FitchRatings

RATING ACTION COMMENTARY

Fitch Assigns 'AA+' Rating to $183.7MM San Francisco, CA's GOs; 'AA' to $80MM COPs; Outlook Negative

Tue 30 Mar, 2021 - 11:29 AM ET

Fitch Ratings - San Francisco - 30 Mar 2021: Fitch Ratings has assigned the following ratings to the following City and County of San Francisco (CA) (city) obligations:

--$95,850,000 refunding general obligation (GO) bonds series 2021-R1 'AA+';

--$87,810,000 refunding GOs series 2021-R2 (forward delivery) 'AA+';

--$80,175,000 certificates of participation (COPs), series 2021A (Multiple Capital Improvement Projects) 'AA'.

The Rating Outlook Remains Negative.

The GO refunding bonds are expected to price via negotiated sale the week of April 12 and the COPs are expected to price via competitive sale on the week of April 19.

Proceeds of the 2021-R1 and 2021-R2 (forward delivery) GO bonds will be used to refinance various outstanding GO bonds for debt service savings. Proceeds of the COPs will be used to finance the acquisition of certain property, including by retiring a portion of the city's outstanding taxable commercial paper notes issued for the acquisition of certain real property, for purposes of relocating the operations of the city's Hall of Justice building.

SECURITY

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

The 2021 COP leased assets includes the North and South Residences and the Pavilion Buildings of the city's Laguna Honda Hospital and the San Bruno Jail Complex.

ANALYTICAL CONCLUSION

The 'AA+' GO bond rating reflects the city's exceptionally strong reserve position relative to Fitch's near-term expectations for sharply negative economic and revenue performance. In addition, Fitch expects the city's revenues to resume strong growth, returning to pre-pandemic levels 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. The 'AA' rating on the COPs is notched from the IDR reflecting the slightly higher optionality associated with the requirement to budget and appropriate for lease obligations.

The Negative Outlook reflects the magnitude of the city's pandemic-related revenue loss and budget gaps in addition to uncertainty about the pace of recovery sensitive to changes to work habits, pressure on commercial real estate and travel-related activity, as well as the execution risk surrounding the city's efforts to reduce spending. The Negative Outlook indicates the direction the rating is likely to move over a one- to two-year period; however, it does not imply that a rating change is inevitable.

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'

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. Reserves are ample when compared to the more significant 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.

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.

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:

--Failure to implement available policy measures that offset risks associated with a return to economic contraction consistent with Fitch's coronavirus downside scenario, resulting in an erosion of the city's gap-closing capacity;

--More severe economic weakness than envisioned in Fitch's coronavirus downside scenario, without evidence that available measures are adequate to counteract associated budgetary risks;

--Sustained weakness in assessed value (AV) that trigger deep revenue declines that erode 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/10111579].

CURRENT DEVELOPMENTS

Near-Term Budget Relief

The recently-enacted the American Rescue Plan (ARP) will provide $350 billion in direct aid to state and local governments, and additional funding for transit systems and school districts (through the states) as well as a significant amount of economic stimulus that should have a positive near-term impact on state and local government revenues. Fitch does not expect the stimulus aid to alter the long-term credit fundamentals of state and local governments but should bridge near-term fiscal gaps.

The city's allocation from the ARP is about $636 million, or a significant 11% above budgeted fiscal 2021 general fund revenues and transfers in, and is not included in its fiscal 2021 budget or in its recent six-month budget status report. The city has not yet made plans for these funds; however, in its forthcoming update to its Five-Year Financial Plan, to the city expects to show half of the funds backfilling revenues in fiscal 2022 and half in fiscal 2023.

Fiscal 2021 Adopted Budget and Current Projections

The city retains superior gap-closing capacity despite severe revenue weakness starting in March 2020. According to the city's fiscal 2020 (June 30 year-end) audit, operations resulted in a $31 million net use of unrestricted fund balance. The 2020 fiscal year end unrestricted fund balance remained substantial, totaling $2.7 billion or 48% of spending. The available reserves include the $229 million rainy-day reserve's economic stabilization account and the newly created $507.4 million Covid Response and Economic Loss Reserve. Due to its currently very high reserve levels combined with its active management of spending, Fitch

expects the city to maintain ample reserves throughout the downturn while adjusting to potentially longer-term changes to commuting and business travel practices.

The revised fiscal 2021 budget adopted in October assumed a nearly 8% loss of overall revenues (approximately $452.4 million) when compared to fiscal 2020 budgeted figures. The nature of the revenue loss reveals the city's reliance on business and leisure travelers, conventions and commuters into the city, as revenues losses are led by hotel room taxes and business taxes. Local sales taxes are also underperforming since daily commuters and tourists to the city are usually a significant driver for sales tax revenues. The city also reports lower returns based on an out-migration of residents as they relocate during the pandemic either temporarily or permanently. This out-migration is evidenced through minimal increase online sales tax revenues and average rents dropping 23% yoy in March 2021 according to ApartmentList.

To close the fiscal 2021 budget gap, the city relied primarily on one-time solutions including $161 million from its rainy-day reserves (the maximum allowed in the first year of a recession), $236 million in FEMA reimbursements, and $82 million from the CARES Act. The budget also includes ongoing revenue of $150 million from a business tax measure which was voter-approved in November 2020 and will be collected in fiscal 2021, and about $249 million in departmental savings from the mayor's request for 10% budget cuts. In February, the city released its Six-Month Budget Status Report that now projects a $125.2 million budget surplus as a result of property taxes and real property transfer taxes over budget by $196 million and $116 million, respectively. These more than offset the weakness in sales taxes, hotel taxes and business taxes which were down $43 million, $55 million and $158 million, respectively, as well as weaker than budgeted department revenues and some departmental expenditure savings.

The city's business tax (a gross receipts tax on employees physically working in the city) has been severely affected due to increased telecommuting and extended state at home orders. For perspective, pre-pandemic in commuting levels would have provided the city nearly $249.4 million above current projected amounts. Going forward, the city assumes only 25% of non-essential workers will return to the office by 4Q fiscal 2021 and only 50% by 3Q fiscal 2022. This shift to telecommuting has pushed office vacancy rates to 16.7%, the highest since 2005 according to commercial real estate firm Cushman & Wakefield. Sustained elevated vacancy rates could drive down the city's assessed valuation on commercial office properties which represent 17.5% of the city's AV.

For fiscal 2022, the mayor requested an additional 7.5% decrease in department expenditures plus a 2.5% contingency. Fitch believes this level of department cuts may not

be achievable without agreement from labor unions. The city had tried to negotiate a deferral of salary increases for non-sworn labor groups for fiscal 2022, but that was not achieved. The sworn groups did defer their fiscal 2021 salary increases which will now be paid in fiscal 2023.

Out Year Projections

The five-year financial plan estimates a budget shortfall of $411 million in fiscal 2022 (roughly 7% of spending), $242 million in fiscal 2023 and $328 million in fiscal 2024. The forecast does not reflect the recently adopted American Rescue Plan, nor does it assume the 7.5% budget cuts included in the mayor's budget instructions for fiscal 2022. Revenues are assumed to gradually recover to pre-pandemic levels by fiscal 2026. The forecast assumes broad levels of vaccination by the fall of 2021 and full capacity at conventions and stadiums by summer 2022. Fitch's assumption for travel recovery is more conservative, assuming increasing hotel bookings through 2022 and 2023 returning to prior peak levels by 2025. For AV, the forecast assumes fiscal 2022 declines of 20% in hotel, retail and unsecured AV, 7% decline in office value and 2% decline in multi-family values.

The five-year financial plan shows the city depleting the rainy day and budget stabilization reserves in fiscal 2023 but retaining the entire COVID Response Reserve ($507 million) and various other discretionary reserves for a total of $620 million in fiscal 2023 and 2024 (about 11% of fiscal 2023 projected spending). These projections do not include unassigned fund balance, which totaled $631 million at the end of fiscal 2019. The city would likely tap these sources if revenue performance is weaker than projected or if expenses are higher than currently forecast.

In the five-year financial forecast, the controller's office outlines recommended solutions that include lower salary increases after current MOUs expire, lower than assumed pay as you go capital expenditures in fiscal 2023 onward (lower than typical levels are already budgeted for fiscal 2021 and 2022), and lower non-personnel cost increases for services and supplies.

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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DATE OF RELEVANT COMMITTEE

01 February 2021

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. 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

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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).

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

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