

RatingsDirect®

Summary:

Costa Mesa Financing Authority, California Costa Mesa; Appropriations

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Credit Profile

US\$28.625 mil 2017 lse rev bnds (Costa Mesa) due 10/01/2042

Long Term Rating AA+/Stable New

Costa Mesa Financing Authority, California

Costa Mesa, California

Costa Mesa Public Fincg Auth (Costa Mesa) APPROP (MBIA of Illinois)

Unenhanced Rating AA+(SPUR)/Stable Upgraded

Many issues are enhanced by bond insurance.

Rationale

S&P Global Ratings raised its underlying rating (SPUR) to 'AA+' from 'AA' on Costa Mesa Public Financing Authority, Calif.'s outstanding certificates of participation (COPs) issued for Costa Mesa. At the same time, S&P Global Ratings assigned its 'AA+' long-term rating to the Costa Mesa Financing Authority, Calif.'s series 2017 lease revenue bonds, issued for Costa Mesa. The outlook is stable.

The upgrade reflects our view of the stabilization of and the improvement in the city's budgetary performance, as well as the increases in its available reserve levels, driven primarily by its council-approved minimum reserve target, which addresses risks associated with the volatility of its major revenue sources.

The 2017 bonds are secured by lease rental payments, made by the city, as lessee, through a lease agreement with Costa Mesa Financing Authority, as lessor, for the use of the city's assets. Under the lease agreement, the city has covenanted to budget and appropriate annual payments. Payments are triple net, without right of set-offs, and the city is responsible for maintenance, taxes, and utilities. Payments may be abated in the event of damage to, or the destruction of, the leased assets. To mitigate the risk of abatement in such a case, the city has covenanted to maintain at least 24 months of rental interruption insurance, as well as casualty insurance equal to the lesser of the replacement value of the leased asset or the aggregate principal of the outstanding bonds. The leased assets are the city hall and two police facilities, which passed our seismic risk test under our criteria. We evaluated the seismic risk of each leased asset pursuant to our criteria and estimated that the leased assets have a less than 5% probability of incurring more than 25% damage during the life of the bonds. Bond documents do not require a debt service reserve, although we note that the lease payments fall more than 90 days after the start of the city's fiscal year. The proceeds of the sale of the 2017 bonds will be utilized to refund the city's existing series 2007 COPs, as well as to partially finance the city's Lions Park Project. The rating on the series 2017 bonds is one notch below our view of the city's general creditworthiness, consistent with our appropriation criteria.

The city's general creditworthiness is eligible to be rated above the sovereign because we believe the city can maintain

better credit characteristics than the U.S. in a stress scenario. Under our criteria "Ratings Above The Sovereign--Corporate And Government Ratings: Methodology And Assumptions," published Nov. 19, 2013, on RatingsDirect, U.S. local governments are considered to have moderate sensitivity to country risk. The city's locally derived revenues are the source of security for the bonds, and the institutional framework in the U.S. is predictable with significant U.S. local government autonomy. In a potential sovereign default scenario, U.S. local governments would maintain financial flexibility through the ability to continue collecting locally derived revenues and U.S. local governments have independent treasury management. Costa Mesa has considerable financial flexibility, as demonstrated by the very strong general fund balance and very strong liquidity.

The rating reflects our view of the city's:

- Very strong economy, with access to a broad and diverse metropolitan statistical area (MSA);
- Very strong management, with strong financial policies and practices under our Financial Management Assessment (FMA) methodology;
- Strong budgetary performance, with operating surpluses in the general fund and at the total governmental fund level in fiscal 2016;
- Very strong budgetary flexibility, with an available fund balance in fiscal 2016 of 54% of operating expenditures;
- Very strong liquidity, with total government available cash at 81.8% of total governmental fund expenditures and 26.4x governmental debt service, and access to external liquidity we consider strong;
- Strong debt and contingent liability position, with debt service carrying charges at 3.1% of expenditures and net direct debt that is 21.9% of total governmental fund revenue, as well as low overall net debt at less than 3% of market value, but a large pension and other postemployment benefit (OPEB) obligation; and
- Strong institutional framework score.

Very strong economy

We consider Costa Mesa's economy very strong. The city, with an estimated population of 114,044, is located in Orange County in the Los Angeles-Long Beach-Anaheim, Calif. MSA, which we consider to be broad and diverse. The city has a projected per capita effective buying income of 116% of the national level and per capita market value of \$161,700. The city's market value grew by 5.6% over the past year to \$18.4 billion in 2018. Overall, the city's assessed value (AV) has experienced strong growth since fiscal 2011, when it experienced only a single year of slight AV decline of 2.2% as a result of the economic recession. The county unemployment rate was 4.0% in 2016, which is historically below state and national averages.

The city encompasses 16.8 square miles in the heart of Orange County, bordering the cities of Newport Beach, Irvine, Huntington Beach, Fountain Valley, and Santa Ana. Due to the city's location along Interstate 405, residents also have easy access to the greater Los Angeles and San Diego areas for employment. Given its nationally recognized South Coast Plaza and its proximity to the multiple beaches and John Wayne International Airport, the city receives many visitors throughout the year. While its tax base is about 63% residential, the city comprises a diverse variety of employers and business centers. In our view, the top 10 taxpayers make up a very diverse 9.6% of the city's tax base, with South Coast Plaza as the leading taxpayer, at only 1.6% of total AV in fiscal 2017.

Very strong management

We view the city's management as very strong, with strong financial policies and practices under our FMA methodology, indicating financial practices are strong, well embedded, and likely sustainable.

The FMA reflects our view of the following:

- The city utilizes a combination of historical trend analysis, outside consultants, and input from citywide departments to make its revenue and expenditure assumptions. The city's trend analysis is based on a 15-year model, and utilizes HdL for sales and property tax revenue. Salaries and benefits are calculated at the employee level, using a vacancy factor, and have been historically conservative. Services and supplies are determined using trend analysis.
- The city's budget-to-actual performance is formally presented to and reviewed by council at midyear. Additionally, the finance director discusses revenue and expenditure accounts with the city manager on a biweekly basis.
- The city has a comprehensive rolling five-year financial forecast for its general fund, which is updated annually and shared with the council.
- The city maintains a formal rolling seven-year capital improvement plan (CIP), which is updated annually.
- The city has a formal investment management policy, which is reviewed by the finance committee and council annually. Investment results are presented to the council monthly.
- The city has a formal debt management policy that identifies the types of debt that can be issued, the structure of the debt, the acceptable use of bond proceeds, refunding guidelines on how much savings must exist, and its relation to its CIP and operating budget.
- The city maintains a council approved reserve policy of \$14.125 million, and a self-insurance reserve requirement of \$2 million. The council also approved a \$55 million reserve minimum, which was determined by a risk-based study that analyzed the volatility of losses in sales, transient occupancy, and property taxes based on data from historical economic downturns.

Strong budgetary performance

Costa Mesa's budgetary performance is strong in our opinion. The city had operating surpluses of 9.5% of expenditures in the general fund and of 11.5% across all governmental funds in fiscal 2016. General fund operating results of the city have been stable over the last three years, with a positive result of 3.3% in fiscal 2015 and a result of 4.4% in 2014. The city's total governmental funds results have also been stable over the last three years, as demonstrated by positive net results of 3.3%, 7.3%, and 11.5% for fiscals 2014, 2015, and 2016, respectively. Our assessment accounts for our view that budgetary results could deteriorate somewhat from fiscal 2016 results, provided the city's expected general fund results for fiscal 2017.

The city regularly budgets for and transfers out 6.5% of its general fund revenue to its major capital projects fund, as well as makes recurring transfers out of the general fund into its law enforcement and financing authority debt service fund. The city's fiscal 2017 unaudited report shows a negative \$1.1 million net result or negative 1.0% of expenditures, but management indicates the city expects to end slightly better than budgeted with closer to a \$1.0 million general fund deficit. Given the city's strong surplus in fiscal 2016, we understand that the city council approved the one-time transfer of about \$6.9 million out of the general fund to the city's various proprietary funds for fiscal 2017, in addition to its recurring transfers out, resulting in the slight deficit.

For fiscal 2018, the city is budgeting for a net positive \$12.8 million of its general fund revenues over expenditures, excluding its regularly scheduled transfers. Management has also noted that sales tax revenues may fall slightly shorter than its original budget, and the costs related to its firefighters association memorandum of understanding may be slightly higher, which may narrow the surplus gap by about \$2 million. Management indicates that it will continue to align its expenditures and transfers with its revenues, and expects to end with balanced to positive general fund results in the near term. Additionally, the city does not anticipate any events such as large capital costs that could place

significant financial pressure on its total governments, as the city budgets 6.5% of revenues toward capital every year out of the general fund, has regularly maintained its infrastructure, and has the capability to defer smaller projects as needed.

Sales taxes and property taxes account for about 80% of the city's general fund revenues, and have collectively increased in each of the last several years. Primarily driven by retail sales at South Coast Plaza and the city's various car dealerships, sales taxes have historically accounted for about 50% of the city's general fund revenues, which we view as a moderately concentrated revenue source. City officials are aware of the cyclical and volatile nature of sales tax revenues, as demonstrated by a significant drop in the city's sales tax revenues in fiscals 2008 and 2009 during the economic recession. As a result, the management team developed a risk-based study to develop and approve a \$55 million reserve policy.

Very strong budgetary flexibility

Costa Mesa's budgetary flexibility is very strong, in our view, with an available fund balance in fiscal 2016 of 54% of operating expenditures, or \$60.0 million. We view the available fund balances inclusive of the city's assigned and unassigned funds totaling \$45.9 million, as well as its available committed funds of \$14.1 million. We expect the available fund balance to remain well above 30% of expenditures for the current and next fiscal years, which we view as a positive credit factor.

The city conducted a risk based study that analyzed the volatility of not just sales tax revenues, but also transient tax and property tax revenues, during the last few recessions. As a result, the council approved a general fund reserve goal of \$55 million, equaling approximately 51% of fiscal 2016 adjusted general fund expenditures. Included in the \$55 million reserve is the city's available \$14.1 million reserve policy held in the city's committed funds. We understand that officials do not anticipate significantly spending down its available general fund balance in the near term, aside from transferring a portion of carryover revenues from fiscal 2016, when the city ended with an excess surplus.

Very strong liquidity

In our opinion, Costa Mesa's liquidity is very strong, with total government available cash at 81.8% of total governmental fund expenditures and 26.4x governmental debt service in 2016. In our view, the city has strong access to external liquidity if necessary.

The city has had strong access to the capital markets, as demonstrated by its previous COPs issuance. We do not consider the city's investments aggressive, as it invests primarily in U.S. government securities with short-term maturity schedules. Given the city's major revenue streams and lack of plans to spend down its liquidity, we do not expect liquidity levels to weaken in the next two years. We also note the city has no direct purchase agreements, private placements, or variable-rate debt outstanding.

Strong debt and contingent liability profile

In our view, Costa Mesa's debt and contingent liability profile is strong. Total governmental fund debt service is 3.1% of total governmental fund expenditures, and net direct debt is 21.9% of total governmental fund revenue. Overall net debt is low at 1.2% of market value, which is in our view a positive credit factor.

We consider amortization fairly rapid, with the city scheduled to retire approximately 60.1% of principal during the

next 10 years. The city recently fully paid its existing series 2003 COPs, leaving the city's series 2006A land-secured revenue refunding bonds as the only long-term debt outstanding, aside from the debt related to the anticipated sale of the series 2017 lease revenue bonds. We understand the city has no immediate plans to issue additional debt over the next two years, and no direct purchases or privately placed debt outstanding.

In our opinion, a credit weakness is Costa Mesa's large pension and OPEB obligation. Costa Mesa's combined required pension and actual OPEB contributions totaled 14.7% of total governmental fund expenditures in 2016. Of that amount, 12.7% represented required contributions to pension obligations, and 2.0% represented OPEB payments. The city made 103% of its annual required pension contribution in 2016. The funded ratio of the largest pension plan is 68.3%.

The city participates in the California Public Employees' Retirement System, a multiple employer defined benefit plan for employee pension benefits, and has consistently made its full required contribution. Using updated reporting standards in accordance with Governmental Accounting Standards Board Statement Nos. 67 and 68, the city's net pension liability was \$264.0 million as of June 30, 2016. The city makes additional contributions of \$500,000 each year to the unfunded liability for the fire safety pension fund. Additionally, we understand that the city's pension committee is considering establishing an irrevocable section 115 trust fund in an attempt to reduce its future pension liabilities. The city's OPEB provides health care benefits to qualified retirees, and is funded on a pay-as-you-go basis.

Strong institutional framework

The institutional framework score for California municipalities required to submit a federal single audit is strong.

Outlook

The stable outlook reflects our view that the city will maintain strong budgetary performance and very strong reserves, despite the volatile nature of sales tax revenues. The outlook also reflects our continuous view of the city's very strong local economy, characterized by its strong per capita incomes, extremely strong per capita market value, and participation in a strong MSA. We do not expect to change the rating within the two-year outlook horizon.

Downside scenario

Should the city be unable to manage its budget, particularly in the event of an economic recession or significant fluctuations in sales tax revenues, leading to a weakening the city's budgetary performance and leading the city to draw down on its reserves, we could lower the rating.

Related Research

- U.S. State And Local Government Credit Conditions Forecast, July 24, 2017
- Standard & Poor's Earthquake Model, Oct. 25, 2012
- S&P Public Finance Local GO Criteria: How We Adjust Data For Analytic Consistency, Sept. 12, 2013
- Incorporating GASB 67 And 68: Evaluating Pension/OPEB Obligations Under Standard & Poor's U.S. Local Government GO Criteria, Sept. 2, 2015
- 2016 Update Of Institutional Framework For U.S. Local Governments

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com. All ratings affected by this rating action can be found on the S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.

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