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U.S. Tax Increment Bond Issuance Grows; Credit Quality Remains Stable

Primary Credit Analyst:
David G Hitchcock
New York
(1) 212-438-2022
david_hitchcock@
standardandpoors.com

Secondary Credit Analysts:
Sussan Corson
New York
(1) 212-438-2014
sussan_corson@
standardandpoors.com

Robert Williams
San Francisco
415-371-5070
robert_williams@
standardandpoors.com

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Standard & Poor's Ratings Services sees the current outlook for tax increment credit quality as generally stable, following moderate improvement in the last several years. Strong real estate trends across most of the country have pushed up real estate valuations and greatly increased the number of rated tax increment bonds, which has caused rated issuance of tax increment debt to grow substantially. However, many issuers of tax increment debt, also called tax allocation debt, have decided to maintain or increase leverage when selling debt and thereby dampen what would otherwise be strong upward movement in rating levels.

In addition, concerns remain about a possible housing bubble. While Standard & Poor's economist David Wyss notes that predicting housing prices has uncertainties similar to predicting the weather, there are a couple of concerns. Nationally, the good news has been that consumers' total housing payments as a percent of their income have remained relatively stable due to low interest rates, despite rising home prices, and real estate prices may be only mildly susceptible to a slight rise in interest rates. However, certain metropolitan areas may be experiencing a housing bubble on a local level. The four national metropolitan areas that have the highest median home prices compared to 2004 median incomes are all located in California—in order, San Diego, San Francisco, Los Angeles, and Orange County—and California redevelopment agencies are the largest issuers of tax increment debt. Nevertheless, this is offset by another factor unique to California: Proposition 13. This voter initiative, passed in 1978, limits annual assessment increases to 2%, unless property changes ownership, which creates a substantial underassessment cushion. Redevelopment district market values can often decline without substantially reducing assessments, as was demonstrated in the last few years following the economic downturn in Silicon Valley. Home prices in California must fall below an often artificially low assessed value before a county assessor reduces a home's assessment.

Ratings—Factors And Distribution

The ratings on all but one series of tax allocation bonds rated by Standard & Poor's currently carry a stable outlook. This may be a little deceptive in that special district debt ratings often move upward on short notice when new development improves revenues and taxpayer diversity. Until new development actually happens, however, tax increment bonds usually carry a stable rating outlook because redevelopment agencies are dependent on independent private entities to accomplish their development goals.

Standard & Poor's tax increment debt rating methodology also anticipates cyclicality in the volatile real estate market. Bonds assigned investment grade ratings are expected to show enough coverage to weather expected economic slowdowns. This remains the case during the current strong real estate market, especially for tax increment districts concentrated in industrial or commercial property. During the 1990s there were prominent defaults for unrated tax increment and special assessment debt due to assessed valuation declines, particularly in areas concentrated in hotel and warehouse development. During this time, however, no tax increment bonds initially rated investment grade by Standard & Poor's ever defaulted, although some slipped below investment grade as the downturn progressed. The history of special district debt shows that real estate markets can turn suddenly.

The average public tax increment bond rating has trended upward slightly in recent years, as demonstrated by the distribution of ratings. In 1996, Standard & Poor's rated 37% of public tax increment ratings 'BBB', 18% 'BBB+', 26% 'A-', and 10% 'A'. Today, 18% of publicly rated tax increment debt is 'BBB', 20% 'BBB+', 37% 'A-', and 16% 'A'. The rating distribution is partially skewed by the desire of many tax increment issuers to structure their debt service in order to get an 'A-' rating, and benefit from the 'A' category interest rate advantage, which somewhat concentrates the non-insured ratings at the 'A-' level.

Chart 1

Tax Increment Ratings Distribution, 1996

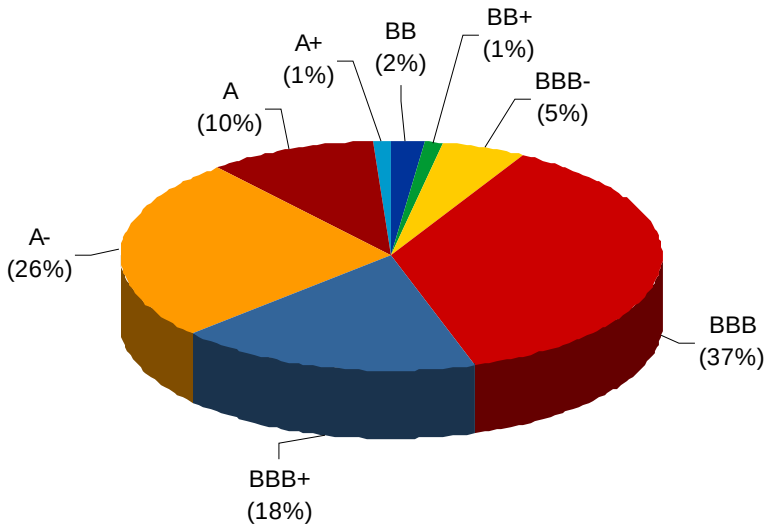
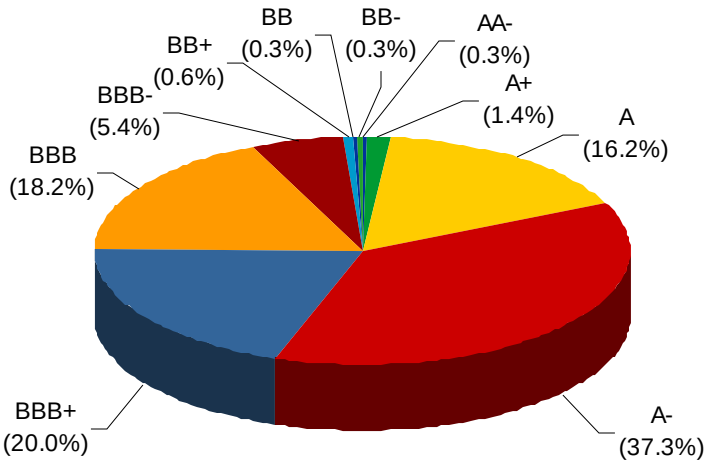


Chart 2

Tax Increment Ratings Distribution, 2006



One other factor possibly skewing ratings upward has been the increased incidence in California of large tax increment districts that almost cover entire cities, and thus have high taxpayer diversity and strong credit quality. A number of redevelopment agencies in the California desert communities, such as Cathedral City, in addition to other areas such as San Marcos, north of San Diego, encompass high-end residential development that covers the bulk of the city. These represent a departure from the objective of the traditional tax increment district that covers just a small urban core in need of redevelopment.

The number of Standard & Poor's publicly rated tax increment bonds has grown steadily over the years. Standard & Poor's rated only 87 publicly rated tax increment bonds in 1989, with all but three of them in California. This grew to 126 total ratings in 1992, and 158 by 1996. Today, Standard & Poor's publicly rates 351 series of tax increment bonds (not including insured bonds that lack an underlying rating or double barreled securities), 40 of which were issued by bond issuers located outside of California. The total par amount of rated tax increment debt currently stands at $13.1 billion, of which $863 million represents tax increment debt issued outside of California. Some of the increase in rated issues is due to the use of underlying ratings by insured bond issues that formerly used only the insurance-based rating—but most of the growth is due to new debt issuance.

Volume Growth Tied To California Real Estate

The growth of tax increment debt volume has largely followed the ups and downs of the real estate market, particularly in Southern California, where most tax increment debt is issued. Gross assessed valuation for the entire state grew 25.6% between 2001-2004, to $3.0 trillion, not including property centrally assessed by the state, such as utilities and railroads. The increase was in part the result of new building—California issued $65.2 billion in residential and non-residential building permits in 2005,

according to preliminary state estimates, up from $45.6 billion in 2001. It was also due to the rising valuation of existing property. The state reports that the median sales price of a California home increased from $262,350 in 2001 to $450,990 in 2004. Growth has been strong in both residential and commercial construction. The state calculates that the number of annual California housing unit authorizations increased to 2.5 million in 2005 from 1.8 million in 2001.

The California State Controller has calculated that the state's tax increment districts combined had incremental valuation of $276.9 billion in 2004, an increase of 2.4% over the year before.

Overall, California has not seen a year-to-year decline in statewide assessed valuation since at least before 1989, although hard-hit Silicon Valley redevelopment agencies, such as the San Jose Redevelopment Agency, have seen some recent assessment declines. In the 2001 recession, Northern California, suffering from the dot-com bust, experienced real estate softness, particularly for commercial areas, while southern California real estate markets stayed strong. For example, the San Jose Redevelopment Agency' s merged project area saw a decline to $15.0 billion in 2005 from a peak assessed valuation of $18.7 billion in fiscal 2003, a decline of 19.6% in total assessed valuation and 21% in incremental assessed valuation. The decline prompted Standard & Poor's to lower the merged area's bond rating to 'A-', with a negative outlook, from 'A'.

The previous recession, in 1991, saw the reverse— Northern California real estate stayed strong, while defense cutbacks weakened Southern California's real estate market. This also produced assessment declines in predominantly commercial project areas, although residential property was not entirely exempt from the slowdown. The Los Angeles County assessor implemented small, across-the-board rollbacks of residential property valuation in the early 1990s. Los Angeles Community Redevelopment Agency's downtown Bunker Hill redevelopment project area, concentrated in major hotels (a particularly volatile sector) and commercial office buildings, saw an almost 50% decrease in its assessed valuation between fiscals 1994 and 1998 from a peak of $3.1 billion in 1994. Other Southern California project areas containing warehouse and commercial properties were also notable for experiencing long-lasting assessment declines during this period.

One interesting experience during the 1990s was the long lead time between real estate weakness and actual assessed value declines, as assessment appeals slowly wended their way through courts and back-logged county assessors gradually caught up with altered real estate values. It wasn't until the mid-to-late 1990s that many commercial tax increment districts hit their assessed valuation low points.

Tax increment districts in general show greater assessment fluctuations than overall state valuations. These districts generally contain recent construction, which means there is less margin for underassessment for California districts; areas with older existing properties that haven't changed ownership are subject to the underassessment cushion created by Proposition 13.

Because incremental assessed valuation, which determines pledged tax revenue, will mathematically increase or decrease faster than total assessed valuation, Standard & Poor's has developed a tax volatility ratio to measure the effect of possible assessed valuation fluctuations: the base to total assessed valuation ratio. This ratio measures the speed with which tax increment will fluctuate with overall changes in assessed valuation. For example, a 0.5 volatility ratio indicates that every $1 change in total assessed valuation will produce a $2 change in incremental assessed valuation. The higher the ratio, the worse the tax revenue volatility. On a statewide basis, California's controller lists tax increment project areas' base assessed valuation at $145.8 billion in 2004, compared to redevelopment project areas' total valuation of $422.7 billion, producing an average statewide volatility ratio of

0.34—a moderate level of volatility. Older project areas, with greater underassessment, may also show less volatility in a real estate downturn.

The most recent recession deviated from previous ones in that real estate growth remained remarkably robust. Nevertheless, there is typically a lag from an economic slowdown and its consequent effect on assessed valuation. For example, the low point in California's assessed valuation growth following the 1991 recession occurred in fiscal 1996, when gross state assessed valuation increased only 0.7%; growth was only 1.3% the year before. In contrast, the 2002 recession hasn't seemed to have much affect on assessed valuations. State assessed valuation increased 9.2% in fiscal 2002, 7.3% in fiscal 2003, and 7.4% in fiscal 2004. This trend is likely to continue when final state figures are published for 2005. Los Angeles County, for example, showed assessed valuation growth of 8.2% in fiscal 2005 and 10.4% in fiscal 2006. This indicates that the volume of new tax increment issuance is likely to stay strong for the foreseeable future, and is also indicative of stable future credit quality for tax increment debt. Although Northern California is still experiencing real estate softness, a smaller portion of statewide population resides there than in the south, and consequently its issuance of tax increment debt is less: about 40% of rated California tax increment debt by par value and 29% by number of ratings is in the northern part of the state. Nevertheless, despite real estate softness, the City of San Francisco managed to show an assessed valuation increase of 6.6% in fiscal 2005 and 0.8% in 2006.

The California Debt and Investment Advisory Commission reports that $2.6 billion of total new tax increment bonds, including both rated and unrated debt, were issued within the state in calendar 2005; $1.7 billion of this amount was net of refunding bonds versus $1.2 billion issued net of refunding bonds in calendar 2002. The state controller reports that California's total tax increment debt outstanding, including unrated debt, increased 31% between 2001-2004, with $13.6 billion of local tax increment debt outstanding at the end of the state's 2004 fiscal year.

California accounts for the bulk of tax increment debt issued nationally (about 93% of rated debt by par amount) for several reasons. First, as the state where the concept first originated, California has a long history of issuing tax increment debt. Second, the passage of Proposition 13 in 1978 prevented cities from issuing GO debt without two-thirds voter approval, while tax increment debt doesn't need to go to the voters, increasing its attractiveness to local officials. Third, Proposition 13's prohibition against cities increasing local property tax rates made the ability of tax increment financing to "re-allocate" property tax from other underlying taxing entities to a redevelopment agency very attractive. Some of the growth nationwide in tax increment debt issuance may also be attributed to the growing desire to make development "pay for itself"—existing residents don't want to pay for the needed infrastructure of newcomers. This is what tax increment financing is designed to do: pay off bonds only with tax revenue from new assessed valuation within a given project area, although bond ratings are usually lower than they would be with a city GO debt issuance.

Tax allocation bonds were severely challenged in California by Proposition 13 in 1978, which simultaneously rolled back assessed values and cut property tax rates by about 75%. In following years, similar tax initiatives hurt tax increment in other states—Measure 5 in Oregon is one prominent example. California, meanwhile, continued to pass statutory laws that hurt tax increment credit quality, including the elimination of business inventory taxation, and court rulings allowed retroactive prior lien passthrough payments of tax revenue to certain school districts. In the past two years, California has required redevelopment areas to contribute a portion of their revenues (called the

Educational Revenue Augmentation Fund, or ERAF, shift) to the state to help the state with its own budget difficulties. However, the state required this only on a basis subordinate to payment of outstanding tax increment debt. While it is possible that new voter initiatives or state laws could likewise affect tax increment credit quality, it is notable that the last several years have actually been quiet in this respect.

Tax Increment Debt Issuance Poised For Further Growth

Ultimately, the security of all tax increment bonds depend on local conditions—local real estate, local tax sharing agreements negotiated with underlying taxing entities, and local concentrations of taxpayers or types of property affecting by specific state laws.

However, strong real estate markets, the desire of cities to issue increasing amounts of tax increment debt, and the desire of bankers to structure deals to hit a minimum rating of 'A', or at least a minimum investment-grade rating for bond insurance purposes, should lead to continued growth in tax increment bond volume, and relatively stable credit quality. It remains to be seen whether the growth of very large tax increment districts in prosperous areas will lead to state laws that will restrict the formation of this type of tax increment district as a perceived abuse of the tax increment process and limit their issuances. This is not currently the case. A slowing real estate market that produces less new tax increment revenues to bond against, another factor that could potentially slow new tax increment issuance, is partly mitigated by the underassessment currently in place in California due to Proposition 13. As property values in California grow at the 2% annual rate allowed under Proposition 13, and also increase to full market value upon a change in ownership, latent assessment values will be unlocked for years to come, creating an upward bias in property assessments, short of an outright real estate crash.