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Criteria | Governments | U.S. Public Finance:
Special-Purpose Districts

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Tax Increment Bonds

Tax increment financing, sometimes called tax allocation bonds, has been issued in a majority of states, although California redevelopment agencies continue to account for the bulk of national volume. Tax increment financing is secured by taxes generated from the increase in property value in a district after a redevelopment project has begun. As such, it does not raise the tax rate on district taxpayers, but merely reallocates tax revenues that would otherwise flow to pre-existing taxing entities in favor of a redevelopment agency that issues debt. Tax revenues produced from pre-existing property before the tax increment district was formed continue to flow through to the underlying taxing entities as before; only the taxes attributable to the increase in property values flow to the redevelopment agency and are pledged to bondholders.

Tax increment bonds benefit from several favorable structural elements compared to other special district debt. Unlike special assessment and Mello-Roos bonds, no additional tax burden is created for taxpayers, and tax collection rates are generally less of a concern, unless project area tax payments are concentrated in a few taxpayers. In addition, while undeveloped land in a special assessment or Mello-Roos district can lead to high debt burdens, undeveloped land in a tax increment district is generally a favorable factor, since tax revenue will increase to the extent new development occurs and taxable property values grow. In contrast, revenues do not increase for special assessment or Mello-Roos debt when property values rise because those taxes are not based on land value, although development may lead to more favorable value to debt ratios.

The main credit risk for tax increment districts is that tax rates and the pace of private development in a project area lie outside the control of the redevelopment agency issuing the debt. Actual tax rates generating the tax are set by the underlying taxing entities?cities, counties, school, park districts, and others--that set their tax rates without consideration of the needs of the redevelopment agency. Changes in state tax law, or assessment practices, can dramatically influence tax increment revenue.

Tax increment district bond pitfalls

A typical investment-grade tax increment district already generates sufficient revenues to cover future maximum annual debt service (MADS) at the time of the sale of bonds, a feature sometimes called "coverage in the ground". However, the experience of southern California during the 1990s shows that many different factors can subsequently reduce tax increment revenues. Some of the common pitfalls of these bonds include volatility in commercial real estate values during an economic downturn, particularly for warehouses and hotel properties, widespread tax appeals that can overwhelm county assessment offices, a residential real estate bust, construction risk on projected projects, state tax law changes, plant closures, concentration in a few taxpayers, purchase or foreclosure of land by tax exempt entities, and a high tax increment volatility ratio for recently formed project areas.

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Tax Increment Suggested Documentation

- Number of project area acres and a description of the land uses within the project area.
- Five year project area assessed valuation history, if available.
- Project area tax rates and underlying taxing entities.
- Base year assessed valuation.
- Debt service schedule.
- Ten largest taxpayers and each of their assessed values.
- Tax collection rates.
- Major pending assessment appeals.
- When sub-areas of a project area, if any, might expire before bond maturity.
- Cumulative project area tax limit, if any, and how much has been collected under it to date.
- Description of tax-sharing agreements with underlying taxing entities, if any is senior to debt service. If they are, disclosure of any that could cause an increase in prior payments in a future year.
- Additional bonds tests and other legal covenants.
- Bond Indenture.
- If there is a consultant's report, a copy should be provided.

Project area analysis

Standard & Poor's Ratings Services analysis focuses first on general economic factors that may affect the economic growth of the project area, such as a municipality's population, employment, and income level. Building permits may indicate overall city construction trends. Nonetheless, the general character of a city is not necessarily a barometer of the conditions within a localized project area. In this respect, a site visit may help give credence to rapidly improving economic conditions that are not reflected in assessed valuation numbers. One way to get a description of a new project area is to read the redevelopment agency's plan, which outlines prior economic conditions and project objectives.

Taxpayer concentration

One weakness of many project areas is their small size, leading to taxpayer concentration. Standard & Poor's has no size limit on investment-grade rated project areas. Generally, smaller districts will have weaker credit characteristics and, thus, lower ratings. A larger project area, generally one of over 150 acres, is usually more diverse and more creditworthy. Standard & Poor's analyzes taxpayer concentration by comparing assessed valuation of the top taxpayers to project area incremental value?not project area total value?because revenues rise or fall based on incremental valuation. It is not uncommon to see each of the top taxpayers representing more than 100% of incremental project area valuation in newly formed project areas, even though top taxpayers may appear deceptively diverse when compared to total project area assessed valuation.

Generally, Standard & Poor's requests the assessed valuations of the top 10 taxpayers. It is typical for 40% or more of the incremental tax base to be held by the top five taxpayers, based on the relatively small size of most project areas. Taxpayers may also not appear overly concentrated when considered individually, yet they may still comprise just one shopping mall or condominium development. Market factors can swing the value of such shops and homes together as a result of their common location and function, apart from fire or natural hazard risks of adjacent buildings. Districts concentrated in a particular type of property, such as aircraft or computer equipment capable of being moved to other locations, may also have other vulnerabilities, even if they are diverse by taxpayer. If payment of debt service is essentially dependent on just a few taxpayers making their tax payments, it may be difficult to achieve an investment-grade rating unless those taxpayers demonstrate creditworthiness, and the property is

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essential to its operations. Even in the case of a rated taxpayer, however, the property should be highly essential to the taxpayer to get the benefit of the credit rating assigned to the taxpayer. An example would be an important generating plant of a rated investor owned utility.

Assessment practices that may at first appear to "guarantee" tax collections have been shown through experience to not always be reliable. A financially strong company can still remit smaller-than-expected tax payments by appealing its assessment (which can take three years or longer to resolve), not rebuilding after a fire, or delaying initial construction. Taxpayer bankruptcy proceedings can also temporarily forestall legal foreclosure or tax assessment sales, since federal bankruptcy law supercedes local law.

Historical assessed valuation growth

Standard & Poor's prefers to examine at least four years of project area assessed values, when available. One of the virtues of tax allocation bonds is the typically high growth rate of assessed valuation within most new project areas. However, a recent base year may cause deceptive percentage rises in incremental assessed valuation because of the comparison to small early-year incremental values (see the tax volatility ratio chart). Total project area assessed valuation may be a more meaningful indicator of growth trends. In a few states, fire, demolition, or conversion to tax-exempt property may be used to decrease the frozen base assessment?increasing incremental assessed value?without new construction.

Future assessment growth

An important indicator of future assessment growth is the acreage available for new development. A fully developed area, with no redevelopment potential, effectively limits the possibility of assessed valuation growth. However, project areas with large undeveloped land areas are not assured of attaining growth. Construction strikes, changes in market conditions, or higher interest rates can suddenly cancel or delay even the most promising development.

Construction risk, when present, is such a risk factor that most investment grade-rated tax allocation bonds already demonstrate coverage of maximum annual debt service by historical tax revenues (Standard & Poor's will consider next year's tax levy an "historical" revenue if it is based on the current assessor's assessment roll and the current tax levy), although exceptions have been made when debt service could be covered with only limited amount of future growth that seems especially likely. Historical coverage of debt service alone, however, does not necessarily guarantee an investment-grade rating.

Management

Policy control of a redevelopment agency usually lies in a city council, with an executive director responsible for implementation. The agency holds broad authority to acquire, develop, and administer property, as well as eminent domain powers. Often a major portion of tax allocation bond proceeds is used to acquire and consolidate parcels of land. Questions for management may encompass additional debt plans, unusual features of the redevelopment plan, and the land use breakdown when the plan is completed.

Legal considerations

Standard & Poor's analysis of the legal structure of a tax allocation bond focuses on the security pledge, flow of funds, debt service reserve fund, and provisions governing the issuance of additional parity debt. The flow of funds is usually simple. Tax increment pays debt service, makes up debt service reserve deficiencies, and then revenues are released for any purpose. Lack of a fully funded reserve is viewed as a negative rating factor in view of the low debt service coverage of most tax increment bonds.

Additional debt issuance is likely over the life of a bond issue. Tests for additional bonds requiring 1.25x coverage of maximum annual debt service by historical revenues, or revenues to be realized as a result of the most recent finalized assessment rolls, are considered a typical provision. However, stricter additional bonds tests may enhance credit quality. Provisions allowing adjustments to revenues based on construction in progress or a consultant's projection can severely weaken the additional bonds test. The coverage multiple required under the additional bonds test is examined in relation to the number of taxpayers excess cash flow could cover in the event of delinquencies among major taxpayers, assuming a redevelopment agency bonded out to the limit of its additional bonds test. Thus, no one additional bonds test or coverage level can guarantee a specific rating.

More established diverse districts have issued debt with less than a 1.25x additional bonds test without a negative impact on their credit rating as their tax volatility ratio declined and their taxpayer concentration diminished. Standard & Poor's weighs a more permissive test against taxpayer diversity, historical and projected growth trends in assessed valuation, the nature of such growth, and the need and likelihood for additional debt issuance. On the other hand, higher debt service coverage and stronger additional bonds tests may offset weaknesses in district economic diversity.

Aside from an issue's legal structure, Standard & Poor's evaluates tax increment authorization laws and litigation. Standard & Poor's examines all new state authorizing legislation for potential problems. Litigation frequently accompanies tax allocation issues, especially in states newly authorizing such financing, because public entities losing the tax revenues have an incentive to sue. Taxpayers and overlapping units often contest the constitutional validity of new tax allocation legislation; counties may wish to postpone the loss of revenues, and taxpayers may want to delay eminent domain proceedings.

Some tax increment bonds also have a pledge of a city's GO. Standard & Poor's will rate such double-barreled securities based on the higher of the GO or tax increment rating, since both are pledged to debt repayment.

Financial operations

Primarily, financial factors include an analysis of fluctuating tax rates, delinquent collection rates (for the project area, not the city), and historical debt service coverage. No specified level of coverage leads to a particular rating, since taxpayer concentration or legal factors may be much more important. When a particular weakness is identified, it is useful to check coverage sensitivity to such vulnerabilities. For example, if an issuer experiences poor property tax collection, coverage levels and additional bonds tests can be raised to compensate. The lower of the additional bonds test coverage level, or current revenue coverage of maximum annual debt service, is used for analysis. Projected coverage based on construction growth is not always reliable, but worth considering.

Various mathematical considerations concerning the ratio of base to total assessed valuation also may affect the volatility of the revenue stream in the event assessed valuation declines (see chart on the tax volatility ratio). In general, the smaller a district's base valuation is compared to its total valuation, the lower the revenue volatility.

Cumulative tax limits

Project areas in California are subject to a cumulative cap on tax increment that can be collected from a project area over the life of the project area. Sometimes, higher-than-projected tax increment can cause the cap to be reached before final bond maturity. If this appears to be a significant possibility, Standard & Poor's would prefer a covenant by the redevelopment agency to annually review the total amount of tax revenues remaining and to escrow revenues or not accept tax monies if it would cause the tax limit to expire before final bond maturity.

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Tax Increment Bond Volatility Ratio

The mathematical formula used to compute incremental tax revenues does not treat all project areas equally on a general decline in assessed values. Tax increment project areas containing a small amount of incremental valuation in relation to their total assessed value will show greater volatility revenues. This is often the case for recently formed project areas. Thus, two project areas, with the same amount of total assessed value, can have unequal loss of tax increment revenues, even when losing the same amount of total assessed value.

Standard & Poor's uses a revenue volatility ratio to highlight the speed at which revenues can fall in the event assessed values decline. The ratio consists of the project area's base assessment to total assessment. This ratio can serve as a proxy for the speed with which tax increment revenues will rise or fall in the event of a fluctuation in assessed value. Standard & Poor's expresses the volatility ratio of base assessment to total assessment as a decimal fraction between 1.0 and 0.0. A higher number represents more volatility. In other words, revenues will rise or fall more rapidly with a small change in project area assessed valuation when the ratio is high. The ratio is incorporated as part of Standard & Poor's rating process.

The ratio serves as a convenient flag for the most vulnerable districts in times of real estate decline. Most of the tax allocation bonds that experienced troubles during California's real estate downturn of the 1990s had high volatility ratios.

On the other hand, a high volatility ratio can also cause a quick increase in revenues and coverage in the event of even modest assessed value increases.

In the example, project areas A and B have the same assessed value and tax allocation coverage, but would respond very differently to a 10% decline in overall project area AV. Project area A has a low base-to-total assessed value volatility ratio of 0.2, while Project area B displays higher revenue volatility with a change in assessed valuation, with a volatility ratio of 0.8. Project area A, which is older and has a smaller base valuation, suffers a much smaller decline in coverage, from 2.0x to 1.75x if total assessed valuation declined 10%. Project area B's debt service coverage falls from 2.0x to 1.0x with the same percentage decline in assessed value because it was more recently formed and has a high base valuation relative to total assessed valuation.

The volatility ratio is specific to each project area, and is independent of the amount of debt issued by a project area.

One alternative way to look at this volatility ratio is to examine its inverse. The inverse represents the percentage that total project area assessed valuation must fall to produce zero tax increment revenues. Thus, a high volatility ratio of 0.8 means total assessed value would have to fall 20% before there would be no more tax increment revenues.

Examples Of Different Base To Total Project Area Assessed Valuations

Different volatility with same initial coverage and assessed valuation

	Low volatility Project area A	High volatility Project area B
Total assessed value	$500 million	$500 million
Base increment	$100 million	$400 million
Incremental assessed value	$400 million	$100 million
Tax rate	1.00%	1.00%
Pledged revenues	$4 million	$1 million
Maximum annual debt service	$2 million	$500,000
Coverage	2.0x	2.0x
If project assessed value fell 10%		
Project assessed valuation	$450 million	$450 million
Incremental assessed value	$350 million	$50 million
Pledged revenues	$3.5 million	$500,000
Coverage	1.75x	1.00x
Base assessed value to total value volatility ratio	0.2	0.8

Special Assessment Bonds

Special assessment bonds are secured by a special tax, such as a street front-footage assessment, which is levied in relation to the benefit a property receives from an improvement. Consequently, the tax is not based on the actual value of a property and debt burdens, as a percent of the market value of a parcel, can vary greatly from one parcel to another. Since each taxpayers' tax payments are usually fixed and can not be raised to cover the delinquency of any other taxpayer, the credit analysis generally focuses on the exposure to the weakest properties, even if overall average property value to debt ratios are strong districtwide.

In particular, special assessments on undeveloped land may create burdensome tax payments for those properties. Undeveloped land typically carries property value-to-debt ratios of 3:1 or less, while developed properties are generally closer to 20:1. Standard & Poor's expects investment grade special assessment bonds to be able to at least withstand two separate sensitivity analyses: (1) a multi-year tax delinquency by the two to five largest special assessment taxpayers; and (2) a permanent delinquency by all special assessment taxpayers with under a 5:1 value-to-overlapping debt ratio, absent special circumstances.

Sources of money to cover potential delinquencies may come from reserve funds, an ability to raise taxes to a limited degree, over-collateralization of tax payments, back-up support from a city's general fund (often found in Arizona), cross-collateralization with other special districts, a senior/subordinate bond structure, or other revenue sources.

Special assessment bonds have proven very popular in growing areas such as California and Florida, where existing residents may be reluctant to pay for infrastructure improvements in new housing developments. However, special assessment financing is used throughout many areas of the country. Examples of projects funded by special assessment bonds include water and sewer lines, lighting improvements, roadways, and sidewalks.

Financing special assessment projects

The special assessment process is often quite simple. In most cases, property owners in a limited area, or their local representatives, petition for the creation of a special assessment district. A project is specified that will directly benefit property owners within the district and be paid for by fees or assessments based on a measurement related to the benefit, such as street frontage or square footage owned. Bonds are sold to finance the project(s), and security is provided by the assessments.

Most improvements provided by special assessment bond financing are related to local infrastructure, although bonds have been sold to finance parking lots, landscaping, and public parks. These improvements benefit district property owners by improving the quality of their neighborhood and contributing to greater property values.

Usually, bonds are used only for the construction of the project and not for maintenance. Often, the municipality will absorb the maintenance cost, since the project generally is tied into a citywide system, such as water and sewer services.

Standard & Poor's believes that the lack of excess cash flow coverage typical for most special assessment bonds may create risks, particularly for undeveloped districts. However, potentially speculative elements can be mitigated through such factors as:

- An ability to raise assessment tax rates to a limited degree;
- The existence of excess cash flow from reserve earnings, refunding savings, or a senior subordinate cash flow structure;
- Strong taxpayer diversity, and a debt service reserve that can cover simultaneous delinquencies of at least the top two taxpayers;
- The ability to sell tax liens to cover delinquencies, although this is restricted under federal law if a taxpayer declares bankruptcy;
- Particularly strong value-to-lien ratios;
- A lien on parity with or ahead of ad valorem taxes;
- Legal protections within the bond structure;
- Economic incentives for timely payment of special assessment obligations; and
- Low risk associated with the particular project.

Major criteria considerations

District makeup and economic base -- A district largely undeveloped or concentrated in one type of industry is viewed negatively. A special assessment district tied to a stable and diversified economic base is desirable. The effects of employment levels, wealth indicators, and regional trends on payment of assessments are evaluated. A wholly residential district usually exhibits little taxpayer concentration, a very favorable situation if fully developed.

Method of assessment collection.

Special assessments collected at the same time and with the same foreclosure methods of ad valorem taxes are preferred. Standard & Poor's also may regard incentives for early payment and disincentives for late payment as positive features. For example, penalties for late payment and discounts for early payment may be worthwhile, depending on their effect on cash flows.

Value-to-debt ratios.
High property value-to-debt ratios, typically above 7:1 for investment-grade ratings, increase the likelihood of making assessment payments on a timely basis. Also, the marketability of property in the district points to added security if properties must be sold as a result of foreclosure or bankruptcy. Value-to-lien ratios are examined on a parcel-by-parcel basis for top taxpayers, since tax levies cannot typically be raised on the strong taxpayers to pay for the weak, rendering overall district value to lien ratios problematical in many cases. Standard & Poor's prefers value to lien ratios using county or city assessed valuation, although independent appraisal reports may be evaluated also if deemed reasonable.

Lien position.
A lien on parity with or ahead of ad valorem taxes is desirable. Preferably, the general property tax bill should be combined on the same statement as the special assessment tax bill to help collection rates.

Treatment of property sales.
Liens typically remain in place upon transfer of property or are extinguished by an immediate acceleration of all outstanding, current, and future special assessments on the property.

Foreclosure/bankruptcy provisions.
Assessment collections should not be hindered by foreclosure, bankruptcy, or sales of tax certificates or tax deeds. Action should be taken on a timely basis to ensure that sufficient funds are available to make scheduled debt service payments. The marketability of property is also a concern here; property should have sufficient value that bids will appear for foreclosed property. Requirements allowing and requiring foreclosures to proceed on an accelerated basis compared to that for general property taxes is considered favorably.

Clear right to issue.
Public hearings and a deadline for discussion are necessary, within legal requirements, so that there are no legal challenges possible once bonds are offered.

Term and redemption of bonds.
The debt service schedule is usually flat or declining over time and is usually within the useful life of the project and improvements.

Debt service reserve.
A reserve fund or other security feature that provides for payment of debt service is essential in the event that assessments are not received on a timely basis. The amount of the debt service reserve and the way that it is funded are important, because funds to cover any revenue shortfall are expected to be available at all times.

Cash flow runs.
Sensitivity tests that demonstrate the bond structure's strength in the event of delinquency of the largest taxpayers are necessary in evaluating the ability of the bond structure to withstand unexpected events. Standard & Poor's normally expects some excess cash, either in a debt service reserve or through excess cash flow, be available to cover a delinquency by at least the top two to five taxpayers, unless the top taxpayer has itself been rated by Standard & Poor's.

In some cases, Standard & Poor's commercial mortgage group can evaluate the credit quality of an individual development for assessment bond purposes and the rating can be based on a single taxpayer or retail development. Usually, however, Standard & Poor's requests information determining the maximum number of taxpayer delinquencies a district can handle before defaulting and compares this to the concentration of the top taxpayers.

Where extremely high taxpayer diversity exists, such as in fully developed residential districts, the debt service reserve alone may be able to cover the permanent loss of the top five taxpayers for a number of years, mitigating excess cash flow needs.

California's Mello-Roos Districts

Mello-Roos bonds, also known as Community Facilities District bonds, are specific to California. They are similar to special assessment bonds in that they levy a charge that is not based on property value, but dissimilar in that they usually have the ability to raise the tax rate up to a maximum level to cover taxpayer delinquencies. Most Mello-Roos districts levy a tax per dwelling unit or per acre, based on development status, but there is no real restriction on the type of tax, other than it cannot be based on property value.

The different types of taxes allowed under the Mello-Roos Act raise varying credit quality considerations, but certain key concerns are common to all Mello-Roos bonds. Probably the greatest credit risks occur in the district's initial phases, when the taxpayer base is concentrated and debt-to-assessed value (loan-to-value) ratios are high because land may be owned by a few developers and largely undeveloped (see Undeveloped Special Districts). As development occurs, credit quality should improve to the extent that ownership becomes more diverse, and loan-to-value ratios decrease. Upon a refunding, several years after a district's creation, credit quality could be vastly improved. Even relatively undeveloped land could receive a favorable initial rating if the area is characterized by numerous taxpayers, good loan-to-value ratios, and flexibility to cover taxpayer defaults by raising tax rates.

Generally, investment grade Mello-Roos districts will show at least close to 1.0x cash flow coverage of debt service from parcels within the district that have an assessed valuation to debt ratio of at least 5:1, with no major taxpayer concentration among these higher value to lien taxpayers.

Easy to implement

Mello-Roos financing is attractive for two reasons. First, unlike special assessment bonds, it allows the financing of general-purpose projects, such as police stations, which may be outside Mello-Roos district boundaries. A second attraction is Mello-Roos districts' easy implementation in undeveloped areas. The Mello-Roos Act declares district landowners to be the voters when 12 or fewer voters reside in a Mello-Roos district, an interpretation that could be subject to future legal challenge if there are actual residents present.

Because districts may be formed in any size or shape, even from noncontiguous parcels, it is relatively easy to form and obtain 'voter' approval of a Mello-Roos district in undeveloped or industrial areas. Different governments, such as school districts or cities, may form separate overlapping Mello-Roos districts as long as each governmental entity is authorized to perform the different service being provided. Practically speaking, district boundaries can be drawn to guarantee that fewer than 12 voters reside in a district or that residents support district formation.

Any type of tax may be imposed in a Mello-Roos district, as long as the tax burden can be evaluated at the time of voter approval and is not levied against property values. Taxes can be designed to mimic property taxes closely, even though by law they can't be imposed solely on the value of a property. For example, a district could tax the number of homes, street frontage, or number of acres. Even a per capita tax can be imposed, using taxes that are fixed or fluctuate up to a cap. An acreage tax or an equivalent dwelling unit tax, are the most popular form of taxation. Taxes may kick in on different dates, and maximum permitted tax rates often escalate 2% per year to accommodate an increasing debt service schedule. Generally, undeveloped land (usually owned by developers) is not taxed, or taxed very little, while future homeowners support actual debt service. As long as bonds are outstanding, the tax cannot be repealed.

The many possible Mello-Roos tax structures create different risks depending on their structure. However, all districts have some features in common. The strongest districts have economic diversity, with numerous taxpayers and high value-to-loan ratios, and levy a well-designed tax that covers a broad tax base. Such a district could receive a favorable credit rating if the existing tax base can produce favorable coverage of future maximum annual debt service, and an additional bonds test locks in the coverage.

The best additional bonds tests use the maximum permitted tax rate on the existing tax base to calculate a minimum coverage requirement on future maximum annual debt service. Weak additional bonds tests may require only an appraiser's report, subject to possible error, estimating a certain minimum value-to-lien ratio. Additional bonds tests based on building permits granted, while stronger than a wholly projected test, are weaker than tests based solely on revenues from owner occupied homes as determined by a certificate of occupancy or the county assessor, due to the time lag between receiving a permit and actually completing a structure.

Concentration of district taxpayers is a particular risk for small or start-up districts. If payment of debt service depends on payments from a few taxpayers, there are obvious vulnerabilities. Apart from the normal cash flow problems caused by delinquency of a major taxpayer, a federal bankruptcy law filing by a taxpayer can indefinitely forestall local foreclosure action. Taxpayer concentration is particularly important, because most districts were originally formed by a few developers holding undeveloped land. The ability to raise tax rates may mitigate concentration risk if additional levies could cover delinquencies by major taxpayers. Sometimes maximum tax rates are designed to increase a certain percent every year to match an increasing debt service schedule. If so, inflation assumptions should be carefully scrutinized in such a case to ensure that homeowners would not be subject to possibly onerous taxes in later years

Many types of taxes can be imposed and pledged to debt service; therefore, Standard & Poor's will examine each Mello-Roos bond issue on a case-by-case basis. Major rating considerations include:

- Surrounding economic characteristics;
- The nature of the development and the developer's track record;
- Tax-to-property value relationships, with emphasis on the percentage of the tax generated by parcels with value to lien ratios above 5:1;
- Restrictions on additional parity debt;
- Existence of overlapping districts;
- Project feasibility;
- Nature and diversity of items taxed and the tax structure;
- Cash flow timing and sensitivity to taxpayer defaults;
- County assessment and collection practices; and
- The property value added by the funded project.

Certain types of development are subject to more risks than others. For example, multifamily housing projects are more cyclical in their sales patterns than single-family homes, and preleasing may mitigate office building construction risk.

In general, the nature of development risk may introduce varying degrees of speculative characteristics to

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undeveloped districts owned by just a few developers. However, credit quality may improve rapidly as development occurs, and homes or commercial development are sold off. The ability to raise tax rates, while limited by reform legislation, still provides Mello-Roos districts with potentially better credit quality characteristics than most special assessment districts, with which they share many similarities.

Special Assessment And Mello-Roos Suggested Documentation

- Size of district.
- General description of the district with estimated build out dates.
- Land use within the district broken out by percent of the tax from taxpayers with less than a 5:1 value to lien ratio, less than 10:1, and greater than 20:1.
- Largest 10 district taxpayers with their assessed values and share of the pledged tax.
- Description of the formula used for generating the pledged tax.
- Debt service schedule.
- Tax collection rates.
- Overlapping tax rates and overlapping debt.
- Median home values in the district.
- Bond Indenture, Bond Resolution, or Fiscal Agent's Agreement.
- Consultant's or Appraiser's report, if any.

Undeveloped Special Districts

Standard & Poor's has extended its criteria for special districts, Mello-Roos (Community Facility District), and special assessment districts to include noninvestment-grade debt and more clearly delineate the types of development risk involved in largely undeveloped special districts.

Such distinctions are important, since the nature of real estate and construction risk can vary widely among undeveloped districts. Special districts with debt rated below investment-grade display an even greater degree of unique variety than more highly rated debt. Nevertheless, certain commonly found situations would compare in terms of creditworthiness (see chart, "Some Selected Common Characteristics Of Special Assessment And Mello-Roos Bonds"). Fundamentally, creditworthiness for special districts depends on prospects for strong real estate values, reasonable debt levels, and taxpayer diversity.

Legal covenants

Strong structural legal protections regarding taxpayer foreclosure, debt service coverage, or debt service reserves cannot, in and of themselves, raise a rating into the investment-grade category unless favorable real estate conditions exist. Legal covenants providing meaningful bondholder protection can lock in the economic benefits of a strong tax base against future issuer actions, such as additional debt dilution or poor tax collection procedures, but general covenants regarding coverage may not help if the tax base does not first generate adequate revenue.

Therefore, a Mello-Roos bond with a weak tax base will not necessarily be able to improve its bond rating with strong structural legal covenant protections, since there is little to protect. Conversely, a Mello-Roos district with a strong tax base may be prevented from obtaining a higher bond rating by weak structural protections.

If development occurs, creditworthiness may improve dramatically in an undeveloped district. However, weak legal protections, written in at the time of bond sale, may limit upside rating potential even if the tax base develops as planned. Investors still need to examine legal covenants closely in almost all situations, even before development occurs.

In particular, a fully funded debt service reserve may buy an issuer some time during periods of heavy foreclosures, but cannot cover against ultimate losses. Other legal provisions of importance include:

- Maximum permitted tax rates;
- Additional bonds tests; and
- The timing of foreclosures and tax rate changes.

There are also key legal differences between unlimited tax special districts, Mello-Roos debt, and special assessment debt, although undeveloped districts share similar real estate development risk. Special district and Mello-Roos bonds usually have the flexibility to raise tax rates to cover a taxpayer foreclosure loss. This is a key strength of special district and Mello-Roos debt over special assessment bonds. Special assessment bonds usually have just 1.0x coverage of annual debt service by yearly special assessments and lack any ability to raise tax rates. In such cases, the bond may be only as strong as the ability to receive ultimate repayment from the weakest property taxed.

Exceptions exist. Sometimes debt service reserve earnings can cover foreclosure losses of the top taxpayers if the top taxpayers are small, compared with the total tax base. Another exception occurs in Florida, where the state allows the special assessment tax rate to be raised in some cases, up to a limited amount. This feature makes these Florida special assessment bonds resemble California's Mello-Roos bonds?a positive feature.

Land appraisals

Appraisals of vacant land by private consultants may be problematic. The difficulty is that they are based only on a value at a point in time, and built on a set of assumptions that developers will follow the expected use of the land. If plans do not materialize as anticipated, or new landowners change their expected use of the land, actual values for vacant land could change appreciably. For this reason, private appraisals of raw land can often be considered unreliable. Standard & Poor's looks at the reasonableness of appraisal assumptions and sometimes may discount appraisal conclusions. There are wide distinctions between different types of development districts, and investors more than ever need to distinguish the strong credits from the weak. In particular, investors may want to determine if legal features could preclude a bond from ever moving into the investment-grade categories. The accompanying table, while it does not cover every case, should provide helpful guidelines. Some positive factors, such as debt service coverage, can offset other negative factors, such as taxpayer concentration.

District Size

Standard & Poor's does not have a minimum size limit for an investment-grade rated special district; rather size affects a special district in that a small size may increase taxpayer concentration. A large district concentrated in a few taxpayers may not be as creditworthy as a small district with little tax base concentration in the top taxpayer. A special district consisting only of a 500-unit single-family housing development, for example, may achieve an investment-grade category rating, depending on the particulars of local real estate conditions.

Special Assessment And Mello-Roos Information

Some Selected Common Characteristics Of Special Assessment And Mello-Roos Bonds

'A' —District is fully or close to fully developed (80% or better), diverse taxpayer base; strong economic location; good maximum annual debt service coverage; debt service reserve may be fully or partially funded, but should ideally should cover the loss of the top five taxpayers for life of the bonds; high value to lien ratios of grater than 20-to-1; strong legal protections regarding additional debt issuance, and promptproperty foreclosures.

'BBB' —District is mostly developed (70% or better); some taxpayer concentration but expected to be reduced as development continues; adequate economic base with good prospects for continued economic growth; adequate maximum annual debt service coverage of at least 1.0x; debt service reserve may be fully or partially funded but should cover the loss of the top five taxpayers for seven to ten years; moderate overall value to lien ratios of at least 10-to-1; strong legal protections regarding additional debt issuance, and prompt property foreclosures.

Non-Investment Grade—District is only partially developed; significant taxpayer concentration with the top ten taxpayers accounting for more than 50% of assessed value; developing economic base with uncertain prospects for economic growth in the future; failure of the debt service reserve to cover the loss of the top five taxpayers for at least 10 years; low overall value to lien ratios of at less than 10-to-1 and a significant amount of properties with value to lien ratios of 5-to-1 or less; adequate legal protections regarding additional debt issuance, and prompt property foreclosures.