FitchRatings

Fitch Rates San Francisco, CA's $16MM COPs 'AA'; Outlook Stable

Fitch Ratings-San Francisco-26 May 2016: Fitch Ratings has assigned an 'AA' rating to the following City and County of San Francisco, California certificates of participation (COPs):

--$16.1 million COPs (War Memorial Veteran's Building Seismic Upgrade and Improvements) Series 2016A (Federally Taxable).

The COPs, scheduled to price through negotiated sale the week of June 6, are being issued to reimburse the city for a portion of the costs of renovating and seismic retrofitting the historic War Memorial Veteran's Building.

In addition, Fitch has affirmed the following ratings:

--$2.2 billion general obligation (GO) bonds at 'AA+';
--$49 million city and county of San Francisco Finance Corporation lease revenue bonds, series 2006 and 2007 (Open Space Fund - Various Park Projects) at 'AA+';
--$1 billion lease obligations at 'AA';
--Issuer Default Rating (IDR) at 'AA+'.

The Rating Outlook is Stable.

SECURITY
The 2016A COPs are payable from lease payments made by the city for use and occupancy of the War Memorial Veteran's Building, on parity with the 2015 War Memorial Veteran's Building COPs.

GO bonds are payable from unlimited ad valorem property taxes.

San Francisco's COPs and lease revenue bonds are supported by the city's covenant to budget and appropriate lease payments, subject to abatement. The COPs and most of the lease revenue bonds are rated one notch below the city's IDR, reflecting the slightly higher degree of optionality associated with payment of appropriation debt. The 2006 and 2007 Open Space Bonds, which are payable from lease payments from a dedicated set-aside of a portion of the city's fixed rate operating tax levy that may only be used for open space, are rated on par with the IDR based on the charter limitation against using the dedicated funds for any other purpose, which Fitch believes significantly enhances the incentive for appropriation.

KEY RATING DRIVERS

The 'AA+' IDR reflects strong budgetary and financial policies that provide a foundation for maintaining ample reserves and financial flexibility throughout economic cycles. The city's strong economic and revenue growth prospects partially offset limitations in expenditure flexibility and revenue-raising ability.

Economic Resource Base
San Francisco's economic resource base is exceptionally strong. Growth in digital media, biotech, and other technology subsectors complement the more traditional finance and business services, health care, education and tourism sectors. The citys' tax structure captures the vast majority of economic activity and includes property, business, hotel, sales, utility, parking and real property transfer taxes. High

education attainment levels and several large research universities support long-term economic growth prospects.

Revenue Framework: 'aa' factor assessment
Very strong economic growth has been generating revenue growth well in excess of CPI and GDP. This strength is partially offset by the city's limited independent revenue raising ability.

Expenditure Framework: 'aa' factor assessment
Recent expenditure growth has lagged the strong revenue growth, but in general Fitch expects the natural pace of spending growth to be in line with, to marginally above, revenue growth given ongoing service demands. A relatively restrictive workforce framework somewhat constrains expenditure-cutting flexibility.

Long-Term Liability Burden: 'aa' factor assessment
Long-term liabilities are a low to moderate burden relative to the city's resource base. Based on the city's debt issuance plans, its direct debt amortization rate and the expected growth of personal income, Fitch expects the liability burden to remain in the low to moderate range.

Operating Performance: 'aaa' factor assessment
The city's gap closing ability is exceptionally strong, largely due to robust reserve levels relative to revenue volatility that offset limited inherent budget flexibility. Furthermore, the city has demonstrated its ability to curb expenditure growth through negotiated concessions when necessary. Charter and ordinance-approved financial policies support maintenance of financial flexibility through economic cycles.

RATING SENSITIVITIES
RESERVE FUND ADEQUACY: An unexpected shift in the city's fiscal policies, including regarding funding of rainy day reserves, could exert downward pressure on the rating.

CREDIT PROFILE
The city is the economic and cultural center of the nine-county San Francisco Bay area. Despite being essentially built out, population continues to grow as parts of the city, including former military bases, are redeveloped with increased density. The economic profile of the city benefits from good wealth levels; per capita personal income is almost twice the national level and market value per capita is over $215,000. The city's tourism sector is performing exceptionally well, resulting in record-high hotel tax revenues. The city's largest private employers include Salesforce, Gap, Wells Fargo and Gap, Inc.

Revenue Framework
As a city and county, San Francisco benefits from a wide variety of revenues, with the vast majority coming from local taxes and the remainder from state and federal revenues as well as local fees, charges and fines. Revenue growth has been robust, reflecting the rapid economic growth as reflected by strong job growth, and offsets the city's limited ability to independently raise revenues.

The city's tax structure captures the diverse and growing economic activity with a variety of taxes, led by property (about 30% of total) as well as business and hotel taxes. Recent revenue growth has well exceeded national GDP growth. The locally generated taxes yield almost three-quarters of general fund revenues, resulting in somewhat less exposure to potential state and federal funding shifts than is the case for other California counties. Total tax revenues for fiscal 2015 were 11% above prior year levels and 42% above receipts for fiscal 2011. Total revenues have increased 8.5% on average annually from fiscal 2011-2015. The city's fiscal 2016 nine-month budget report is forecasting further general fund tax growth of 3.4% and overall revenue growth of about 5%.

Like all local governments in California, the city's independent legal ability to raise its revenues is constrained by various voter-approved initiatives. However, Fitch assesses the city's revenue raising ability as moderate due to the city's historically very low revenue volatility, which forms the basis for the analytical assessment.

Expenditure Framework
As a city and a county, San Francisco provides a wide variety of services, with the majority of expenditures focused on public health and social services, followed by public safety.

Given the city's very rapid revenue growth and the nature of its spending responsibilities, Fitch expects that growth in major spending areas is likely to be in line with revenue growth on average over time.

Estimated governmental carrying costs for direct debt service and pension costs are moderate; however, the city's workforce framework is somewhat restrictive, including binding arbitration, salary comparisons, and some staffing minimums in public health and public safety. This leaves the city with an adequate ability to cut spending as needed.

Long-Term Liability Burden
The city has about $2 billion in voter-approved GO bonds outstanding and another $1 billion in lease obligations paid from the general fund (about half of which are also voter approved). The city has very limited variable rate exposure. Given the city's policies which limit lease obligation debt service to 3.25% of general fund discretionary revenues and GO debt service to remain at the current property tax rate, Fitch expects the direct debt burden to grow roughly in line with the city's resource base as measured by personal income. The city's 10-year general fund capital improvement plan totals $4.7 billion.

The city's combined debt and pension liability currently equals about 11% of personal income. San Francisco maintains its own pension system (SFERS) with a public safety and a miscellaneous plan. In addition, a small portion of employees participate in CalPERS. The city funds the pensions at the actuarially required contribution (ARC) level, so funding should improve over time unless the assumed 7.5% return is not achieved. Fitch expects the long-term liability burden to remain low to moderate relative to the growing resource base.

The city's OPEB liability is sizeable; however, several charter amendments lowered the liability and resulted in contributions from employees and the city being deposited into an OPEB trust which may not be drawn upon until it is fully funded. The city expects the combination of these sources of OPEB contributions to reach the ARC in about 30 years.

Operating Performance
Given the city's historically low revenue volatility and high reserves that offset the limited budget flexibility, Fitch expects the city to retain exceptional financial flexibility through the economic cycle. Charter and ordinance approved financial policies require formulaic deposits to various budgetary and fiscal reserves based on revenue performance, and likewise their use during downturns is limited by formula. Despite the somewhat constrained labor agreements, the city has a solid history of negotiating concessions with labor groups during downturns, including furloughs and pay deferrals. Layoffs have also been employed.

The city's available fund balance (including rainy day funds) at the end of fiscal 2015 totaled $1.1 billion, equal to 28% of expenditures. Fitch expects that the city would maintain reserves throughout a downturn at a level above the 8% reserve safety margin that Fitch believes consistent with an 'aaa' financial resilience assessment based on the city's low revenue volatility, moderate ability to raise revenues, and adequate spending flexibility.

Budget management is conservative and the city's charter features several conservative requirements that promote financial stability. The budget must be based on revenue projections published by the independent controller. The charter also requires periodic budget status reports and permits the controller to freeze appropriations if actual revenues are less than budgeted.

A 2009 voter-approved charter amendment led to the adoption of various financial policies including: two-year budgeting, a biennial five-year forecast with balancing strategies, limiting use of one-time revenues for one-time expenditures, and budgetary reserve funding policies and procedures. Importantly, one of the budgetary reserves, the budget stabilization account, is funded from two of the city's most volatile revenue sources, including real property transfer tax revenues in excess of the five-year average, limiting volatility in the city's budget.

The new reserve policies in particular have contributed to the city's improved financial position, helping to rein-in expenditure growth during an extended period of economic expansion. Rainy day and budget stabilization reserves have increased materially since their low point in fiscal 2010 and the rainy day reserve portion is no longer available for the separately-managed local school district, protecting city reserves more than in previous downturns. In addition, the requirement to fund reserves from above-average growth in certain cyclical revenues helps curb the city's historical reliance on unsustainable revenue growth for ongoing expenditures. Although most of the city's new mechanisms remain untested by a severe fiscal shock, in Fitch's view the city is now well-positioned to absorb future economic and revenue uncertainty.

San Francisco's public hospital has maintained sound financial operations since implementation of the Affordable Care Act, as increased revenue from newly insured patients has exceeded the reductions in state and federal support. General fund transfers to the hospital remain at historical levels. Nonetheless, continued reductions in state and federal support for indigent care as well as competition for insured patients may pose a challenge going forward; however, Fitch believes the city's hospital is well positioned to address these challenges and that its general fund financial exposure is manageable.

The city's fiscal 2016 budget closed a modest deficit while adding social services for the homeless and additional public safety officers, as well as funding a modest cost of doing business increase for its nonprofit service providers. The Dec. 1, 2015 updated five-year financial forecast revealed a growing out-year deficit due to higher retiree costs resulting from lower than assumed investment returns, adjustments to mortality data, and a court ruling reversing a voter-approved adjustment to benefits. In response, the mayor directed departments to cut 1.5% of ongoing costs from fiscal 2017 and 2018 budgets, roughly offsetting the increased retiree costs.

The city's five-year forecast continues to project that expenditures will increase more rapidly than revenue and presents options for closing the projected gap, the largest of which are slowing capital spending and department savings. Fitch believes the city has sufficient expenditure flexibility to address the larger forecast deficits, though wage pressures could present a challenge. Notably, the five-year forecast includes a recession scenario allowing the city to begin discussing actions that would be needed to address significantly larger deficits.

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

Applicable Criteria
U.S. Tax-Supported Rating Criteria (pub. 18 Apr 2016) (https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=879478&cft=eyJ0eXAiOiJKV1QiLCJhbGciOiJIUzI1NiJ9.eyJleHAiOjE0NjQzMjQ5MjcsInNlc3Npb25LZXkiOiJZTFEwT1BKNFNXWlBJT0tSU0NISktNNEpJS0tSWlFDNU1DV1FOWEE2In0.KwrowrobHGD5CnQge_ubHDLPZm4iQlvliXtFt-V7tfo)

Additional Disclosures
Dodd-Frank Rating Information Disclosure Form (https://www.fitchratings.com/creditdesk/press_releases/content/ridf_frame.cfm?pr_id=1005203&cft=eyJ0eXAiOiJKV1QiLCJhbGciOiJIUzI1NiJ9.eyJleHAiOjE0NjQzMjQ5MjcsInNlc3Npb25LZXkiOiJZTFEwT1BKNFNXWlBJT0tSU0NISktNNEpJS0tSWlFDNU1DV1FOWEE2In0.KwrowrobHGD5CnQge_ubHDLPZm4iQlvliXtFt-V7tfo)
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