S&P Global
Ratings

RatingsDirect®

Summary:

South San Francisco Public Facilities Financing Authority
South San Francisco; Appropriations; General Obligation

Primary Credit Analyst:
Chris Morgan, San Francisco + 1 (415) 371 5032; chris.morgan@spglobal.com

Secondary Contact:
Jennifer Hansen, San Francisco + 1 (415) 371 5035; jen.hansen@spglobal.com

Table Of Contents

Summary:

South San Francisco Public Facilities Financing Authority
South San Francisco; Appropriations; General Obligation

Credit Profile		
US$88.445 mil lse rev bnds (South San Francisco) ser 2021A due 06/01/2046		
Long Term Rating	AA+/Stable	New
South San Francisco ICR		
Long Term Rating	AAA/Stable	Affirmed
South San Francisco Pub Facs Fin Auth, California		
South San Francisco, California		
South San Francisco Pub Facs Fin Auth (South San Francisco) lse rev bnds		
Long Term Rating	AA+/Stable	Affirmed

Rating Action

S&P Global Ratings assigned its 'AA+' long-term rating to the City of South San Francisco Public Facilities Financing Authority's expected $88 million series 2021A lease revenue bonds, which are an obligation of South San Francisco. At the same time, S&P Global Ratings affirmed its 'AAA' issuer credit rating (ICR) on the city and its 'AA+' long-term rating on the authority's previously issued appropriation obligations. The outlook is stable.

The city will have about $134 million in governmental debt outstanding at the end of fiscal 2021.

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 2021A and its previously issued lease revenue bonds. We have set our rating on these obligations 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 bulk of the proceeds of the series 2021A to complete its community civic campus, the second phase of which will include a library and community center that will include a community theater and city council chamber. A smaller portion will fund street pavement improvements and solar projects.

Credit overview

We see the COVID-19 pandemic as buffeting South San Francisco economically in the short term, but it also bolstered the city in the long term through its implications. The city's businesses focusing on business travel have suffered from a plunge in demand and the city has seen losses in lodging tax revenue to match, with management expecting only the beginnings of a recovery for fiscal 2022. But the pandemic also has increased investor interest in and national policy supporting the growth of the life science industry, which arguably has its largest U.S. cluster in and around South San Francisco. The industry's largest player, Genentech, is adding research space, and developers are finding demand for competing and complementary business within the city, leading us to anticipate that the 2020s will bring intensifying land uses, particularly in terms of office and research space. We think that development momentum as well as a recent history of voter support for tax increases put the city on sound financial footing in the current decade, but we view the city's lack of a long-term financial planning practice as potentially making it less likely than its highest-rated peers to identify and respond to future structural budgetary challenges.

The rating reflects our view of the city's:

- Very strong economy, with participation in a broad and diverse metropolitan statistical area;
- Strong management, with good financial policies and practices under our financial management assessment methodology;
- Strong budgetary performance, with operating results that we expect could weaken in the near term relative to fiscal 2020, which closed with operating surpluses in the general fund and at the total governmental fund level;
- Very strong budgetary flexibility, with an available fund balance in fiscal 2020 of 46% of operating expenditures;
- Very strong liquidity, with total government available cash at 1.7x total governmental fund expenditures and 126.7x governmental debt service, and access to external liquidity we consider strong;
- Weak debt and contingent liability profile, with debt service carrying charges at 1.4% of expenditures and net direct debt that is 76.5% of total governmental fund revenue, and a large pension and other postemployment benefit (OPEB) obligation and the lack of a plan to sufficiently address the obligation, but low overall net debt at less than 3.0% of market value; and
- Strong institutional framework score.

Environmental, social, and governance (ESG) factors

We view the city has having elevated environmental risk in the form of exposure to seismic events--the San Andreas Fault runs just west of the city--and, more long term, from sea level rise associated with climate change. The city has undertaken an inventory of "soft story" architectural designs, which experts believe are particularly vulnerable in earthquakes, to focus response resources in a disaster scenario.

The city is managing 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.

We view the city's social and governance risks as comparable to those of national peers. The city has made housing affordability challenges, which we view as a social risk that can threaten economic performance, a priority, including income-tested affordable housing development as a way of slowing gentrification in a high-cost region. The city manages cybersecurity risk, a form of governance risk, by using cloud-based services and backups for resiliency, adopting an information technology master plan to minimize the risk of obsolescence, and making the information technology management a senior position.

Stable Outlook

Downside scenario

Consistent with our view that the economic effects of the COVID-19 pandemic are starting to recede and that federal grants will shore up revenue for most local governments, our rating and outlook anticipate strong budgetary performance, but we also see potential for the city's financial performance to weaken to adequate in the intermediate term, which could lead to a modest draw on reserves. However, we could lower the rating if another recession or unexpected costs related to the community civic campus project materialize such that the city substantially draws its available general fund balance down to a level below what we consider very strong.

Credit Opinion

Very strong economy

South San Francisco, located five miles south of the city limits of its larger namesake, encompasses an established service area with 67,100 residents. The economic mix of the city, which was once a steel town, primarily consists of neighborhoods that have good rail and highway access to regional job centers, logistics, and lodging services associated with nearby San Francisco International Airport (SFO) and a life sciences cluster anchored by] Genentech. The biotechnology behemoth 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 750 hotel rooms and 3,650 housing units. We think activity at SFO, which had a particularly high proportion of business and international travelers relative to U.S. peers, will be slow to bounce back even as higher vaccination rates and relaxed public health rules allow domestic travel to surge in the second half of 2021, and believe that local hotels will recover similarly slowly. However, management reports that hotel sites within its boundaries have remained open or have used the pandemic to renovate facilities.

We anticipate that the city's income and wealth profile will remain very strong, in our view, with a 2020 market value of $344,400 and what we project will be a 2024 per capita effective buying income of 134% of the national average. The city's overlapping county unemployment rate briefly topped 10% at the height of public health controls in 2020, but has since subsided and, we anticipate, will have averaged about 6%. Consistent with our forecast of real GDP growth and a subsidence in the unemployment rate for the Pacific U.S. states for 2021 and 2022, we anticipate that the city's unemployment rate will improve in the coming year.

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 updates presented to the council to allow for midyear adjustments and set the stage for the next year's budget-building process;
- A lack of formal long-term financial planning after a period of using a 10-year model;
- 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 what is now a monthly reporting interval to the council on performance and holdings;
- Principle-based debt management policy that lacks material numerical constraints other than a minimum refunding savings threshold; and
- A formal two-prong reserve policy of 2% of general fund budgeted revenue as a reserve for emergencies such as natural disasters and 7% for economic events affecting revenue, such as the loss of a major taxpayer, and an informal additional two months' expenditures minimum.

Strong budgetary performance

South San Francisco came into the COVID-19-driven recession with the wind at its back, including two years of general fund net results in excess of 10% of expenditures and, despite the effects of the recession and pullback on travel at the end of fiscal 2020, another very strong year. We calculate fiscal 2020 net general fund results at 10% of expenditures after excluding a one-time transfer out for the civic campus project, and total governmental funds net results were 25% of expenditures following similarly robust results during fiscal years 2018 and 2019. We view recent performance as a function of a voter-approved sales tax increase known as Measure W that took effect in fiscal 2016 (and runs through 2046) and of development demand, which has added to property tax revenue. The city also may have achieved modest savings toward the end of fiscal 2020 as a result of a hiring freeze and of suspending a portion of discretionary spending even as lodging tax revenue, the collection of which has an approximate two-month delay, plunged in the final months of the fiscal year.

Fiscal 2021 will likely look different, with the pandemic reducing lodging taxes derived from the city's 34 hotels by what the city has budgeted to be 57% despite the phasing-in of a voter-approved lodging tax rate increase in January 2020 and January 2021. Lodging tax revenue as budgeted has shrunk to 5% of general fund revenue in 2021 (including the city's midyear revisions and our adjustment to add Measure W revenue for comparability) from 10% in fiscal 2020. Despite this revenue loss, we don't think a negative general fund result for fiscal 2021, should it occur, will be large given expenditure reductions equivalent to about 3% of expenditures and the first American Rescue Plan grant approximating 5% of expenditures.

Long term, we think that the city's development pipeline will boost property tax revenue, which tends to be resilient in recessions as a result of state constitutional restrictions on assessed valuation increases without a property sale. Such revenue is the single largest source of adjusted fiscal 2021 general fund revenue at 36%, followed by sales tax revenue (including Measure W proceeds), which we calculate at 25%.

Very strong budgetary flexibility

South San Francisco's budgetary flexibility is very strong, in our view, with an available fund balance in fiscal 2020 of 46% of operating expenditures, or $49 million. Consistent with our view of the city's strong budgetary performance, we anticipate that budgetary flexibility will remain very strong through fiscal 2022, although the pandemic has introduced uncertainty and we think reserves could weaken to about 40% of expenditures depending on how the city uses American Rescue Plan grants and how fast lodging and sales tax revenue recover. Our calculation of the city's budgetary flexibility excludes its committed fund balance, which, although classified as for "local services" in the city's recent financial statements, is intended to make up part of the financing mix for the city's civic campus and for street improvements.

Very strong liquidity

In our opinion, South San Francisco's liquidity is very strong, with total government available cash at 1.7x total governmental fund expenditures and 126.7x governmental debt service in 2020. 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 holdings aggressive, as they are weighted toward the state local agency investment fund (22% of assets as of March 2021), followed by U.S. Agencies (21%) and U.S. Treasuries (20%).

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

Weak debt and contingent liability profile

In our view, South San Francisco's debt and contingent liability profile is weak. Total governmental fund debt service was 1.4% of total governmental fund expenditures in fiscal 2020, but net direct debt including the series 2021A is 77.0% of total governmental fund revenue. Overall net debt is low at 1.8% of market value, and the city is unusual among older California cities in that it has no tax increment debt outstanding (although the city itself has an obligation payable to its former redevelopment agency). Following this issuance, management doesn't anticipate the city issuing additional debt for the foreseeable future other than potential community facilities district debt associated with a development project, and we note that the city's voter-approved Measure W sales tax revenue has been identified as the source of debt service for the series 2021A (and previously issued series 2020A) to minimize the risk of strain on the general fund; even after diminishment during the recession, these legally unrestricted resources represent about 1.4x annual debt service on both series combined.

Pension and OPEB highlights:

- In our view, the city has a large pension and OPEB liability that could negatively affect 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 partly mitigates the risk of adverse credit effects.

The city participated in the following plans funded as of June 30, 2020:

- California Public Employees' Retirement System (CalPERS) agent multiple-employer plan for safety employees: $112 million in net liability and 67% funded
- CalPERS agent multiple-employer plan for miscellaneous employees: $81 million in net liability and 67% funded
- Single-employer OPEB plan: $64 million in net liability, and 27% funded

South San Francisco's required pension and actual OPEB contributions totaled 17% of total governmental fund expenditures in 2020, with 14% representing required contributions to pension obligations and 3% representing OPEB payments. The city's 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' 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 accelerate recovery of plan funding following years of poor investment performance or upward revisions to the pension liability. 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.

The city has taken steps to manage these costs, including designating $5.5 million in its general fund balance as a stabilization reserve, and we think statewide changes to pension benefits for new hires in 2013 and the city's shift to a defined contribution from defined benefit health benefit for new hires starting April 2010 will slow cost growth. At the same time, we consider actions to date unlikely to substantially lower pension and OPEB carrying charges, which likely will rise this decade.

Strong institutional framework

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

Local ratings' relationship with U.S. sovereign

We view the city's general creditworthiness as 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.

Related Research

- The COVID-19 Outbreak Weakens U.S. State And Local Government Credit Conditions, April 2, 2020
- SeismiCat Earthquake Model, May 4, 2018
- 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
- Through The ESG Lens 2.0: A Deeper Dive Into U.S. Public Finance Credit Factors, April 28, 2020
- Economic Outlook U.S. Q2 2021: Let The Good Times Roll, March 24, 2021
- 2020 Update Of Institutional Framework For U.S. Local Governments