# FITCH AFFIRMS ARIZONA WATER INFRASTRUCTURE FINANCE AUTHORITY'S SRF BONDS AT 'AAA'; OUTLOOK STABLE

Fitch Ratings-Austin-16 October 2018: Fitch Ratings has affirmed its 'AAA' rating on the following bonds issued by the Water Infrastructure Finance Authority of Arizona (WIFA or the authority):

--Approximately $437.510 million outstanding parity bonds.

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 Model (PSM).

LOSS PROTECTION PROVIDED BY OVERCOLLATERALIZATION: WIFA's bonds benefit from overcollateralization as surplus loan repayments provide minimum annual debt service coverage of 1.5x. The debt service reserve account (DSRA), the financial assistance account (FAA), and the loan acquisition fund provide additional protection from losses.

MODERATE POOL CONCENTRATION: WIFA's combined loan pool is small and moderately concentrated. The top-10 borrowers represent 58% of the pool, displaying average concentration relative to Fitch's 2017 'AAA' median of 55%.

AVERAGE POOL QUALITY: Approximately 58% of WIFA's loan pool consists of borrowers exhibiting investment-grade ratings. Loan security is very strong, with approximately 91% backed by utility system revenues, general obligation debt or a combination of the two.

EFFECTIVE PROGRAM MANAGEMENT: WIFA completes a due diligence review of each of the borrower's legal, managerial and technical capabilities prior to loan origination. The authority adheres to consistent and conservative underwriting policies.

RATING SENSITIVITIES

REDUCTION IN MODELED STRESS CUSHION: Significant deterioration in aggregate borrower credit quality, increased pool concentration or increased leveraging resulting in the Water Infrastructure Finance Authority of AZ revolving loan 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 not likely to occur.

CREDIT PROFILE

WIFA is an independent authority 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.

FINANCIAL STRUCTURE EXHIBITS STRONG DEFAULT TOLERANCE

Fitch's cash flow modeling demonstrates that the availability of program resources allow for hypothetical loan defaults of 100% in the first, middle and last four years of the program's life (as per Fitch criteria, a 90% recovery is also applied in its cash flow model when determining default tolerance) while still paying bond debt service in full. This is in excess of Fitch's 'AAA' liability rating stress hurdle of 40%, thereby indicating a passing result under Fitch's quantitative analysis.

As an additional measure of financial strength, Fitch calculates the program asset strength ratio (PASR). The PASR, an asset-to-liability ratio, includes total scheduled loan repayments plus any additional pledge funds divided by total scheduled bond debt service. The resulting PASR for WIFA's program is strong at approximately 1.7x, slightly below Fitch's 2017 'AAA' median level of 1.9x.

ADEQUATE POOL QUALITY WITH MODERATE CONCENTRATION

Fitch estimates that approximately 58% of program participants exhibit investment-grade credit quality. In aggregate, pool credit quality is in line with similarly-rated municipal pools, as reflected by a 'AAA' PSM liability stress of 40%, which is slightly above Fitch's median of 30% (lower liability stresses correlate to stronger credit quality). Loan security provisions are strong with approximately 91% backed by utility system revenues, general obligation debt or a combination of the two.

The program consists of approximately 76 active borrowers, the top 10 of which comprise a high 58% of the total pool. The two largest borrowers are the city of Peoria (15%, Peoria's senior lien water and wastewater WIFA loan rated 'AA'/Stable) and the city of Prescott (8.2%,not rated). The remaining top-10 borrowers range in size from 2.9% to 7.2% of the total pool.

LOSS PROTECTION PROVIDED BY OVERCOLLATERALIZATION

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 1.5x. Also protecting bonds from losses are the DSRA and the FAA.

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 was approximately $57.0 million on Sept. 30, 2018, which equates to 13.0% of bonds outstanding. At the same time, the FAA was funded at approximately $250.0 million (or 57.1% of outstanding bond principal). The total of all pledged accounts, including the FAA and the DSRA, currently provide an additional 70.1% in loss protection to the bonds.

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.

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Applicable Criteria
Rating Criteria for Public-Sector, Revenue-Supported Debt (pub. 26 Feb 2018)
https://www.fitchratings.com/site/re/10020113
U.S. Public Finance State Revolving Fund and Municipal Finance Pool Program Rating Criteria (pub. 27 Sep 2018)
https://www.fitchratings.com/site/re/10045104