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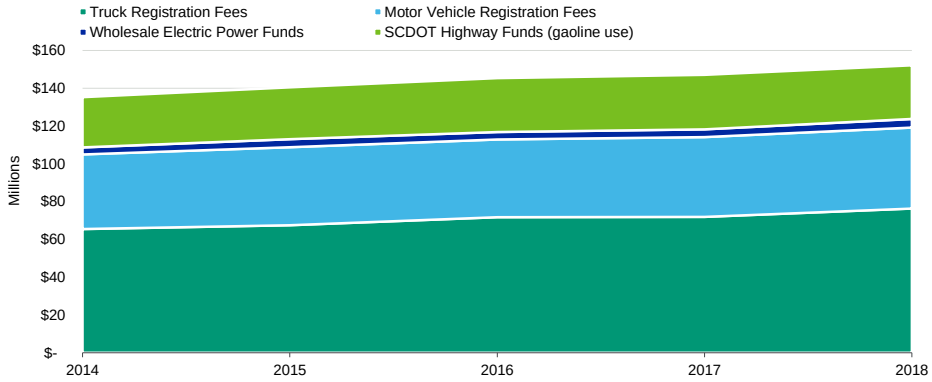
South Carolina Transp. Infrastructure Bank

Update to credit analysis

Summary

The South Carolina Transportation Infrastructure Bank's (SCTIB) Aa3 revenue bond rating is supported by a history of oversight from the State of South Carolina (Aaa, stable), which relies on the SCTIB to finance large road and bridge projects. The state consistently has allocated additional financial resources to SCTIB, both to ensure adequate debt service coverage for the revenue bonds and to help fund projects. SCTIB's recent upgrade was driven largely by our expectation the state will keep providing such support, while avoiding actions that materially erode the ratio of pledged revenue to debt service, indicating a closer credit alignment between the SCTIB and its parent government. In addition, core pledged revenue has risen steadily in recent years, as shown in Exhibit 1. These factors will mitigate certain credit weaknesses, primarily the SCTIB bond program's comparatively lax leverage constraint.

Exhibit 1
Pledged registration fees and other "system" revenue has steadily risen in recent years



Source: South Carolina Transportation Infrastructure Bank disclosures.

Credit strengths

» Oversight by a highly rated state and importance of SCTIB's financing program to meeting the state's transportation infrastructure needs

» History of state proactively adding revenue sources for debt repayment and capital funding needs

» Availability of non-pledged revenue to cover debt service

Credit challenges

» Additional bonds test constraint that allows high program leverage

» Vulnerability of pledged revenue to economic or other conditions affecting motor vehicle use in South Carolina

» Exposure to risks from debt portfolio that includes interest rate swap agreements

Rating outlook

The stable outlook is supported by expectations the state will keep taking actions to ensure that pledged revenue provides adequate debt service coverage, given SCTIB's central role in financing the state's large transportation infrastructure projects.

Factors that could lead to an upgrade

» Programmatic enhancements, such as strengthening the additional bonds test

Factors that could lead to a downgrade

» Deterioration in the state's credit quality

» Weakening of pledged revenue (or increase in leverage) that leads to deterioration in debt service coverage

» Addition of lower credit quality municipalities (or other borrowers) to the infrastructure bank's loan portfolio

Key indicators

Exhibit 2

FY	2013	2014	2015	2016	2017	2018
System revenue	$ 130,706,757	$ 135,238,902	$ 140,449,565	$ 145,293,961	$ 147,053,847	$ 152,143,549
Series revenue	$ 68,217,880	$ 69,487,405	$ 64,907,711	$ 66,452,469	$ 50,273,227	$ 54,450,885
Investment earnings	$ 477,679	$ 512,596	$ 564,862	$ 623,472	$ 663,788	$ 707,068
Current Year's DS coverage	1.27	1.25	1.32	1.34	1.48	1.45
MADS Coverage Ratio	1.22	1.27	1.30	1.35	1.36	1.44
MADSCR, per resolution ABT	1.60	1.60	1.57	1.59	1.64	1.70
Outstanding revenue bonds	$ 1,973,615,000	$ 1,902,065,000	$ 1,834,940,000	$ 1,743,565,000	$ 1,671,045,000	$ 1,584,930,000

Sources: SCTIB audited financial reports and bond offering documents

Profile

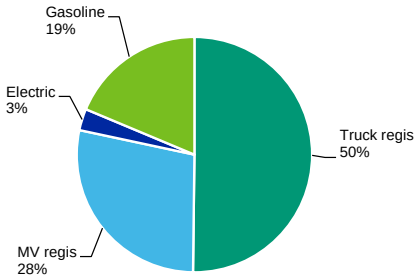
The South Carolina Transportation Infrastructure Bank (SCTIB) was created by 1997 state legislation to finance large transportation projects through loans and grants to local governments or other entities. Since its inception, the SCTIB has contributed $1.73 billion to now completed projects. Projects with another $1.1 billion of funding from the infrastructure bank are underway. The SCTIB is closely monitored by and aligned with the state government (see Governance section below).

Detailed credit considerations

Tax base and nature of pledge

Revenue for payment of the SCTIB's bonds comes from a mix of highway user fees on the one hand and from project-specific loan repayments on the other. The SCTIB calls revenue that is largely derived from (or determined by) highway use "system" revenue, while loan repayments are termed "series" revenue. System revenue currently accounts for about three-quarters of total pledged revenue. The loan repayments component has decreased in recent years, as loans matured without being replaced. Local entities (such as counties) that participate in the program and provide series revenue must first demonstrate capacity to repay,[1] and the local governments' state aid and state-administered funds are subject to intercept by the state treasurer in the event of late payment.

Exhibit 3
Truck and motor vehicle (MV) fee revenue accounts for most of SCTIB's "system" revenue



Fiscal 2018 data.
Source: SCTIB disclosure documents.

As shown in Exhibit 3 above, system revenue consists of four components: truck registration fees, motor vehicle registration fees, payments equal to a 1-cent per gallon tax on gasoline sales and an amount equal to half the state's gross electric utility tax revenue exceeding $20 million. With the exception of the electric power-linked revenue, these sources are somewhat vulnerable to circumstances (such as elevated gasoline prices) that reduce individual or commercial motor vehicle use or, to a lesser extent, sales of motor fuels. The state's "privilege tax" on electric power sales was $29 million in fiscal 2018, resulting in electricity tax-linked payments of $4.5 million in that year. The 1 cent-per-gallon levy amounted to $28.4 million in 2018. For both the electric power and the 1 cent-per-gallon revenue sources, payments are provided by the South Carolina Department of Transportation, which uses non-state-tax resources — primarily Federal Highway Administration (FHWA) reimbursements under US Code Title 23. This somewhat unusual configuration of revenue components reflects the South Carolina Constitution's limits on debt supported by state tax revenue. The constitution (in Article X, Sect. 13) says the state can only issue either general obligation bonds or debt payable from either a revenue-producing project or from certain kinds of nontax revenue.

Payment of principal and interest on SCTIB's bonds is not subject to appropriation, although South Carolina's General Assembly does enact measures authorizing disbursements for SCTIB's operations and project funding. While the state itself has no legal commitment to pay debt service on SCTIB's bonds, the South Carolina Department of Transportation, an agency of the state government, is a party to a master funding agreement under which it pledges to make payments for specific state projects to the SCTIB. The SCDOT is currently the SCTIB's largest source of "series" payment revenue, as the borrower in five loan agreements. As discussed earlier, the SCDOT also provides the system revenue linked to both motor fuel and electric utility tax revenue. Under the master funding agreement, the SCDOT covenants that it will maintain 3.0 times coverage of these payment obligations together with any parity obligations it may enter into later. Because of South Carolina's constitutional constraints on pledging state tax revenue to bonds, the SCDOT uses revenue other than general state taxes to meet its SCTIB payment obligations.

The SCDOT's total nontax revenue amounted to $1.076 billion in fiscal 2018, providing an ample buffer of revenue available for payment. The total incorporates $990 million of FHWA reimbursements and another $86 million of other nontax revenue, such as outdoor advertising fees and other fines, fees and charges collected by the SCDOT. The total amount of SCDOT revenue was almost 16 times the payments required to the infrastructure bank in 2018. The surplus SCDOT funds constitute additional revenue that is effectively available for payment of SCTIB's debt service, although these extra funds are not specifically pledged.

Another component of pledged revenue is any transfers to the pledged revenue fund from the Revenue Stabilization Fund. This fund was created to offset the cyclical nature of truck registration revenue, which historically tended to decline every other year because of biennial renewal patterns. This fund receives revenue in years when registration revenue outperforms and makes transfers to the pledged revenue fund when registration revenue is likely to decline. It currently contains about $30 million and has not actually had to make a transfer to the pledged revenue fund in recent years.

Debt service coverage and revenue metrics

System revenue has increased at a modest but steady pace since the last recession, with growth strengthening more recently, as reflected in Exhibit 1 on the first page. The system revenue grew at a 3.1% compound annual growth rate (CAGR) in the past five years, compared with a 1.8% CAGR during the past 10 years. The biggest one-year decline in system revenue in the 10 years through fiscal 2018 was 1.6% in 2009, during the last recession. Series revenue does not fluctuate in response to economic trends as does SCTIB's tax and fee "system" revenue.

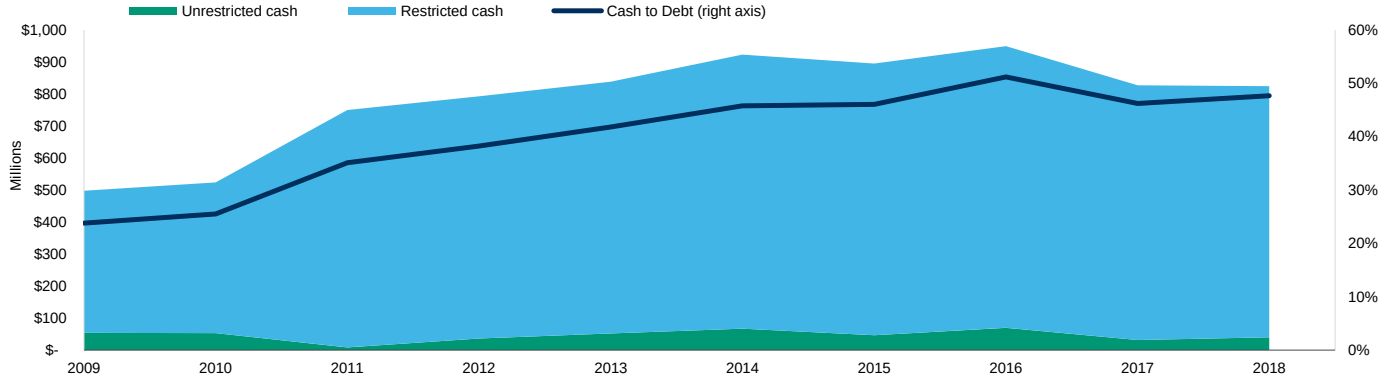
As shown in Exhibit 2, actual debt service coverage from system, series and investment revenue has been narrow, averaging about 1.28 times from fiscal 2014 through 2018. The annual ratio improved to more than 1.4 times in fiscal years 2017 and 2018, reflecting both reduced debt service and improved system revenue, which offset a decline in series (loan repayment) revenue. The current maximum annual debt service (MADS) of $137.2 million (occurring in fiscal 2022) was covered 1.51 times by pledged revenue of $207.3 million from fiscal 2018, the most recent year for which revenue figures are available. This differs slightly from the MADS coverage for fiscal 2018 presented in Exhibit 2 because at the end of fiscal 2018, the MADS figure was larger.

LIQUIDITY

The SCTIB has amassed a growing amount of liquidity, judging by the cash and equivalents reported on its balance sheet in SCTIB's audited annual financial reports since the last recession. Including both of these amounts (those characterized as restricted as well as those that are unrestricted), the cash reported as of June 30, 2018, amounted to 48% of the infrastructure bank's outstanding revenue bonds, compared with just 24% in 2009, as shown in Exhibit 4.

Exhibit 4

Cash and equivalents as reported in financial statements and as a share of revenue debt outstanding



Source: SCTIB audited annual financial statements

The amounts of cash held by SCTIB are not specifically mandated by policies or statutes. The available reserves have risen in recent years as a result of several conditions, including revenue exceeding forecasts and outlays for approved projects either falling below budget or being deferred. The accumulated cash will likely decrease as funding of pending projects gets underway.

Debt and legal covenants

Under the bonds' Master Trust Indenture, the SCTIB can issue additional parity debt to the extent that projected net pledged revenue (defined as total pledged revenue less series payments) will cover maximum annual debt service (also reduced by the amount of series payments) by at least 1.35 times.[2] By this measure, the program currently enjoys projected 1.7 times coverage of maximum net debt service, which is $112.7 million in fiscal 2032. However, in our earlier discussion of maximum annual debt service coverage, we used not only total future MADS but also the actual revenue from the most recent fiscal year, a more common (and more conservative) way to assess leverage.

DEBT STRUCTURE

The SCTIB has $1.48 billion of revenue bonds outstanding. As mentioned earlier, while the bonds' legal documents allow for subordinate-lien debt, no subordinate debt is outstanding or anticipated. Barring additional issuance, total debt service is slated to fall in fiscal 2023 before rising modestly and then dropping off more sharply, in fiscal 2035. Most of the SCTIB's debt – about 76%

– is fixed-rate. While straightforward in many respects, and lacking any puttable obligations, the SCTIB's debt portfolio is complex because of interest rate swap agreements linked to variable-rate bonds originally issued in 2003. The underlying debt, Series 2003B, was remarketed in May as floating rate notes after being held by a bank under a three-year agreement starting in 2016. The bonds currently pay interest at rates linked to one-month Libor (specifically, 67% of the index rate, plus 45 basis points).

DEBT-RELATED DERIVATIVES

The SCTIB's interest rate swaps are intended to hedge its exposure to rising interest rates in connection with the 2003 variable-rate debt. Under the terms of these agreements, the bank in effect exchanges the obligation to pay variable rates on the bonds for the obligation to pay certain fixed rates. Interest rate fluctuations in the market affect the value of these swap agreements; the swaps had a value of minus-$75.3 million in aggregate as of June 30, 2019. While the infrastructure bank's obligation to make regular payments on the swap contracts is on parity with its debt service obligation on its revenue bonds, the potential obligation to make termination payments (representing the negative market value of the swaps in the event of unscheduled termination) is subordinate to debt service. The swap agreements also subject the SCTIB to credit rating-based collateral posting requirements. The collateral the SCTIB had posted as of August 31, 2019, was $50.2 million.

PENSIONS AND OPEB

Pensions and other post-employment benefits are not a factor under the US Public Finance Special Tax Methodology, which applies to the SCTIB's debt.

Environmental, Social and Governance Considerations

ENVIRONMENTAL

US state governments are generally less exposed to environmental risk than many other rated entities, given their broad and resilient economies, their ability to raise revenue and their ability to obtain federal relief after hurricanes or other natural disasters. South Carolina's location on the southeastern seaboard gives it elevated exposure among states to the environmental risks – both severe weather events and sea-level rise – that are intensifying as temperatures rise. The state's 2,876-mile Atlantic coast has put it on the front line of tropical cyclone exposure for storms such as Hugo, a Category 4 hurricane that made landfall in the state three decades ago.[3]The sea level at Charleston, the state's largest city on the coast, has been rising at a rate of 1.3 inches per decade since 1921 compared with a 0.7-inch global rate, according to the National Climate Assessment. The SCTIB's credit structure, which relies in part on revenue related to gasoline use, makes it somewhat vulnerable to stagnant or declining motor fuel consumption as cars are forced to become more fuel-efficient and transition to electric motor technology.

SOCIAL

Social issues, such as demographics, labor force, income and education, are key influencers of South Carolina's economy, governance stability and financial and leverage trends. South Carolina faces elevated poverty levels, like other states in its region, though less acutely. Its percentage of people below 100% of the federal poverty level was 13.6%, according to the 2018 Community Population Survey, somewhat below Florida and Oklahoma and well below Mississippi's 18.7%. Per capita personal income is weak versus the nation's, at just under 80%. At the same time, the state's population is comparatively fast-growing, with a 1.3% five-year CAGR through 2018, compared with 0.7% for the US as a whole.

GOVERNANCE

South Carolina's governance and financial management are characterized by a practice of reducing budgeted spending during downturns and increasing financial reserves during periods of strong revenue growth. The state's process for addressing deficits – which are estimated on a quarterly basis — calls for executive budget office cuts to appropriated funds in the event of shortfalls no more than 3% from budget and, in the case of larger shortfalls, potentially the convening of special legislative sessions to impose such measures. The state's financial reserves (the General Reserve Fund and the Capital Reserve Fund) have grown substantially in recent years, as has the state's GAAP-basis unassigned general fund balance.

The state closely oversees the financial management and infrastructure outlays of the SCTIB. This fact is evident in the composition of the organization's board of directors. The SCTIB's board consists of seven directors: the chairman of the South Carolina Department of Transportation Commission, ex officio; two appointees of the governor and two appointees each for the house speaker and senate president. The speaker and senate president's appointees must include, in both cases, a member of their respective legislative bodies.

Endnotes

1 The capacity-to-repay test requires demonstration that underlying revenue provides 1.2 times coverage through the repayment period, A-category credit ratings or rating agency confirmation that addition of the borrower to the program will not result in a downgrade of SCTIB's debt below the A category.

2 While there is currently no subordinate-lien debt outstanding, the indenture provides that in the event such debt is issued, coverage of senior- and subordinate-lien together would have to equal at least 1.2 times. This ratio would also be demonstrated by using projected revenue and netting out any "series" revenue from both revenue and debt service.

3 National Oceanic and Atmospheric Administration, Office for Coastal Management: "Shoreline Mileage of the United States."

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