



Fitch Rates Los Angeles, CA's \$172MM GOs 'AA-'; Outlook Stable

Fitch Ratings-San Francisco-09 June 2017: Fitch Ratings has assigned a 'AA-' rating to Los Angeles, California (the city) bonds:

- \$87 million general obligation (GO) bonds, series 2017-A (taxable);
- \$83 million GO refunding bonds, series 2017-B (tax-exempt).

In addition, Fitch has affirmed the following ratings:

- Issuer Default Rating at 'AA-';
- \$720 million outstanding general obligation bonds, series 2005-B, 2006-A, 2008-A, 2009-A, 2009-B, 2011-A, 2011-B, and 2012-A at 'AA-';
- \$23 million outstanding judgment obligation bonds, series 2009-A and 2010-A at 'A+';
- \$1.5 billion outstanding Municipal Improvement Corporation of Los Angeles (MICLA) lease revenue bonds, series 2009-A, 2009-C, 2009-D, 2010-A, 2010-B, 2010-C, 2012-A, 2012-B, 2012-C, 2014-A, 2014-B, 2015-A, 2016-A, and 2016-B at 'A+'.

The Rating Outlook is Stable.

The 2017 GO bonds are scheduled to sell competitively on June 27. The purpose of the series 2017-A GO bonds is to finance housing for the homeless and those in danger of becoming homeless, and facilities to increase access to mental health care, drug and alcohol treatment, and other services. The series 2017-B GO refunding bonds will refund GO bonds, series 2005-B, 2006-A, and 2008-A for interest savings.

SECURITY

GO bonds are payable from ad valorem property taxes levied without limitation on rate or amount upon taxable properties within the city.

Judgment obligation bonds are payable from any legally available funds based on the city's absolute and unconditional obligation to pay principal and interest to refund an obligation imposed by law.

MICLA lease revenue bonds are payable solely from the city's lease rental payments for use and occupancy of various facilities and equipment. The city covenants to budget and appropriate sufficient annual debt and interest payments from any available source of funds, subject to abatement.

KEY RATING DRIVERS

The city's 'AA-' Issuer Default Rating is based on the city's solid revenue growth, adequate expenditure flexibility, moderate debt burden, and exceptionally strong gap-closing capacity. The city faces ongoing challenges arising from its limited ability to independently raise revenues, strong labor environment, multiyear remuneration increases, increasing pension system and other post-employment benefit (OPEB) employer contributions, judicial impediments to benefits reform, and growing service pressures.

Economic Resource Base

Los Angeles is the commercial and cultural center of a very large, diverse economy that continues to benefit from revenue, employment, and property market improvements. The city's wealth characteristics remain somewhat mixed, as would be expected for such a large urban area. Nevertheless, Fitch expects further economic and tax base growth.

Revenue Framework: 'aa' factor assessment

Revenue growth has been slightly below national GDP growth but above inflation, reflecting the city's ability to capture revenues from across its wide range of economic activity. However, the city's independent ability to raise revenues is limited by the state constitution.

Expenditure Framework: 'a' factor assessment

Over time, expenditure growth is expected to be roughly in line with, to marginally above, the city's strong revenue growth given rising employee salary and benefit costs and growing service pressures. Expenditure flexibility

is adequate. While there is labor contract flexibility, the labor environment can be contentious.

Long-Term Liability Burden: 'aa' factor assessment

The long-term liability burden is moderate relative to personal income.

Operating Performance: 'aa' factor assessment

The city has exceptionally strong gap-closing capacity relative to expected revenue volatility. Reserves in combination with the city's midrange inherent budget flexibility leave it well positioned to address future downturns. The city has made consistent efforts to retain financial flexibility but remains reliant on one-time funding to achieve annual budgetary balance even at a time of economic recovery.

RATING SENSITIVITIES

Sound Financial Management: Fitch expects that the city will continue to exercise sound budget management and maintain solid liquidity and reserves through the economic cycle.

CREDIT PROFILE

The city continues to benefit from economic expansion characterized by employment growth, business sector expansion, strong tourism growth, and numerous new construction projects, particularly downtown. Since minor recessionary losses in fiscal years 2010 and 2011, the city's assessed valuation has grown by a strong 32% through fiscal 2017, with further growth projected given rising values, new residential development, and good commercial sector performance.

Revenue Framework

A variety of taxes enable the city to translate its active economy into revenue, capitalizing on the city's size and economic diversity. In fiscal 2016, property taxes represented 37% of total general fund revenues, followed by utility users' taxes (13%), business taxes (10%), sales taxes (9%), and other taxes (12%). In recent years, the annual transfer from the power revenue fund has represented approximately 5% of annual general fund revenues. General fund revenues were relatively resilient (particularly property taxes) during the

recession, with solid post-recessionary growth.

Historically, the city's general fund revenues have slightly trailed national GDP but exceeded inflation. Relative to budget, general fund revenues underperformed in fiscal years 2016 and 2017, although the fiscal 2017 shortfall has been offset by one-time property sale proceeds. The city's multiyear projections assume revenue growth as a result of steady increases in employment, income, taxable sales, and tourism.

The city's independent legal revenue-raising capacity is limited by a variety of voter-approved state propositions. The key revenue flexibility for California cities are fees-for-services and fines. However, the city does not have a good record of expeditiously increasing its fees and charges, and parking fine revenues continued to underperform in fiscal 2017 due to staffing vacancies. The fiscal 2018 general fund budget includes revenues from billboard leasing and modernization agreements and a development linkage fee that are awaiting city council approval. Certain general fund revenue streams could be affected by council policy changes, particularly short-term rental tax revenues.

Given lower power sales, the fiscal 2018 general fund budget absorbs a projected \$49 million decline in the annual transfer from the power revenue fund. This annual transfer has long been a source of controversy but a recently negotiated resolution to litigation on the matter is now ready for court approval. The negotiated settlement is designed to provide budgetary assurance about the amount of the annual transfer in the future (approximately \$240 million annually, around 4% of budgeted fiscal 2018 general fund revenues).

Expenditure Framework

The city has demonstrated its ability to control expenditures. Between fiscal years 2009 and 2016, general fund expenditures grew by less than 8% compared to 13% general fund revenue growth. In fiscal 2016, approximately 61% of general fund expenditures were for public safety.

The city faces expenditure pressure. Moderate baseline spending growth will result from agreed-upon compensation increases in the city's multiyear labor

contracts, additional new positions, and new service priorities. Pension and OPEB contributions will likely rise at a faster rate than other expenditures. To manage its expenditure pressures, the city is focusing on limiting future employee cost increases, making resource allocation decisions based on performance-based budgeting in all departments, and limiting the backfilling of federal grant cuts. While the city considers backfilling on a case-by-case basis, grant-funded positions are "at will" under civil service rules, providing necessary flexibility.

General fund expenditure flexibility is adequate given the city's moderately high debt, pension, and OPEB carrying costs at 24% of governmental expenditures. Fitch expects that rising pension contribution costs will further pressure general fund expenditure flexibility in the future. The city's multiyear projections do not yet include these anticipated increases. Similarly, the multiyear projections do not include future compensation increases. Many of the city's labor agreements expire in 2018 and will need to be renegotiated.

Long-Term Liability Burden

The city's long-term debt and pension liability burden is moderate at approximately 14% of personal income.

The vast majority of the debt burden is generated by overlapping jurisdictions outside of the city's control (in particular the Los Angeles Unified School District and the Los Angeles Community College District). The city itself currently has limited new money debt issuance plans and has not yet decided whether to issue \$60 million in judgment obligation bonds to reimburse general fund reserves for recent higher than expected litigation settlement costs. The city has limited exposure to variable rate debt and no swap agreements are payable from the general fund.

In the longer term, the general fund direct debt burden could be affected by the need to fund projects to ensure Clean Water Act compliance if the city cannot secure voter approval for new funding sources. The city's share of such projects costs is estimated at over \$7 billion in the next 25 years.

The city's two pension systems report a combined \$7 billion net pension liability, an 11% increase over the previous year despite the city's consistent

funding of the actuarially required employer contributions. The actuarial liability is expected to grow, since both pension systems are considering lowering their investment rates of return and making actuarial assumption changes. Such actions will drive increased employer contributions from fiscal 2019 onwards (projected \$138 million increase in fiscal 2019 alone). Fitch estimates the combined net pension liability at a much higher \$15 billion using a more conservative 6% investment return assumption.

The county's unfunded actuarial accrued OPEB liability is approximately \$2 billion, affordable at around 1% of personal income. The liability related to the city's two police overtime banks (\$104 million) is gradually reducing as the city appropriates more funding for police overtime.

Operating Performance

The city has exceptionally strong gap-closing capacity. During the economic recovery in fiscal years 2012 to 2016, the city's general fund saw net operating surpluses after transfers, growing fund balances and reserves, and stronger liquidity. This was achieved in the face of increasing expenditures. The city ended fiscal 2016 with an unrestricted general fund balance of \$984 million or 19% of spending.

On a budgetary basis, the city's fiscal 2016 emergency and contingency reserves represented over 8% of general fund revenues, above its 5% policy goal. Adding the budget stabilization fund and unappropriated balance increased reserves to 10%. While struggling to meet its 5% reserves goal consistently throughout fiscal 2017, the city projects ending the year with emergency and contingency reserves of approximately 6%, rising to almost 8% when the budget stabilization fund is taken into account. The fiscal 2018 general fund budget assumes emergency and contingency reserves of 5% (7% including the budget stabilization fund).

The city's most recent multiyear general fund projections assume above-average revenue growth in fiscal 2018 due to one-time transfers and new ongoing revenues, and growth in line with the historical average thereafter. The projections also assume workforce size will remain constant after fiscal 2018 and no major increases to city services. The projections show an ongoing but manageable general fund structural imbalance through fiscal

2021 (not exceeding 2% of projected general fund revenues at its largest). They also show slightly better than breakeven operations in fiscal 2022, two to three years later than the city had previously projected. However, achievement of structural balance in fiscal 2022 remains vulnerable to both continued revenue growth and ongoing expenditure control. In particular, the projections do not include yet-to-be negotiated labor agreements and rising employer contribution costs for pensions and OPEBs.

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