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San Diego Metropolitan Transit System, CA Ratings Raised To 'AA' From 'A+' Applying New Criteria

S&PGR Raises San Diego MTS, CA Ratings To 'AA' From 'A+'

DATELINE--S&P Global Ratings raised its issuer credit rating on San Diego Metropolitan Transit System (MTS), Calif., and its long-term rating and underlying rating (SPUR) on MTS' series 2004A pension obligation bonds (POBs) to 'AA' from 'A+', applying its Global Not-For-Profit Transportation Infrastructure Enterprises (TIE) criteria, published Nov. 2, 2020. The outlook is negative.

“The 'AA' long-term rating reflects our opinion of MTS's very strong enterprise risk and financial risk profiles, as well as its significant sales tax revenues,” said S&P Global Ratings credit analyst Kenneth Biddison. Sales tax revenues, which totaled $203 million or 42% of total revenues in fiscal 2020, and other operating grants fund most of MTS' operations. Consequently, the bulk of MTS's revenues are not sensitive to ridership declines, partially mitigating the effects of COVID-19.

We analyzed the transit system's risks related to environmental, social, and governance factors and determined that, with the exception of social risks, all are in line with our view of the standard for mass transit. MTS is exposed to social risks related to COVID-19 social distancing requirements to promote health and safety that are already causing operating and financial pressures. However, we also believe the county's tax base is somewhat exposed to environmental risks posed by the threat of wildfires and, over the longer term, sea level rise. We will continue to evaluate these risks as the situation evolves.

We could lower the rating over the next one to two years if financial metrics weaken materially as a result of MTS issuing a significant amount of debt to fund its large CIP or due to lower-than-expected activity-based revenue.

We could revise the outlook to stable if we believe financial metrics can be maintained at levels consistent with the current rating on a sustained basis.

Rating Action

S&P Global Ratings raised its issuer credit rating on San Diego Metropolitan Transit System (MTS), Calif., and its long-term rating and underlying rating (SPUR) on MTS' series 2004A pension obligation bonds

(POBs) to 'AA' from 'A+', applying its Global Not-For-Profit Transportation Infrastructure Enterprises (TIE) criteria, published Nov. 2, 2020. The outlook is negative.

A first lien on MTS' gross farebox revenue secures the POBs, which have $10.4 million outstanding as of fiscal year-end 2020. There is no debt service reserve fund established for the bonds which we do not view as a credit concern due to our expectation that MTS will maintain an overall strong liquidity position.

Credit overview

The 'AA' long-term rating reflects our opinion of MTS's very strong enterprise risk and financial risk profiles, as well as its significant tax support. Sales tax revenues, which totaled $203 million or 42% of total revenues in fiscal 2020, and other federal operating grants fund most of MTS' operations. Consequently, the bulk of MTS's revenues are not sensitive to ridership declines, partially mitigating the effects of COVID-19.

The negative outlook reflects our view that MTS's financial metrics could be weaker than we expect, especially if the effects of the pandemic and associated impacts worsen and become more prolonged. For more information, see "Activity Estimates For U.S Transportation Infrastructure Show Public Transit And Airports Most Vulnerable To Near-Term Rating Pressure," (published June 4, 2020, on RatingsDirect).

MTS entered the pandemic financially and operationally strong, with extremely strong historical debt service coverage (DSC; S&P Global Ratings-calculated); relatively stable, but declining, ridership levels (85.4 million in fiscal 2020); and a strong overall liquidity position, with financial metrics supported by significant, stable, and growing historical sales tax revenues. Entering the pandemic, we viewed MTS's market position as very strong and still view it as very strong, despite ridership declines of 17.4% in fiscal 2020 (ended June 30) and further projected declines in fiscal 2021, compared with fiscal 2019 levels as a result from COVID-19. MTS, in our opinion, is an important and dominant provider of mass transit services in the growing San Diego metropolitan statistical area (MSA). MTS also benefits from strong political support, as reflected by significant sales tax revenues, reducing volatility due to the pandemic and associated effects. The main local source of operating subsidy for MTS transit programs is Transportation Development Act (TDA) funding. One-fourth of one percentage point of the local sales tax in each California county is dedicated to transportation purposes. On a local level, area voters approved a half-cent transportation sales tax in 1987, called TransNet. One-third of the sales tax proceeds are allocated for transit purposes, and MTS and the North County Transit District further divide this based on the population within the area of each jurisdiction.

In our opinion MTS benefits from a diverse mix of revenues. More specifically, the system's fiscal 2020 total revenue of $413.4 million consisted of $101 million in operating revenue (24% of total, with fares constituting 19%), $105 million in local TDA funds (25%), $90 million in federal funds (22%), $40 million in TransNet funds (10%), and $29 million in other funding sources (7%). Operating revenue was down approximately 7.4% in fiscal 2020. MTS estimates that ridership will be down to 49.5 million in fiscal 2021. Nevertheless, we expect the pandemic and related recession could significantly affect operating revenue and sales tax revenues.

Our financial risk profile assessment reflects MTS's historically extremely strong DSC (S&P Global Ratings calculated), very strong debt and liabilities capacity reflective of a moderate but manageable capital improvement program (CIP)], and an overall liquidity position that we expect will remain strong due to an infusion of approximately $220 million of Coronavirus Aid, Recovery, and Economic Security (CARES) Act money. Management intends to use $17.9 million and $80-85 million of CARES Act funding in fiscal 2020 and fiscal 2021 respectively with a balance of approximately $115-120 million for future uses. We expect management actions, including expense reductions, could allow MTS to maintain financial metrics through the pandemic, although with lower than historical levels, consistent with the rating.

Although estimated revenue impacts on MTS appear to be manageable, the projected effects on future key financial metrics are subject to considerable uncertainty, in our view. We could weaken the financial risk profile if ridership levels and sales tax revenues are weakened for an extended period, further pressuring financial metrics, including DSC (S&P Global Ratings-calculated, which excludes the use of CARES Act money) and debt-to-net revenues. While the early approval of vaccines is a positive development, countries' approval of these vaccines is merely the first step toward a return to social and economic normality; equally critical is the widespread availability of effective immunization, which could come by mid-2021. We use this assumption in assessing the economic and credit implications associated with the pandemic (see our research here: www.spglobal.com/ratings). As the situation evolves, we will update our assumptions and estimates accordingly.

Our enterprise risk profile assessment reflects our view of MTS's:

- Very strong market position, reflective of an essential public transit system with varied offerings (bus and trolleys) that plays a vital role within its service area, tempered by exposure to potentially prolonged weak or unpredictable ridership as a result of the ongoing pandemic and lingering ancillary effects (such as the pandemic-induced recession, shifting travel restrictions, stay-at-home and social-distancing restrictions, or behavioral changes with respect to use of public transit) that are outside of management's control;
- Extremely strong service area economic fundamentals due to favorable levels of economic activity as measured by GDP per capita, and unemployment comparable with the national average but elevated because of the effects of COVID-19;
- Low industry risk relative to that of other industries and sectors; and
- Very strong management and governance, evidenced by a fiscally conservative management team that has considerable expertise and a record of success in routinely meeting or exceeding its fiscal targets, mitigating risk, and successfully managing the system.

Our financial risk profile assessment reflects our view of MTS's:

- Extremely strong financial performance, which reflects DSC, per our calculations, above 20x in fiscal 2020 due in part to revenue stability from sales tax revenues significantly supporting operations. Although we note there is potential for DSC to be pressured in the interim from near-term farebox revenue losses due to the pandemic or if additional bonds are issued to fund the CIP;
- Very strong debt and liabilities capacity, with a very low debt burden of $10.4 million of debt outstanding, temperedby five-year capital improvement plan identifying $735 million in total project needs and weakness in pension and other postemployment benefit liabilities;
- Strong liquidity and financial flexibility based on our expectation that management will maintain unrestricted reserves ($104 million at fiscal year-end 2020) near 120 days' cash on hand and well above 100% of debt outstanding, further supported by CARES Act funds.

Environmental, social, and governance (ESG) factors

We analyzed the transit system's risks related to environmental, social, and governance factors and determined that, with the exception of social risks, all are in line with our view of the standard for mass transit. MTS is exposed to social risks related to COVID-19 social distancing requirements to promote health and safety that are already causing operating and financial pressures. However, we also believe the county's tax base is somewhat exposed to environmental risks posed by the threat of wildfires and, over the longer term, sea level rise. We will continue to evaluate these risks as the situation evolves.

Negative Outlook

Downside scenario

We could lower the rating over the next one to two years if financial metrics weaken materially as a result of MTS issuing a significant amount of debt to fund its large CIP or due to lower-than-expected activity-based revenue.

Return to stable scenario

We could revise the outlook to stable if we believe financial metrics can be maintained at levels consistent with the current rating on a sustained basis.

Credit Opinion

U.S. economy

The evolution of the pandemic, and its effect on the economy and general mobility, remains a fluid situation, causing ongoing uncertainty. With national virus transmission rates rising to new peaks, economic uncertainty is again elevated. The recovery remains fragile. Real-time indicators show that the economic picture is improving, but at a decelerating pace as higher uncertainty about the pandemic and federal stimulus introduces downside risks for the economic outlook in the fourth quarter 2020 and beyond. The U.S. economy, which has recouped two-thirds of the economic losses from the COVID-19 recession, is now showing signs of weakness as infection rates climb. As this recovery unfolds, the greater risks have increased: no coronavirus vaccine yet available as the country heads into flu season and a lack of new fiscal stimulus, with more pandemic-related stimulus expiring at year-end. Increasing trade tensions with China further exacerbate the situation. Consequently, the U.S. economy post-election won't be very different than where it was before Nov. 3, with a slow recovery and a 25%-30% risk of recession, closer to the top of the range.

With consumer spending proving largely resilient through summer 2020 (helped by federal fiscal stimulus) and unemployment--while still notably high--softening a bit more than S&P Global Economics had forecast, third-quarter GDP experienced a steeper rebound than many market participants expected, increasing 33.1% from the previous quarter, although that will only partially offset the massive losses in the first half of 2020. Our current U.S. economic baseline forecast shows U.S. growth declining 2.3% (quarter over quarter annualized) in the fourth quarter. Although a one-quarter decline does not signal recession, it does increase the chances that the U.S. could see another downturn soon.

S&P Global Economics' current baseline forecast anticipates ending 2020 at a negative 3.9% real GDP growth rate and rebounding to a slower growth phase heading into 2021, with 4.2% estimated for next year, up from the 3.9% in our September 2020 economic forecast, but weaker than the 5.2% in our June economic forecast and the previous 2021 estimate of 6.2%. The baseline forecast, however, assumes passage of a $1 trillion stimulus package before year-end. The national unemployment rate declined to 8.4% in August 2020 from its post-1947 record high of 14.75% (in April 2020); however, we don't expect the unemployment rate to return to its pre-pandemic low until after 2023. Our current downside U.S. economic forecast, which shows real GDP declining 4.4% in 2020 and rising only 0.8% in 2021, assumes no more fiscal stimulus and a COVID-19 resurgence that cripples growth in the fourth quarter. Our current upside U.S. economic forecast, which shows real GDP declining 3.8% in 2020 and rebounding 4.5% in 2021, assumes reopenings taking place sooner amid promising treatment and vaccine news, and the government providing $1.5 trillion of additional support. (See "Economic Research: Staying Home For The Holidays, " published Dec. 2, 2020.)

Significant tax support

MTS funds operations through farebox revenue and other operating sources, including federal, state, and local subsidies. The main local source of operating subsidy for MTS transit programs is Transportation Development Act (TDA) funding. One-fourth of one percentage point of the local sales tax in each California county is dedicated to transportation purposes. On a local level, area voters approved a half-cent transportation sales tax in 1987, called TransNet. One-third of the sales tax proceeds are allocated for transit purposes, and MTS and NCTD further divide this based on the population within the area of each jurisdiction. Additionally, MTS receives state transit assistance that is funded through the state sales tax on gasoline and is subject to appropriation by the state legislature.

Related Research

- How We Apply Our Global Not-For-Profit Transportation Infrastructure Enterprise Criteria, Nov. 2, 2020
- Through The ESG Lens 2.0: A Deeper Dive Into U.S. Public Finance Credit Factors, April 28, 2020