

Fitch Affirms Douglas, AZ Muni Prop Corp's Bonds at 'A'; Outlook Stable

Fitch Ratings-Austin-11 March 2011: Fitch Ratings assigns an implied general obligation rating (GO) of 'A' to Douglas, AZ (the city) and takes the following action on Douglas, Arizona Municipal Property Corporation (the corporation) as part of its continuous surveillance efforts:

--\$2.2 million excise tax revenue bonds affirmed at 'A'. The Rating Outlook is Stable.

The city has no GO debt outstanding.

RATING RATIONALE:

--The rating on the excise tax bonds reflects high debt service coverage and strong performance of pledged revenues despite some softening due to economic pressures.

--Bond holders have a first lien on the pledged excise tax revenues and lease payments are not subject to appropriation.

--The implied GO rating reflects the city's sound financial profile despite recent weakness in major operating revenue sources and a high dependence on economically sensitive revenues.

--Management has prudently responded to revenue declines by reducing general fund spending.

--The local economy is somewhat reliant on shoppers from Mexico for local sales tax revenue, creating exposure to the sensitivity of border-crossing access and immigration and security measures.

--Despite a recent uptick, area unemployment levels remain below the state and national average.

--Debt levels are moderate and the pace of amortization is above average; the city has no plans to issue additional debt in the near term.

KEY RATING DRIVERS:

--Management's ability to budget conservatively and make spending adjustments in light of further anticipated declines in state-shared revenues.

--Preservation of healthy general fund reserves given the city's dependence on economically sensitive excise taxes.

SECURITY:

The bonds are special obligations of the corporation payable from lease payments to be made by the city. The lease payments are secured by a pledge of and first lien on the city's excise taxes. The lease payments are unconditional obligations of the city and not subject to annual appropriation.

CREDIT SUMMARY:

The city of Douglas, with an estimated population of 20,300 for 2011, is situated in southeastern Arizona on the international border with Mexico. The local economy consists primarily of government services, tourism, and manufacturing. As of December 2010, the area unemployment rate had ticked up to 8.3% but was still below the state (9.1%) and national rate (9.1%). As of third quarter 2010, independent housing data available to Fitch indicates foreclosures within the city were below the national average and city officials note no material valuation declines typical of other Arizona cities. Douglas is across the U.S. border from Agua Prieta, Mexico with a population of about 125,000. Agua Prieta has several manufacturing plants, or maquiladoras (twin plants) with corresponding facilities in or around Douglas. Shoppers from Agua Prieta generate a large share of Douglas' sales tax revenues.

Debt service on the bonds is paid through a lease agreement between the city and corporation. Bondholders have a first lien on excise tax revenues and lease payments are not subject to annual appropriation. The excise taxes pledged to the bonds consist of local sales taxes, state shared revenue (income and sales taxes), franchise fees, licenses and permits, and fines and forfeitures. While previously posting steady and healthy gains, pledged revenues weakened by 8% in fiscal 2010, driven by lower sales tax and state-shared revenues, but still provided a high 16.4 times debt service coverage. Fiscal 2011 year-to-date results show improvement in local sales tax revenues (current collections are roughly 10% above the same period in the prior year) but the city has seen further declines in state-shared revenues. Nonetheless, debt service coverage is expected to remain high because excise taxes represent a high 70% of the city's general fund revenues.

The city's financial profile remains notably stable despite the reliance on sales taxes and state aid, both pressured in the current economic environment. Conservative fiscal management provides for strong reserve levels and surplus operations in six of the last seven fiscal years. Fiscal 2010 results continued this trend with an unreserved fund balance of \$4.2 million or 34% of spending. Management achieved positive results despite declining revenues by reducing operating expenditures 11% through freezing vacated positions, consolidating department personnel, and largely eliminating capital outlays. In contrast to previous years, management expects a modest net loss in the general fund in fiscal 2011 due to continued declines in state-shared revenues. The city is projecting an operating deficit for fiscal 2011 but maintenance of strong reserves totaling 30% of spending.

The city's debt profile is a credit positive, characterized by moderate debt levels (overall direct debt at roughly \$1,120 per capita and 2.9% of market value) and an above average rate of amortization. Debt levels are expected to remain manageable as the city has no current plans to issue debt in the near term. The city issued loans totaling \$9 million in fiscal 2009 for the acquisition and construction of a call center. The loans are payable through 2029 and lease revenues from the private entity (roughly \$690,000 annually through 2023) are expected to cover the majority of annual debt service on the loan. Debt service on the MPC debt is currently

low at 4% of general fund spending but would rise to an above average 13% if the city had to fully cover loan payments.

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In addition to the sources of information identified in the *Tax-Supported Rating Criteria*, this action was additionally informed by information from Creditscope, University Financial Associates, LoanPerformance, Inc., and IHS Global Insight.

Related Research:

'Tax-Supported Rating Criteria', dated 16 Aug 2010.

'U.S. Local Government Tax-Supported Rating Criteria', dated 08 Oct 2010.

For information on Build America Bonds, visit www.fitchratings.com/BABs.