Fitch Ratings

Fitch Affirms San Diego County, CA's Pension Obligation and Lease Rev Bonds at 'AA+'; Outlook Stable

Fitch Ratings-San Francisco-15 March 2017: Fitch Ratings has affirmed the following ratings for San Diego County, California:

--Issuer Default Rating (IDR) at 'AAA';
--$649.9 million outstanding San Diego County pension obligation bonds (POBs) at 'AA+';
--$311 million San Diego County certificates of participation (COPs) and San Diego Regional Building Authority lease revenue bonds (LRBs) at 'AA+'.

The Rating Outlook is Stable.

SECURITY
The POBs are absolute and unconditional obligations of the county imposed by law, and are payable from all lawfully available funds. COPs and LRBs are supported by annually appropriated lease payments for use and occupancy of various leased assets, subject to abatement.

KEY RATING DRIVERS

The 'AAA' IDR incorporates the county's strong operating performance, supported by solid expenditure and revenue frameworks, as well as moderate long-term liabilities. Ratings on the county's POBs and lease debt are one notch lower at 'AA+', consistent with Fitch's approach for contractual obligations and appropriation-backed debt.

Economic Resource Base
San Diego County is the nation's fifth most populous county with over three million residents and 18 incorporated cities. The core industries of its diverse economy include manufacturing, the military and related defense industries, and tourism. The county's tax base has experienced steady growth over the long term with a 51% increase in assessed value between 2005 and 2017.

Revenue Framework: 'aa' factor assessment
Historical revenue growth has outpaced overall U.S. economic performance and Fitch expects continued out-performance based on above-average population growth. The county retains authority to increase fines and fees and other cost-based charges, but its legal ability to raise revenues is constrained by state constitutional provisions that require voter approval for tax increases.

Expenditure Framework: 'aaa' factor assessment
Based on the county's current spending practices and a history of above-average revenue growth, Fitch expects the natural pace of expenditure growth to be slower to equal with revenue growth. Expenditure-cutting flexibility is solid and fixed costs for debt service and pensions are moderate.

Long-Term Liability Burden: 'aa' factor assessment
Long-term liabilities for overall debt and pensions are moderate relative to the county's resource base.

Operating Performance: 'aaa' factor assessment
Solid reserve levels and limited revenue volatility contribute to exceptionally strong gap-closing ability that has increased during the current economic recovery.

RATING SENSITIVITIES
Financial Flexibility: The IDR is sensitive to shifts in fundamental credit characteristics, most notably Fitch's expectations for ongoing expenditure growth relative to available revenues.

CREDIT PROFILE

The county's population growth has been well above the national average, rising 6.6% between 2010 and 2015. Employment levels have increased steadily since 2010 while unemployment rates have fallen below 5%. Median home values have similarly improved and now match pre-recession levels.

Revenue Framework
Intergovernmental revenues accounted for about 57% of total general fund

revenues in fiscal 2016. Such revenues represent state and federal support for mandated health and human services programs managed by the county, including transfer payments as well as sales taxes reserved for public safety. General taxes provided about 29% of general fund revenues in fiscal 2016 and consisted primarily of property taxes.

The growth of total general fund revenues is heavily influenced by the county's receipt of intergovernmental revenues, which are largely determined by caseload trends as well as state and federal service mandates. Both total general fund revenues and locally generated revenues have increased more rapidly than inflation historically. Fitch expects these trends to continue based on ongoing population and tax base growth.

Like other California local governments, the county's independent legal ability to raise revenues is limited by state constitutional provisions requiring voter approval for tax increases. The county retains the ability to set fees and service charges at sufficient levels to recover costs and updates such items regularly as part of its annual budget process.

Expenditure Framework

Health and social services spending represents more than half of total general fund expenditures, with an additional 37% accounted for by public safety spending. Like other California counties, health and social services spending is largely funded from state and federal revenues while locally generated property tax provides the majority of support for public safety expenses.

Based on current spending practices, Fitch expects the natural pace of expenditure growth to be in line with to marginally above revenue growth in the absence of policy action.

The county's ability to reduce expenditures is solid, and is supported by moderate fixed costs for debt service and retiree benefits, which accounted for approximately 12% of governmental expenditures in fiscal 2016. The county's long-standing practices of funding capital needs from current resources, pre-payment of debt, and funding of other post-employment benefits (OPEBs) at actuarial levels provide ready sources of additional flexibility should the county need to reduce expenditures to address a budgetary imbalance.

Long-Term Liability Burden
Long-term liabilities, including net pension liabilities and overall debt, are at the low end of the moderate range relative to the county's resource base at approximately 10% of personal income. Debt issuances of overlapping jurisdictions account for about 80% of such liabilities. The county participates in the San Diego County Employees Retirement System and the plan's estimated ratio of assets to liabilities was about 75% in fiscal 2016 based on a Fitch-adjusted assumed investment return rate of 7%. The county closed its OPEB plan to new entrants in 2007 and its unfunded liability was reported at $152 million at the end of fiscal 2016, equal to a modest 0.1% of personal income.

Operating Performance
The county's gap-closing ability in a moderate recession scenario is very strong and is supported by solid reserves and a history of limited revenue volatility. Unrestricted fund balance of $1.7 billion was equal to nearly 46% of general fund spending at the end of fiscal 2016. Fitch expects that the county would reduce expenditures to offset revenue declines in a downturn, with limited use of reserves.

Budget management is conservative and the county has increased financial flexibility during the current economic recovery with regular additions to its already healthy reserves. The county's fiscal 2017 budget is balanced and management reports expectations of further additions to fund balance at year end.

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In addition to the sources of information identified in Fitch's applicable criteria specified below, this action was informed by information from Lumesis and InvestorTools.

Applicable Criteria

U.S. Tax-Supported Rating Criteria (pub. 18 Apr 2016) (https://www.fitchratings.com/site/re/879478)

Additional Disclosures

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