

January 13, 2014

Ms. Teveia Barnes  
Executive Director  
California Infrastructure & Economic Development Bank  
980 9th Street, Suite 900  
Sacramento, CA 95814

Dear Ms. Barnes:

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We are pleased to have had the opportunity to be of service to you. If we can be of further assistance, please feel free to contact us at any time.

Jeff Schaub  
Managing Director, Operations  
U.S. Public Finance /  
Global Infrastructure & Project Finance

JS/mb

Enc: Notice of Rating Action  
(Doc ID: 187611)

# Notice of Rating Action

| <u>Bond Description</u>                                                                                                | <u>Rating Type</u> | <u>Action</u> | <u>Rating</u> | <u>Outlook/<br/>Watch</u> | <u>Eff Date</u> | <u>Notes</u> |
|------------------------------------------------------------------------------------------------------------------------|--------------------|---------------|---------------|---------------------------|-----------------|--------------|
| California Infrastructure & Economic Development Bank (CA) infrastructure state revolving fund revenue bonds ser 2014A | Long Term          | New Rating    | AAA           | RO:Sta                    | 10-Jan-2014     |              |
| Key: RO: Rating Outlook, RW: Rating Watch; Pos: Positive, Neg: Negative, Sta: Stable, Evo: Evolving                    |                    |               |               |                           |                 |              |

## **FITCH RATES CALIFORNIA INFRASTRUCTURE & ECON DEVEL BANK'S SER 2014A SRF BONDS 'AAA'; OUTLOOK STABLE**

Fitch Ratings-Austin-10 January 2014: Fitch Ratings assigns an 'AAA' rating to the following bonds issued by the California Infrastructure and Economic Development Bank (CIEDB) under its 2014 Master Indenture (MI):

--Approximately \$95.5 million Infrastructure State Revolving Fund revenue bonds (ISRF), series 2014A.

The bonds are expected to price via negotiation the week of January 20. Bond proceeds will be used to finance or refinance loans to eligible borrowers, to refund all of the outstanding series 2004 and 2005 bonds issued under the 2004 MI (the previous indenture), and to pay for the cost of issuance.

The Rating Outlook is Stable.

### **SECURITY**

The bonds are secured by pledged loan repayments, reserves and account interest earnings.

### **KEY RATING DRIVERS**

**SOLID FINANCIAL STRUCTURE:** Fitch's cash flow modeling demonstrates that the program can continue to pay bond debt service even with loan defaults in excess of Fitch's 'AAA' liability default hurdle, as produced using Fitch's Portfolio Stress Calculator (PSC).

**STRENGTHENED POLICIES:** Recent changes to the ISRF program's policies now include the intent and ability to finance borrowers of higher credit quality. Previously, loans were made available to borrowers with limited market access. The potential additions of more rated entities should lead to improved overall pool credit quality.

**AVERAGE POOL DIVERSITY:** The ISRF's borrower pool is somewhat small at about 60 borrowers. The largest borrower, the city of Hawthorne, represents a manageable 7.6% of the pool. The largest 10 borrowers represent approximately 47% of the total pool.

**LARGELY UNRATED POOL:** Approximately 70% of the loan portfolio consists of unrated entities which Fitch conservatively assumes to be of speculative-grade credit quality in its analysis. In accordance with its criteria, Fitch has obtained an assessment of credit quality on a minimum of 33% of the loan pool.

**STRONG PROGRAM MANAGEMENT:** Program management adheres to a formal underwriting policy which includes, among other things, minimum coverage requirements for most borrowers. To date, there have been no pledged loan defaults in the ISRF program.

### **RATING SENSITIVITIES**

**REDUCTION IN MODELED STRESS CUSHION:** Significant deterioration in aggregate borrower credit quality, increased pool concentration, or increased bond leveraging resulting in the program's

inability to pass Fitch's liability default 'AAA' hurdle would put downward pressure on the rating. The Stable Outlook reflects Fitch's view that these events are not likely to occur.

## CREDIT PROFILE

CIEDB created the ISRF program in 1999 to provide low-cost loans for several different categories of eligible public infrastructure projects throughout the state. The series 2014A bonds are the first to be issued under the 2014 indenture. These bonds will refund series 2004 and 2005 bonds, issued under the 2004 MI. The series 2008 bonds (2004 MI) will remain outstanding and separately secured from the 2014 MI bonds after issuance of the 2014A bonds.

## FINANCIAL STRUCTURE EXHIBITS STRONG DEFAULT TOLERANCE

Fitch calculates the program's asset strength ratio (PASR), which includes total scheduled loan repayments plus any reserve balances and account earnings divided by total scheduled bond debt service, to be very strong at approximately 2.3x versus Fitch's 'AAA' median of 1.6x. Additionally, projected minimum annual coverage excluding reserves is very strong at 1.8x versus Fitch's 'AAA' median of 1.2x.

Because of this strong coverage, cash flow modeling demonstrates that the program can continue to pay bond debt service even with hypothetical loan defaults of 100% over any four-year period (as per Fitch criteria, a 90% recovery is also applied in its cash flow model when determining default tolerance). This is in excess of Fitch's 'AAA' liability stress hurdle of 60% as produced by the PSC. The liability stress hurdle is calculated based on overall pool credit quality as measured by the rating of underlying borrowers, size, loan term, and concentration.

## IMPROVEMENTS IN PROGRAM POLICY, 2014 MASTER INDENTURE

In October 2013, the board approved amended and restated program criteria, priorities and guidelines.

Amended changes to the criteria include eligibility for larger borrowers with public ratings (previously program borrowers were largely limited to those unrated entities with limited market access) and certain non-profit private entities with public sponsorship.

The 2014 indenture is considered 'open' in the sense that all assets are pledged to all bonds rather than certain assets pledged only to certain series of bonds (i.e. a 'closed' indenture). Improvements versus the 2004 MI include the addition of the supplemental revenue fund as described below.

## LARGELY UNRATED LOAN POOL EXHIBITS AVERAGE DIVERSIFICATION

The ISRF loan pool under the 2014 indenture is composed of about 60 borrowers. At 7.6%, the largest loan is secured by lease revenues paid by the city of Hawthorne (parity bonds not rated by Fitch). In aggregate, the top 10 borrowers represent approximately 47% of the loan pool, similar to Fitch's 'AAA' median level of 52%.

The majority of the loan pool is to borrowers that do not carry a public rating. Therefore, in its effort to ascertain a credit view on a minimum of 33% of the pool, Fitch assigned an internal credit opinion to one unrated borrower. The remaining unrated portion of the pool was conservatively estimated to be of speculative-grade credit quality ('BB') in Fitch's analysis, in accordance with its criteria.

Given the largely unrated loan pool, the resulting 'AAA' liability hurdle is high at 60% versus an 'AAA' median of 33%. However, the strong cash flow coverage mitigates much of the risk associated with the unrated pool. Additionally, around two-thirds of the pool is backed by strong security pledges in the form of water/sewer net system revenue and combination revenue/general obligation pledges.

## STRONG PROGRAM MANAGEMENT AND UNDERWRITING

The ISRF program is separate from other state revolving fund (SRF) programs, such as the Clean Water and Drinking Water SRFs. Pursuant to loan agreements, underwriting criteria generally include covenants requiring each borrower to collect tax revenues or charge sufficient enterprise rates to meet all debt service requirements. Rate charges may also include a minimum coverage requirement.

To date, there have been no loan payment defaults from ISRF program borrowers. However, two credits in the ISRF program have declared bankruptcy, including the city of San Bernardino in August 2012 and the Los Osos Community Service District in August 2006. Neither of these entities has exposure in the 2014A pool.

## DEBT SERVICE RESERVE FUND

The 2014 bonds are additionally secured by a reserve fund subject to a reserve requirement equal to the least of (a) 10% of the initial bonds, (b) 1.0x maximum annual debt service, and (c) 1.25x average annual debt service. Aggregate reserves total \$6.4 million or about 6.7% of outstanding bonds.

## ADDITIONAL BONDS TEST

Additional parity bonds can be issued provided that the 'coverage test' is met. The coverage test requires that annual projected pledged revenues provide 1.2x annual debt service coverage through the program's expected life. For the purpose of calculating the coverage test with respect to the ability to issue additional bonds, amounts in the supplemental revenue fund are excluded. Generally, management has indicated to Fitch that actual target minimum coverage is 1.3x-1.4x.

## SUPPLEMENTAL REVENUE FUND

If the coverage test described above is not met, annual surplus amounts will be deposited into the supplemental revenue fund by the trustee. This fund is a new addition to the 2014 MI and is viewed by Fitch as a positive but not significant credit feature, as surplus amounts are likely to be modest if the coverage test is not being met. Once the coverage test is passed (test excludes amounts in the supplemental revenue fund) excess amounts can then be released from lien of the indenture.

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Applicable Criteria and Related Research:

- 'State Revolving Fund and Leveraged Municipal Loan Pool Criteria' (May 17, 2013);
- 'State Revolving Fund and Leveraged Municipal Loan Pool 2013 Peer Review' (Oct 31, 2013);
- 'Revenue-Supported Rating Criteria' (June 3, 2013).

Applicable Criteria and Related Research:

Revenue-Supported Rating Criteria

[http://www.fitchratings.com/creditdesk/reports/report\\_frame.cfm?rpt\\_id=709499](http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=709499)

State Revolving Fund and Leveraged Municipal Loan Pool (2013 Peer Review)

[http://www.fitchratings.com/creditdesk/reports/report\\_frame.cfm?rpt\\_id=719991](http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=719991)

State Revolving Fund and Leveraged Municipal Loan Pool Criteria

[http://www.fitchratings.com/creditdesk/reports/report\\_frame.cfm?rpt\\_id=707257](http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=707257)

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