S&P Global Ratings

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Summary:

Ocean Shores, Washington; Special Assessments

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Credit Profile		
Ocean Shores Local Improv dist No. 2007-01 bnds		
Long Term Rating	BBB+/Stable	Affirmed

Rationale

S&P Global Ratings affirmed its 'BBB+' long-term rating on Ocean Shores, Wash.'s series 2011 local improvement district (LID) bonds, issued for LID No. 2007-01. The outlook is stable.

The LID bonds are special limited obligations of the city and are payable from assessments in annual installments on parcels within the district, with additional credit support from a shared guarantee fund and a covenant to issue warrants against the guarantee fund secured by a subsequent-year citywide property tax levy.

The rating reflects our view of:

- Fixed assessment levies equal to those needed to cover estimated debt service payments, which could result in shortfalls in the event of delinquencies;
- A significant 34% portion of parcels with a direct value to lien (VTL) of less than 5 to 1, partly reflecting a large proportion of undeveloped parcels;
- The potential for prepayments to increase the proportion of low VTL ratio parcels, thus weakening payment capacity;
- The potential for a changing mix of LIDs to increase the potential delinquency exposure of a guarantee fund, which provides pooled credit support to LIDs citywide;
- The absence of a debt service reserve fund dedicated to this series; and
- Local economic concentration in tourism.

Partly offsetting the above weaknesses, in our view, are:

- An established taxing area substantially encompassing Ocean Shores;
- Flexibility in the form of a fixed annual assessment schedule but an estimated sequential bond redemption schedule, and a single final maturity scheduled for two years after the final scheduled assessment payment to allow for foreclosure collections;
- Covenanted maintenance of the guarantee fund at no less than 10% of assessments outstanding among all LIDs and, in the event of delinquencies, annual replenishment through an unlimited citywide property tax; and
- A covenant for the city to issue property tax warrants in addition to, or as a substitute for, guarantee fund draws equal to as much as 5% of assessments outstanding, if needed to cure delinquencies.

The city has provided an estimated bond redemption schedule but must redeem the bonds:

- In the sequence of CUSIP numbers earlier or later than the estimated dates, depending on the pace of prepayments or delinquencies; and

- In 2031, which is two years after the final scheduled assessment payment.

The city bills the fixed assessments (using a contractor that also administers LID billing in other cities in the state) separately from general property taxes, which are senior to LID assessments under state law. Property owners pay their assessments in level installments and declining fixed-interest payments equal to the LID bonds' interest rate, and they may prepay their full assessment balance in any year. We note that this ability, in addition to what we understand is a common requirement of mortgage lenders for borrowers to prepay LID assessments, has contributed to changes in the composition of the assessment payment base from that at the time of the series 2011 issuance. In the event of assessment payer delinquencies, the city is required to draw on the cash-funded guarantee fund to pay assessments according to the current debt service payment estimate. In the event of draws on the guarantee fund, the city has covenanted to levy a special citywide ad valorem property tax to replenish the guarantee fund in the following year to 10% of LID assessments outstanding citywide. If it is required to do so to cure delinquencies, the city can also issue warrants against ad valorem property taxes in the subsequent year equal to another 5% of assessments outstanding and can substitute warrants for guarantee fund draws.

The city may create additional LIDs that may overlap with LID 2007-01 and issue debt secured by additional assessments that could change the guarantee fund's exposure. Management reports that the city is unlikely to create an additional LID for the foreseeable future.

Ocean Shores was founded in 1960 as a planned resort community, and its economy remains tourism based. The number of vehicles entering the city swells to about 60,000 during the summer compared with 5,000 in the winter, and roughly 50% of the city's housing is vacant--mostly, we believe, because of seasonal housing. We understand that the city's estimated year-round population of 5,900 could eventually grow to 25,000 if all lots within the city were developed. Median household effective buying income in the city is adequate, in our view, at 82% of the national level.

Although the district's assessments do not depend on assessed value (AV), we view AV as an indicator of tax base performance. The county recalibrates the city's AV to market value less than annually, which can lead to major shifts. We understand that this caused the city's property tax base value to decrease by 23% in 2012, reflecting what we understand was a cumulative multiyear decline in home values. Total AV rose by less than 1% in aggregate for 2013 and 2014, followed by another major decline of 14% for 2015. The district's AV increased by a slight 0.4% for 2016.

LID 2007-01 encompasses approximately 3,200 parcels that have assessments outstanding, down from approximately 4,600 in 2015, and we anticipate that this count will continue to shrink in some form for 2017 as a result of prepayments. For parcels with assessments, we estimate that total market value stands at 107x direct LID direct debt within the district. However, we note that just 36% of total parcels with assessments show more than $1,000 in AV from structures (suggesting they have been built on) because of what we understand were the full subdivision of the city approximately 50 years ago. Despite some development in the intervening period, a significant amount (34%) of assessment payers' property holdings outstanding within the city have direct VTL of less than 5 to 1, which we consider high. However, assessment payer concentration is low, in our view, with the 10 largest accounting for 7.4% of total assessments. We calculate that the median assessment outstanding is $3,718, or $248 annually amortized over the remaining 13-year assessment period.

Partly offsetting the district's exposure to low VTL parcels, in our view, are credit support in the form of the guarantee fund and a requirement to issue warrants if necessary to address delinquencies. The scheduled annual assessment payments do not provide an excess margin to cover delinquencies, but the city has covenanted to employ the equivalent of 15% of assessments outstanding citywide to absorb assessment payer delinquencies. (The state's property levy rate limitations on cities do not apply to this taxing obligation.) We view the combination of mandatory bond calls and an estimated (rather than fixed) payment schedule prior to the final maturity as providing the LID flexibility to weather real estate cycles. Assuming that the city reduces the guarantee fund to match assessments outstanding during the life of the obligations, we estimate that available resources would cover scheduled assessment principal and interest payments by 1.17x. Because of the guarantee fund replenishment mechanism, we estimate that a permanent delinquency by all of the parcels with VTL of less than 5 to 1 would result in similar coverage at 1.18x. According to management, current delinquencies for 2016 are 5.5% as of April 2017 mainly as a result of timing, and that percentage will improve as normal delinquency management efforts continue. The district's delinquency rates have remained what we consider low the past three years, reflecting rates of 1% or lower.

Outlook

The stable outlook reflects our view that the district's high proportion of parcels with low VTL creates a risk of significant delinquencies during the life of the obligations but that they will remain low during our two-year outlook horizon. We do not expect to change the rating during the two-year outlook horizon.

Upside scenario

We do not anticipate raising our rating during the two-year outlook horizon because of a long development process that makes a significant reduction in low-VTL parcels unlikely.

Downside scenario

We could lower the rating if weakening real estate values or prepayments dim our view of the composition of the assessment base, with additional increases in the proportion of low VTL parcels potentially weakening the district's credit profile. Also potentially affecting our view of credit quality would be additional LID obligations that we view as changing the guarantee fund's exposure to delinquencies.

Related Research

Special Assessment Bond Ratings Are Trending Up As The U.S. Economic Recovery Continues, March 28, 2016