FitchRatings

RATING ACTION COMMENTARY

Fitch Rates $316.2MM San Francisco, CA's GOs 'AA+'; Affirms Outstanding; Outlook Revised to Stable

Fri 15 Apr, 2022 - 5:12 PM ET

Fitch Ratings - San Francisco - 15 Apr 2022: Fitch Ratings has assigned an 'AA+' rating to the following City and County of San Francisco (CA) (city) general obligation (GO) bonds:

--$316,195,000 GO refunding bonds, series 2022-R1.

In addition, Fitch has affirmed the following ratings:

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

--$2.5 billion outstanding city and county of San Francisco GO bonds at 'AA+';

--$14.6 million outstanding finance corporation lease revenue bonds, series 2010-R1 and 2018B at 'AA';

--$29.1 million outstanding finance corporation lease revenue bonds (open space fund-various park project), refunding series 2018A at 'AA+';

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

--$483.8 million special tax bonds, series 2017A, 2017B, 2019A, 2019B, 2020B and 2021B at 'AA+'.

The Rating Outlook has been revised to Stable from Negative.

The GO bonds are expected to price via negotiated sale the week of April 25.

Proceeds of the series 2022-R1 bonds will be used to refund certain outstanding GO bonds for debt service savings.

SECURITY

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

COPs and finance corporation lease revenue bonds are payable from lease payments made by the city for use and occupancy of various city assets, subject to abatement.

The 2018A finance corporation lease revenue bonds are payable from lease payments made by the city to the corporation for certain park properties. Such payments are to be made from the city's open space fund, which receives the park dedicated property tax set-aside and is restricted for open space uses.

The special tax bonds are payable from a first pledge of special tax revenues levied and collected by the city against all buildings subject to the special tax within the community facilities district.

ANALYTICAL CONCLUSION

The revision of the Outlook to Stable reflects Fitch's view that the city will effectively manage spending and maintain a high level of fundamental financial flexibility while revenues continue to recover from pandemic-fueled declines. The city expects to reduce its reliance on one-time budget solutions over the medium term while maintaining very strong fiscal reserves. Risks in the recovery remain, largely driven by changes in work and travel policies, but are largely offset in Fitch's view by the magnitude of available reserves which will allow the city to gradually restore its operating budget to structural balance.

The 'AA+' IDR and GO bond rating reflect the city's exceptionally strong reserve position relative to Fitch's near-term expectations for weak economic and revenue performance. Fitch expects the city's revenues to return to pre-pandemic levels, albeit over several years.

The city benefits from solid spending flexibility and long-term liabilities at the low end of the moderate range. 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.

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 2022 is about $357,000. The city's largest private employers include Salesforce, Wells Fargo & Company, Sutter Health, Uber Technologies, Kaiser Permanente and PG&E. 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 associated with increasing salary and pension costs to be in line with or marginally above revenue growth. 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'

Fitch views the city's gap-closing ability as exceptionally strong, evidenced by robust reserve levels relative to low expected revenue volatility during a typical recession and the more significant stress experienced due to the pandemic. Charter- and ordinance-approved financial policies, including formulaic rainy-day reserves and budgetary policies, support an expectation for the maintenance of a high level 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:

--Sustained economic or tax base weakness as evidenced by suppressed business, sales and hotel tax revenues and an expectation for revenue growth below U.S. economic performance;

--Failure to implement available policy measures to reduce reliance on one-time revenues, including federal stimulus and fiscal reserves;

--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/10111579.

CURRENT DEVELOPMENTS

Slower Economic and Revenue Recovery

The city entered the pandemic recession in an exceptionally strong financial position, but has experienced sizable revenue loss since the onset of the pandemic. Federal aid along with some budgetary adjustments have allowed the city to retain a very strong financial position despite a slower than average revenue and economic recovery.

The nature and severity of the revenue loss reveals the city's reliance on business and leisure travelers (particularly international), conventions, and commuters into the city, as revenues losses were led by hotel room taxes and business taxes (a gross receipts tax on employees physically working in the city) and these taxes remain below pre-pandemic levels. Local sales taxes have lagged compared with the state since daily commuters and tourists to the city had been a significant driver for sales tax revenues. Taxable sales statewide increased almost 20% between Q3 2019 and Q3 2021, while in San Francisco taxable sales declined around 18% over the same period.

According to Fitch's U.S. Metro Labor Market Jobs Tracker, dated Feb. 17, 2022, the San Francisco-Oakland-Hayward MSA has only recovered 61% of the jobs lost between February 2020 and April 2020 compared with the 81% median among major MSAs. Professional and business services and information have fully recovered while leisure and hospitality and trade, transportation and utilities employment remain well below their pre-pandemic levels. Furthermore, while job growth in the information sector (including the technology industry) is strong, the city is not benefitting economically in the same way it did before the pandemic as evidenced by negative absorption of office space and other indicators as telecommuting is likely to persist in some form over the long term.

Strong Financial Position Despite Slower Revenue Recovery

Pre-pandemic, several years of very strong economic and related revenue growth as well as two years of significant unbudgeted excess property tax revenue (related to statewide school funding formulas) positioned the city well, and it ended fiscal 2020 (June 30 year-end) with available fund balance totaling close to $2.7 billion or 48% of spending.

The city relied significantly on one-time sources to balance its fiscal 2021 budget, including $156.5 million from its rainy-day reserves (the maximum allowed in the first year of a recession). The budget also included a new business tax approved by voters in November 2020, and some departmental savings from the mayor's request for 10% budget cuts.

Property taxes and real property transfer taxes make up about 47% of general fund revenues and outperformed the budget while hotel taxes and business taxes, which accounted for about 13% of fiscal 2021 general fund revenue, underperformed. Pre-pandemic, business taxes and hotel taxes had accounted for about 15.6% and 6.6% of general fund revenues, respectively.

In March 2021, the American Rescue Plan Act (ARPA) allocated $624.8 million to San Francisco, with half received in May 2021 and the other half to be received in May 2022. The city used the first tranche in fiscal 2021 since revenues underperformed budget which enabled it to end fiscal 2021 with a modest $51 million deficit on an audited basis, equal to 0.8% of spending.

The city plans to use the remainder of ARPA funds in fiscals 2023, 2024 and 2025. The fiscal 2022 and fiscal 2023 budgets were adopted in July 2022. Fiscal 2022 was balanced with the use of almost $500 million in prior year fund balance and $280 million in reserves. The fiscal 2022 six-month budget status report projects revenues to be $319 million above budget (mostly property, sales, hotel and real property transfer taxes partially offset by lower than budgeted business taxes); however, the board has also approved about $249 million in supplemental appropriations for one-time uses.

A portion of the supplemental appropriations are related to the ongoing coronavirus emergency and some is related to affordable housing and other temporary spending measures. After considering the additional ongoing revenues reported in the six-month budget update report, Fitch estimates the total of non-recurring resources to balance the budget at approximately $460 million, million or roughly 8% of estimated ongoing spending.

The second year of the two-year budget (fiscal 2023) is assumed to use an additional $300 million in prior year fund balance and $14 million in reserves. Starting in fiscal 2024, Fitch estimates the structural deficit of around $100-$150 million equal to roughly 2.5% of annual appropriations.

Given additional revenue growth not yet incorporated into the fiscal 2023 budget, FEMA reimbursements for past years, current year FEMA-eligible spending, and unknown factors, Fitch expects there to be changes, especially to the out years. However, given the sizable unrestricted fund balance (including committed, assigned and unassigned), Fitch expects the city to make the needed changes to better align ongoing revenues and expenditures over the medium term. Should the budget gaps increase due to increasing spending or slower than expected revenue recovery without sufficient action to realign revenues and spending, there could be negative rating action.

Five Year Forecast

The city expects the business tax will remain below pre-pandemic levels for an extended period due to increased telecommuting. For the previous five-year forecast, the city had assumed office workers would telecommute 15% of the time but more recently, companies have announced their longer-term expectations of employees, and the city is now forecasting that office workers will telecommute 33% of the time. In addition to affecting the business tax, this shift to telecommuting has pushed up office vacancy rates and may suppress the sales tax recovery in the downtown area. Sustained elevated vacancy rates could drive down the city's assessed valuation on commercial office properties, which about represent 17.5% of the city's assessed value (AV).

At the end of fiscal 2026, after the use of the reserves mentioned above, the forecast assumes designated reserves still total over $1 billion which is equal to about 15% of projected fiscal 2026 revenues and transfers in. Furthermore, the city has identified spending which it could adjust with minimal service impact. These include debt financing capital equipment rather than cash funding (saving roughly $15 million over the forecast period), removing the discretionary CalPERs payments ($62 million), reducing general fund capital spending by 25%-50% each year ($85 million-$169 million), slowing the issuance of general fund backed debt ($192 million), and slowing or holding hiring for vacant positions ($350 million-$700 million).

The 'AA+' rating reflects the city's strong fiscal management capabilities along with substantial resources, which allow for ample time to make necessary adjustments should the recovery be less than complete. The Stable Outlook reflects Fitch's view that the city's strong fiscal management capabilities and policies, along with significant identified spending flexibility and ample resources sufficiently mitigate the potential risks over the medium term as the city adjusts to lower revenues and potentially slower revenue growth.

CREDIT PROFILE

As the economic and cultural center of the San Francisco Bay Area, the city benefits from high wealth levels, historically low unemployment and strong economic growth. Labor force and job growth increased above the national average for several years. Prior to the pandemic, the city's tourism sector performed exceptionally well. Hotel taxes totaled about 7% of general fund revenue in fiscal 2019. Current economic conditions remain quite weak as the tourism sector and the city's central business district face headwinds from the stay at home orders and uncertainty regarding the future of office work.

Additional Notes

For more information on the city's IDR, please see "Correction: Fitch Assigns 'AA+' to $485MM San Francisco, CA GOs; 'AA' to $118.9MM COPs," dated Jan. 28, 2021.

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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

San Francisco (City & County) (CA) [General Government] has an ESG Relevance Score of '4' for Labor Relations & Practices due to 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, which has a negative impact on the credit profile, and is relevant to the ratings in conjunction with other factors.

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

RATING ACTIONS

ENTITY / DEBT ⬍	RATING ⬍	PRIOR ⬍

San Francisco (City & County) (CA) [General Government]	LT IDR	AA+ Rating Outlook Stable	Affirmed	AA+ Rating Outlook Negative
San Francisco (City & County) (CA) /General Obligation - Unlimited Tax/1 LT	LT	AA+ Rating Outlook Stable	Affirmed	AA+ Rating Outlook Negative
San Francisco (City & County) (CA) /Lease Obligations - Non-Standard/1 LT	LT	AA+ Rating Outlook Stable	Affirmed	AA+ Rating Outlook Negative
San Francisco (City & County) (CA) /Lease Obligations - Standard/1 LT	LT	AA Rating Outlook Stable	Affirmed	AA Rating Outlook Negative
Transbay Transit Center Community Facilities District (CA) [General Government]				
Transbay Transit Center Community Facilities District (CA) /Property Assessment - Mello Roos/1 LT	LT	AA+ Rating Outlook Stable	Affirmed	AA+ Rating Outlook Negative

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

U.S. Public Finance Tax-Supported Rating Criteria (pub. 04 May 2021) (including rating assumption sensitivity)

APPLICABLE MODELS

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

FAST Econometric API - Fitch Analytical Stress Test Model, v3.0.0 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

San Francisco (City & County) Finance Corp. (CA)	EU Endorsed, UK Endorsed
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