

FITCH RATES SAN ANTONIO, TX LIMITED TAX BONDS 'AAA'; OUTLOOK STABLE

Fitch Ratings-Austin-26 July 2018: Fitch Ratings has assigned a 'AAA' rating to the following city of San Antonio, TX obligations:

- \$155.9 million general improvement bonds, series 2018;
- \$136.9 million combination tax and revenue certificates of obligation, series 2018;
- \$8.6 million combination tax and revenue certificates of obligation, taxable series 2018;
- \$28.9 million tax notes, series 2018.

In addition, Fitch has affirmed the following ratings that are linked to the city:

- Issuer Default Rating (IDR) at 'AAA';
- \$1.6 billion limited tax bonds at 'AAA';
- \$547.6 million public facilities corporation (PFC) lease revenue bonds at 'AA+';
- \$28.1 million municipal facilities corporation (MFC) lease revenue bonds at 'AA+';
- \$19.1 million Starbright Industrial Development Corporation (Starbright Project) contract revenue refunding bonds, taxable series 2013 at 'AA+'.

The Rating Outlook is Stable.

The current offerings are scheduled for a negotiated sale on July 31, 2018. Proceeds will be used to fund various public improvements.

SECURITY

The bonds, certificates of obligation (COs), and notes are payable from an annual property tax levy, limited to \$2.50 per \$100 assessed valuation (AV) for operations and debt service. The CO's are additionally payable from the net revenues (not to exceed \$1,000) of the city's municipal parks system.

ANALYTICAL CONCLUSION

The 'AAA' IDR reflects the city's strong revenue flexibility and growth prospects, minimal revenue volatility and superior financial resilience. These metrics offset the more moderate assessment of the city's expenditure framework that is driven by rapidly rising public safety spending. Voter-petitioned city charter amendments that are expected to be placed on the November 2018 ballot are likely to place limitations on the city's revenue and expenditure flexibility if approved. City responses that erode its superior financial resiliency could lead to negative rating pressure.

Economic Resource Base

San Antonio is the second largest city in the state and the seventh largest in the U.S. Prominent sectors include military and government, domestic and international trade, convention and tourism, medical and healthcare and telecommunications. Steady population growth is fueled by a favorable employment environment and ample developable land.

KEY RATING DRIVERS

Revenue Framework: 'aaa'

Diverse resources include utility revenues, property taxes, and sales taxes that support the city and are expected to yield continued strong gains due to rapid population growth and economic

expansion. The city's independent legal ability to raise property tax revenues provides ample flexibility.

Expenditure Framework: 'aa'

The city's adequate expenditure flexibility is derived from management's prudent budgeting practices and moderate but rising carrying costs, balanced against rapidly growing public safety spending driven by costly benefits. Recently realigned benefits for police officers are expected to help alleviate public safety spending pressure. The city has demonstrated a solid ability to cut spending during times of economic weakness and revenue decline.

Long-Term Liability Burden: 'aa'

Addressing the city's sizable deferred capital needs and needs related to overlapping issuers' growth are expected to be accompanied by commensurate growth in the area's resource base, allowing the liability burden to remain moderate. The city consistently funds its pensions at actuarially determined levels.

Operating Performance: 'aaa'

The combination of the city's expenditure cutting flexibility, revenue-raising authority, and minimal revenue volatility leaves it well positioned to address cyclical downturns. The city has demonstrated a commitment to prudent fiscal practices.

RATING SENSITIVITIES

Shift in Fundamentals: The IDR and bond ratings are sensitive to material change in the city's strong revenue and expenditure flexibility and operating performance. Fitch expects city financial practices to remain strong throughout economic cycles.

City Charter Amendments: The successful passage of city charter amendments that would make any ordinance subject to referendum and allow firefighters to unilaterally declare an impasse during CBA negotiations and require binding arbitration is likely to place limitations on the city's revenue and expenditure flexibility. City responses that do not sustain its superior financial position could lead to negative rating pressure.

CREDIT PROFILE

The local economy continues to expand rapidly with continued sector development in high technology, medical and healthcare, higher education and financial services, providing diversity beyond the military presence, which remains a major economic factor. Lackland Air Force Base, Randolph Air Force Base and Fort Sam Houston account for nearly 76,000 military and civilian personnel. These facilities benefited from very large investments and additions to troop strength in past base realignments. They also include high-value missions such as the sole medical school for all military medical personnel.

Large corporations that are headquartered within the city include: United Services Automobile Association (over 17,000 employees), Valero (IDR of 'BBB') and Rackspace. The expansive employment base remained resilient during the 2015-2016 downturn in drilling activity in the nearby Eagle Ford Shale. Fitch believes ongoing development of the area's oil shale resources combined with the current oil-price environment will continue to boost the area's energy sector and related sectors in construction/mining and manufacturing through the medium term.

The MSA's median home prices have grown by a compound annual average of 5.9% from 2012-2017, leading to a 2017 median of \$210,229. Building permit values have exceeded \$3 billion (2.7% of fiscal 2018 market value) annually since 2014. Property value appreciation and new construction have resulted in steady AV gains, averaging 8.5% over the past five years, including a 9.6% increase in fiscal 2018.

Revenue Framework

The city relies on a combination of utility revenues (33% of fiscal 2017 general fund revenues), property taxes (29%), and sales taxes (25%). Utility revenues are primarily from City Public Service (CPS; senior lien bonds rated 'AA+') plus a modest amount from the San Antonio Water System (SAWS; senior lien bonds rated 'AA+').

Historical revenue growth has been above the level of inflation and U.S. GDP growth. The city's revenues are projected to continue this trend given the rapidly expanding employment base and strong demographic trends.

With a current total tax rate of \$0.558, ample taxing margin remains under the \$2.50 per \$100 AV property tax cap for operations and debt service. If a proposed tax rate results in an 8% year-over-year levy increase (based on the prior year's values), the rate increase may be subject to election if petitioned by voters.

Utility revenue-raising flexibility is limited as CPS payments are capped at 14% of CPS' gross revenues per city ordinance and CPS' master indenture. The city council does, however, approve rate increases. Under the flow of funds for CPS utility revenue bonds, distribution of the 14% of gross revenues to the general fund is the fifth priority, preceded by operations and maintenance expenses, payment of parity bonds and reserves, payment of inferior lien obligations and a distribution to the repair and replacement account.

Expenditure Framework

Typical of municipalities, public safety leads as the city's largest expenditure. It is the city's goal and practice to cap public safety spending at 66% of expenditures and transfers out in order to avoid the crowd-out of other services.

The pace of spending growth absent policy actions is likely to be in line with or marginally above the natural pace of revenue growth as the city expands its service levels to accommodate a rapidly growing population and costly public safety health insurance benefits.

The city's fixed cost burden is moderate, with carrying costs for debt, pensions and OPEB equal to about 19% of fiscal 2017 governmental expenditures. Fitch expects the growth in debt service to cause overall carrying costs to increase over time but remain manageable given the city's goal and practice to maintain a level tax rate to fund its capital plans.

The framework for collective bargaining agreements (CBA) in Texas gives management control over police/fire hiring and firing and staffing patterns but requires that pay hikes and benefit levels be determined via CBAs. The CBAs for police and fire expired in September 2014, causing both groups to operate under an evergreen clause whereby the terms of the expired agreements, excluding pay hikes, are automatically renewed through September 2024.

Negotiations with the police and fire associations stalled as the city attempted to realign the costly benefits for police and fire employees and their dependents. Subsequently, the city filed a lawsuit claiming the expired CBA's 10-year evergreen clause is unconstitutional due to the length of the term. The lack of wage hikes in fiscal years 2015-2017 nearly offset the cost of the contested health insurance benefits.

In 2016, the Texas 4th Court of Appeals granted the city's request to mediate the lawsuit for police, leading to a five-year CBA that includes employee contributions for healthcare, a reduction in the evergreen clause to eight years from 10 years and a 17% pay increase from fiscal years 2017-2021. Additionally, employee health premiums are allowed to escalate during evergreen periods. Fitch

believes the agreement will help mitigate public safety spending pressures but notes that it lacks a provision for annual reopeners in the event economic conditions decline.

Court-ordered mediation of the evergreen lawsuit against the firefighters resulted in an impasse in April 2017. In August 2017, the Court of Appeals determined that the evergreen provision is not unconstitutional, leading the city to seek a review by the Texas Supreme Court. On June 22, 2018, the Texas Supreme Court decided that it would not hear the case. As a result, the city's five-year financial forecast assumes firefighters' salaries and benefits remain subject to the 2014 CBA and the city continues to invite the firefighters to negotiate.

The firefighters successfully conducted a campaign to place three petitions to amend the city charter which is expected to be on the November 2018 ballot. One petition lowers the threshold of signatures needed for a referendum to 20,000 from 70,000 and expands the timeframe for obtaining the signatures to 180 days from 40 days. It also seeks to expand the subjects of referendums to any ordinance before the city council, including those authorizing appropriations, levying taxes, setting utility rates and zoning. The second petition seeks to allow the firefighters to declare an impasse in collective bargaining unilaterally and to require binding arbitration upon the city. The third petition seeks to eliminate the city council's authority to determine the city manager's compensation, limit the city manager's term to eight years and require a supermajority to select the city manager. Fitch believes these petitions have the potential to greatly limit the city's revenue and expenditure flexibility and interfere with management's ability to operate the city. Successful passage of these petitions, particularly those that make any ordinance subject to referendum and allow the firefighters to require binding arbitration, would lead to negative rating pressure should the city be unable to effectuate effective responses.

Long-Term Liability Burden

The long-term liability burden, including overall debt and unfunded pension liabilities, is moderate at less than 17% of personal income and is comprised primarily of overlapping debt (about 60% of total). Given the city's goal to maintain a flat debt service tax rate, Fitch expects the liability burden to remain moderate as the city addresses its large deferred capital needs with measured debt issuance. Voters approved an \$850 million GO authorization in 2017 of which over \$580 million will remain after the current offerings. The city expects to issue the remaining authorization by 2021, along with additional COs and tax notes, assuming reasonable AV growth assumptions. The city's debt model includes \$925 million in GO bond authorizations in 2022 and 2027. The 10-year principal amortization rate for all tax-supported obligations and appropriation debt is average.

Civilian and certain public safety employees participate in an agent multiple-employer defined benefit pension plan administered by the Texas Municipal Retirement System (TMRS). Firefighters and police participate in a single-employer defined benefit pension plan administered by a separate board. The aggregate ratio of assets to liabilities equals nearly 80% and declines to less than 69% based on Fitch's adjustment for a 6% return assumption on investments. At \$1.9 billion, the Fitch-adjusted net pension liability equals 3% of personal income. Annual pension payments consistently meet the actuarially determined contribution.

Operating Performance

The city's financial resilience is derived from a combination of revenue and expenditure flexibility and minimal general fund revenue volatility. These credit strengths are expected to keep the issuer's reserve levels well above the 'aaa' financial resilience assessment during an economic downturn. CPS revenues have trended upward but are subject to some volatility due to swings in weather and natural gas prices. The relative stability of AV during downturns has provided steady property tax revenues. Sales tax revenues perform in line with the overall economy.

The fiscal 2017 audit posted a \$29 million (2.6% of spending) operating surplus, increasing its unrestricted fund balance to \$278 million, or 25% of spending. Management projects balanced operations for fiscal 2018.

In the wake of the last downturn, the city gradually increased its formal general fund balance policy to 10% of spending from 9% of spending and increased its two-year budget reserve to 5% from 3% of spending. The city annually appropriates its two-year budget reserve but annual operating surpluses have precluded utilization of the reserve since fiscal 2013. The city's five-year financial forecast projects continued maintenance of an aggregate 15% fund balance based on assumptions of moderate growth in AV, utility revenues, and sales taxes.

Appropriation Debt

The payment of debt service on the PFC and MFC lease revenue bonds and the Starbright IDC contract revenue bonds requires an annual appropriation by the city. The contract revenue bonds, unlike other appropriation debt, is payable solely from CPS' payments to the city's general fund. Coverage from pledged revenues on contract revenue bond debt service is very high.

Pursuant to an economic development contract between the city and the IDC, the city is unconditionally obligated to pay debt service on the contract revenue bonds. The payments are not subject to reduction, and the corporation covenants it will maintain the contract in full force as long as bonds are outstanding. Although no additional leveraging is planned, Fitch notes that additional bonds are allowed under the indenture.

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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. Public Finance Tax-Supported Rating Criteria (pub. 03 Apr 2018)

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