S&P Global Ratings

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Summary:

South San Francisco, California; Appropriations; General Obligation

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Table Of Contents

Rationale

Outlook

Related Research

Summary:

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Credit Profile		
ICR		
Long Term Rating	AAA/Stable	New

Rationale

S&P Global Ratings assigned its 'AAA' issuer credit rating (ICR) to South San Francisco, Calif. At the same time, S&P Global Ratings affirmed its 'AA+' long-term rating on the City of South San Francisco Public Facilities Financing Authority's series 2020A lease revenue bonds, which are an obligation of the city. The outlook is stable.

The city will have about $81 million in governmental debt outstanding at the end of fiscal 2020.

Security and use of proceeds

The ICR reflects our forward-looking opinion of South San Francisco's overall creditworthiness, focusing on the city's capacity and willingness to meet its financial commitments as they come due. The ICR is not specific to any financial obligation.

Lease payments made by the city, as lessee, secure the series 2020A. These ratings are one notch below our view of the city's general creditworthiness to reflect our view of appropriation risk. Lease payments, for which the city has covenanted to budget and appropriate over the life of each appropriation series, are subject to abatement, but South San Francisco has agreed to maintain 24 months of rental interruption insurance to partly mitigate abatement risk, and the leased assets meet our criteria for seismic risk during the life of each series. The city will use the proceeds of the series 2020A to finance the construction of a police station, which will represent the first phase of a larger civic center project.

Local ratings' relationship with U.S. sovereign

Our issue ratings are based on our view that the city's general creditworthiness is above that of the U.S. sovereign. This reflects our view that the city would not default in a stress scenario likely to accompany a sovereign default given autonomy from sovereign intervention. We view the city as exhibiting relatively low funding interdependency with the federal government, as local taxes represent the vast majority of total governmental funds revenue. However, consistent with our view that U.S. state and local governments are moderately sensitive to country risk, we would be unlikely to set ratings on the city's obligations more than two notches above the U.S. sovereign rating.

Credit overview

South San Francisco's revenue performance is riding a wave of strong economic growth fueled by development and economic growth associated with the biotechnology sector anchored by Genentech. Although the city is largely built out, we anticipate that the early 2020s will bring redevelopment and intensifying land uses, particularly office and

research space. We think development momentum, along with a long-term financial planning practice, will help the city weather the next economic downturn and see the city's main challenge in managing long-term cost in pension and other postemployment benefit (OPEB) costs.

The rating reflects our view of the city's:

- Very strong economy, with access to a broad and diverse metropolitan statistical area;
- Strong management, with good financial policies and practices under our financial management assessment methodology;
- Very strong budgetary performance, with operating surpluses in the general fund and at the total governmental fund level in fiscal 2019;
- Very strong budgetary flexibility, with an available fund balance in fiscal 2019 of 42% of operating expenditures;
- Very strong liquidity, with total government available cash at 1.6x total governmental fund expenditures and 64.0x governmental debt service, and access to external liquidity we consider strong;
- Strong debt and contingent liability position, with debt service carrying charges at 2.5% of expenditures and net direct debt that is 27.0% of total governmental fund revenue, as well as low overall net debt at less than 3.0% of market value, but a large pension and OPEB obligation; and
- •Strong institutional framework score.

Very strong economy

Located five miles south of the city limits of its larger namesake, South San Francisco encompasses an established service area with 67,100 residents that is undergoing a period of growth, particularly in its commercial eastern portion. Its income and wealth profile is very strong, in our view, with a 2020 market value of $310,800 and what we project will be a 2023 per capita effective buying income of 121% of the national average. Overall, the city's market value grew by 8.7% over the past year to $20.9 billion in 2020. The county unemployment rate was 2.2% in 2018.

Part of the diverse San Francisco-Oakland-Hayward metropolitan statistical area, the city's historical economic niche as the site of steel production 100 years ago evolved into that of a bedroom community for the larger region and a logistics and lodging aimed at serving the nearby San Francisco International Airport (SFO). These economic anchors endure and the city is well served by the region's freeway and rail networks, but the growth of biotechnology behemoth Genentech arguably has had the most significant effect on local economic conditions in the past decade, with the city and its neighbors now including more than 200 life science companies. Genentech has requested planning approval to almost double its 4.7 million square feet of office and research space, and management has noted another three sites at different stages of the entitlement process that would add a total 6.2 million of similarly utilized space in the coming years. This commercial development, plus continuing volume growth at SFO, have attracted the attention of hotel and residential developers, with management calculating a pipeline of about 1,000 hotel rooms and 3,650 housing units (across five sites).

Consistent with our expectation of real GDP growth in the Pacific U.S. states through 2021, we anticipate that the city will continue to see growth in property values and taxable activities, but we see a less than 50/50 risk of a recession in the coming year, with the most significant risk coming from international trade disputes, the effects of which could be

magnified locally given the city's economic ties to the airport.

Strong management

We view the city's management as strong, with good financial policies and practices under our financial management assessment methodology, indicating our view that financial practices exist in most areas, but that governance officials might not formalize or monitor all of them on a regular basis.

Elements of the city's financial policies and practices include:

- Sophisticated budget-building methodology, with an extensive analytical budget message explaining management's recommendations and assumptions relative to the prior and current budget year;
- Six-month financial update presented to council to allow for midyear adjustments and set the stage for the next year's budget-building process;
- 10-year financial forecasting model that tracks budget line-items that tends to inform budgeting decisions and strategic questions and is not formally integrated into the biennial budget currently but could be in the future, as the city is working on a fiscal sustainability study to enhance its planning abilities;
- Capital planning with a five-year horizon and detail on timing and funding sources that the city updates annually;
- Investments that are governed by a comprehensive formal policy and quarterly reporting to the council on performance, and holdings in the city's annual financial report;
- Principles-based debt management policy that lacks material numerical constraints other than a minimum refunding savings threshold; and
- Formal two-prong reserve policy of 2% of general fund budgeted revenue as a reserve for emergencies such as natural disasters and a 7% reserve for economic events affecting revenue, such as the loss of a major taxpayer.

The city has been actively pursuing other environment, social, and governance topics we view as important to credit quality:

- On the environmental front, the city is managing the risk of sea level rise on its largely commercial eastern shores by requiring resiliency designs in development projects and pursuing grant funding. Management reports that most of the city's service area is now protected by seawalls designed to protect against the city's estimate of exposure in the 21st century.
- The city has also undertaken an inventory of "soft story" architectural designs, which experts believe are particularly vulnerable in earthquakes, to focus response resources in a disaster scenario, and has cut down or trimmed trees identified as elevating risk to residences next to parks.
- The city has made housing production, including income-tested affordable housing, a priority as a way of slowing gentrification in a high-cost region.
- The city's cybersecurity approach has included moving to cloud-based services and backups for resiliency, adopting an information technology master plan to minimize the risk of obsolescence, and recently elevating the authority of senior information technology role.

Very strong budgetary performance

South San Francisco's budgetary performance is very strong, in our opinion. The city had operating surpluses of 25% of expenditures in the general fund and of 34% across all governmental funds in fiscal 2019. These are among the highest ratios nationwide and in the state within the universe of municipalities with debt that we rate, and we view recent performance as a function of a new voter-approved sales tax and development demand, which has added to property tax revenue and demand that fuels taxable activity such as retail sales and hotel stays. The city's formal budget and forecast point to its general fund net results moderating to less than 5% of expenditures, which we think will happen eventually, but we think that past conservative budgeting practices and current development momentum will result in continuing very strong performance through fiscal 2021.

Similar to its peers in the state, the city has a diverse general fund revenue structure, led by revenue from property taxes at 29% of general fund revenue in fiscal 2019, followed by core sales tax revenue (24%) and lodging tax revenue (13%). We think this mix is likely to continue in similar form, although we think that hotel development that points to a more upscale base and a two-percentage-point hotel tax rate increase that will be fully be phased in by 2021 could increase the proportion of the third source. The city received a boost in ongoing resources for public services and facilities with the passage of Measure W in 2015, the revenue of which is part of the percentage quoted above and equivalent to 12% of general fund expenditures. This revenue stream sunsets in 2046 and will be a primary source of funding for the city's civic center projects.

Very strong budgetary flexibility

South San Francisco's budgetary flexibility is very strong, in our view, with an available fund balance in fiscal 2019 of 42% of operating expenditures, or $43.1 million. Consistent with our view of the city's very strong budgetary performance, we anticipate that its budgetary flexibility will remain very strong in the medium term, although we think the city could decide to use its reserves for one-time capital projects from time to time. Our calculation of the city's budgetary flexibility excludes its committed fund balance, which we understand will likely be deployed during the next two years as part of the financing of the city's civic center project.

Very strong liquidity

In our opinion, South San Francisco's liquidity is very strong, with total government available cash at 1.6x total governmental fund expenditures and 64.0x governmental debt service in 2019. In our view, the city's capital market access during the past 20 years gives it strong access to external liquidity if necessary. We don't consider its investment portfolio, which is weighted toward the state local agency investment fund (44% of assets as of June 2019) and money market holdings (29%), to be aggressive.

Management has confirmed that the city has no alternative financing obligations, which we find can represent a source of contingent liquidity risk, outstanding.

Strong debt and contingent liability profile

In our view, South San Francisco's debt and contingent liability profile is strong. Total governmental fund debt service is 2.5% of total governmental fund expenditures, and net direct debt is 26% of total governmental fund revenue. Overall net debt is low at 1.6% of market value, and the city is unusual among older California cities in that it does not have tax increment debt outstanding (although the city itself has an obligation payable to its former redevelopment

agency). Our credit opinion incorporates the likelihood that the city will issue another $55 million in appropriation obligations in the coming year to continue its civic center project, and also incorporates the potential that our assessment could shift to adequate from strong as a result of this issuance.

Pension and OPEB highlights:

- In our view, the city has a large pension and OPEB liability that could have a negative effect on financial performance in the coming years.
- The city's pension plans' funded status, combined with recent changes to assumed discount rate and amortization methods, will likely lead to accelerating costs in the medium term, but we believe this approach will help the city make timely progress reducing pension liabilities.
- While the city is not making full actuarially determined contributions toward its OPEB liability, the city's legal flexibility to alter OPEB benefits limits adverse credit impacts from its OPEB liability.

The city participated in the following plans funded as of June 30, 2018:

- California Public Employees' Retirement System (CalPERS) agent multiple-employer plan for safety employees: $106 million in net liability, and 68% funded
- CalPERS agent multiple-employer plan for miscellaneous employees: $77 million in net liability, and 67% funded
- Single-employer OPEB plan: $61 million in net liability, and 27% funded

South San Francisco's required pension and actual OPEB contributions totaled 15% of total governmental fund expenditures in 2019, with 12% representing required contributions to pension obligations and 3% representing OPEB payments. The city's fiscal 2019 actuarially determined contributions for both CalPERS plans fell short of both static funding and minimum funding progress, indicating no funding progress and an increase in liabilities. We see CalPERS' recent adoption of a 20-year, level dollar amortization approach for new gains and losses as a turning point in that contribution increases from a shorter amortization period will provide faster recovery to plan funding following years of poor investment performance or upward revisions to the pension liability, which we view favorably. However, we believe costs will continue to increase for the next several years to retire existing unfunded liability, much of which is amortized over 30-year periods using a level-percent-of-payroll approach. In our view, the discount rate of 7.15% could lead to contribution volatility. South San Francisco has planned for higher contribution rates in its multiyear projections, designated $5.5 million in its general fund balance as a stabilization reserve, and has explored setting aside reserves in excess of its annually required contribution. However, it does not have plans, such as a substantial funding of a side fund for either its pension or OPEB liabilities, that we think would give it more flexibility in managing upcoming contribution increases.

Strong institutional framework

The institutional framework score for California municipalities required to submit a federal single audit, which triggers enhanced reporting requirements, is strong.

Outlook

The stable outlook reflects our view that the city will continue to enjoy medium-term growth and the tax revenue increases that development and economic activity bring as it embarks on its phased civic center project. Should revenue growth slow--particularly the Measure W sales tax revenue that the city expects will fund the pay-as-you-go portion of the civic center project--we think the city will adjust the size and timing of borrowing or adjust the pacing of the projects while maintaining very strong budgetary flexibility. We don't expect to change our rating during the next two years.

Downside scenario

We could lower the rating if a recession scenario caused a severe weakening in budgetary performance and we thought the city had difficulty coming up with an effective set of budgetary adjustments sufficient to restore at least adequate budgetary performance and maintain very strong budgetary flexibility. We could also lower the rating if the city decided to deploy a large portion of its available general fund balance for the civic center or other one-time capital projects, particularly if budgetary performance were weakening.

Related Research

- U.S. State And Local Government Credit Conditions Forecast, Oct. 29, 2019
- S&P Public Finance Local GO Criteria: How We Adjust Data For Analytic Consistency, Sept. 12, 2013
- Criteria Guidance: Assessing U.S. Public Finance Pension And Other Postemployment Obligations For GO Debt, Local Government GO Ratings, And State Ratings, Oct. 7, 2019
- Medians And Credit Factors: California Municipalities, Jan. 22, 2020
- 2019 Update Of Institutional Framework For U.S. Local Governments

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.

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