

RATING ACTION COMMENTARY

Fitch Upgrades Sacramento, CA's IDR to 'AA'; Outlook Stable

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Fitch Ratings - San Francisco - 16 Aug 2021: Fitch Ratings has upgraded the following ratings of the City of Sacramento, CA:

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

--\$259 million Golden 1 Center 2015 lease revenue bonds (LRBs) issued by the Sacramento Public Financing Authority to 'A+' from 'A'.

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.

ANALYTICAL CONCLUSION

The one-notch upgrade to 'AA' on the IDR reflects the city's steady improvements in financial resilience based on incremental gains in reserves. Sacramento's underlying economic growth coupled with a voter approved sales tax, which has been permanently renewed, have fueled the increase in reserves. The rating also incorporates Sacramento's solid long-term revenue growth prospects, tight budget management, adequate expenditure flexibility, and moderate long-term liabilities.

The LRBs are rated two notches below the IDR because the city's repayment plan relies on prospective revenues that Fitch views as uncertain.

ECONOMIC RESOURCE BASE

Sacramento is California's state capital and sixth-largest city with approximately 512,000 residents. The city's economy is driven by the government sector but is slowly diversifying into healthcare, education, and business services.

KEY RATING DRIVERS

Revenue Framework: 'aa'

Fitch expects solid revenue growth that outpaces inflation but remains below U.S. economic performance. Property and sales taxes dominate the revenue profile and are expected to grow considering continued housing demand and population gains. The city's independent ability to raise revenues is constrained by state tax limitations but satisfactory relative to the city's low revenue volatility.

Expenditure Framework: 'a'

The city's adequate level of spending flexibility is underpinned by strong control over headcount. Carrying costs associated with other post-employment benefits (OPEB), pensions, and debt are moderately elevated, and the collective bargaining

environment is complex with binding arbitration for large public safety unions. The natural pace of spending is likely to be in line with to marginally above revenues in the absence of policy action.

Long-Term Liability Burden: 'aa'

Debt and pensions are a moderate burden relative to personal income with overlapping debt accounting for nearly half the liability burden.

Operating Performance: 'aaa'

The city has the highest level of gap-closing capacity, reflecting robust reserves relative to very limited historical revenue volatility. Budget management is sound with consistent efforts in support of financial flexibility, though somewhat limited by the expenditure constraints.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade on the IDR:

--Stronger natural revenue growth during the economic recovery period that exceeds GDP on a sustained basis.

--An improvement in Fitch's assessment of the city's expenditure flexibility due to declines in fixed debt service and retiree benefit costs.

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

--A deterioration of the city's financial flexibility as a result through an over-reliance on reserves (or other non-structural items) or overly demanding labor negotiations that reduce expenditure flexibility or cause unsustainable ongoing cost increases.

--Evidence that the lingering effects of the pandemic materially weaken the city's economic and revenue growth prospects.

Factors that could, individually or collectively, lead to positive rating action/upgrade on the lease revenue bonds:

--Upgrade of the IDR.

Factors that could, individually or collectively, lead to negative rating action/downgrade on the lease revenue bonds:

--A downgrade of the IDR.

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

As is similar in other cities, the pandemic has caused mixed results on Sacramento's revenues. According to city officials, the first 11 months of FY 2021 (FYE June 30) show property taxes trending 7% (\$11.8 million) above FY 2020 property taxes in the same time frame. FY 2021 general fund sales taxes are 5% (\$3.8 million) above FY 2020, but are offset by a nearly 16% (\$14 million) decline in charges for services.

The city benefited substantially from voters renewing and increasing an additional sales tax that could be used for general purposes. In FY 2020, the sales tax was raised to 1.0% from 0.5%, causing revenues to increase from \$64 million in FY 2019 to \$104 million in FY 2020. According to city management, this sales tax in FY 2021 is trending nearly 8% (6.7 million) above FY 2020 levels. Year-end FY 2020 unrestricted reserves were a robust \$278 million (51% of general fund expenditures), due in part to revenue generated by this sales tax. Fitch would expect the city to expend some of its fund balance to address future revenue shortfalls, but to also institute additional cost saving measure. The city's strong revenue performance has allowed the

city to avoid large-scale expenditure cuts, but management did institute a hiring freeze and delayed some salary increases during FY 2021 in order to realize savings. Other cuts will be implemented as necessary.

Shelter-in-place and continued pandemic mitigation efforts sharply reduced parking revenues, which are used to partially offset the general fund's requirement for debt service payments on the Golden 1 Center Lease Revenue Bonds. The city estimates FY 2021 parking revenues from both the general fund and the parking fund down nearly 25% (\$7.3 million) when compared to FY 2021 budgeted figures. Out year estimates show incrementally improving parking revenues as the economy reopens, but they are expected to remain below pre-pandemic levels until early 2026. Further hindering parking revenues was a fire at the city hall garage in March 2021 that has closed the structure indefinitely. The city anticipates covering the parking revenue shortfall with general fund reserves to pay for the debt service. Annual debt service on the Golden 1 Center bonds averages \$18 million.

The city received approximately \$89 million in CARES Act funding to cover pandemic expenses, with some possibly supplementing allowable general fund expenditures. The city also expects to receive nearly \$112 million total from the American Rescue Plan Act (ARPA), which will be used to address the pandemic-related needs and mitigate any potential revenue losses. Half the ARPA funds was received in FY 2021, and the other half is expected in FY 2022.

CREDIT PROFILE

Prior to the pandemic, the economy and tax base were in a particularly strong upswing. Major development projects were underway, including the resumption in developing the 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 Golden 1 Center. Fitch believes this upswing will continue after the pandemic given the economy's strong reliance on the government sector and residential demand remaining strong given the city's affordability compared to the nearby Bay Area.

The median household income is lower than the state's but on par with the national average. The unemployment rate experienced steady annual declines prior to the pandemic, reaching a low of 3.8% in 2019. The pandemic caused a spike in unemployment to a rate of 14.6% but is expected to decline as the economy reopens. The poverty rate trends unfavorably to both state and national averages.

REVENUE FRAMEWORK

Approximately 72% of all general fund revenues are generated through taxes, according to the FY 2020 audit. The largest revenue source is property tax (36%), followed by the city's share of a statewide sales tax (17%), and utility users tax (12%). Charges for services and fines account for most of the remainder. The city also benefits from a local general use sales tax not accounted for in the general fund.

General fund revenues generally trend above inflation. Continued development throughout the city coupled with high housing demand fuels expectations revenues will perform at the same solid pace for the foreseeable future.

Fitch considers Sacramento's independent legal ability to raise revenues is satisfactory relative to its revenue volatility. California municipalities' revenue flexibility is constrained by the strict tax limitations of Proposition 13, which prohibits operating property tax rate increases, limits growth of taxable assessed values and requires voter approval of allowable tax increases. Sacramento's revenue flexibility is largely limited to its charges for services, fines and permit fees, which Fitch considers a satisfactory level of flexibility relative to the 1.4% revenue decline reported by the Fitch Analytical Stress Test model (FAST).

Partially offsetting the city's limitations on revenue raising abilities is Sacramento voters' recent approvals of additional revenues called Measure U. The funds are accounted for outside the general fund, but pay for services formerly paid for by general fund resources. In 2012, voters approved a temporary half-cent sales tax that could be used for general purposes. The voters renewed and increased this sales tax in 2019 to 1% with no sunset provision. In fiscal 2020, the first full year of the increased rate, Measure U's revenues were \$104 million (about 20% of the general fund's revenue).

EXPENDITURE FRAMEWORK

Sacramento provides a full range of services including fire, police, library, parks and recreation, transportation planning and maintenance, and economic development. Public safety is the largest individual expenditure category, accounting for approximately 58% of fiscal 2020 general fund spending.

Fitch expects the natural pace of spending growth to be in line with to marginally above revenue performance. Salary and benefits are the main drivers to expenditure growth. The city also anticipates gradual spending needs as it meets the demands

of a growing population.

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, OPEB and debt service are slightly elevated at 20.6% of FY 2020 governmental spending. Both police and fire unions are subject to binding arbitration, which limits policymaker control over salaries of its largest labor groups. The city entered five-year labor contracts prior to the Great Recession that proved difficult to afford during that downturn in the absence of revenue flexibility. The city is in current negotiations with a majority of its labor unions and anticipates 12-18 month contracts, but the past negotiating results continue to weigh on the rating. The city retains the ability to control headcount and adjust service levels, which Fitch expects the city to exercise to align expenditures with revenues.

LONG-TERM LIABILITY BURDEN

Long-term liabilities, which include overlapping and direct debt plus the Fitch-adjusted net pension liability (NPL), are moderate at approximately 15% of the city residents' personal income.

Overlapping debt and direct debt totals \$2.4 billion, or approximately 9% of personal income. The adjusted NPL accounts for the remainder. The city has no current plans to issue new money debt.

The city offers defined pension benefits through the closed single-employer Sacramento City Employees' Retirement System (SCERS) plan and the agent multi-employer plans managed by California Public Employees' Retirement System (CalPERS). As of June 30, 2020, the city's combined proportionate share of the systems' NPL was reported at about \$1.0 billion. When adjusted by Fitch to reflect a 6% discount rate, the NPL rises to \$1.6 billion, or approximately 6% of resident personal income. Using this discount rate, Fitch calculates the assets to liabilities ratio currently stands at 62%.

OPERATING PERFORMANCE

Sacramento exhibits the highest level of gap-closing capacity. The city's unrestricted reserves were a robust \$278 million (51% of general fund expenditures and transfers out) at the end of FY 2020. Reserves have improved significantly since the FY 2010 recessionary low of \$48 million (12% of general fund expenditures and transfers out) due to consistent gains in general fund revenues and the voter-approved sales tax.

FAST relates historical tax revenue volatility to GDP. It is not a forecast, but it represents Fitch's estimate of possible revenue behavior in a downturn based on historical performance. Actual revenues will vary from FAST results, but FAST does provide a relative sense of risk exposure for a particularly city compared to other cities. According to the FAST model, a moderate 1% US GDP decline would generate a minimal decline in operating revenues. Fitch expects the city to manage revenue declines through a combination of reserve spending and exercising its expenditure flexibility through headcount and service level adjustments.

Budget management is strong. The city rebuilt and maintained reserves above the internal policy of 10% of general fund expenditures. Most services, with the help of the voter approved sales tax, have been restored to pre-recession levels.

Non-Standard Lease Revenue Source

The rated lease revenue bonds financed the city's contribution to construction of the Golden 1 Center (home of the Sacramento Kings) in downtown Sacramento. Construction completed in 2015 and the arena is fully functioning now. 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 two-notch distinction from the IDR reflects the additional risk features associated with the expectation that debt service will be repaid by a revenue source that Fitch regards as uncertain. Annual debt service for the LRBs approximates \$18 million, or 2.1% of governmental expenditures.

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

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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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
● Sacramento (CA) /Lease Obligations - Non- Standard/1 LT	LT	A+ Rating Outlook Stable	Upgrade	A Rating Outlook Stable

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APPLICABLE CRITERIA

APPLICABLE MODELS

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FAST Econometric API - Fitch Analytical Stress Test Model, v3.0.0 (1)

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