Public School Credit Enhancement Program; State Revolving Funds/Pools

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Credit Profile		
US$0.0 mil issuer credit rating due 06/01/2099		
Long Term Rating	AA-/Stable	New

Rationale

S&P Global Ratings has assigned its 'AA-' issuer credit rating (ICR), and stable outlook, to the Arizona Public School Credit Enhancement Program. This allows for a 'AA-' rating to be applied to eligible public schools or charter schools that are approved and accepted into the program. The 'AA-' ICR is based on the combination of our assessment to the program's enterprise and financial risks. Key credit features include:

- Establishment of the program by state statute,
- A limit to the amount of bonds that can be guaranteed,
- A formal application process to determine participant eligibility,
- A formal process that outlines disbursements in the event of a potential debt service deficiency, and
- Projected sufficient overcollateralization to provide rating stability.

The enhancement program was created in 2016 to provide eligible schools with access to a lower cost of borrowing. The guarantee will be supported by deposits to the Arizona Public Schools Enhancement Fund. This will initially be funded via an $80 million program funding obligation issued by the Credit Enhancement Eligibility Board, coupled with a required investment of $23.9 million deposit to the fund. This includes $3.9 million in the fund's expense account. This fund will provide support to bonds issued by eligible schools within the state. Currently, there are no bonds guaranteed by the program, but issues from two eligible schools have been approved. Ultimately, qualified financings will originate from schools, of which at least 75% are rated 'BB-' or higher. Parameters of the program limit the principal amount of bonds guaranteed to an ultimate leverage ratio of 3.5 to 1.

In order to participate in the program, a school must meet the requirements to be an Achievement District School, which are detailed in A.R.S 15-2141(B), and complete an application as outlined in Title 7 of the Arizona Administrative Register. If a participating school does not expect to make a required principal or interest payment when due, and if money available in the debt service reserve associated with that issue are fully expended, the newly created Credit Enhancement Eligibility Board shall be notified at least five days prior to that pending debt service due date. Upon being notified, the board shall notify the State Treasurer, who will forward sufficient funds within two business days.

The very strong enterprise risk profile reflects the nature of the credit enhancement program being established by state statutes. In addition, the authorizing statutes require that the board of the program establish various criteria for program eligibility.

The strong financial risk profile reflects our expectation that at any given time there will be no more than 3.5x of outstanding guaranteed principal compared to the amount of investments held in the enhancement fund. We also expect that over time the balance of the enhancement fund will be drawn down to keep this ratio of qualified bonds to enhancement fund balance intact. If the enhancement fund needs to be used to pay any scheduled principal or interest payments, the state treasurer is precluded from transferring distributions out of the enhancement fund until the ratio indicated above is projected to remain no higher than 3.5 to 1. The state treasurer has also the right to intercept any state aid due to a qualified school in order to make payments on any guaranteed bonds.

Supporting the financial risk profile are various policies and guidelines, the framework for which has been established by Arizona Revised Statutes that authorized the enhancement program. These include the following:

- Formal eligibility criteria that include financial planning, enrollment demand metrics, and academic outcomes;
- A statutory mechanism that addresses the payment of guaranteed bond debt service if there are payment delays or defaults by the underlying schools;
- A requirement that if the state treasurer needs to make a payment from the enhancement fund, the school causing this must repay the draw within 12 months; and
- Investments of the enhancement fund that are limited by state statute.

Outlook

The stable outlook on the rating is based on our expectation that the board will manage the enhancement fund balance in a fashion that maintains or outperforms the leverage 3.5 to 1 ratio. We base this expectation on the fact that the maintenance of that ratio is established in state statute and not discretionary. If actual defaults on guaranteed financings occur, we would expect that for the most part transfers out to the state would be precluded due to the requirement to maintain the minimum leverage ratio. Rating stability is also predicated on the assumption that there will be a ramp-up of demand for the program that increases the number of participating schools. Should there be an increase in leverage, while the number of participating schools remains below 10, the rating will likely be adjusted to reflect a modified weak-link approach that is more dependent on specific school credit quality.

Downward scenario

If there are future statutory changes that increase the leverage ratio, this could cause significant downward pressure on the rating. We would also consider a lower rating if, due to the weighted average rating of the guaranteed bonds not being high enough, the program is not able to withstand a level of defaults consistent with the current rating.

Upward scenario

As the program ramps up, we would not foresee raising the rating, at least within the two-year outlook horizon. Once the program has matured, there is upside potential should there be a period of sustainably strong program performance.

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria.

Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com. All ratings affected by this rating action can be found on the S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.