

City of
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**ADDITIONAL (VOLUNTARY) DISCLOSURE
RATING AFFIRMED**

Dated: January 23, 2018

NOTICE IS HEREBY GIVEN that on January 22, 2018, Fitch Ratings ("Fitch") affirmed the following ratings:

- City of Sacramento's long-term issuer default rating of "AA-" with a stable outlook.
- Sacramento Public Financing Authority Lease Revenue Bonds, Series 2015 (Golden 1 Center) long-term rating of "A" with a stable outlook.

The rating report from Fitch is attached.

City of Sacramento



Brian Wong
Debt Manager

Attachment: Fitch Ratings Press Release – IDR and 2015 LRB G1C

FITCH AFFIRMS SACRAMENTO, CA AREA FINANCE AUTHORITY BONDS AT 'A'; OUTLOOK STABLE

Fitch Ratings-San Francisco-22 January 2018: Fitch Ratings has affirmed the following ratings to the City of Sacramento, CA:

- \$273 million Golden 1 Center 2015 lease revenue bonds (LRBs) issued by the Sacramento Public Financing Authority 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.

ANALYTICAL CONCLUSION

The 'AA-' IDR reflects the city's adequate expenditure control, moderate long-term liabilities, and strong reserves relative to the city's moderate revenue volatility. 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 sixth-largest city with almost 500,000 residents and the state capital. The government sector is a stable driving force in the region's economy, which has been diversifying into healthcare, education, and business services.

KEY RATING DRIVERS

Revenue Framework: 'a'

Fitch expects slow revenue growth based on historical performance. A significant portion (10%) of the city's operating revenues is subject to periodic reauthorization. The city's independent legal ability to raise revenues remains constrained by Proposition 13, which requires voters' approval for tax increases.

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: 'aa'

The city has very strong gap-closing capacity despite its limited budget flexibility. The city rebuilt reserves during the recovery period and began enacting policies to address rising retiree benefits costs, leaving it well positioned in the event of an economic downturn.

RATING SENSITIVITIES

Budgetary Balance: The ratings could come under downward pressure if the city fails to align expenditures with revenues, particularly if a sales tax renewal failure results in a significant budgetary gap. The rating could come have upward movement if improvements in reserves and revenue growth rates prove durable over time.

CREDIT PROFILE

Sacramento is one of California's major urban centers. The median household income is lower than both state and national averages while the percentage of residents in poverty trends higher than the aforementioned averages. Unemployment has experienced a continuous decline the past six years but still trends slightly higher than both state and national averages. Development throughout the city is underway with several large-scale development projects that that have the potential to revamp major sections of the city.

Revenue Framework

Approximately 62% of all general fund revenues are generated through taxes, according to the fiscal 2018 budget. The largest revenue source is property tax (32%), followed by sales tax (17%), and utility users tax (13%). Charges for services and fines account for most of the remainder.

Fitch expects slow growth based on historical performance. General fund revenues grew at a 10-year compound annual growth rate (CAGR) of 1.6% between fiscal years 2007 and 2017, which was below U.S. GDP growth and in line with inflation.

The city will ask voters in calendar year 2018 for a reauthorization of the Measure U half-cent sales tax which began in fiscal 2013 and provides \$45 million in revenues annually, or about 10% operating revenues in fiscal 2017. Failure to reauthorize the sales tax would materially reduce the city's operating revenues and require offsetting policy action, most likely in the form of deep expenditure cuts.

A tax on cannabis sales began in January 2018, but is not included in the city's 2% sales tax growth assumptions this year. Fees are automatically raised by cost-of-living adjustments, according to city policy.

Like other California general governments, the city has limited independent legal ability to raise revenues. State tax limitations prohibit increases in the property tax rate, and other taxes can only be increased with a vote of the people. Policymakers' independent revenue raising flexibility is limited to fees and fines that make up only a moderate proportion of total general fund revenues.

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 57% of fiscal 2017 general fund spending.

Fitch expects the natural pace of spending growth to be in line with to marginally above revenue performance, assuming voters renew the six year sales tax increase which was enacted in April 2013. The city anticipates gradual spending growth as it serves the needs of a growing population. The Measure U sales tax measure provided revenue for expanded services, particularly in the public safety and parks and recreation departments. Fitch's assessment assumes this revenue source

continuing, as loss of this revenue would materially impact the city's ability to fund its growing spending requirements.

Carrying costs related to debt service, pensions, and OPEB were 22.8% of governmental spending at the end of fiscal 2017. Nearly 56% of carrying costs relate to pension contributions. City officials and budget documents suggest steadily increasing pension costs for the foreseeable future. Fitch's supplemental pension metric, which assumes a 20-year level payoff of the Fitch-adjusted liability, indicates that contributions at the actuarial level would likely be insufficient to reduce pension liabilities over time.

The city's labor negotiating framework provides the city with some flexibility with policymakers retaining control of head count. The two largest unions, police and fire, are subject to binding arbitration, limiting the policymakers' control over salaries. There are no re-openers based on economic conditions contained in the contracts. The city has strong control over service levels, which have been restored since the recession.

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 17% of the city residents' personal income.

Overlapping debt and direct debt totals \$2.5 billion, or approximately 11% of personal income. The adjusted NPL accounts for the remainder. The city has no general fund supported debt plans.

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, 2017, the city's combined proportionate share of the systems' NPL was reported at about \$864 million. 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 59%.

The OPEB liability was equivalent to 1.5% of personal income in fiscal 2017. The city established an OPEB trust in fiscal 2016, currently funded at 1.5% to address the liability of its retiree benefits.

Operating Performance

The city retains very strong gap-closing capacity based on the city's limited inherent budget flexibility and strong reserves relative to revenue volatility. The budget flexibility is limited due to the bargaining framework, elevated carrying costs, and very few independent revenue raising capabilities. Fitch believes the city's gap-closing capacity would allow the city to manage through economic downturns while maintaining an adequate level of fundamental financial flexibility.

Fitch's standard 1% U.S. GDP decline scenario suggests the city may experience a general fund revenue decline of about 2.5% in a moderate economic downturn based on historical results, according to the Fitch Analytical Sensitivity Tool (FAST). Unrestricted reserves at the end of fiscal 2017 were 33% of general fund expenditures. Budget documents indicate a balanced fiscal 2018 budget with a proposed \$5 million pension liability spending commitment to address unfunded pension liabilities.

Budget management is strong. The city rapidly rebuilt and maintained reserves above the internal policy of 10% of general fund expenditures for the past six years. Most services, with the help of Measure U, have been restored to pre-recession levels.

Non-Standard Lease Revenue Source

The rated LRBs financed the city's contribution to construction of the Golden 1 Center (home of the Sacramento Kings) in downtown Sacramento. Construction has completed and the arena is fully functioning now. While the bonds are structured as LRBs 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 is \$18.2 million, or 2.7% of governmental expenditures.

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In addition to the sources of information identified in Fitch's applicable criteria specified below, this action was informed by information from Lumesis and InvestorTools.

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Additional information is available on www.fitchratings.com

Applicable Criteria

U.S. Public Finance Tax-Supported Rating Criteria (pub. 31 May 2017)

<https://www.fitchratings.com/site/re/898466>

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