S&P Global Ratings

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Summary:

Costa Mesa Financing Authority, California
Costa Mesa; Appropriations

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Costa Mesa Fincg Auth (Costa Mesa) 2017 lse rev bnds (Costa Mesa) due 10/01/2042		
Long Term Rating	AA+/Stable	Affirmed

Rating Action

S&P Global Ratings affirmed its 'AA+' long-term rating on the Costa Mesa Financing Authority, Calif.'s lease revenue bonds outstanding issued for Costa Mesa. The outlook is stable.

The lease revenue bonds are secured by lease rental payments by the city, as lessee, through a lease agreement with Costa Mesa Financing Authority, as lessor, for the use of the city's assets. Consistent with our "Issue Credit Ratings Linked To U.S. Public Finance Obligors' Creditworthiness" criteria, published Nov. 20, 2019, on RatingsDirect, we rate these obligations one notch lower than the city's general creditworthiness to account for the appropriation risk associated with the lease payments. The city has pledged its best efforts to seek appropriations annually out of its operating budget and has considered the affordability of the lease payments in its long-term plans. In our view, the lease features and terms identified in our criteria are standard, with no unusual risks regarding timely payment of debt. Under the agreements, the city can abate lease payments in the event the leased property is damaged or destroyed. To mitigate the risk of abatement in such a case, the city has agreed to maintain at least two years of lease interruption insurance as well as casualty insurance equal to the full replacement cost of the damages. Proceeds were used to refund the city's series 2007 COPs and partly finance the city's Lions Park Project.

The city's general creditworthiness is eligible to be rated above that of the U.S. sovereign. In our view, Costa Mesa would be unlikely to default in a stress scenario likely to accompany a sovereign default, given autonomy from sovereign intervention. We view the city as exhibiting relatively low funding interdependency with the federal government, as local taxes represent most of the total governmental funds revenue. However, consistent with our view that U.S. state and local governments are moderately sensitive to country risk, we would be unlikely to set issue ratings more than two notches above that on the U.S. sovereign.

Credit overview

Costa Mesa has long maintained a strong income and property wealth profile, and total assessed value declined modestly by approximately 2.2% during the Great Recession. However, the economy is primarily based on retail commercial business, mainly from its South Coast Plaza shopping mall, and the state's shelter-in-place orders resulting from the COVID-19 pandemic mean weaker performance from the city's sales taxes in fiscal 2019-2020. Although sales taxes account for the largest portion of the city's operating revenue, at 45%, property taxes account for 30%, and the city approved a formal reserve policy of a $55 million total general fund balance goal based on a risk study to mitigate potential shortfalls in sales tax revenue.

The stable outlook reflects our view of the city's very strong economy, coupled with very strong budgetary flexibility and very strong management profiles that will continue to anchor the city's goal to achieve and maintain stronger budgetary performance given the cyclical and volatile nature of its sales tax revenue. Our outlook is generally for two years, but we see potential downside risk as a result of the pandemic and recessionary pressure during the next 12 months.

The ratings further reflect our view of the city's:

- Very strong economy, with access to a broad and diverse metropolitan statistical area;
- Very strong management, with strong financial policies and practices under our financial management assessment methodology;
- Weak budgetary performance, with a slight operating deficit in the general fund and an operating deficit at the total governmental fund level in fiscal 2018-2019;
- Very strong budgetary flexibility, with an available fund balance in fiscal 2018-2019 of 35% of adjusted operating expenditures;
- Very strong liquidity, with total government available cash at 60.9% of total governmental fund expenditures and 34.4x governmental debt service, and access to external liquidity we consider strong;
- Strong debt and contingent liability position, with debt service carrying charges at 1.8% of expenditures and net direct debt that is 16.3% of total governmental fund revenue, as well as low overall net debt at less than 3.0% of market value, but a large pension and other postemployment benefit (OPEB) obligation; and
- Strong institutional framework score.

Environmental, social, and governance (ESG) factors

We analyzed the city's ESG risks relative to its economy, management, financial measures, and debt and liabilities profile. We believe that the city has elevated exposure to environmental risks, with earthquakes and wildfires--including the Silverado Fire on the southeastern edge of its neighboring city, Irvine--the most prominent. We think a newer building stock, most of which has been subject to improvements to the state's building codes as earthquake hazards to buildings became better known, partly mitigates the city's seismic risk. In addition, we believe the city has elevated social risks associated with the lack of international travelers that account for a large percentage of its sales tax revenue because of business closures and limited travel as a result of the pandemic. Finally, we also reviewed governance risks and consider them better than the sector standard because of the city's very strong management profile with strong financial policies and practices, and successful economic development efforts. The rating incorporates our view of the health and safety risks posed by the COVID-19 pandemic. Absent the implications of COVID-19, we consider the city's social risks in line with our view of the sector standard.

Stable Outlook

Downside scenario

We could lower the rating if the city is unable to manage its budgets, particularly in the event of continuing recessionary pressures or significant fluctuations in sales tax revenue, leading to a weakening of the city's budgetary performance and substantial drawdown on reserves to levels below those of similarly rated peers.

Credit Opinion

Very strong economy

We consider Costa Mesa's economy very strong. The city, with an estimated population of 116,655, is in Orange County in the Los Angeles-Long Beach-Anaheim metropolitan statistical area, which we consider broad and diverse. The city has a projected per capita effective buying income of 118% of the national level and per capita market value of $180,905. Total AV has grown annually for the past 10 years to approximately $22 billion. Although the county's unemployment rate rose sharply to 13.8% in April 2020 and peaked at 14.7% in May 2020, it subsequently declined to 9.9% for August 2020.

Costa Mesa encompasses approximately 17 square miles in the heart of Orange County, bordering the cities of Newport Beach, Irvine, Huntington Beach, Fountain Valley, and Santa Ana. Given the city's location along Interstate 405, residents have access to the greater Los Angeles and San Diego areas for employment. With its nationally recognized South Coast Plaza and its proximity to multiple beaches and John Wayne International Airport, the city receives many visitors throughout the year. The city continues to grow with several major business, housing, and retail developments, as well as a new museum, an Education First campus, and a new auto dealership underway.

For more information on our view of the U.S. economy, see our report "Economic Research: The U.S. Economy Reboots, With Obstacles Ahead," published Sept. 24, 2020.

Very strong management

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

Our view of the city's financial policies and practices reflects the following practices:

- The city utilizes a combination of historical trend analysis, outside consultants, and input from citywide departments to make revenue and expenditure assumptions. The city's trend analysis is based on a 15-year model and utilizes the HdL Companies service 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, which is updated annually.
- The city has a formal investment management policy, which the finance committee and council review 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 debt related to its capital improvement plan and operating budget.
- The city maintains a council-approved reserve policy of $14.1 million for declared disaster, $7.5 million for economic, and a $2.0 million self-insurance reserve requirements. 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.

Weak budgetary performance

We view Costa Mesa's budgetary performance as weak as a result of weaker operating performance in recent audited years following multiple years of strong results, mainly as a result of recurring inferfund transfers out. The city had a slight deficit operating results in the general fund of 1.3% of expenditures that includes $4 million in one-time spending to purchase a homeless shelter and a deficit result across all governmental funds of 3.6% in fiscal 2018-2019. Based on the city's unaudited estimates for fiscal 2019-2020, we anticipate that the general fund will yield a small net operating surplus that includes transfers out. The city adopted a budget for fiscal 2020-2021 with a net operating deficit of approximately 7.5% on a conservative basis, according to management. The adopted budget includes cost savings of approximately $13.8 million from employee furloughs and operating reductions. We understand the city is seeking other sources of operating revenue to mitigate the operating deficit. But as a worst-case scenario, the city has council approval to use $4 million of committed reserves and cut $6 million in capital improvement projects, according to management. This contingency plan would result in a significantly smaller operating deficit than budgeted.

Our assessment accounts for our view of the cyclical and volatile nature of sales tax revenue and that budgetary results could improve given the city's willingness to adjust budgets to mitigate potentially weaker sales tax revenue performance in fiscal 2020-2021 as a result of a weaker economic environment and the uncertainties associated with the COVID-19 pandemic. We note that these figures include multiple quantitative adjustments to treat recurring transfers out as expenditures for comparability with the city's peers.

Sales taxes accounted for approximately 45% of the city's general fund revenue in fiscal 2018-2019, and property taxes for approximately 30%, having collectively increased in each of the past several years. Primarily as a result of retail sales at South Coast Plaza and the city's various car dealerships, sales taxes have historically accounted for approximately 50% of the city's general fund revenue, making them what we consider a moderately concentrated revenue source. Officials are aware of the cyclical and volatile nature of sales tax revenue, as demonstrated by a significant drop in fiscal years 2007-2008 and 2008-2009 during the recession. As a result, the management team developed a risk-based study and the city approved a policy for a $55 million total general fund balance goal.

Very strong budgetary flexibility

Costa Mesa's budgetary flexibility is very strong, in our view, with an available fund balance in audited fiscal 2018-2019 of 35% of adjusted operating expenditures, or $51 million. We view the available fund balances inclusive of the city's $8.9 million assigned, $20.5 million unassigned, and $21.6 million committed funds totaling approximately $51.0 million. We note that adjusted operating expenditures include recurring transfers out.

The city conducted a risk-based study that analyzed the volatility of not just sales tax revenue, but also transient tax and property tax revenue, during the past few recessions. As a result, the council approved a total general fund balance goal of $55 million that consists of the declared disaster, self-insurance, and economic reserves, as well as the restricted and unrestricted fund balances. According to the June 30, 2020, unaudited estimates, the city's total general fund balance is $53.3 million. We understand the city has no plans to spend down available reserves, aside from the $4 million contingency plan, with its total general fund balance goal in mind.

Very strong liquidity

In our opinion, Costa Mesa's liquidity is very strong, with total government available cash at 60.9% of total governmental fund expenditures and 34.4x governmental debt service in fiscal 2018-2019. We view the city's access to external liquidity as strong based on its previous lease revenue bond issuance. We note the city has no direct purchase agreements, private placements, or variable-rate debt outstanding. We do not consider the city's investment portfolio aggressive.

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 1.8% of total governmental fund expenditures, and net direct debt is 16.3% of total governmental fund revenue. Overall net debt is low at 1.1% 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% of principal during the next 10 years. We understand the city has no plans to issue new money debt over the next two to three years.

Pension and other postemployment benefit (OPEB) liabilities

- In our view, the city has a large pension and OPEB liability, but the city has taken advantage of the California Public Employees' Retirement System (CalPERS) prepayment annual plan that saves an estimated $750,000 in annual pension costs, and approved a Section 115 Trust in January 2020 to help to reduce future pension liabilities.
- The city's OPEB liability is manageable, and we do not believe that it will be a source of significant budgetary pressure.

The city participated in the following plans funded as of June 30, 2019:

- CalPERS cost-sharing multiple-employer miscellaneous plan: $94.2 million in net liability, and 67% funded
- CalPERS cost-sharing multiple-employer police safety plan: $123.7 million in net liability, and 59% funded
- CalPERS cost-sharing multiple-employer fire safety plan: $75 million in net liability, and 73% funded
- Single-employer OPEB plan: $53.2 million in net liability, and 0% funded

In our opinion, a credit weakness is Costa Mesa's large pension and OPEB obligation. Costa Mesa's required pension and actual OPEB contributions totaled 15.9% of total governmental fund expenditures in fiscal 2018-2019, with 14.9% representing required contributions to pension obligations and 1.0% representing OPEB payments. The city's contributions translate into 60% of the pace needed to achieve minimum funding progress under our approach to assessing pension liabilities. In our view, a discount rate higher than our 6% guideline could lead to contribution volatility, but we view CalPERS' recent funding changes to a 20-year, level dollar amortization approach for new gains and losses, in line with our guidelines, as positive for credit quality. While this will lead to more immediate contribution increases, a shorter amortization period that no longer defers costs will provide a faster funding recovery following years of poor investment performance and upward revisions to the liability. Contributions to the OPEB liability are made on a pay-as-you-go basis, but as a result of previous contributions the city has nearly fully funded the liability.

Strong institutional framework

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

Related Research

- S&P Public Finance Local GO Criteria: How We Adjust Data For Analytic Consistency, Sept. 12, 2013
- Criteria Guidance: Assessing U.S. Public Finance Pension And Other Postemployment Obligations For GO Debt, Local Government GO Ratings, And State Ratings, Oct. 7, 2019
- Through The ESG Lens 2.0: A Deeper Dive Into U.S. Public Finance Credit Factors, April 28, 2020
- 2019 Update Of Institutional Framework For U.S. Local Governments