FitchRatings

FITCH RATES WATER INFRASTRUCTURE FINANCE AUTH OF AZ'S SERIES 2014A SRF BONDS 'AAA'; OUTLOOK STABLE

Fitch Ratings-Austin-22 October 2014: Fitch Ratings has assigned an 'AAA' rating to the following bonds issued by the Water Infrastructure Finance Authority of Arizona (WIFA):

--Approximately $358.2 million water quality revenue refunding bonds, series 2014A.

Bond proceeds will be used to refund portions of the authority's outstanding bonds and to pay for the costs of issuance. The bonds are expected to price via negotiation the week of Oct. 27.

In addition, Fitch has affirmed the following:

--$760 million outstanding parity bonds at 'AAA'.

The Rating Outlook is Stable.

SECURITY

The bonds are secured by certain loan repayments payable from local borrowers, pledged account and reserve funds, and account investment earnings.

KEY RATING DRIVERS

STRONG FINANCIAL STRUCTURE: Fitch's cash flow modeling demonstrates that the 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 Calculator (PSC).

CONCENTRATED POOL: WIFA's combined loan pool is somewhat small and somewhat concentrated. On a combined basis, the largest borrower represents approximately 23% of the pool and the largest 10 borrowers represent an elevated 66% of the total.

AVERAGE POOL QUALITY: Approximately 34% of IFA's loan portfolio consists of unrated entities, which Fitch conservatively assumes to be of speculative grade credit quality in its analysis. Overall, pool credit quality is in line with other SRFs rated by Fitch.

EFFECTIVE PROGRAM MANAGEMENT: WIFA adheres to consistent, conservative underwriting policies. Management and underwriting strength is exhibited by the fact that the program has never experienced a default.

RATING SENSTIVITIES

REDUCTION IN MODELED STRESS CUSHION: Significant deterioration in aggregate borrower credit quality, increased pool concentration, or increased leveraging resulting in the program's inability to pass Fitch's 'AAA' liability rating stress hurdle would put downward pressure on the rating. The Stable Outlook reflects Fitch's view that these events are unlikely to occur.
CREDIT PROFILE

WIFA is an independent agency of the state of Arizona and was established to provide below-market financing for the construction, rehabilitation, and improvement of drinking water, wastewater, wastewater reclamation, and other water quality facilities/projects within the state.

SOLID FINANCIAL STRUCTURE

The strength of the program's financial structure is exhibited by its sound Program Asset Strength Ratio (PASR). Fitch calculates the PASR, which includes the sum of total scheduled loan repayments, debt service reserve account (DSRA) funds and account earnings divided by total scheduled bond debt service, to be solid at approximately 1.5x versus Fitch's 'AAA' median of 1.6x.

Because of this available margin, cash flow modeling demonstrates that the program can continue to pay bond debt service even with hypothetical loan defaults of 100% in the first, middle and last four years of the outstanding bonds' expected life (as per Fitch criteria, a 90% recovery is also applied in its cash flow model when determining default tolerance). This is in excess of Fitch's 'AAA' liability rating stress hurdle of 30% as produced by the PSC. The liability 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 AND RESERVES

Under the program's financial structure, each series of bonds is protected from losses by borrower loans made in excess of bond debt service (overcollateralization). On an annual basis, loans overcollateralize bonds by a minimum of 30% or 1.3x. Also protecting bonds from losses are the debt service reserve account (DSRA), the financial assistance account (FAA), and the loan acquisition fund.

Loan repayments are deposited into each respective clean water and drinking water state revolving fund FAA, which are then available to make debt service payments on any bonds issued under the master trust indenture. Once the aforementioned payments are made, excess amounts in each account can be transferred to the other to make up any deficiencies, resulting in cross-collateralization of the two funds. This increases the diversity of the aggregate loan pool and lessens the risk of any one borrower's default eroding reserve balances and threatening bondholder payments. Any such transfer creates a repayment obligation by the deficient account, but the obligation is subordinate to the trust estate's pledge under the bond indenture. Due to the cross-collateralization feature, Fitch combines the programs in its cash flow modeling.

After taking into account all transfers from the FAAs, the DSRA will be used to cure debt service payment shortfalls. The program indenture requires that the DSRA be maintained at the least of: 10% of the original balance of all outstanding bond principal; 1.0x maximum annual debt service; or 1.25x of the average annual debt service remaining. The DSRA may be funded with cash or a letter of credit, surety bond or other similar arrangement.

The total DSRA balance is projected to be approximately $83.6 million on Jan. 1, 2015, which will equate to 11.7% of bonds outstanding. At the same time, the FAA is expected to be funded at approximately $139.1 million (or 19.4% of outstanding bond principal). The total of all pledged accounts including the FAA, the DSRA, and the loan acquisition fund, are projected to provide an additional 36.5% in loss protection to the bonds.

CONCENTRATED LOAN POOL

The combined loan pool is composed of 65 borrowers. At a combined 23%, Lake Havasu is the pool's largest borrower. Loans to Lake Havasu secured by net utility system revenues (senior lien wastewater WIFA loan rated 'A'/Stable Outlook by Fitch) represent about 14% of the aggregate pool and loans secured by a combination general obligation and revenue pledge represents 9% of the pool (Fitch rates Lake Havasu's general obligation debt at 'AA-' with a Stable Outlook). In aggregate, the top 10 borrowers represent approximately 65% of the loan pool versus Fitch's 'AAA' median level of 52%.

Pool credit quality is in line with similarly-rated municipal pools, as reflected by the PSC liability stress hurdle of 30% versus Fitch's 'AAA' median level of 33% (lower liability stresses correlate to stronger credit quality). Loan security provisions are strong with nearly 90% backed by utility system revenues, general obligation debt, or a combination of the two.

EFFECTIVE PROGRAM MANAGEMENT AND UNDERWRITING

WIFA's loan underwriting guidelines, evidenced by extensive formalized policies and procedures, are a key credit strength. Prior to loan origination, WIFA staff performs a due diligence review and a financial capability review. The due diligence review includes determination of legal, managerial, technical, and financial capability. The financial capability review focuses on a borrower's historical performance over the previous three-year period, with results used to analyze trends and project future performance. To date, as a result of WIFA's underwriting and monitoring policies, there have been no program defaults.

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Applicable Criteria and Related Research:
--'State Revolving Fund and Leveraged Municipal Loan Pool Criteria' (April 28, 2014);
--'State Revolving Fund and Leveraged Municipal Loan Pool 2013 Peer Review' (Oct. 31, 2013);
--'Revenue-Supported Rating Criteria' (June 16, 2014).

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State Revolving Fund and Leveraged Municipal Loan Pool Criteria
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=746076
Revenue-Supported Rating Criteria