MATERIAL EVENT NOTICE
REPORT OF RATING CHANGE

City of San Diego
Community Facilities District No. 2 (Santaluz)
Improvement Area No. 1
Special Tax Refunding Bonds, Series A of 2011
(CUSIP Number 802808)

NOTICE IS HEREBY GIVEN that on September 15, 2017, Standard & Poor Global Ratings (S&P) raised its long-term rating on the City of San Diego's Community Facilities District No. 2 (Santaluz) Improvement Area No. 1 (the "District"), Special Tax Refunding Bonds, Series A of 2011 to "A-" from "BBB+." The outlook on the rating is stable.

This is not a recommendation to buy, sell or hold any District indebtedness. Generally, a rating agency bases its ratings on the information and materials furnished to it and on investigations, studies and assumptions of its own. There is no assurance that such ratings will continue for any given period or that such ratings will not be revised downward or withdrawn entirely provided, if in the view of such rating agency, circumstances warrant. Any such downward revision or withdrawal of such ratings may have an adverse effect on the market price or marketability of the District's obligations identified above.

DATED: September 20, 2017

CITY OF SAN DIEGO

By: Mary Lewis

Mary Lewis
Chief Financial Officer

Distribution: Electronic Municipal Market Access (EMMA)
MUFG Union Bank, N.A.

S&P Global
Ratings

RatingsDirect®

Summary:

San Diego Community Facilities District (CFD) No. 2 (Santaluz) Improvement Area No. 1, California; Special Assessments

Primary Credit Analyst:
Michael Parker, Centennial 303-721-4701; michael.parker@spglobal.com

Secondary Contact:
Jean C Lee, San Francisco +1 415.371.5057; jean.lee@spglobal.com

Table Of Contents

Summary:

San Diego Community Facilities District (CFD) No. 2 (Santaluz) Improvement Area No. 1, California; Special Assessments

Credit Profile		
San Diego Comnty Facs Dist No. 2 (Santaluz) Imp Area No. 1 spl tax rfdg bnds		
Long Term Rating	A-/Stable	Upgraded

Rationale

S&P Global Ratings raised its long-term rating to 'A-' from 'BBB+' on San Diego Community Facilities District (CFD) No. 2 (Santaluz) Improvement Area No. 1, Calif.'s series 2011A special tax refunding bonds. The outlook is stable.

The rating action is based on our view of the district's continued property wealth improvement for several years, which has led to direct and overlapping value-to-lien (VTL) ratios in line with those of higher-rated peers.

The rating reflects our view of the CFD's:

- Built-out and primarily residential nature that participates in the broad and diverse economy of the San Diego-Carlsbad metropolitan statistical area (MSA);
- Good assessed value (AV) growth for three consecutive years, leading to improved VTL ratios;
- Closed parity lien except for refunding purposes; and
- Low taxpayer delinquencies.

Partly offsetting the above strengths, in our view, is the somewhat elevated percentage of the special tax levy generated from properties with an overall VTL ratio below 10 to 1, at 9.2%.

The bonds are secured by special taxes collected from real property in the district, net of administrative expenses. Special tax rates vary across parcels and are based on square footage. Debt service coverage (DSC) is based on the Mello-Roos law limitation of the district's ability to increase the annual levy by 10% on residences above the amount that would have been levied as a result of delinquencies or defaults. The bonds are protected by a fully funded debt service reserve (DSR), which is required to be equal to the least of maximum annual debt service, 125% of average annual debt service, or 10% of the original par amount. The district agrees not to issue any additional parity debt except for refunding purposes.

San Diego CFD No. 2 is located 20 miles northeast of downtown San Diego, and encompasses 2,546 gross acres. The district is primarily residential and mostly built out, with a total of 999 developed parcels. All infrastructure related to development with the district is complete, including a privately owned golf course. The district's direct and overlapping, or overall, VTL ratio was about 21.6 to 1 in fiscal 2017; direct VTL ratio in fiscal 2017 was 35.3 to 1. Although the district's special tax is on a per-property basis and not dependent on AV, we view AV as an indicator of tax base performance. The district's AV has grown for consecutive years, as the local housing recovery has been strong since recessionary declines. Since 2014, AV has increased at an annual average rate of 9.0% to $1.5 billion in fiscal 2018. In our view, given the primarily residential composition of the district, the tax base is diverse, with the top 10 taxpayers responsible for 5.8% of the special taxes. The leading taxpayer, a golf course, constitutes only 2.7% of the fiscal 2017 special tax levy.

While the maximum levy would provide DSC of about 1.57x for the bonds, the district is practically limited to raise the levy by 10% as a result of delinquencies. In 2016, it levied roughly 63% of the maximum tax for fiscal 2017 to cover debt service on the bonds, which resulted in 0.98x coverage. For the remaining portion needed for debt service, the district used some extra cash on hand from a surplus fund as a credit to taxpayers in the district. The district intends to use the surplus account for next several years, which should continue to provide some minor relief to taxpayers. The effective tax rate is about 1.43% in fiscal 2017.

At 1.1x coverage, we calculate that the district could withstand either a permanent tax delinquency equivalent to the amount generated by its top 10 largest special taxpayers (representing approximately 5.8% of the estimated 2016-2017 maximum tax), a permanent delinquency of special taxpayers with overall VTL ratios of less than 5 to 1 (representing about 4.5% of the estimated 2016-2017 maximum tax), or 15% delinquencies annually until the DSR is exhausted. When including the remaining $557,000 in the surplus fund, we calculate that the district could withstand a slightly better, 16% delinquency rate annually. The fiscal year-end 2016 delinquency rate was very low, in our view, at 0.1%. We understand the district has historically set the actual levy based on historical delinquency rates, estimated administrative fees, and debt service.

The San Diego economy

We consider San Diego's economy very strong. The city, with an estimated population of 1.4 million, is located in San Diego County in the San Diego-Carlsbad, Calif. MSA, which we consider to be broad and diverse. Median household and per capita effective buying incomes for San Diego are strong, in our view, at 121% and 117% of the national levels, respectively. Overall, the city's market value grew by 6.0% over the past year to $218.4 billion in 2016. As of July 2017, the city and San Diego County unemployment rates stood at 4.5% and 4.7%, respectively.

A primary employment center in San Diego County, the city represents about half of the county's total employment. The economy consists of various high-tech clusters, including biotech and telecommunications, combined with a reliance on tourism, and the military and defense industries. Higher education and scientific research institutions also support the economy, including the University of California-San Diego (28,459 employees), San Diego State University, Scripps Research Institute, the Salk Institute for Biological Studies, and the San Diego Supercomputer Center. We believe that, historically, the U.S. Navy and the U.S. Marine Corps have provided a stabilizing presence in the regional economy.

As we said in our most recent U.S. State And Local Government Credit Conditions Forecast (published July 24, 2017, on RatingsDirect), the Pacific states continue to be key engines for U.S. growth. While growth was slower than expected for the country overall in 2016, the durability of growth in the tech and other professional sectors helped lead to stronger-than-expected, 2.9% growth in economic output for the Pacific region--first among all regions and well above the 2.0% growth in economic output of the second-fastest growing South Atlantic region. However, constrained housing supply and a cooling of employment growth in higher-paying professional industries is expected to weigh on economic output in the coming years, leading the Pacific region to slip into third place with projected growth in economic output of 2.7% and 2.9% in 2017 and 2018, respectively--though we note that the projections have improved somewhat since our last forecast. Providing further evidence of this dynamic, our revised forecast for 2017 housing starts dropped to only 4.5% growth from 12.0%, causing the Pacific region to slip to fifth place from first in the nation. However, we expect some of the growth to occur in the future, helping the Pacific states regain their lead with growth of 18.2% in 2018. While tight housing supply may limit the region's near-term economic potential, and associated growth in sales and income tax receipts, housing prices in the Pacific states are projected to lead the nation in 2018 and 2019, which should help boost local government property tax receipts.

Outlook

The stable outlook reflects our view of the district's built-out status and San Diego's strong incomes, which suggest the levy will continue to provide adequate coverage to support debt service. It also reflects our view of the district's low delinquency rates and consecutive years of AV growth, leading to greater overall VTL ratios. We do not anticipate changing the rating within the two-year outlook horizon.

Upside scenario

We could raise the rating if the share of properties with an overall VTL ratio below 10 to 1 were to decline materially, and if AV grows significantly enough to increase the district's overall VTL to levels above those of similarly rated peers.

Downside scenario

Should delinquencies substantially rise or AV declines push overall VTL ratios down, we could lower the rating.

Related Research

Special Assessment Bond Ratings Are Trending Up As The U.S. Economic Recovery Continues, March 28, 2016