FitchRatings

Fitch Affirms Sacramento, CA's IDR at 'AA-', LRBs at 'A'; Outlook Stable

Fitch Ratings-San Francisco-26 May 2016: Fitch Ratings has affirmed the following city of Sacramento, California ratings:

--$272.9 million Golden 1 Center lease revenue bonds (LRBs) at 'A';
--Issuer Default Rating (IDR) at 'AA-'.

The Rating Outlook is Stable.

SECURITY
The bonds are payable from lease rental payments from the city (the obligor) to 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.

KEY RATING DRIVERS

The 'AA-' IDR reflects Sacramento's strong operating performance in a somewhat challenging operating environment and a moderate long-term liability burden. A lack of independent revenue raising flexibility and fairly restrictive collective bargaining requirements make budgeting a challenge, but the city has managed these challenges well across business cycles.

Sacramento's economic resource base provides strong fundamental support for bond repayment. The city is California's state capital and sixth-largest city with almost 500,000 residents. The city's economy is driven by the government sector but is slowly diversifying with population growth.

Revenue Framework: 'a' factor assessment
The city's property tax dominated revenue framework provides solid long-term growth at about the level of inflation, but the city has very limited independent revenue flexibility due to the strict property tax limits of the California state constitution. Most revenue increases require a vote of the people.

Expenditure Framework: 'a' factor assessment
Policymakers have adequate, but not full, control over spending due to somewhat restrictive charter requirements for collective bargaining. The city controls spending largely through headcount control, which can require cuts to core services during downturns. Fitch expects expenditure growth to roughly match revenue growth across the business cycle despite short-term imbalances during recessions.

Long-Term Liability Burden: 'aa' factor assessment
The total long-term liability burden is moderate relative to the city's large economic base. Pensions are adequately funded.

Operating Performance: 'aa' factor assessment
The city's overall financial performance is strong, but variable. The conservatively managed city builds large reserve balances during economic expansions, but it has experienced sustained periods of deficits in recessions because it lacks full control over spending and revenues. Reserves are currently very high relative to moderate revenue volatility, positioning the city well for the next downturn.

RATING SENSITIVITIES
BUDGET BALANCE KEY: The rating is unlikely to move higher because of the institutional limits on budget management (strict tax limitations and a difficult collective bargaining environment). The rating could come under downward pressure if the city fails to continue to actively align expenditures with revenues, slipping into a

sustained structural budget imbalance during periods of economic expansion or recovery.

CREDIT PROFILE
The economy and tax base are currently in a particularly strong cyclical upswing, and major development projects could add noticeably to revenues and the tax base over the next decade, including the resumption of development Natomas neighborhood (following federally funded repairs to levees) and redevelopment of the city's old downtown rail yards (mixed use development about the size of the existing downtown at the edge of the city center) and around the new basketball arena. Economic development projects rarely have the ability to meaningfully alter a large, established city's finances and tax base, but they could alter the underlying growth rate of revenues and population growth for a sustained period in Sacramento as the city captures more of the region's rapid growth for a period.

Revenue Framework
The city benefits from a diverse general fund revenue mix that is dominated by property (33% of total revenues), sales (18%) and utility user (15%) taxes. This revenue structure provides solid growth over time with mild downturns and fairly prompt recovery. However, Sacramento policymakers have little independent revenue raising flexibility due to the strict property tax limitations in Proposition 13.

Organic revenue growth is solid with general fund revenues generally keeping pace with inflation, but falling below the level of national GDP growth in the absence of policy actions. The compound annual growth rate (CAGR) of revenues was equal to the rate of inflation at 2.3% over the past decade.

The city has very limited independent revenue raising flexibility due to California Proposition 13 tax limitations. The city may not raise its operating property tax rate under any circumstance, and it may only raise other taxes with a vote of the people. The council's only independent policy lever for revenue control is the level of fees, and this tool is insufficient to offset cyclical revenue declines in typical recessions. For example, a 10% increase in fees would only cover about three-quarters of the typical cyclical revenue loss Fitch estimates the city might experience in a moderate downturn.

Partially offsetting this concern, Sacramento had success going to voters for additional revenues in the last downturn. In 2012, the city sought voter approval for a temporary half percent sales tax (Measure U) to restore revenues lost in the unusually steep downturn. The measure was approved by 64% of city voters and provided $43.9 million in revenues in 2015 (about 10% of operating revenues). The funds are accounted for outside the general fund, but pay for services formerly paid for by general fund resources. The tax expires in 2019. Policymakers appear likely to request an extension and have identified services funded by the measure in case voters choose not to extend the funding. While the loss of temporary revenues could strain the city's budget, the successful measure has significantly improved the city's overall financial position.

Expenditure Framework
Sacramento is a full service city with responsibility for police, fire, parks and recreation, public libraries, and public works. The city's expense structure is typical and dominated by labor with public safety workers accounting for the plurality of the workforce and majority of spending.

The natural pace of spending growth is expected to be in line with revenue growth on average. The city's main expense drivers are wages, which track inflation (and revenues) well.

Expenditure flexibility is adequate, but can be challenging due to somewhat elevated fixed costs and a difficult collective bargaining environment. The carrying costs of pension, other post-employment benefits (OPEB) and debt service are slightly elevated at 21.1% of governmental funds expenditures. Both police and fire unions are subject to binding arbitration, which limits policymaker control over salaries of its largest labor groups. The city has at times agreed to long-term contracts that severely limited its spending flexibility in past downturns. Current contracts appear more manageable at two to three years with affordable terms, but the past negotiating practices continue to weigh on the rating. The city entered five year labor contracts during the last expansion that proved quite difficult to afford during the last downturn in the absence of revenue flexibility.

The city has a strong track record of controlling expenditures despite institutional constraints. The city controls spending mainly by managing employee headcount. It has shown a strong willingness to adjust staffing to match resources even when reductions in public safety staffing were required.

Long-Term Liability Burden
The total direct and overlapping debt burden is moderate at 15.3% of personal income and consists primarily of overlapping debt of local school districts and a significant net pension liability. The city's outstanding direct governmental debt portfolio is dominated by fully amortizing fixed-rate lease revenue bonds, including the rated Golden 1 Center basketball arena bonds. The city has no current plans to issue new money debt backed by general fund resources, but the debt burden is likely to remain high for the foreseeable future due to overlapping debt levels and gradual direct debt amortization.

The city offers defined benefit pensions through the closed Sacramento City Employees' Retirement System (SCERS) and agent multi-employer plans managed by California Public Employees' Retirement System (CalPERS). The estimated combined funded ratio is about 74% at Fitch's standard 7% rate of return assumption. Given the size of plans and lack of full funding, pensions represent 26% of the overall long-term liability burden after Fitch's standard adjustments.

The rated lease revenue bonds financed the city's contribution to construction of the Golden 1 Center (the future home of the Sacramento Kings) in downtown Sacramento. Construction is currently underway and nearing completion. While the bonds are structured as lease revenue bonds with a standard general fund pledge to budget and appropriate debt service annually, the city plans to make debt service payments largely from parking modernization revenues and team rent payments.

The bonds are rated two notches below the IDR because the city's repayment plan relies on prospective revenues that Fitch views as uncertain and because the project is a sports and entertainment asset that is not a core governmental purpose.

Operating Performance
Sacramento is currently well positioned to withstand cyclical revenue stresses due to strong reserves relative to its manageable revenue volatility. Fitch's standard (1% decline in U.S. GDP) stress scenario yields a decline of 2.6% in revenues. Fitch expects the city to manage declines through a combination of reserve spending and continued strong control over headcount. While Sacramento's inherent budget flexibility is limited by the collective bargaining framework and very limited revenue raising flexibility, it has performed solidly in downturns by controlling headcount. Voters have also eased pressure by approving temporary tax increases. However, some risk remains due to the difficulty of reducing public safety staffing, particularly given fairly narrow current staffing levels relative to historical levels of police and fire personnel.

Sacramento's budget management in times of recovery is particularly strong. The city pays the full actuarially required pension contributions and has begun to gradually address its retiree healthcare liabilities, including establishment of an OPEB trust and a recently proposed policy that would gradually increase funding of the trust up to the full actuarially required contribution. The city also conducts comprehensive and conservative long-range budget forecasting that keeps policymakers focused on maintaining and restoring structural budget balance.

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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.

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.eyJleHAiOjE0NjU4Nzg2NDMsInNlc3Npb25LZXkiOiJESEtGN0RJOE5XWjdMVkg4SVVEQlVGREU1TFoyRE5FWTRIUlFYVlVKIn0.RbALcQGQH9Bw5rOKOh6PO264GVf6AF58R_LTy9Ii5d8)

Additional Disclosures
Dodd-Frank Rating Information Disclosure Form
(https://www.fitchratings.com/creditdesk/press_releases/content/ridf_frame.cfm?pr_id=1005211&cft=eyJ0eXAiOiJKV1QiLCJhbGciOiJIUzI1NiJ9.eyJleHAiOjE0NjU4Nzg2NDMsInNlc3Npb25LZXkiOiJESEtGN0RJOE5XWjdMVkg4SVVEQlVGREU1TFoyRE5FWTRIUlFYVlVKIn0.RbALcQGQH9Bw5rOKOh6PO264GVf6AF58R_LTy9Ii5d8)
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