Fitch Rates California Infrastructure & Econ Dev Bank's 2020A ISRF Bonds 'AAA'; Outlook Stable

Fitch Ratings - San Francisco - 24 Nov 2020: Fitch Ratings has assigned a 'AAA' rating to the following bonds issued by the California Infrastructure & Economic Development Bank (IBank) under its 2014 master indenture (MI):

--Approximately $325.1 million Infrastructure State Revolving Fund (ISRF) revenue bonds, series 2020A.

The bonds are expected to price via negotiation the week of Nov. 30. Bond proceeds will be used to advance refund and establish an escrow to defease all or a portion of the ISRF revenue bonds under the 2014 MI, and to pay costs of issuance.

Additionally, Fitch has affirmed its 'AAA' rating on the following outstanding bonds:

--Approximately $270.5 million ISRF revenue bonds under the 2014 MI.

The Rating Outlook is Stable.

SECURITY

The bonds are secured by pledged loan repayments, account interest earnings, and other pledged funds.

KEY RATING DRIVERS

Sufficient Financial Structure: Fitch's cash flow modeling demonstrates that the ISRF program can continue to pay bond debt service even with loan defaults in excess of Fitch's 'AAA' liability rating stress hurdle, as produced using Fitch's Portfolio Stress Model (PSM).

Favorable Pool Diversity: The largest currently pledged borrower, the Fresno Airport, represents a manageable 8% of the pool. The largest-10 borrowers represent approximately 44% of the total pool. These measures compare favorably to Fitch's medians of 17% and 54% for single-borrower and top-10 concentration, respectively, although the loan pool is smaller and includes a higher percentage of non water or sewer pledge loans than other rated portfolios.

Adequate Pool Credit Quality: Approximately 44% of the loan portfolio is investment-grade or better. This is lower than Fitch's 74% median and attributable to the lack of a public rating for many of the
pool obligors.

Sound Program Management: Program management adheres to a formal underwriting policy which includes, among other things, minimum coverage requirements for most borrowers. To date, there have been no pledged loan payment defaults in the ISRF program.

RATING SENSITIVITIES

Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade

--Not applicable given the 'AAA' rating.

Factors that Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade

--Significant deterioration in ISRF's aggregate borrower credit quality, increased pool concentration or increased bond leveraging, resulting in the program's inability to pass Fitch's 'AAA' liability rating stress hurdle;

--Deterioration of performance of loans with higher susceptibility to economic downturns, such as airports and other borrowers not related to water and sewer utilities.

Best/Worst Case Rating Scenario

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit [https://www.fitchratings.com/site/re/10111579].

CREDIT PROFILE

IBank created the ISRF program in 1999 to provide low-cost loans for various categories of public infrastructure projects throughout the state. The series 2020A bonds are the fourth series to be issued under the 2014 MI. The 2014 MI is considered 'open' in the sense that all assets are pledged to all bonds rather than certain assets pledged only to certain series of bonds, such as a 'closed' indenture. In connection with the issuance of the Series 2020A bonds, IBank is seeking to amend certain provisions of the 2014 MI. The amendments will become effective when all the 2014 Bonds, 2015 Bonds and 2016 Bonds are defeased, which may be on or after the date of issuance of the Series 2020A Bonds.
Since its inception, the loan pool has diversified. However, due to the somewhat small albeit increasing pool size, both credit quality and concentration are somewhat volatile. A relatively high percentage of loans (24%) for purposes that are not related to water/sewer systems or tax-supported is reflected in the pool's weaker credit metrics.

FINANCIAL STRUCTURE EXHIBITS SUFFICIENT DEFAULT TOLERANCE

Fitch measures financial strength of municipal loan pools by calculating the program asset strength ratio (PASR). The PASR includes total scheduled pledged loan repayments and other pledged funds divided by total scheduled bond debt service. The ISRF's PASR is 1.8x, which is lower than Fitch's 'AAA' rating category median of 1.9x and therefore indicative of a somewhat below-average yet sufficient financial structure.

Due to the sufficiency of the financial structure, cash flow modeling demonstrates that the program can continue to pay bond debt service even with hypothetical loan defaults of 83% in the initial four-year period and 100% over the middle and prior four-year period. Per Fitch criteria, a 90% recovery is also applied in its cash flow model when determining default tolerance. This level is in excess of Fitch's 'AAA' liability rating stress hurdle of 65%, as produced by the PSM. The rating stress hurdle is calculated based on overall pool credit quality as measured by the rating of underlying borrowers, size, loan term and concentration.

LOSS PROTECTION PROVIDED BY OVERCOLLATERALIZATION

The ISRF program bondholders are protected from losses by pledged loans made in excess of bond debt service (overcollateralization) and other pledged funds. At about 1.3x, minimum annual loan-to-bond debt service coverage is lower than Fitch's 'AAA' median of 1.6x, but is still considered sound. The 2014 MI does not establish a reserve requirement, but includes a supplemental revenue fund that requires 1.2x annual debt service coverage, equal to the additional bonds test, before surplus amounts can be released to the program's unpledged assets account. At closing, the 2014 trust estate will include funds from the revenue fund ($32.6 million), and restricted equity fund ($41.6 million). IBank plans to lend $61.3 million of these current balances to loans that they intend to originate by Dec. 31, 2021. The debt service reserve fund for the 2014 bonds, 2015 bonds and 2016 bonds will move to the restricted asset account upon the defeasance of each series. These funds are not accounted for in Fitch's cash flow model, thereby understating the assets available to support the bonds.

FAVORABLE POOL DIVERSITY AND ADEQUATE QUALITY

The current ISRF loan pool is composed of 87 obligors, which is smaller than the 'AAA' median of 227 borrowers. In aggregate, the top-10 obligors represent approximately 44% of the total, besting Fitch's 'AAA' median level of 56%. At 8%, the largest expected obligor is the Fresno Airport (revenue bonds rated 'BBB+'). CARES Act funds are expected to be allocated to the airport as a fiscal-2021 reimbursement for payroll costs, utilities and other operating expenses. The next two largest obligors are the cities of Santa Cruz and San Diego, representing 5.6% and 5.3% of the pool, respectively.

Given the large portion of unrated pool obligors, the resulting 'AAA' liability rating stress hurdle is
elevated at 65%, versus a 'AAA' median of nearly 31%, as higher stress hurdles correlate to lower credit quality. The majority of the pool, approximately 76%, is backed by water/sewer revenue, lease or tax revenue, or a combination of tax and utility revenue, all of which are considered to be among the strongest pledge types by Fitch. However, the remainder of the portfolio is primarily composed of obligors backed by airport revenues (14%) or other revenues (10%), which Fitch considers to have a higher risk profile.

SOUND PROGRAM MANAGEMENT AND UNDERWRITING

The ISRF program is separate from the state's other state revolving fund programs, including the Clean Water and Drinking Water. Pursuant to loan agreements, underwriting criteria generally include covenants requiring each borrower to collect tax revenues or charge sufficient enterprise rates to meet all debt service requirements. Rate charges may also include a minimum coverage requirement. Additionally, some borrowers may be required to hold local reserves.

To date, there have been no loan payment defaults from ISRF program borrowers. However, two credits in the ISRF program have declared bankruptcy, including the city of San Bernardino in August 2012 and the Los Osos Community Service District in August 2006. While there is currently program exposure to San Bernardino, Fitch does not expect it to negatively affect the program’s performance.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

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• California Infrastructure & Economic Development Bank (CA) /Infrastructure State LT Revenues - 2014 Master Indenture/ 1 LT

RATINGS KEY  OUTLOOK  WATCH

POSITIVE  ☀  ❯
NEGATIVE  ☯  ❯
Evolving  ☯  ◆
RATINGS KEY  OUTLOOK  WATCH

STABLE

Applicable Criteria

Public Sector, Revenue-Supported Entities Rating Criteria (pub.27 Mar 2020) (including rating assumption sensitivity)

U.S. Public Finance State Revolving Fund and Municipal Finance Pool Program Rating Criteria (pub.18 Sep 2019) (including rating assumption sensitivity)

Applicable Models

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Portfolio Stress Model, v1.10.2 (1)

State Revolving Fund Cash Flow Model, v1.18.1 (1)

Additional Disclosures

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