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Ratings

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Summary:

Santa Margarita Water District, California; General Obligation

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Credit Profile		
US$29.06 mil GO rfdg bnds (Improvement District No. 2,3 And 4) ser 2017A due 08/01/2038		
Long Term Rating	AA+/Stable	New
Santa Margarita-Dana Point Auth, California		
Santa Margarita Wtr Dist, California		
Santa Margarita-Dana Point Auth (Santa Margarita Wtr Dist) wtr rev bnds		
Long Term Rating	AA+/Stable	Upgraded

Rationale

S&P Global Ratings raised its long-term rating to 'AA+' from 'AA' on Santa Margarita-Dana Point, Calif.'s existing series 2009A revenue bonds, issued as general obligation (GO) bonds, for the Santa Margarita Water District (SMWD). At the same time, S&P Global Ratings assigned its 'AA+' rating to the district's series 2017A GO refunding bonds. The outlook is stable.

The raised rating reflects our view of each of the pledged underlying improvement district's (IDs) affluent tax bases, significant taxable assessed value (AV) growth, improved delinquency rates, and diversified taxpayer bases.

The bonds are special revenue obligations of the Santa Margarita/Dana Point Authority, payable from local obligations of the SMWD. The local obligations are secured by an unlimited ad valorem assessment levied on land AV within SMWD's ID Nos. 2, 3, and 4. Additional security for the payment of the bonds is provided by a lien on standby charges and each IDs share of property taxes received by the county. We understand that the proceeds from the sale of the 2017A bonds will be used to refund the district's series 2009A bonds.

While the security on the bonds includes a mixture of IDs Nos. 2, 3, and 4 revenues, we view ID 4 as the weak link of the participating districts. Nevertheless, the districts overall have many strengths, in our view, including:

- Their location within the broad and diverse Orange County economy;
- Wealthy tax bases and very strong income levels, which provide stability and flexibility if the district needs to raise its assessment levy;
- Sufficient treatment capacity for both water and wastewater; and
- A debt service stabilization fund that provides an additional source of payment.

Partially offsetting the above strength, in our view, is ID 4's high overall debt burden.

In order to supply the service area's demands, we understand that SMWD imports about 76% of its water from Metropolitan Water District of Southern California through the Municipal Water District of Orange County. We understand that the district has regularly updated its rates to pass through rising wholesale water costs. The remaining supply comes from recycled water produced by SMWD. The entire district serves approximately 160,000 customers through 50,285 residential connections, 2,244 commercial connections, and 2,879 irrigation connections. SMWD includes 14 individual IDs and one community facilities district, and we understand that the district has sufficient treated and untreated water capacity and transmission to supply the expected development needs of all IDs through 2040.

SMWD is located in southern Orange County 50 miles southeast of Los Angeles, and serves the communities of Mission Viejo, Rancho Santa Margarita, San Clemente, Las Flores, Coto de Caza, and Ladera Ranch. We consider these communities' income levels very strong, with median household effective buying income (EBI) ranging from 163% to 264% of the national average. On a per capita basis, EBIs throughout these communities range from 143% to 232%, a level we also view as very strong. Because ID 4 is about 85% built out, its tax base is the most concentrated of all the IDs, but has significantly diversified over the last few years as it has become more developed. For fiscal 2017, the top 10 taxpayers account for a very diverse 9.7% of the district's total land AV, a significant improvement from 35.4% in fiscal 2012. Being fully built-out and mainly residential, IDs 2 and 3 have very diverse taxpayer bases, with the top 10 taxpayers accounting for 4.2% and 7.7%, respectively, in fiscal 2017. Delinquency rates have significantly decreased over the years to below 1% for each of the three districts in fiscal 2016. Specifically, ID2's and ID 4's delinquency rates of 0.68% in fiscal 2016 have significantly improved from greater than 2.5% in fiscal 2012.

IDs 2, 3, and 4 have experienced significant AV growth over the last few years, after AV declines during the housing downturn. ID 2's taxable land AV has risen in each of the last four years to $2.2 billion for fiscal 2017, a 27% increase since fiscal 2013. ID 3's taxable land AV has increased in each of the last four years to $800 million for fiscal 2017, a 39% increase since fiscal 2013. ID 3's taxable land AV has grown in each of the last three years to $6.1 billion for fiscal 2017, a 54% increase since fiscal 2014. We note that the taxable AV on only land represents roughly half of the total AV, which includes both land and improvements. When taking into account the total AV, per capita property wealth levels range from $147,048 to $333,170, which we view as extremely strong levels.

Each improvement district has its own tax base, debt, and attributed capital, while SMWD operates as a single water and wastewater operation with a consolidated statement of operations. Although the bonds are not paid from net system revenues, the district's operations demonstrate stability. We consider the district's liquidity strong, with an unrestricted net asset balance of $79.1 million, consisting of cash and cash equivalents, which represented roughly 344 days' cash.

Our view of the overall debt levels for each of the IDs in fiscal 2017 varies somewhat. We consider ID2's overall net debt low, at 0.6% of market value and $1,006 per capita. For ID3, we view overall net debt as moderate as a percentage of market value and on a per capita basis, at 3.2% and $2,512, respectively. We consider ID4's overall net debt high, at 11.0% of market value and $10,582 per capita. Amortization for ID2 debt is slow, with 32% of the district's direct debt to be retired within 10 years; however, amortization is fairly rapid to rapid for IDs 3 and 4, with over 70% of the district's direct debt to be retired within 10 years. While our view the overall debt levels are high for ID4, we believe that the district's affluent tax base supports its debt service requirements.

Additionally strengthening the security of the bonds is the district's debt service stabilization fund. The fund is allocated to the individual IDs and serves as an additional source of liquidity for debt service. For all SMWD IDs (including those not pledged to the bonds), the stabilization fund balance was about $5.6 million at the end fiscal 2016; we understand that the district will utilize the fund over the next several years to lessen the taxpayer burden. Management indicates that it strategically analyzes the use of the stabilization fund along with determining the assessment rates in order to sufficiently cover annual debt service requirements. Although the district has a substantial portion of its bond authorization remaining, we understand that the district's current capital needs are met, and management does not expect to issue new-money GO debt during the next few years.

The district made its full pension contributions to California Public Employees' Retirement System in fiscal 2016, totaling $2.5 million. Total contributions for pension benefits came to approximately 0.4% of expenditures in fiscal 2016. We understand that the district maintains a pension reserve, which is set aside for unfunded retirement liabilities, and currently holds $5.0 million. The district does not offer other postemployment benefits.

SMWD maintains a rolling five-year capital improvement plan that identifies funding sources for all years and is linked to the operating budget and long-term financial plan. The district has a reserve policy, which includes current balances for various funds but does not specify guidelines regarding minimum reserve requirements. Finally, the district has its own formal investment management policy, which details types of accounts the district may invest with. We understand that the district does not have derivatives, swaps, or variable-rate debt.

Outlook

The stable outlook reflects our view of that district's wealthy tax base will continue to support each ID's tax assessments in order to make debt service payments. Our outlook also reflects the districts' increasing AV trends, improved delinquency rates, and greater diversification of the top taxpayers. Finally, we believe the district's strong liquidity, debt service stabilization fund, and tax rate-raising ability somewhat offset our view of the risk regarding ID 4's high debt levels. We do not expect to change the rating over the next two years.

Upside scenario

While unlikely within the outlook horizon, should the district strengthen its formal financial management policies, and should ID4's debt levels significantly improve, we could raise the rating.

Downside scenario

We could lower the rating if the district is unable to manage ID4's high debt levels, AV declines significantly, or liquidity and reserves deteriorate markedly.

Related Research

Credit FAQ: Financial Management Assessment In U.S. Public Finance, June 27, 2006

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.