Moody's
INVESTORS SERVICE

New Issue: MOODY'S ASSIGNS A2 RATING TO SAN DIEGO'S LEASE SUPPORTED OBLIGATIONS

Global Credit Research - 17 May 2010

AFFIRMS Aa3 GENERAL OBLIGATION RATING

San Diego (City of) CA
Municipality
CA

Moody's Rating

ISSUE	RATING
Lease Revenue Refunding Bonds, Series 2010A (Master Refunding Project)	A2

Sale Amount	$168,000,000
Expected Sale Date	05/19/10
Rating Description	Lease Rental

Opinion

NEW YORK, May 17, 2010 -- Moody's Investors Service has assigned an A2 rating to San Diego's General Fund Master Refunding Project Lease Revenue Bonds, Series 2010 A. We have also affirmed the city's Aa3 General Obligation rating as well as the A2 rating on outstanding lease supported obligations. The outlook on these ratings is stable. The ratings reflect the city's stabilizing fundamental credit factors, including likely bottoming out of residential real estate prices, which should help the city's next assessed valuations, and modest signs of improvement in the economy, which should improve economically sensitive revenues, such as sales tax and transit occupancy tax. The ratings also reflect the city's high unemployment rate, which continues to weigh on these credit factors. The city's financial operations continue to be stressed as the economically challenged revenues remain weak and prevent the city from improving its reserve position. Despite the city's lackluster general fund revenue growth, the city continues to aggressively control its expenditures to preserve its narrow reserve position which remains consistent with the current rating. The management's ability to operate effectively under these very tight financial conditions continues to be an important credit factor. The proceeds of the current offering will be used to refund three outstanding lease supported obligations.

The two notch rating distinction between the A2 on the current offering and the city's Aa3-rated general obligation bonds represents Moody's standard notching differential for fixed asset leases relative to a California issuer's general obligation rating. Broadly speaking the two notches reflect the risk of abatement and the narrower, general fund security pledge for leases compared to the very strong, voter-approved unlimited property tax pledge securing general obligation bonds.

FINANCIAL OPERATIONS ARE NARROWLY BALANCED BUT STABLE.

Since its low point of several years ago, the city's financial position has improve slowly but steadily. The early part of the financial recovery benefited from generally robust revenue growth through 2007. However, San Diego was among the first areas to be hit by the collapse of the statewide housing market and then the severe economic recession, which brought the previous revenue growth to a standstill. Therefore in 2008 and 2009, the city's financial operations were primarily focused on controlling expenditures to persevere financial health, and the city was largely successful. Close monitoring with midyear adjustments are key to the city's ability to persevering financial stability. These adjustments include one- time measures as well as long term solutions such as permanent staffing reductions and modified pension benefits for new hires. As a result, the city's general fund suffered minimal erosion in 2008 and 2009 as the general fund balance decreased from 12.3% of general fund revenues at the end of 2007 to 10.2% in 2009. The undesignated fund balance held steady at approximately 7% as the city continued to grow its general fund reserves as defined by the city's comprehensive reserve policy. The city's goal was to increase its general fund reserves to 8% by 2012 from its June 30, 2008 level of 6.0%. Although the policy target of 6.5% in 2009 was met, current year budget shortfall is likely to prevent the city from meeting its 2010 reserve target of 7.0%. Further, the proposed 2011 budget calls for a one year suspension of the 0.5% annual increase. Based on the most recent current year estimates, and with no additional measures to address the current budget gap, 2010 general fund expenditures are likely to exceed revenues by $11.2 million, which is higher than the 2008 shortfall of $7.3, million and 2009 shortfall of $10.4 million. This is an unfavorable trend and the city will be challenged to reverse it in 2011.

The city is currently struggling to bridge a budget gap of $179 Million in 2011. Departmental reductions are expected to address $87 million of this gap, most notably with a reduction of 486 positions. With other one-time and on-going adjustments the city expects to close an additional $82 million of the gap. We expect the city to achieve a balanced budget for 2011 without significant further deterioration of its reserve position. The city's commitment of funding its pension obligations contributes significantly the breadth of the 2011 budget gap. Recent market losses increased the general fund portion of the city's ARC to $180 million in 2011 from $125 milli0on in 2010. This ARC represents approximately 16% of the city's general fund revenues and is projected to increase steadily over the next several years, which will continue to impair operating flexibility as it represents a fixed expenditure. Although the size of the city's 2011 budget gap appears large, it is based on generally conservative revenue estimates. All economically sensitive revenues are generally budgeted to remain flat, although signs of improvement in the economy may suggest modest growth.

LARGE AND DIVERSE ECONOMY MAY HAVE REACHED ITS CYCLICAL BOTTOM

The city's economy is fundamentally diverse with tourism, the military, higher education, trade and biotechnology playing important roles. The population benefiting from this economy has historically boasted above average wealth and income levels. However, the city was among the first in the state to be affected by the downturn in the housing market and the subsequent recession. As a result, AV growth came to a halt in 2010 with a year-over -year decrease of 0.6%, although full value per capita remained relatively high at $127,000. Employment also suffered, as approximately 24,500 jobs were lost between February 2009 and February 2010, reducing total employment to 619,500 and increasing the unemployment rate to 10.6%. The loss of jobs is even more severe when compared to the 2008 average of 657,300 jobs and an unemployment rate of 6.0%. However, just as San Diego was early to enter the recession, it may be a leader in coming out of the recession. Recent home price data suggest that among large cities throughout the country, the city's home values are recovering at a better than average rate. If the recovery extends to other parts of the economy, the city's financial picture is also likely to improve with economically sensitive revenues such as sales tax and transit occupancy tax leading the upturn.

THE CITY'S DEBT POSITION IS GENERALLY FAVORABLE

The city's direct and overall debt ratios of 0.3% and 2.9%, respectively are in line with other cities in the state, but significantly better than most large cities in the country. Apart from very modest $4.3 million in general obligation bonds at the end of 2009, the remainder of the city's $534 million of direct debt is largely comprised of lease supported obligations. The resulting lease burden of approximately $43 million represents a manageable 3.9% of 2009 general fund revenues. However, substantial amount of non general fund revenues result in a much lower net lease burden. The current transaction is structured as an asset transfer obligation under a master lease where a group of essential facilities with combined value of $205 million will serve as the subject of the lease. The lease includes some typical features, such as a covenant to annually budget and appropriate lease payments, maintain rental interruption insurance for two years for all properties except for the three in which only land is leased and title insurance. However, the reserve fund will be sized to only 50% of maximum annual debt service, which is a notable weakness. The current rating is not adversely affected by this weakness because the payment of lease payments six months in advance of bond payments, and the reserve fund combine to provide the trustee with a full year's debt service at any given time. The diversity of the pool of assets and the diminished likelihood of abatement of three of the assets comprised of land, and totaling $95 million in value, also support the current rating. Going forward, as the subject of the matter lease may change, we will evaluate the entirety of the structure on its merits in assigning future ratings.

Outlook

The outlook on the ratings is stable. Moody's expects the city to continue to operate under generally tight but stable financial conditions. Given the city's modest reserves, significant deterioration of reserves can put downward pressure on bond holder security. By adhering to its reserve policy, the city can avert such credit deterioration. While the current economic conditions are weakening revenues, in the long term the city's economy will benefit from its size and diversity.

KEY STATISTICS

Fiscal 2009, GAAP basis:

Net cash as % of revenue: 7.7%

Total fund balance as % of revenue: 10.2%

Available fund balance as % of revenue: 7.1%

Net direct debt as % of FY 2010 AV: 0.3%

Overall net debt as % of FY 2010 AV: 2.9%

2000 Census:

Median Family Income: $53,060 (100.1% of the state average)

Per Capita Income: $23,609 (104.% of the state average)

Individuals below poverty level: 14.6%

The principal methodology used in rating San Diego, CA was Moody's "General Obligation Bonds Issued by U.S. Local Governments," published in October 2009 and available on www.moodys.com in the Rating Methodologies sub-directory under the Research & Ratings tab. Other methodologies and factors that may have been considered in the process of rating this issuer can also be found in the Rating Methodologies sub-directory on Moody's website.

The last rating action with respect to San Diego was on June 22, 2009 when a rating of MIG 1 was assigned to San Diego's 2009 TRANs.

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