FitchRatings

RATING ACTION COMMENTARY

Fitch Rates San Francisco, CA's $183MM COPs 'AA'; Affirms IDR at 'AA+'; Outlook Stable

Fri 06 Oct, 2023 - 4:01 PM ET

Fitch Ratings - San Francisco - 06 Oct 2023: Fitch Ratings has assigned a 'AA' rating to the following City and County of San Francisco (CA) (city) certificates of participation (COPs):

--$103.9 million COPs Series 2023A, Affordable Housing and Community Facilities Project (taxable);

--$79.3 million COPs Series 2023B, Multiple Capital Improvements.

In addition, Fitch has affirmed the following ratings:

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

--$2.6 billion outstanding city and county of San Francisco GO bonds at 'AA+';

--$60.2 million outstanding finance corporation lease revenue bonds, series 2008-1, 2008-1 (bank bonds), 2008-2, 2008-2 (bank bonds), 2010-R1 and 2018B at 'AA';

--$19.6 million outstanding finance corporation lease revenue bonds (open space fund-various park project), refunding series 2018A at 'AA+';

--$1.3 billion in outstanding COPs at 'AA';

--$569.2 million Transbay Transit District Community Facilities District special tax bonds at 'AA+'.

The Rating Outlook is Stable.

RATING ACTIONS

ENTITY / DEBT	RATING			PRIOR
San Francisco (City & County) (CA) [General Government]	LT IDR	AA+ Rating Outlook Stable	Affirmed	AA+ Rating Outlook Stable
San Francisco (City & County) (CA) /General Obligation - Unlimited Tax/1 LT	LT	AA+ Rating Outlook Stable	Affirmed	AA+ Rating Outlook Stable
San Francisco (City & County) (CA) /Lease Obligations - Non-Standard/1 LT	LT	AA+ Rating Outlook Stable	Affirmed	AA+ Rating Outlook Stable
San Francisco (City & County) (CA) /Lease Obligations - Standard/1 LT	LT	AA Rating Outlook Stable	Affirmed	AA Rating Outlook Stable
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 Stable

VIEW ADDITIONAL RATING DETAILS

Series 2023A COP proceeds will be used to finance and refinance certain capital improvement, affordable housing and community facilities projects. Series 2023B COP proceeds will be used to finance and refinance certain capital improvement projects, including street resurfacing and reconstruction and various critical repairs. The COPS are expected to sell competitively the week of Oct. 16, 2023.

SECURITY

The series 2023A and 2023B COPs are payable from lease payments, made under a master lease agreement, by the city for use and occupancy of portions of the city's Laguna Honda Hospital facility and the San Bruno Jail facility, with an estimated value in excess of the aggregate outstanding par amount. The city covenants to budget and appropriate for lease payments, which are subject to abatement.

ANALYTICAL CONCLUSION

The 'AA+' IDR reflects the city's strong fiscal management capabilities along with substantial reserves and accumulated fund balance, which allow for ample time to make necessary adjustments to what appears to be a structural change to the city's revenue base. The Stable Outlook reflects Fitch's view that the city's strong fiscal management capabilities and policies, along with ample resources and significant identified spending flexibility, sufficiently mitigate the potential risks over the medium term as the city adjusts to reduced revenues and potentially slower revenue growth. The rating on the COPs, one notch below the city's IDR, reflects the slightly higher optionality associated with the requirement to appropriate.

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 exceeded the state and nation between 2010 and 2020, as parts of the city, including former military bases and former industrial areas, were redeveloped with increased density. However, with the onset of the pandemic in March 2020, the city lost population as people relocated while working remotely. It is unclear to what degree these residents will return or if population growth will resume.

The city's economic profile benefits from exceptional income and wealth indicators; per capita personal income is over two and a half times the national average, and assessed value per capita for fiscal 2024 is about $426,000. The city's largest private employers include Salesforce, Wells Fargo & Company, Sutter Health, Uber Technologies, and Kaiser Permanente. Between 2008 and 2020, growth in technology jobs drove rapid labor force and employment gains. Growth in technology employment has resumed after reductions in workforce in late 2022 and early 2023.

KEY RATING DRIVERS

Revenue Framework: 'aa'

Very strong economic growth had been generating revenue growth well in excess of U.S. GDP for many years. Post-pandemic, Fitch expects certain revenues to be challenged given structural economic changes. Expectations for long-term revenue growth below U.S. GDP could affect the revenue framework assessment. 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:

--A sustained liability burden materially below 10% of personal income.

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

--Lack of continuing recovery in economically sensitive revenues such as sales, hotel and business taxes;

--Failure to implement available policy measures, as needed, to reduce the structural deficit for the next budget cycle (fiscal 2025 and 2026);

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

CURRENT DEVELOPMENTS

Slow Economic and Revenue Recovery; Strong Financial Position

San Francisco's diverse revenue base continues to recover, albeit slowly, as office attendance and certain business and leisure visitor numbers remain below pre-pandemic levels. Despite its much slower than typical post-pandemic economic and revenue recovery, the city is seeing strong year over year growth in some important economically sensitive revenues like property, sales, hotel, and parking taxes. Property tax revenue growth is expected to stagnate as taxable assessed value (TAV) is pressured by the weak commercial office values as well as weakness in hotel and retail property values. The city expects appeals activity to accelerate, which could suppress property tax revenue growth over several years.

Federal aid along with some budgetary adjustments allowed the city to retain and even grow its financial cushion between fiscal 2020 and 2022. The city received $175 million from the Coronavirus Aid, Relief, and Economic Security Act and $624.8 million from the American Rescue Plan Act (ARPA), as well as $218.9 million in reimbursements (of $602.1 million anticipated to be reimbursed) from FEMA. Through at least fiscal 2022, these funds enabled the city to largely maintain its fiscal reserves and other available fund balance for future use.

According to its most recent audit, the city ended fiscal 2022 with a net operating surplus after transfers of $235 million (3.8% of $6.2 billion in expenditures and transfers out) and an unrestricted fund balance of $2.8 billion (44.8%), increasing to $2.9 billion (46.7%) when the rainy-day reserve is included. This large surplus was enabled by the second tranche of ARPA funds ($312.4 million) and over $300 million in better than budgeted revenues (especially property, real property transfer and hotel room taxes, as well as state subventions), as well as further spending management and salary savings due to vacant positions. These balances are up from the fiscal 2019 available fund balance of $2.7 billion (49% of fiscal 2019 general fund spending).

According to the city's July 2023 economic report, economic indicators are mixed. The San Francisco metro area (San Francisco and San Mateo Counties) exceeded its pre-pandemic employment base of about 1.2 million. Recent job growth has been dominated by the information and professional services sectors, comprising 6,000 of the 8,400 jobs added in June. The unemployment rate is 3.6% in August 2023, lower than the national level of 3.9%. Office vacancies increased in the second quarter of 2023 while office rents declined slightly and attendance was flat. Apartment rents increased in July yoy while condo and single-family residence prices have been declining since peaking in May 2022. Domestic and international enplanements remain below 2019 levels and the hospitality sector was still about 10,000 jobs below its February 2020 level. Reflecting the weak recovery in total visitors to the city, San Francisco's revenue per available room in June 2023 about 75% of its October 2019 level.

The city faces economic and revenue challenges related to the durability of remote office work reducing the number of people commuting into the city, and related business, sales and property taxes, as well as an only partial recovery in business travel. Many workers are either fully remote or only come into the office two to three days per week, which has pushed the office vacancy rate to 28% as of the second quarter of 2023, up from 24% in the third quarter of 2022. Kastle Systems estimates the rate of office occupancy in the San Francisco metro area for the week ending Sept. 27 at 44%, compared to their 10-city average of 50%.

The high office vacancy rate along with higher interest rates are expected to adversely affect commercial property values and related property tax revenues. About 17% of the city's assessed value is comprised of commercial office buildings. The city has created a model to estimate, and set aside funds for, potential reductions to TAV and property tax refunds. On a per parcel basis, using lease terms, cap rate and interest rate information, the city estimates fiscal 2024 value at risk (assessed value less estimated market value) for office buildings at about $5.15 billion. When other property types (such as hotel, retail and residential) are included, the estimated value at risk rises to $11.5 billion (about 3.3% of net assessed value). For fiscal 2024, the city estimates this loss in value would result in a required tax loss reserve deposit from the general fund of $64 million.

For fiscal 2025, the city estimates total AV at risk of $18.5 billion and a general fund tax loss reserve deposit of $103 million. The funds deposited into the tax loss reserve are outside the general fund and result in a reduction to revenue recognized by the city in the year the reserve deposit is made. These estimates are incorporated into the city's fiscal 2024 and 2025 budgets budget and its five-year financial plan update from March 2023.

Fiscal 2024-2025 Budgets Point to Continuing, but Smaller Structural Deficits

The city adopts rolling two-year budgets each year. The adopted fiscal 2024 and 2025 budget solved an estimated $780 million current service funding gap, using about $1 billion in non-recurring sources over the two years to close the gap and fund targeted investments aimed at public safety, community support, homelessness and economic recovery. For fiscal 2024, the city identified about $432 million in non-recurring sources, including fund balance ($123 million), its Fiscal Cliff Reserve ($90.2 million), FEMA reimbursements ($170 million), and $49 million in miscellaneous special revenue funds/reserves which displace general fund spending. In addition, the budget makes departmental reductions ($142.6 million), including by cutting salary budgets to account for position vacancies and generates citywide operating savings ($133.3 million), including reduced funding levels in capital, IT, equipment, fleet cost reduction.

Five Year Forecast - fiscal 2024-2028

The city's most recent five-year forecast from March 2023 projects flat revenues in fiscal 2024 followed by relatively tepid revenue growth thereafter. Business, sales and most other taxes are projected to continue moderate growth while hotel taxes are projected to rebound for two years before reverting to moderate growth. Property taxes are projected to be relatively flat over the forecast period, due primarily to expected softness in commercial office values that offsets value appreciation in residential and other property types as discussed earlier.

The forecast as of March 2023 projected a $724 million structural deficit for fiscal 2025-2026. The city used a mix of one-time and ongoing solutions to balance the fiscal 2024-2025 budgets. About $200 million of ongoing solutions (sources and uses) were included in the fiscal 2024 and 2025 adopted budgets. Due to these measures the city estimates a likely shortfall in excess of $500 million in fiscal 2025-2026. The five-year forecast acknowledges longer-term structural challenges facing the city in contrast to previous recessions, after which revenues recovered quite quickly. The forecast recommends making ongoing spending reductions of $200 million to $250 million per year from assumed expenditures and using one-time sources to bridge the budget gap until revenues and expenditures are more closely aligned. This approach would minimize service disruptions and provide time to implement more complex solutions while retaining a strong financial cushion.

The forecast assumes designated reserves at the end of fiscal 2028 still total over $1 billion, which is equal to about 14.6% of projected fiscal 2028 revenues and transfers in. The rating and Stable Outlook reflect the expectation that the city is able to achieve needed ongoing spending reductions and maintain its superior gap closing capacity. Negative rating action may occur if the budget gaps increase due to spending or revenue variances without sufficient action to realign revenues and spending.

Fitch views the city's current superior gap-closing capacity and tools to resolve projected budget deficits as sufficient to support the rating and Stable Outlook. Fitch could take negative rating actions if the revenue picture materially worsens from current expectations, or if the city is unable to continue to reduce its forecast structural budget deficit, or if available reserves are significantly depleted before the structural deficits are resolved.

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.

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.

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APPLICABLE CRITERIA

Exposure Draft: U.S. Public Finance Local Government Rating Criteria - Master Criteria (pub. 21 Sep 2023) (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

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