

RATING ACTION COMMENTARY

Fitch Rates \$236.3MM San Francisco, CA's GOs 'AA+'; Affirms Outstanding; Outlook Stable

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Fitch Ratings - San Francisco - 20 Mar 2023: Fitch Ratings has assigned an 'AA+' rating to the following City and County of San Francisco (CA) (city) GO bonds:

--\$28,850,000 GO bonds (Health and Recovery, 2020) series 2023A;

--\$39,095,000 GO bonds (Embarcadero Seawall Earthquake Safety, 2018) series 2023B; and

--\$168,375,000 GO bonds (Social Bonds - Affordable Housing, 2019) series 2023C.

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+';

--\$70.3 million outstanding finance corporation lease revenue bonds, series 2008-1, 2008-2, 2010-R1 and 2018B at 'AA+';

--\$22.9 million outstanding finance corporation lease revenue bonds (open space fund-various park project), refunding series 2018A at 'AA+';

--\$1.35 billion in outstanding certificates of participation (COPs) at 'AA+';

--\$576.1 million special tax bonds, series 2017A, 2017B, 2019A, 2019B, 2020B, 2021B, 2022A and 2022B 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](#)

The GO bonds are expected to sell competitively March 28.

Proceeds of the series 2023A bonds will be used to finance facilities that deliver services to improve the accessibility, safety and quality of parks, open spaces and recreation facilities; and pay related costs.

Proceeds of the 2023B bonds will be used to protect the waterfront, BART and San Francisco Municipal Transit Agency buildings, historic piers, and roads from earthquakes, flooding and rising seas by: repairing the 100 year old Embarcadero Seawall; strengthening the Embarcadero; and fortifying transit infrastructure and utilities serving residents and businesses.

Proceeds of the 2023C bonds will be used to finance affordable housing to extremely-low, low and middle-income households through programs that will prioritize vulnerable populations; preservation of existing affordable housing; repair and reconstruct distressed and dilapidated public housing developments and their underlying infrastructure; and assist middle-

income residents in obtaining affordable rental or home ownership opportunities including down payment assistance and support for new construction of affordable housing.

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 'AA+' rating reflects the city's strong fiscal management capabilities along with substantial resources, 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 significant identified spending flexibility and ample resources, sufficiently mitigate the potential risks over the medium term as the city adjusts to reduced revenues and potentially slower revenue growth.

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 2022 is about \$350,000. 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. In recent months, many of the city's large technology firms have announced layoffs.

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:

--Expectation for long-term revenue growth below U.S. economic performance due to sustained economic or tax base weakness as evidenced by suppressed property, business, sales and hotel tax revenues;

--In the upcoming fiscal 2024 and 2025 budget cycle, failure to implement available policy measures to reduce ongoing spending and reliance on one-time sources, including federal stimulus and fiscal reserves;

--Inability to manage increasing 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

Slow Economic Revenue Recovery; Strong Financial Position

Despite a slower than originally expected recovery from the pandemic, the city remains in a very strong financial position. The revenue losses from the pandemic started in the last quarter of fiscal 2020 and to date, federal aid along with some budgetary adjustments have allowed the city to retain and grow its financial cushion. 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 requested) from FEMA. These funds have 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 spending 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 (\$324 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, by November 2022, the San Francisco metro area (San Francisco and San Mateo Counties) had regained nearly all of the jobs lost in the pandemic, although the hospitality sector was still about 30,000 jobs below its November 2019 level. Reflecting the weak recovery in total visitors to the city, San Francisco's revenue per available room in October 2022 was only about 70% of its October 2019 level. Despite recent layoffs, the technology sector had performed well over the last three years, adding about 51,000 jobs. According to the city, by 2019, 15.5% of all private sector jobs in the city were tech jobs; this percentage further increased to 18.7% by 2021.

The city faces economic and revenue challenges related to the structural shift to a significant amount of remote office work, an only partial recovery in business travel, and emerging softness in the technology sector (in which the city's recent economic

growth had been concentrated). A smaller share of office workers than originally expected have returned to work in the offices in the city. Workers are either fully remote or only come into the office two to three days per week which, along with recent job losses, pushed the office vacancy rate to 24% as of the third quarter of 2022. Kastle Systems estimates the rate of office occupancy in the San Francisco metro area for the week ending March 8 at 46%, compared to their 10-city average of 50.1%.

If sustained, the high office vacancy rate - along with higher interest rates - has the potential to adversely affect commercial property values and tax revenues. The impact on commercial real estate tax revenues will take longer to materialize as commercial lease terms are typically up to 10 years, and there is a several month lag between when properties are assessed and when appeals and/or delinquencies will be known. The city's assessed value includes about 18.6% commercial office space and property taxes make up about 37% of general fund revenues. Further, fewer workers in the city also constrains further growth of tax revenues generated by retail and other economic activity. Several large companies have recently announced requirements for at least some previously remote workers to return to the office, including Salesforce. It remains to be seen what impact this will have on the number of office workers in the city.

Fiscal 2023 budget and Five Year Financial Plan Point to Continuing Structural Deficits

The city's fiscal 2023 budget increases spending by about 5.4% to \$6.3 billion, including transfers out. Expenditures are estimated to exceed revenues and the gap was closed with budgeted use of about \$153 million in fiscal reserves and \$471 million in accumulated fund balance. Including budgeted FEMA revenue, the budget uses about \$700 million in non-recurring revenues (equal to about 11% of fiscal 2023 budgeted spending).

The fiscal 2023 six-month report is mixed in terms of revenue performance. Some revenue sources are outperforming budget (property, sales, hotel, utility user, and executive pay tax) by an aggregate roughly \$310 million, while aggregate real property transfer tax and business taxes are now estimated at \$210 million below budget due to a dearth of real estate transactions in this fiscal year. In addition, FEMA relief in fiscal 2023 is now expected to be below budget due to FEMA prioritizing new applicants. Some state subventions and state realignment revenues are over budget. Overall, the six-month report estimates revenues above budget by about \$30 million with a small net reduction in spending. The city currently has an unusually high number of vacancies which will likely reduce actual spending compared to budget over the near term.

Five Year Forecast - fiscal 2024-2028

The city's five year forecast 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. Even if home values decline, proposition 13 (which limits AV growth to 2% per year) ought to provide a sizeable cushion between the AV and current market value of many properties. As noted, the city has more exposure to commercial office space taxable value than is typical. Commercial office makes up about 16.8% of taxable value. In November 2022, the city controller estimated revenue loss from revalued office properties at about \$80 million in fiscal 2024, increasing to \$125 million in fiscal 2028.

The five-year forecast assumes longer-term structural challenges facing the city in contrast to previous recessions, after which revenues recovered quite quickly. The city's upcoming two-year budget cycle (fiscal 2024 and 2025) will be critical in preparing the city to manage the structural change to its revenue base. 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 mayor's budget instructions request departments provide 5% reductions for fiscal 2024 and 8% for fiscal 2025, which the city estimates would result in roughly \$75 million in ongoing savings in fiscal 2024 and \$125 million in fiscal 2025.

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.

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.

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.

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.

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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)

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US Public Finance Infrastructure and Project Finance North America United States

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