San Diego Public Facilities Financing Authority, California

Lease Revenue Bonds
New Issue Report

Ratings

New Issues

San Diego Public Facilities Financing Authority Lease Revenue Bonds, Series 2015A (Capital Improvement Projects)	A+
San Diego Public Facilities Financing Authority Lease Revenue Bonds, Series 2015B (Capital Improvement Project)	A+

Outstanding Debt

Implied Unlimited Tax General Obligation Bonds	AA−
San Diego Public Facilities Financing Authority Lease Revenue Bonds	A+
Convention Center Expansion Financing Authority Lease Revenue Refunding Bonds	A+

Rating Outlook

Stable

Related Research

Fitch Affirms San Diego Public Facilities Financing Authority, CA Lease Revenue Bonds at 'A+'; Outlook Stable (March 2014)

San Diego, California (June 2013)

Analysts

Alan Gibson
+1415 732-7577
alan.gibson@fitchratings.com

Stephen Walsh
+1 415 732-7573
stephen.walsh@fitchratings.com

New Issue Details

Sale Information: $109,275,000 San Diego Public Facilities Financing Authority Lease Revenue Bonds, Series 2015A (Capital Improvement Projects) and 2015B (Capital Improvement Projects), via negotiation the week of April 6.

Security: San Diego's lease revenue bonds are payable by the city's lease rental payments, which the city covenants to budget and appropriate annually. The lease rental payments are subject to abatement, which is mitigated by standard rental interruption insurance provisions.

Purpose: Fund various capital projects improving city facilities, storm drains, streets, sidewalks, and Americans with Disabilities Act access.

Final Maturity: Mature serially, Oct. 15, 2015–2044. Subject to optional, mandatory sinking fund, and special mandatory redemption.

Key Rating Drivers

Solid Financial Operations: The city continues to demonstrate solid financial results resulting from its ongoing commitment to conservative financial management policies, general fund balance and reserves preservation, and strong financial disclosure practices, bolstered by a stabilized management environment.

Fundamental Economic Strengths: The city benefits from a diverse economy, strong key revenue streams, a declining unemployment rate, a healthy tax base, and its desirable geographic location.

High Debt; Sizable Capital Needs: The city's overall debt burden is expected to remain high as the city begins to address large identified capital needs, a significant portion of which are mandated by regulation. Those capital costs will become more defined over the next two years, as will the city's related funding options.

Positive Effects of Benefits Reform: Carrying costs are expected to remain substantial, in part because of the city's sustained focus on reducing unfunded pension and other post-employment benefit (OPEB) liabilities. Paydown of these liabilities is being facilitated by pension system reform and OPEB modifications made in the face of considerable labor opposition. However, litigation against pension reform remains unresolved.

Large Cross-Collateralized Asset Pool: The series 2015 bonds and parity debt are secured by a fully cross-collateralized pool of leased assets. In the unlikely event of default, the trustee could seek remedy across all of the pooled properties up to the amount of the underpayment, thereby eliminating concerns about individual assets' relative essentiality.

Rating Sensitivities

Continued Positive Trajectory: While the city faces sizable capital pressures and some uncertainty related to pension litigation, the ability of the city's current administration and management team to continue achieving stable-to-positive financial operations coupled with greater clarification on capital and litigation issues could lead to an upgrade of the credit over the next few years.

Rating History — GOs

Rating	Action	Outlook/ Watch	Date
AA–	Affirmed	Stable	3/23/15
AA–	Affirmed	Stable	3/14/14
AA–	Affirmed	Stable	6/10/13
AA–	Affirmed	Stable	5/29/12
AA–	Affirmed	Stable	4/13/12
AA–	Affirmed	Stable	6/7/10
AA–	Revised	Stable	4/30/10
A+	Affirmed	Stable	6/8/09
A+	Upgraded	Stable	12/11/08
BBB+	Affirmed	Positive	3/27/08
BBB+	Downgraded	Negative	5/27/05
A	Downgraded	Negative	2/16/05
AA	Affirmed	Negative	9/23/04
AA	Downgraded	Negative	2/27/04
AAA	Upgraded	—	5/28/02
AA+	Assigned	—	4/3/98

Rating History — COPs and Lease Revenue Bonds

Rating	Action	Outlook/ Watch	Date
A+	Affirmed	Stable	3/23/15
A+	Affirmed	Stable	3/14/14
A+	Affirmed	Stable	6/10/13
A+	Affirmed	Stable	5/29/12
A+	Affirmed	Stable	4/13/12
A+	Affirmed	Stable	6/7/10
A+	Revised	Stable	4/30/10
A	Affirmed	Stable	6/8/09
A	Upgraded	Stable	12/11/08
BBB–	Affirmed	Positive	3/27/08
BBB–	Downgraded	Negative	5/27/05
A–	Downgraded	Negative	2/16/05
AA–	Affirmed	Negative	9/23/04
AA–	Downgraded	Negative	2/27/04
AA+	Assigned	—	5/28/02

Related Criteria

Tax-Supported Rating Criteria (August 2012)

U.S. Local Government Tax-Supported Rating Criteria (August 2012)

Credit Profile

San Diego is the second largest city in California, with a stable population of approximately 1.3 million. The city's diverse economy is experiencing good recovery in terms of job growth, higher consumer spending, more residential and commercial construction, and increasing tourism. Nine new hotels are due to open in 2015 and 2016, adding 1,633 hotel rooms.

The unemployment rate has declined to around the national average, residents' socioeconomic indicators are largely above average, and the tax base is rebounding. The relatively minor cumulative 2.5% taxable assessed valuation (TAV) decline between fiscal years 2010–2013 has been more than offset by the 10.9% TAV rebound occurring in fiscal years 2014–2015. A further 3.4% TAV increase is projected for fiscal 2016. House prices are increasing, commercial vacancy rates are declining, and the numbers of delinquencies and foreclosures have fallen. Continuation of these factors will likely fuel further TAV growth, particularly given the lower inventory of housing currently available.

Solid Financial Operations

The city ended fiscal 2014 with a total general fund balance of $350.1 million, a strong 26.6% of spending. The total general fund balance benefited from a net operating surplus after transfers of $3.3 million and the city is projecting an almost $5.0 million further net operating surplus after transfers in fiscal 2015.

However, the majority of the total general fund's growth from the $222.5 million in fiscal 2013 (18.2% of spending) was due to accounting changes. These included reclassification of the self-insurance internal service fund into the general fund and consolidation of special revenue funds into the general fund where the majority of their expenditures occurred. Cumulatively, all accounting changes added $114.7 million to the general fund's beginning balance.

Rolling the self-insurance internal service fund into the general fund eliminated auditor concerns about the city having an internal service fund with deficits. However, it also masked the associated liabilities because governmental funds do not report long-term liabilities. There was no corresponding transfer into the general fund of the $237.5 million in related long-term liability claims. Nevertheless, the city funds its workers' compensation, public liability, and long-term disability reserves at or above its current policy goals. The city's multiyear projections assume continued compliance with these reserve policy goals through fiscal 2020.

In February 2014, the city council voted to increase the general fund reserve requirement to 14% of general fund revenues, up from 8%. The city had already been exceeding the revised goal since fiscal 2012 and has continued to exceed it. The city expects to end fiscal 2015 with a general fund reserve of $169.8 million, or 15.1% of revenues.

California cities have limited revenue flexibility. Furthermore, San Diego's revenue structure is less diverse than most other large California cities. For example, it does not levy a utility user tax or a trash collection fee, has a relatively low business license tax rate, and there would likely be considerable taxpayer and voter resistance to introducing or increasing such taxes. Nevertheless, its four primary general fund revenue sources (property, sales, and transient occupancy taxes, and franchise fees) recovered well from the recession and are all projected to continue increasing over the next five years, albeit returning to more stable levels of growth.

The city's general fund expenditures are dominated by personnel expenditures (68.6% of the fiscal 2015 adopted budget). Future labor costs have been rendered somewhat predictable by five-year labor agreements through fiscal 2018 which freezes pensionable pay but provide for increases in non-pensionable compensation. Such increases are currently projected to cost

between $10 million and $13 million annually. The city is currently negotiating a modification and two-year extension to the police labor agreement to address specific police officer retention issues. The goal is to provide for pensionable pay increases in both fiscal years 2019 and 2020, after the five-year freeze expires, plus benefits, allowances, and leave increases in the interim, for a total fiscal impact of between $11 million and $25 million per year through fiscal 2020. Priority initiatives to be funded from surplus monies in fiscal years 2016 to 2020 will add to the city's overall personnel costs, with the expectation that general fund structural balance will be maintained.

High Debt Burden; Sizable Capital Needs

The city's overall debt burden is high on a per capita basis ($4,953) but moderate at 3.5% of market valuation. Debt amortization is average at approximately 50% in 10 years. The city did not need to issue tax revenue anticipation notes in fiscal years 2014 and 2015 and does not expect to do so in fiscal 2016 either.

Proceeds from the series 2015 bonds will be used to address various capital needs. The city anticipates issuing a further $270 million in lease revenue bonds between fiscal years 2017 and 2019 to further address capital funding needs. These bond issues would not greatly alter the city's debt burden on a per capita or market valuation basis. However, these amounts are small compared to the city's total capital needs.

The city has identified $3.9 billion in capital projects going forward. Of the estimated $2.3 billion that would be the general fund's responsibility, an estimated $1.7 billion is currently unfunded. These amounts could increase as an ongoing evaluation process works through the city's inventory of capital assets in more detail. However, there is also a strong possibility that storm water program capital and operating costs associated with new regulatory requirements could be reduced by as much as $980 million if all regulatory parties concur with the city's alternate proposals. Negotiations are underway presently.

Securing new primary funding sources for capital costs could prove challenging. Historically, the city's electorate has been resistant to new taxes. This is reflected in the city's less diverse revenue structure and recent successful litigation against a special tax district to partially fund expansion of the convention center. Raising storm water fees to assist with the storm water system upgrade costs would likely be difficult and the city will not be able to rely on lease revenue bonds to fund all of its capital needs.

Positive Effects of Benefit Reform

The city has undertaken considerable pension system reform and OPEB modification. Litigation against the pension reform is ongoing. In the event that pension reform has to be wholly or partially unwound in response to the litigation outcomes, there would be little near-term impact on the city's costs. However, the city's long-term liabilities would increase. An initiative to cap the city's annual OPEB contributions successfully withstood a legal challenge on the basis that OPEBs are an employment benefit rather than a vested contractual right and, therefore, can be modified.

In June 2012, following earlier pension reforms, the electorate voted in favor of closing the San Diego City Employees Retirement System (SDCERS) plan to all new employees except police, accelerating paydown of the system's UAAL, limiting pensionable salaries through fiscal 2018, and only offering defined contribution plans to new employees. These pension reforms benefit the city in the long-term by shifting investment and longevity risks to future city employees, and

accelerating the paydown of the pension system's UAAL. The UAAL is projected to decrease from $2.03 billion in fiscal 2014 to $560 million by fiscal 2025 (assuming a 7.25% annual investment return rate). The city will need to continue making substantial annual contributions to achieve this; they are projected to decline from $264 million in fiscal 2015 to a still significant $218 million in fiscal 2025. The general fund is currently responsible for 72% of annual pension contributions.

As a result of these pension reforms and improved investment returns, in 2014 SDCERS was 74.2% funded using SDCERS's 7.25% discount rate, or 72.2% funded using Fitch's more conservative 7.0% discount rate. This represents a steady improvement from 2009 when, due to investment losses, the funded ratio hit a low of 66.5% using SDCERS's then 7.75% discount rate or an estimated 61.4% using Fitch's 7.0% discount rate.

In terms of the city's closed OPEB plan, the city still has a UAAL of roughly $479.5 million, or a low 0.3% of TAV, after negotiating a new health plan for the remaining OPEB plan members in 2012. The new retiree health plan is projected to save $714 million in healthcare costs over 25 years by lowering the benefits' value and increasing employee contributions. Due to multiyear labor agreements, the city does not expect its annual OPEB contribution to exceed $57.9 million through fiscal 2015, with annual increases of up to 2.5% thereafter.

In fiscal 2014, the city's total carrying costs related to annual debt repayments, actuarially required pension contributions, and OPEB pay-as-you-go payments represented a high 26.2% of total governmental expenditures. These carrying costs are likely to increase as additional debt is issued while annual pension and OPEB contributions remain significant in order to reduce those unfunded liabilities.

Large Cross-Collateralized Asset Pool

The parity series 2012, 2013, and 2015 lease revenue bonds (estimated combined par amount of $241.7 million) are secured by a fully cross-collateralized pool of leased assets, valued at $262 million. In the event of default, the trustee could seek remedy across all of those properties up to the amount of the underpayment. The trustee, not the city, would choose which assets to use to cure any event of default, therefore protecting against the risk that the city would choose to default on the least essential assets in the pool.

Four of the leased assets are ground leases for land under facilities developed and owned by third parties. The two most valuable ground leases extend up to or beyond the final maturity of all the parity bonds. A third lease extends up to or beyond the final maturity of the series 2012 bonds and new money portion of the series 2013 bonds. The fourth lease extends beyond the final payment on the refunding portion of the series 2013 bonds. Fitch evaluates the ground leases as very strong leased assets. They generate a significant revenue stream (approximately $5.6 million annually) which would provide the trustee with a partial but proportionately significant remedy in the event of a default (although they alone would be insufficient to cover a full debt service default of up to $17 million per year).

Also, the ground leases have no meaningful abatement risk and they cover inherently valuable land (currently valued at $94.7 million) which the city has the option to sell. For all these reasons, the city has strong incentives to make the related lease rental payments.

2015 Bond Litigation

The series 2015 bond sale has been delayed by lawsuits challenging the validity of the bonds and related indenture and lease documents, asserting (amongst other claims) that abatement

leases violate the constitutional debt limit. The superior court recently decided in favor of the city for the series 2015A bonds and dismissed the litigation against the series 2015B on the basis of non-timely submission. The litigants are now appealing the decision regarding the series 2015A bonds and are seeking to take further action regarding the series 2015B bonds.

In the event that the state court of appeals decides against the city, the city plans to appeal to the state supreme court. Subsequently, if the state supreme court was to rule in the plaintiff's favor, the series 2015 bonds and related indenture and lease documents would be invalid. Under that scenario, purchasers of the series 2015 bonds would not be entitled to repayment and could lose their entire investment. The city would not be obligated to make and might be precluded from making lease rental payments, thereby adversely affecting bondholders. Bondholders could be required to repay to the authority any previous principal and interest payments made on the series 2015 bonds. It is unclear what remedies, if any, bondholders would have. If they were to file a suit for damages or recovery against the city in this situation, they would be unsecured creditors.

In the event that the city is unable to make a timely payment of bond principal and interest, Fitch would indicate that a default had taken place and withdraw the rating.

Fitch has reviewed the opinion of the city's bond counsel which states that the allegations against the city are without merit. Bond counsel's opinion is based, in part, on the 1998 state supreme court decision which upheld the principal that abatement leases do not violate the constitutional debt limit. Furthermore, bond counsel considers that the joint powers authority has the necessary powers to issue the series 2015 bonds and has met all the procedural requirements to do so.

The city is proceeding with the series 2015 bond issuances now because it seeks to address pressing capital needs in an environment of rising construction costs and interest rates.

The ratings above were solicited by, or on behalf of, the issuer, and therefore, Fitch has been compensated for the provision of the ratings.

ALL FITCH CREDIT RATINGS ARE SUBJECT TO CERTAIN LIMITATIONS AND DISCLAIMERS. PLEASE READ THESE LIMITATIONS AND DISCLAIMERS BY FOLLOWING THIS LINK: HTTPS://FITCHRATINGS.COM/UNDERSTANDINGCREDITRATINGS. IN ADDITION, RATING DEFINITIONS AND THE TERMS OF USE OF SUCH RATINGS ARE AVAILABLE ON THE AGENCY'S PUBLIC WEB SITE AT WWW.FITCHRATINGS.COM. PUBLISHED RATINGS, CRITERIA, AND METHODOLOGIES ARE AVAILABLE FROM THIS SITE AT ALL TIMES. FITCH'S CODE OF CONDUCT, CONFIDENTIALITY, CONFLICTS OF INTEREST, AFFILIATE FIREWALL, COMPLIANCE, AND OTHER RELEVANT POLICIES AND PROCEDURES ARE ALSO AVAILABLE FROM THE CODE OF CONDUCT SECTION OF THIS SITE. FITCH MAY HAVE PROVIDED ANOTHER PERMISSIBLE SERVICE TO THE RATED ENTITY OR ITS RELATED THIRD PARTIES. DETAILS OF THIS SERVICE FOR RATINGS FOR WHICH THE LEAD ANALYST IS BASED IN AN EU-REGISTERED ENTITY CAN BE FOUND ON THE ENTITY SUMMARY PAGE FOR THIS ISSUER ON THE FITCH WEBSITE.

Copyright © 2015 by Fitch Ratings, Inc., Fitch Ratings Ltd. and its subsidiaries. 33 Whitehall Street, NY, NY 10004.Telephone: 1-800-753-4824, (212) 908-0500. Fax: (212) 480-4435. Reproduction or retransmission in whole or in part is prohibited except by permission. All rights reserved. In issuing and maintaining its ratings, Fitch relies on factual information it receives from issuers and underwriters and from other sources Fitch believes to be credible. Fitch conducts a reasonable investigation of the factual information relied upon by it in accordance with its ratings methodology, and obtains reasonable verification of that information from independent sources, to the extent such sources are available for a given security or in a given jurisdiction. The manner of Fitch's factual investigation and the scope of the third-party verification it obtains will vary depending on the nature of the rated security and its issuer, the requirements and practices in the jurisdiction in which the rated security is offered and sold and/or the issuer is located, the availability and nature of relevant public information, access to the management of the issuer and its advisers, the availability of pre-existing third-party verifications such as audit reports, agreed-upon procedures letters, appraisals, actuarial reports, engineering reports, legal opinions and other reports provided by third parties, the availability of independent and competent third-party verification sources with respect to the particular security or in the particular jurisdiction of the issuer, and a variety of other factors. Users of Fitch's ratings should understand that neither an enhanced factual investigation nor any third-party verification can ensure that all of the information Fitch relies on in connection with a rating will be accurate and complete. Ultimately, the issuer and its advisers are responsible for the accuracy of the information they provide to Fitch and to the market in offering documents and other reports. In issuing its ratings Fitch must rely on the work of experts, including independent auditors with respect to financial statements and attorneys with respect to legal and tax matters. Further, ratings are inherently forward-looking and embody assumptions and predictions about future events that by their nature cannot be verified as facts. As a result, despite any verification of current facts, ratings can be affected by future events or conditions that were not anticipated at the time a rating was issued or affirmed.

The information in this report is provided "as is" without any representation or warranty of any kind. A Fitch rating is an opinion as to the creditworthiness of a security. This opinion is based on established criteria and methodologies that Fitch is continuously evaluating and updating. Therefore, ratings are the collective work product of Fitch and no individual, or group of individuals, is solely responsible for a rating. The rating does not address the risk of loss due to risks other than credit risk, unless such risk is specifically mentioned. Fitch is not engaged in the offer or sale of any security. All Fitch reports have shared authorship. Individuals identified in a Fitch report were involved in, but are not solely responsible for, the opinions stated therein. The individuals are named for contact purposes only. A report providing a Fitch rating is neither a prospectus nor a substitute for the information assembled, verified and presented to investors by the issuer and its agents in connection with the sale of the securities. Ratings may be changed or withdrawn at anytime for any reason in the sole discretion of Fitch. Fitch does not provide investment advice of any sort. Ratings are not a recommendation to buy, sell, or hold any security. Ratings do not comment on the adequacy of market price, the suitability of any security for a particular investor, or the tax-exempt nature or taxability of payments made in respect to any security. Fitch receives fees from issuers, insurers, guarantors, other obligors, and underwriters for rating securities. Such fees generally vary from US$1,000 to US$750,000 (or the applicable currency equivalent) per issue. In certain cases, Fitch will rate all or a number of issues issued by a particular issuer, or insured or guaranteed by a particular insurer or guarantor, for a single annual fee. Such fees are expected to vary from US$10,000 to US$1,500,000 (or the applicable currency equivalent). The assignment, publication, or dissemination of a rating by Fitch shall not constitute a consent by Fitch to use its name as an expert in connection with any registration statement filed under the United States securities laws, the Financial Services and Markets Act of 2000 of the United Kingdom, or the securities laws of any particular jurisdiction. Due to the relative efficiency of electronic publishing and distribution, Fitch research may be available to electronic subscribers up to three days earlier than to print subscribers.