Fitch Affirms San Francisco, CA's GOs at 'AA+'; Affirms IDR; Outlook Stable

Wed 09 Sep, 2020 - 8:42 PM ET

Fitch Ratings - San Francisco - 09 Sep 2020: Fitch Ratings has affirmed the following ratings for San Francisco (City & County) (CA):

-- $135.8 million general obligation (GO) bonds (transportation & road improvement bonds, 2014), series 2020B at 'AA+';

-- $2.2 billion outstanding city and county of San Francisco GO bonds at 'AA+';

-- $29.1 million outstanding San Francisco Finance Corporation (finance corp) lease revenue bonds (open space fund - various park projects) at 'AA+';

-- $89.3 million outstanding finance corp lease revenue bonds at 'AA';

-- $1.3 billion in outstanding certificates of participation (COPs) at 'AA'; and

-- Issuer Default Rating (IDR) at 'AA+'.

Fitch originally assigned an 'AA+' rating on the 2020B GO bonds in March 2020. The transaction was delayed due to market conditions and is now scheduled for sale competitively on Sept. 17th.
The Rating Outlook is Stable.

Proceeds of the 2020B bonds will be used to construct, redesign and rebuild streets and sidewalks and to make infrastructure repairs and improvements that increase Muni service reliability, ease traffic congestion, reduce vehicle travel times, enhance pedestrian and bicycle safety and improve disabled access. The 2020B bonds are expected to sell competitively on September 17th.

SECURITY

The GO bonds are payable from an unlimited ad valorem property tax on all taxable property in the city.

The lease revenue bonds and COPs are payable from lease payments made by the city for use and occupancy of city assets.

ANALYTICAL CONCLUSION

The 'AA+' IDR and GO bond rating and Stable Rating Outlook reflect the city's exceptionally strong reserve position relative to Fitch's near-term expectations for sharply negative economic and revenue performance. In addition, the city benefits from expectations for strong revenue growth prospects over time, solid spending flexibility and moderate long-term liabilities. The ratings also consider the city's superior financial management, which includes strong budgetary and financial policies and practices that provide a foundation for maintaining ample reserves and financial flexibility throughout economic cycles.

The 'AA' rating on lease revenue bonds and COPs reflects the slightly higher optionality associated with the requirement to budget and appropriate for lease obligations. The 'AA+' rating on the open space lease revenue bonds, which are also appropriation-backed, reflects the restricted nature of the property tax set-aside for the appropriation payment, almost eliminating any incentive not to pay for budgetary reasons.

ECONOMIC RESOURCE BASE

The city is the economic and cultural center of the nine-county San Francisco Bay area. Despite being essentially built out, the population growth rate since the 2010 Census exceeded the state and nation as parts of the city, including former military bases and former industrial areas, are redeveloped with increased density. The city's economic profile benefits from exceptional income and wealth indicators; per capita personal income is over twice the national average and assessed value per capita for fiscal 2020 is about $336,000. The city's largest private employers include Wells Fargo & Company, Salesforce, Sutter Health, Uber Technologies, Kaiser Permanente and Gap, Inc. Growth in technology jobs continues to drive overall strong labor force and employment growth in the city.

KEY RATING DRIVERS

Revenue Framework: 'aa'

Very strong economic growth had been generating revenue growth well in excess of U.S. GDP and Fitch expects this to continue over the long term. This strength is partially offset by only moderate independent revenue-raising ability.

Expenditure Framework: 'aa'

Over time, Fitch expects expenditure growth to be in line with or marginally above revenue growth due to increasing salary and pension costs. Expenditure flexibility is solid, reflecting a moderate fixed-cost burden, a demonstrated ability to curb expenditure growth through negotiated labor concessions and the ability to temporarily reduce general fund capital spending in a downturn.

Long-Term Liability Burden: 'aa'

Long-term liabilities, net of those attributable to enterprise operations, are at the low end of the moderate range relative to the city's economic resource base. Based on the city's debt issuance plans, its amortization rate and the expected growth in the resource base, Fitch expects the liability burden to remain in the moderate range.
Operating Performance: 'aaa'

The city’s gap-closing ability is exceptionally strong, evidenced by robust reserve levels relative to low expected revenue volatility during a typical recession. Reserves are ample when compared to current recessionary declines. Charter- and ordinance-approved financial policies, including formulaic rainy day reserves and budgetary policies, support maintenance of financial flexibility throughout economic cycles.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

-- Sustained liability burden materially below 10% of personal income.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

-- An inability to effectively address the fiscal challenges triggered by the expected severe economic contraction, which results in a shift in the city’s financial flexibility.

-- An economic contraction extending well into fiscal 2021 or beyond, consistent with Fitch’s coronavirus downside scenario, which triggers sustained and deep revenue declines and materially erodes the city’s gap-closing capacity.

-- Inability to manage rising carrying costs in a manner consistent with the current rating.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from ‘AAA’ to ‘D’. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit [https://www.fitchratings.com/site/re/1011579].
CURRENT DEVELOPMENTS

Sectorwide Coronavirus Implications

The recent outbreak of the coronavirus and related government containment measures worldwide creates an uncertain global environment for U.S. state and local governments and related entities in the near term. As severe limitations on economic activity only began very recently, most state governments' fiscal and economic data do not reflect any credit impairment. Material changes in revenues and expenditures are occurring across the country and likely to worsen in the coming weeks and months as economic activity suffers and public health spending increases. Fitch's ratings are forward looking, and Fitch will monitor developments in state and local governments as a result of the virus outbreak as it relates to severity and duration and incorporate revised expectations for future performance and assessment of key risks.

In its baseline scenario, Fitch assumes an initial activity bounce in 3Q20 is followed by a slower recovery trajectory from 4Q20 amid high unemployment and further pullback in private-sector investment. GDP remains below the 4Q19 level for 18-30 months, with the U.S. on the shorter-end of this range. Additional details, including key assumptions and implications of the baseline scenario and a downside scenario, are described in the special report, "Fitch Ratings Coronavirus Scenarios: Baseline and Downside Cases -- Update," published September 2020, which is available on www.fitchratings.com

Adequate Liquidity

The city reports it held $2.9 billion in cash and investments with up to a one month maturity as of August 15, 2020, and another $3.0 billion with up to a four month maturity, compared to its general fund budget of about $6.0 billion. Fitch anticipates that available liquidity, aided by the city's broad cash management tools, will be sufficient for near-term operating needs.

Federal Aid Provides Some Support

Under the Coronavirus Aid, Relief, and Economic Security (CARES) Act enacted on March 27, 2020, the U.S. Treasury department distributed $150 billion to state and local governments using a population-based formula. The statute limits the use of funds to coronavirus-related expense reimbursement rather than to offset anticipated state tax revenue losses. San Francisco received $174.5 million, which it expects to spend on costs consistent with federal
guidelines. Fitch notes uncertainty surrounding which budget items will ultimately be reimbursable by CARES Act money.

Budget Impact and Response

The city is in an exceptionally strong financial position to address this crisis. The city ended fiscal 2019 with a $495 million surplus, all of which was added to the available fund balance, bringing its total to $2.7 billion, equal to 49% of fiscal 2019 expenditures and transfers out. The city's nine-month report for fiscal 2020 showed a revenue loss of $436 million compared to budget. The city put together a rebalancing plan and expects to end the fiscal year 2020 with largely balanced operations.

In March 2020, the city revised its January 2020 revenue estimate (Joint Report) for the two-year budget starting July 1, 2020, to enable the city to respond to the sharp decline in economic activity and revenues. The city also delayed its budget adoption to October 1 from August 1 to allow for additional time to make needed budgetary changes.

On July 31, the mayor submitted her budget proposal and subsequently, pursuant to the city's charter, the independent controller certified the revenue assumptions as reasonable. The proposed budget assumes revenues decline by about $911 million, or about 16% compared to the fiscal 2020 budget. These declines are led by hotel room taxes which are estimated at $126.2 million in fiscal 2021 compared to $389.1 million in fiscal 2020 (a 68% decline), real property transfer taxes, estimated at $138 million in fiscal 2021 compared to $296.1 million in fiscal 2020, and business taxes, estimated at $831 million compared to $1.05 billion (a 21% decline). Property taxes revenues are estimated to increase by 3% compared to the fiscal 2020 budget despite a certified 7% increase in taxable property. The lower revenue estimate allows for unpaid taxes, lower unsecured property values, and assumptions for appeals of value primarily by hotel, retail and multifamily housing property owners.

The budget proposal includes the maximum use of the city's economic stabilization reserves ($156.5 million), $236.0 million in FEMA reimbursements and $82.0 million from the CARES Act, and notably assumes voter approval of a November 2020 business tax reform measure which would, among other things, provide the city with $150 million for fiscal 2021. On the spending side, the proposal includes a deferral of wage increases which bargaining groups would need to agree to ($55 million in fiscal 2021) and departmental and other solutions pursuant to the mayor's request for 10% in across-the-board general fund spending reductions, which is worth about $249 million in lower spending. Given the uncertainties in the budget, in particular, the business tax measure, labor concessions and the general
economic and revenue environment, management expects to submit a three-month budget update to the board, which will incorporate the results of the November ballot measure and the first quarter revenue performance.

In order to better manage its reserves through the recession, the city consolidated various discretionary reserves into one COVID Response and Economic Loss Reserve totaling $507 million. In addition to this reserve, the city maintains its Rainy Day Reserve with an estimated balance of $229 million at the end of fiscal 2020, and its Budget Stabilization Reserve, which has an estimated balance of $292.6 million at the end of fiscal 2020. Both the Rainy Day and Budget Stabilization Reserves are governed by the city's charter and are structured to be used over three years - up to 30% is available for use in the first year, 50% in the second year and the remainder in the third year.

CREDIT PROFILE

The city's $521 million in rainy day reserves plus $507 million in other discretionary reserves equals about 19% of fiscal 2019 spending. Due to its currently very high reserve levels combined with the its active management of spending, Fitch expects the city to maintain available reserves throughout the downturn at a level above the minimum reserve safety margin consistent with its 'aaa' operating performance assessment (about 5% of spending).

ADDITIONAL NOTES

For more information on the city's IDR, please see "Fitch Rates City & County of San Francisco, CA's $377.7MM GO Bonds 'AA+'; Affirms Outstanding; Stable Outlook", dated March 13, 2020.

In addition to the sources of information identified in Fitch's applicable criteria specified below, this action was informed by information from Lumesis.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

**ESG CONSIDERATIONS**

The City and County of San Francisco (CA) has an ESG relevance score of '4' for Labor Relations and Practices because of the somewhat challenging labor framework under which the city operates, which includes 37 bargaining units, binding arbitration for most contracts, salary surveys and some staffing minimums in public safety and is relevant to the rating in conjunction with other factors.

Except for the matters discussed above, the highest level of ESG credit relevance, if present, is a score of 3. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity(ies), either due to their nature or to the way in which they are being managed by the entity(ies). For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg

**RATING ACTIONS**

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**VIEW ADDITIONAL RATING DETAILS**

Fitch Affirms San Francisco, CA’s GOs at ‘AA+’; Affirms IDR; Outlook Stable

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APPLICABLE CRITERIA

U.S. Public Finance Tax-Supported Rating Criteria (pub. 27 Mar 2020) (including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

FAST States & Locals - Fitch Analytical Stress Test Model, v2.4.0 (1)

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Dodd-Frank Rating Information Disclosure Form

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Endorsement Policy

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