

RATING ACTION COMMENTARY

Fitch Upgrades Sacramento, CA's IDR to 'AA+' due to Criteria Change

Tue 25 Jun, 2024 - 2:51 PM ET

Fitch Ratings - San Francisco - 25 Jun 2024: Fitch Ratings has upgraded the following ratings of the City of Sacramento, CA due to a criteria change:

--Issuer Default Rating (IDR) to 'AA+' from 'AA';

--Golden 1 Center 2015 lease revenue bonds (LRBs) issued by the Sacramento Public Financing Authority to 'AA-' from 'A+'.

The Rating Outlook is Stable. The rating has been removed from Under Criteria Observation.

RATING ACTIONS

ENTITY / DEBT ↕	RATING ↕			PRIOR ↕
Sacramento (CA) [General Government]	LT IDR	AA+ Rating Outlook Stable	Upgrade	AA Rating Outlook Stable

Sacramento (CA) /Issuer Default Rating - General Government/1 LT	LT	AA+ Rating Outlook Stable	Upgrade	AA Rating Outlook Stable
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Sacramento (CA) /Lease Obligations - Non-Standard/1 LT	LT	AA- Rating Outlook Stable	Upgrade	A+ Rating Outlook Stable
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[VIEW ADDITIONAL RATING DETAILS](#)

The upgrade of the IDR to 'AA+' reflects the implementation of Fitch's new U.S. Public Finance Local Government Rating Criteria. The IDR incorporates the city's 'aaa' financial resilience given its high level of reserves relative to its low ability to raise revenues and midrange expenditure control. In fiscal 2019, city voters increased a sales tax supporting general fund services, which helped boost the city's financial cushion.

Despite this additional revenue source and the city's other improving revenues, city documents indicate revenues have started to grow more slowly than expenditures, resulting in a projected \$66 million deficit in fiscal 2025. In order to close this budget gap, the city council increased charges for services and eliminated vacant positions in the adopted fiscal 2025 budget. Fitch expects the city will continue taking proactive steps to address out-year budget gaps and maintain its reserves at levels that support a 'aaa' financial profile.

The 'AA+' IDR is supported by continued population growth, the city's large size, diverse economy and above-average education attainment levels. The city's unemployment rate consistently tracks above the national rate and income levels are slightly below Fitch's portfolio median (when adjusted for price parity), resulting in a midrange demographic level assessment.

The city's long-term liability burden is weak given its high debt and net pension liabilities when compared with both resident personal income and total revenues. Fixed costs associated with debt service and adjusted for benefits contributions accounted for about 18% of total governmental expenditures in fiscal 2023, which is on the higher range in Fitch's portfolio.

The IDR incorporates Fitch's application of an Additional Analytical Factor of +1.0 due to the city's economic and institutional strength as the state capital and an anchor within the Sacramento-Roseville-Folsom MSA.

The LRBs are rated two notches below the IDR because the city's repayment plan relies on prospective revenues that Fitch views as uncertain. Fitch also views the funding of the arena as a non-core essential funding item for the city's operations providing an additional level of optionality in the case of a downturn.

RATING SENSITIVITIES

Factors that Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade

--Inability to align expenditures with revenues, resulting in imbalanced operations and the city's unrestricted fund balances used for general purposes falling below 25% of expenditures and transfers out, the minimum level needed for a 'aaa' financial resilience assessment;

--The long-term liability burden more than doubling when assuming no changes from current personal income levels, or total governmental expenditures or revenues;

--The 2015 LRBs could be downgraded if the city's IDR changes.

Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade

--A nearly 10% decrease in the long-term liability burden when assuming no changes from current personal income levels, or total governmental expenditures or revenues;

--A stronger demographic level assessment through the city's unemployment rate sustaining below the national rate combined with median household income levels trending consistently above Fitch's portfolio median.

--The 2015 LRBs could be upgraded if the revenues supporting the bonds, particularly the parking revenues, overcome pandemic induced declines and also grow to levels that would greatly lessen the likelihood of general fund support.

SECURITY

The LRB are payable from lease rental payments from the city (the obligor) to the Sacramento Public Financing Authority (the issuer) for use and occupancy of the arena. The city has covenanted to budget and appropriate lease rental payments from any

legally available resource. The lease is subject to abatement risk and bondholders lack the right to foreclose on the property in a default.

FITCH'S LOCAL GOVERNMENT RATING MODEL

The Local Government Rating Model generates Model Implied Ratings which communicate the issuer's credit quality relative to Fitch's local government rating portfolio (the Model Implied Rating will be the IDR except in certain circumstances explained in the applicable criteria). The Model Implied Rating is expressed via a numerical value calibrated to Fitch's long-term rating scale that ranges from 10.0 or higher ('AAA'), 9.0 ('AA+'), 8.0 ('AA'), and so forth down to 1.0 ('BBB-' and below).

Model Implied Ratings reflect the combination of issuer-specific metrics and assessments to generate a Metric Profile, and a structured framework to account for Additional Analytical Factors not captured in the Metric Profile that can either mitigate or exacerbate credit risks. Additional Analytical Factors are reflected in notching from the Metric Profile and are capped at +/-3 notches.

RATINGS HEADROOM & POSITIONING

Sacramento Model Implied Rating: 'AA+' (Numerical Value: 9.87)

-- Metric Profile: 'AA' (Numerical Value: 8.87)

-- Net Additional Analytical Factor Notching: +1.0

Individual Additional Analytical Notching Factors:

-- Economic and Institutional Strength: +1.0

Sacramento's Model Implied Rating is 'AA+'. The associated numerical value of 9.87 is at the upper end of the 9.0 to 10.0 range for its current 'AA+' rating.

KEY RATING DRIVERS

FINANCIAL PROFILE

Financial Resilience - 'aaa'

Sacramento's financial resilience is driven by the combination of its 'Low' revenue control assessment and 'Midrange' expenditure control assessment, culminating in a 'Limited' budgetary flexibility assessment.

--Revenue control assessment: Low

--Expenditure control assessment: Midrange

--Budgetary flexibility assessment: Limited

--Minimum fund balance for current financial resilience assessment: $\geq 25.0\%$

--Current year fund balance to expenditure ratio: 48.6% (2023)

--Five-year low fund balance to expenditure ratio: 40.9% (2023)

Revenue Volatility - 'Weak'

Sacramento's weakest historic three-year revenue performance has a modest negative impact on the Model Implied Rating.

The revenue volatility metric is an estimate of potential revenue volatility based on the issuer's historical experience relative to the median for the Fitch-rated local government portfolio. The metric helps to differentiate issuers by the scale of revenue loss that would have to be addressed through revenue raising, cost controls or utilization of reserves through economic cycles.

--Lowest three-year revenue performance (based on revenues dating back to 2005): 8.4% decrease for the three-year period ending fiscal 2012

--Median issuer decline: -4.5% (2023)

DEMOGRAPHIC AND ECONOMIC STRENGTH

Population Trend - 'Midrange'

Based on the median of 10-year annual percentage change in population, Sacramento's population trend is assessed as 'Midrange'.

Population trend: 1.1% 2022 median of 10-year annual percentage change in population (58th percentile)

Unemployment, Educational Attainment and MHI Level - 'Midrange'

The overall strength of Sacramento's demographic and economic level indicators (unemployment rate, educational attainment, median household income [MHI]) in 2023 are assessed as 'Midrange' on a composite basis, performing at the 43rd percentile of Fitch's local government rating portfolio. This is due to high education attainment levels offsetting midrange median-issuer indexed adjusted MHI and an elevated unemployment rate.

--Unemployment rate as percentage of national rate: 130.6% 2023 (20th percentile), relative to the national rate of 3.6%

--Percent of population with a bachelor's degree or higher: 35.8% (2022) (66th percentile)

--MHI as a percent of the portfolio median: 94.7% (2022) (42nd percentile)

Economic Concentration and Population Size - 'Strongest'

Sacramento's population in 2022 was of sufficient size and the economy was sufficiently diversified to qualify for Fitch's highest overall size/diversification category.

The composite metric acts asymmetrically, with most issuers (above the 15th percentile for each metric) sufficiently diversified to minimize risks associated with small population and economic concentration. Downward effects of the metric on the Metric Profile are most pronounced for the least economically diverse issuers (in the 5th percentile for the metric or lower). The economic concentration percentage shown below is defined as the sum of the absolute deviation of the percentage of personal income by major economic sectors relative to the U.S. distribution.

--Population size: 525,297 (2022) (above the 15th percentile)

--Economic concentration: 40.4% (2023) (above the 15th percentile)

Demographic and Economic Strength Additional Analytical Factors and Notching: +1.0 notch (for Economic and Institutional Strength)

The one-notch increase for economic and institutional strength reflects the city's role as a core component of the Sacramento-Roseville-Folsom MSA, which has a real metro product equal to 0.8% of U.S. GDP. In conjunction with the city's size, it serves as the state capital providing a stabilizing employment institution.

LONG TERM LIABILITY BURDEN

Long-Term Liability Burden - 'Weak'

Sacramento's liabilities to governmental revenue have deteriorated while carrying costs to governmental expenditures remain moderately weak and liabilities to personal income remain moderately weak. The long-term liability composite metric in 2023 is at the 36th percentile, indicating a somewhat elevated liability burden relative to the Fitch local government rating portfolio.

--Liabilities to personal income: 6.4% Analyst Input (41st percentile) (vs. 7.1% 2023 Actual)

--Liabilities to governmental revenue: 201.2% Analyst Input (39th percentile) (vs. 221.7% 2023 Actual)

--Carrying costs to governmental expenditures: 17.7% Analyst Input (30th percentile) (vs. 19.6% 2023 Actual)

Analyst Inputs to the Model

Adjustments were made to the long-term liability burden to account for changes in direct debt and carrying costs associated with out-year assumptions in debt service levels. Pension and OPEB liabilities and payments were scaled to the size of the governmental activities' pension and OPEB liabilities. Fitch used the benefits payments amount for OPEB expenditures to determine the carrying cost metric.

Most of Fitch's portfolio does not pay the full actuarial OPEB cost, but instead pays the pay-go cost. The adjustment made for Sacramento is done as an assumed pay-go cost in order to compare the fixed cost to the rest of Fitch's portfolio.

PROFILE

Sacramento is California's state capital and sixth-largest city with approximately 525,000 residents. The city's economy is driven by the government sector but has been diversifying into healthcare, education and business services.

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 highest level of ESG credit relevance is a score of '3', unless otherwise disclosed in this section. A score of '3' 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. Fitch's ESG Relevance Scores are not inputs in the rating process; they are an observation on the relevance and materiality of ESG factors in the rating decision. For more information on Fitch's ESG Relevance Scores, visit <https://www.fitchratings.com/topics/esg/products#esg-relevance-scores>.

FITCH RATINGS ANALYSTS

Graham Schnaars

Director

Primary Rating Analyst

+1 415 732 7578

graham.schnaars@fitchratings.com

Fitch Ratings, Inc.

One Post Street Suite 900 San Francisco, CA 94104

Karen Ribble

Senior Director

Secondary Rating Analyst

+1 415 732 5611

karen.ribbon@fitchratings.com

Jose Acosta

Senior Director

Committee Chairperson

+1 512 215 3726

jose.acosta@fitchratings.com

MEDIA CONTACTS

Sandro Scenga

New York

+1 212 908 0278

sandro.scenga@thefitchgroup.com

Additional information is available on www.fitchratings.com

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APPLICABLE CRITERIA

[U.S. Public Finance Local Government Rating Criteria \(pub. 02 Apr 2024\) \(including rating assumption sensitivity\)](#)

APPLICABLE MODELS

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

U.S. Local Government Rating Model, v1.2.0 (1)

ADDITIONAL DISCLOSURES

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Sacramento Public Financing Authority (CA)

EU Endorsed, UK Endorsed

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