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Ratings

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**Summary:**

# Sonoma Marin Area Rail Transit District, California; Sales Tax

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## Rating Action

S&P Global Ratings revised the outlook to stable from negative and affirmed its 'AA' long-term rating on the Sonoma Marin Area Rail Transit District (SMART), Calif.'s Measure Q sales tax revenue refunding bonds, series 2020A.

The rating reflects the application of our "Priority-Lien Tax Revenue Debt" criteria, published Oct. 22, 2018, which factors in both the strength and stability of the pledged revenue, as well as SMART's general credit quality.

SMART issued the series 2020A bonds to refund its series 2011A sales tax revenue bonds. The refunding resulted in a 23% reduction in maximum annual debt service (MADS) requirements through leveling of annual debt service requirements, and did not extend bond maturity.

A gross first-lien pledge of Measure Q sales tax revenue, net of an administrative fee paid to the California Department of Tax and Fee Administration (CDTFA), secures the bonds. Measure Q is a 0.25% sales tax charged on transactions within Sonoma and Marin counties. Voters of the two counties approved the tax in 2008, and Measure Q collections began April 1, 2009. The tax sunsets March 31, 2029, following final maturity on the bonds.

### Credit overview

The outlook revision reflects our view of SMART's improved general credit quality resulting from the application of our updated criteria "Global Not-For-Profit Transportation Infrastructure Enterprises," published Nov. 2, 2020, on RatingsDirect. Although we note that downside pressure persists for SMART's general creditworthiness--given a sustained depression in ridership and moderate decline in sales tax revenue in 2020, both spurred by the COVID-19 pandemic--SMART's higher credit quality resulting from our criteria application means that a worsening of SMART's general credit quality would be less likely to lead to a lower rating on its sales tax bonds.

SMART's credit profile reflects the extremely high incomes and broad and diverse economic base of its two-county service area. The coverage protections of an additional bonds test (ABT) requiring historical revenue produce MADS coverage no lower than 1.5x for additional bonds to be issued, combined with the cushion between current and forecast MADS coverage and this 1.5x threshold, provide further credit support, in our view.

We previously noted the potential for the economic effects of COVID-19 and related social distancing measures as a potential credit risk for SMART's sales tax revenue bonds. Specifically, we noted that economic pressures related to the pandemic could not only lower pledged revenue and coverage on the bonds, but also lead to a worsening in

SMART's general creditworthiness, along with that of other mass-transit operators (see our report "Mass Transit Agencies' Priority Lien Revenue Bond Outlooks Revised To Negative On Anticipated COVID-19 Pressures," published March 27, 2020). Although we believe downside risk remains related to the potential for a prolonged U.S. economic recovery (see "Staying Home For The Holidays," published Dec. 2, 2020), S&P Global Economics expects the economy to continue to recover in 2021. We believe improving economic conditions will help mitigate the risk of significant declines in SMART's pledged revenue stream throughout our outlook period, which is generally up to two years.

The stable outlook reflects our opinion that coverage will remain above the level of the ABT. It further reflects our view that although near-term credit pressure remains for SMART's general creditworthiness given the persistence of the COVID-19 pandemic into 2021 and a sustained depression in transit ridership levels, any downside pressure on SMART's general creditworthiness is unlikely to be so severe as to force the rating on its Measure Q revenue bonds lower.

The rating reflects our view of:

- The very strong economic fundamentals of SMART's two-county district that spans two broad and diverse metropolitan statistical areas (MSAs);
- SMART's strong MADS coverage from pledged revenue and an ABT that requires 1.5x MADS coverage from historical revenue for additional bonds to be issued;
- The historically low volatility of nationwide sales tax revenue, a view that extends to our view of SMART's pledged sales tax revenue collected across its two-county district; and
- Our view that SMART's general creditworthiness does not currently constrain the rating on its sales tax bonds.

SMART was created in 2002 to oversee the development and operation of passenger rail service along an approximately 70-mile rail corridor extending from Cloverdale in Sonoma County to Larkspur in Marin County. The first phase of the rail line began operations in August 2017.

SMART has approximately $132.6 million in debt outstanding, consisting solely of the series 2020A revenue refunding bonds.

### Environmental, social, and governance (ESG) factors

Our rating considers the ESG risks relative to SMART's Measure Q revenue bonds' economic fundamentals, revenue volatility, coverage and liquidity, and obligor's creditworthiness. Our ratings incorporate our view of the health and safety social risks related to the COVID-19 pandemic, which we believe will continue to challenge SMART's general creditworthiness as transit ridership remains materially below prepandemic levels, and which may pose some downside pressure on pledged sales tax revenue.

We consider the district's service area across both Marin and Sonoma counties exposed to heightened environmental risks relative to other mass transit priority lien debt issuers. In our view, the district's territory is particularly exposed to wildfires and seismic risks, the latter of which we consider somewhat mitigated by the state's strong building codes. In recent years, including the summer and early fall of 2020, numerous wildfires have burned throughout California. For the second time in three years, wildfires have forced evacuations for parts of Santa Rosa, the largest city in Sonoma County. We understand wildfires have not caused material declines in pledged revenue, although the Tubbs Fire in the fall of 2017 did contribute to a decline in ridership. We consider governance factors for this issuer in line with the sector.

## Stable Outlook

### Downside scenario

If operational challenges, including persistently depressed ridership levels, or substantial declines in sales tax revenue lead to a weakening in SMART's general creditworthiness, we could lower the rating on its Measure Q sales tax revenue bonds.

### Upside scenario

If SMART's general creditworthiness stabilizes and sales tax revenue grows, leading to a material strengthening of coverage, we could raise the rating.

## Credit Opinion

### Economic fundamentals: Very strong

SMART's district covers the counties of Sonoma and Marin, with a combined population of approximately 770,000 in 2019. Sonoma County, with a 2019 total population of approximately 507,000, is located within the broad and diverse Santa Rosa-Petaluma MSA and in the heart of Northern California's wine country. Local economic drivers include tourism and agriculture.

Marin County, with a 2019 population of 262,000, is located within the broad and diverse San Francisco-Oakland-Hayward MSA. Located across the Golden Gate Bridge from the City and County of San Francisco, Marin County's economic indicators reflect its proximity to the abundant and high-paying jobs in San Francisco and other Bay Area communities.

On a weighted average basis by population, district per capita effective buying income was 154% of the national level in 2019. In our view, the district's high income levels support the robust sales tax base that secures SMART's sales tax revenue bonds. The district's taxing base is diverse by taxpayer and by sector. With the top 25 sales tax remitters accounting for 23.6% of total sales tax revenue, there is no material sales taxpayer concentration.

### Coverage and liquidity: Strong

SMART's $39.0 million in pledged revenue in fiscal 2020 produced 2.3x annual debt service coverage (DSC) and 1.8x MADS coverage. The MADS coverage figure improves to 2.3x when comparing fiscal 2020 pledged revenue to the debt service schedule following the series 2020A refunding.

Fiscal 2020 pledged revenue dropped 5.5% from fiscal 2019, though the fiscal 2020 estimated figure was still 5.0% higher than in fiscal 2018. We understand that administrative issues at the state level led to some undercounting of locally levied sales tax revenue for fiscal 2018 and some over-counting for fiscal 2019. For fiscal 2020, the district estimates it received an additional $1.4 million as a result of the South Dakota v. Wayfair Inc. decision settled in 2018 that permitted the levy of sales taxes on goods sold to local purchasers by out-of-state sellers.

SMART's amended budget as of January 2021 indicates an expected $39.1 million in pledged revenue, producing 2.3x MADS coverage. The revised Measure Q figures were calculated using nine months of actual data received since the original budget was formulated. Although further declines in pledged revenue could erode coverage from current projected levels, pledged revenue would have to decline by 35% from fiscal 2021's projected level for MADS coverage to equal 1.5x on the postrefunding debt service schedule. We consider a decline of this magnitude unlikely.

SMART's ABT requires that Measure Q collections in 12 consecutive months of the past 24 produce MADS coverage no lower than 1.5x on existing and proposed bonds. Given SMART's lack of additional borrowing plans and the legal constraints of the ABT, we expect coverage will remain strong. SMART indicates it has no plans to issue additional debt. With the pledged tax scheduled to sunset in March 2029, and given SMART relies on Measure Q revenue to fund its operations we believe it is unlikely SMART will bond down to the level permitted by its ABT.

The series 2020A bonds will not benefit from the added security of a debt service reserve. However, given our coverage and volatility assessments, we do not apply a liquidity factor adjustment to the coverage and liquidity assessment for the Measure Q sales tax revenue bonds.

### Revenue volatility: Low

We assess the volatility of pledged revenue to evaluate the likely availability of revenue across different economic cycles. We have two levels of volatility assessment: macro and micro. Our macro volatility assessment begins with an assessment of the historical volatility of the economic activity being taxed, and includes an analysis of societal, demographic, political, and other factors that could affect these activities. We use the variance of national economic activity that we believe most closely represents the taxing base over multiple economic cycles to inform our expectations of volatility. To determine our view of the volatility of sales taxes, we used total retail food and service sales data from the U.S. Census Bureau for the period 1993 to 2014.

On a micro level, we do not believe internal or external influences materially improve or worsen SMART's revenue volatility assessment relative to our macro assessment. Measure Q collections began April 1, 2009. Annual growth has since been steadily positive, before fiscal 2020's estimated declines. Although Sonoma County's sales tax revenue declined 30% in fiscal years 2007 through 2010, Marin County's taxable sales were somewhat more resilient, falling about 17%.

### Obligor linkage: Limited relationship

The CDTFA administers the collection and disbursement of the pledged sales tax revenue. Per the indenture, the CDTFA collects the pledged revenue and remits it directly to the trustee, after deducting its administrative fee. Each month, the trustee deposits one-sixth of semiannual interest requirements into an interest fund, and either one-sixth of semiannual or one-12th of annual principal requirements into a principal fund. Only after funding debt service requirements does the trustee remit surplus pledged revenue to SMART. Given the flow of funds and trustee intercept, we believe the pledged revenue is sufficiently removed from SMART's control to mitigate operating risk.

In addition, we consider SMART as having extraordinary expenditure flexibility as a mass transit operating entity that is primarily funded through nonoperating revenue sources. We believe that SMART can materially adjust expenditures by reducing service levels without proportionately reducing revenue. This flexibility further insulates the pledged revenue stream from SMART's operating risk as a mass transit operator.

### Rating linkage to SMART's general creditworthiness

In our analysis of SMART as an operating entity, we consider its creditworthiness to be supported by several factors. In our view, SMART benefits from significant sales tax revenues (89% of total revenues in fiscal 2020, excluding capital grants) that fund the majority of operations, which we view as a stabilizing factor to partially mitigate the financial effects of ridership declines as a result of COVID-19. Prior to the pandemic, financial metrics had improved due to sales tax growth supported by a moderate and growing population base, economically healthy service area, and exposure to the broader San Francisco Bay Area region.

Our view of SMART's market position reflects its limited operating history, startup nature, and relatively low ridership levels of about 717,000 in fiscal 2019 prior to the pandemic. Due to the effects of COVID-19, ridership declined 21.2% to about 567,000 in fiscal 2020 from 717,000 in fiscal 2019, and is expected to remain materially depressed in fiscal 2021 due to ongoing and lingering effects of COVID-19. For more on our forward-looking view of mass transit activity levels, see "Updated Activity Estimates For U.S. Transportation Infrastructure Show Public Transit And Airport Operators Still Face A Long Recovery," published Jan. 13, 2021.

SMART's financial profile is supported by historical financial metrics, including strong all-in DSC. Liquidity has been bolstered by an infusion of about $15 million in Coronavirus Aid, Relief, and Economic Security (CARES) Act funds to offset revenue losses from the COVID-19 pandemic. Furthermore, additional federal stimulus aid is expected in the near term following congressional approval of $14 billion for transit operators in December 2020; however, the timing of receipt and size are still indeterminate for SMART.

In addition, we note that longer-term funding challenges remain, as Measure Q is set to sunset in 2029, and SMART's voters rejected a ballot measure to extend Measure Q in March 2020. While the tax sunsets after the bonds reach final maturity, SMART's sustainability as a mass transit operator over the longer term likely depends on an extension of the sales tax levy or identification of a new primary funding stream.

## Related Research

Through The ESG Lens 2.0: A Deeper Dive Into U.S. Public Finance Credit Factors, April 28, 2020