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Ratings

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## Summary:

# Los Angeles County Public Works Financing Authority, California
# Los Angeles County; Appropriations; General Obligation

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| Credit Profile | | |
|---|---|---|
| US$341.905 mil lse rev bnds (Los Angeles Cnty) ser 2020A due 12/01/2050 | | |
| *Long Term Rating* | AA+/Negative | New |
| Los Angeles Cnty ICR | | |
| *Long Term Rating* | AAA/Negative | Affirmed |

## Rating Action

S&P Global Ratings assigned its 'AA+' long-term rating to Los Angeles County Public Works Financing Authority, Calif.'s pro forma $341.905 million 2020 series A lease revenue bonds (LRBs; LACMA Building for the Permanent Collection Project), issued on behalf of Los Angeles County. At the same time, S&P Global Ratings affirmed its 'AAA' issuer credit rating (ICR) on the county, and its 'AA+' long-term rating and underlying rating (SPUR) on the county's existing appropriation debt. The outlook is negative.

The authority is issuing the 2020 series A bonds to finance a portion of the cost of construction of a new museum facility to house the Los Angeles County Museum of Art's permanent collection, and refinance $125 million of commercial paper (CP) notes that were previously issued to fund a portion of this construction project.

The 2020 series A LRBs are secured by semiannual lease payments made by the county to the authority. The rating is one notch below our view of the county's general creditworthiness to reflect our view of the risk of nonappropriation. The leased assets include the Broad Contemporary Art Museum, the Resnick Exhibition Pavilion, the Pritzker Parking Garage, and the Japanese Pavilion. These buildings meet our criteria for seismic risk during the life of the obligation, and the leased assets are sufficient to support debt service on the 2020 series A bonds. Upon completion of the project, the county intends to release these properties from the lien of the site lease and sublease, and substitute the project as the leased asset supporting the transaction.

Lease payments are payable from all available funds of the county and are subject to annual appropriation. The county is not funding a debt service reserve for the bonds; however, the debt service payments are well after the beginning of the county's fiscal year, mitigating the risk of nonappropriation due to late budget adoption. Lease payments are subject to abatement in the event of material damage to, destruction of, or condemnation of the leased assets, and the county covenants to maintain casualty insurance to the full insurable value of the property. The county also covenants to maintain rental interruption insurance in an amount equivalent to two times maximum annual debt service to mitigate abatement risk.

The ICR reflects our view of the county's general creditworthiness and does not incorporate the features of any particular debt instrument. The ICR reflects our view that the county's general creditworthiness is above that of the U.S. sovereign. This reflects our view that the county would not default in a stress scenario likely to accompany a sovereign default given autonomy from sovereign intervention. We view the county as exhibiting relatively low funding interdependency with the federal government, as local taxes represent the vast majority of 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 ratings on the county's obligations more than two notches above the U.S. sovereign rating.

## Credit overview

The negative outlook reflects our view of the county's challenges as it addresses financial pressures driven by the COVID-19 pandemic and associated recession. In particular, the county's budget for fiscal 2021 includes draws on reserves in the general fund as well as in the Department of Health Services (DHS) fund, which we believe indicates weakening financial performance and flexibility as the county adjusts to a starkly different future than projected before the pandemic. We acknowledge, however, that the county's financial performance for fiscal 2020 and budget for fiscal 2021 have meaningfully improved since our last review in June 2020. At the national level, S&P Global Economics believes that recent improvements in unemployment rates are likely the easier half of the jobs market recovery, and we do not expect the unemployment rate to reach its precrisis level until mid-2024. The reluctance of residents to return to their normal activities will likely dampen the pace of further improvements in local economic conditions, which could in turn lead to slow rehiring and a prolonged period with a county unemployment rate above 10%. We believe that the trajectory forward is also highly uncertain given the lack of an effective vaccine, and the rise in the number of COVID-19 cases reported across the country during the past few months that continues to slow or halt the reopening of local economies.

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

The ratings reflect our view of the county's:

- 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;
- Adequate budgetary performance, with a projected operating deficit in the general fund for fiscal 2021;
- Strong budgetary flexibility, with an available fund balance in fiscal 2019 of 17% of operating expenditures, but that we anticipate could decline if budgetary challenges persist into future fiscal years;
- Very strong liquidity, with total government available cash at 38.8% of total governmental fund expenditures and 33.7x governmental debt service, and access to external liquidity that we consider exceptional;
- Strong debt and contingent liability profile, with debt service carrying charges at 1.2% of expenditures and net direct debt that is 7.4% of total governmental fund revenue, as well as low overall net debt at less than 2.4% of market value, but a large pension and other postemployment benefit (OPEB) obligation and the lack of a plan to sufficiently

address the obligation; and

- Strong institutional framework score.

### Environmental, social, and governance (ESG) factors

We analyzed the county's ESG risks relative to its economy, management, financial measures, and debt-and-liability profile. Our ratings incorporate our view regarding the health and safety risks posed by the COVID-19 pandemic. Although wildfires have affected California, we do not consider fire within the county an immediate risk. The county also has elevated exposure to seismic risk; however, we believe this risk is mitigated in part by strong state building codes. Absent the implications of COVID-19, we consider the county's ESG risk to be in line with our view of the sector standard.

## Negative Outlook

### Downside scenario

Should the county's operations significantly deteriorate, with a weakening of both budgetary performance and flexibility, we could lower the ratings. We could also lower the ratings if the county's hospital and medical center operations deteriorate, weakening general fund performance. A weakened local economy, as demonstrated by persistently high unemployment rates above 10%, or pension and OPEB increases without corresponding increases in revenues or expenditure reductions could also pressure the ratings.

### Return to stable scenario

We may revise the outlook to stable if the county is able to return to budgetary balance without significantly drawing down reserves in the general fund and DHS fund, such as if the recovery from the pandemic and recession is quicker than projected or if the county receives substantial state or federal aid that offsets the need for reserve draws.

## Credit Opinion

### Strong economy

We consider the county's economy generally strong although currently experiencing reduced activity levels and high unemployment driven by social distancing and local business closures. With an estimated population of 10.2 million, Los Angeles County is in the Los Angeles-Long Beach-Anaheim, Calif., MSA, which we consider broad and diverse. The county has a projected per capita effective buying income of 96% of the national level and per capita market value of $171,967. The county's assessed valuation grew 6.0% during the past year to $1.7 trillion in 2021. However, the county's unemployment rate was 16.1% for August 2020, which is substantially elevated when compared with the annual unemployment rate of 4.4% in 2019. During the prior recession, unemployment rose to 11.5% in 2009 and remained above 10% through 2012. We understand that the county utilizes the UCLA Anderson Forecast, which previously predicted that the county's unemployment rates will remain above 10% for 2020 and 2021 before declining to 9% in the second quarter of 2022.

Los Angeles is the largest county in the U.S., by population. Assessed value (AV) has grown since fiscal 2011, with a 6.0% increase for fiscal 2021. The county experienced only a relatively minor dip in AV during the prior recession: a reflection of its large and mature property tax base coupled with Proposition 13 limitations on AV growth.

Similar to other large coastal areas of California, the county's housing prices and lack of affordable housing are a continuous concern. There are some indications that although the housing market is not retracting, growth is slowing. Management indicates that some slowdown may be beneficial to the county, as more residents are able to purchase homes; additionally, a large number of homes are assessed under 1975 valuations due to Prop 13, and therefore any turnover will be beneficial to county revenue.

The county has a large and growing technology sector known as the Silicon Beach, with more than 500 technology startup companies and major employers such as Google, Yahoo!, YouTube, BuzzFeed, Facebook, Salesforce, AOL, and Electronic Arts. The county also has a very large entertainment industry with major movie studios, television networks, recording studios, video game developers, publishers, and artists.

### Very strong management

We view the county'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 county uses state economic data and actual historical trends in revenue forecasting and reviews expenditures and revenue against budget monthly. It prepares a five-year revenue and expenditure forecast, as well as a seven-year long-term capital plan. The county has adopted a debt management plan and a written investment policy and prepares monthly investment performance reports that it submits to the county board. The county has set a goal of building 10% of locally generated revenues in a "rainy day" and economic reserve, and has budgeted a $53.5 million deposit in fiscal 2021 that will increase the rainy day fund balance to $695.9 million. Management also has a policy of setting aside 5%-10% of its discretionary revenue for contingencies, and has set aside about 10% for the past several years.

### Adequate budgetary performance

Los Angeles County's budgetary performance is adequate, in our opinion. While the county has produced consistent surplus operating results in the general fund and across all governmental funds during the past three audited fiscal years, we anticipate that it will likely report close to balanced operations for fiscal 2020, but a modest operating deficit for fiscal 2021.

The county's budgets tend to be conservative, underestimating tax growth and overestimating expenditures. The general county portion of the fiscal 2021 final adopted general budget is $738 million, or 2.6%, larger than the fiscal 2020 adopted budget, which is a reversal from the $981 million, or 3.5%, reduction that was budgeted in the fiscal 2021 revised recommended budget. The change between the two versions of the budgets is largely driven by additional state realignment backfill revenues and an updated sales tax projection. This is notable because the revised recommended budget included a 25% reduction in sales tax revenue reflecting reduced purchases during the "safer at home" period, and this reduction in sales tax revenue was driving a need for significant cost reductions. The county was able to eliminate the use of the rainy day fund in fiscal 2020 and fiscal 2021, but still plans to use about $197 million of one-time funds, equivalent to about 0.7% of expenditures, in fiscal 2021. AV grew 6.0% for fiscal 2021, which is only modestly less than the 6.3% growth experienced in the prior fiscal year. We understand that the county eliminated 2,556 budgeted positions in the fiscal 2021 final adopted budget, but no layoffs were required. County officials generally focus on balancing ongoing revenue with ongoing expenditures, and in 2017 received voter approval for a 10-year, 25-cent dedicated sales tax to fund homelessness initiatives.

We also anticipate that changes to federal health care spending could pressure operations, given the size of the county's health services department. The 2021 budget does not anticipate an increase in net county cost to subsidize the DHS fund; however, a significant federal overhaul in the next few years of the Affordable Care Act (ACA) could result in a cut to state and federal support for health services, which would be a challenge for the county. Since the advent of ACA, uninsured inpatient visitors fell below 10% as compared to about 25% prior to the implementation of ACA. This risk was somewhat mitigated, by the county's buildup of reserves in the DHS fund to $1.1 billion; however, we understand that the county plans to draw down $3 million and $245 million of these reserves in fiscal 2021 and 2022, respectively. In recent years, management has restructured DHS from a hospital-based to an integrated ambulatory care system, which we believe could position the county better than many to minimize the cost of adapting to changes in health care funding.

General fund and governmental fund revenue and expenditures were adjusted to account for recurring transfers to and from the county's hospital funds. In addition, the general fund expenditures were adjusted to account for recurring transfers to the library and various debt service funds. Taxes (primarily property taxes) represented 31% of the audited fiscal 2019 general fund revenue. The county's other major revenue streams were intergovernmental revenue from the federal government (20%) and state government (32%). Charges for services represented another 13%. Other smaller revenue sources included fines and forfeitures.

### Strong budgetary flexibility

In our view, the county's budgetary flexibility is strong. While the county was able to prudently set aside funds into reserves during the past several years, management plans to use $197 million of one-time trust accounts to balance the budget in fiscal 2021. According to the county's audited financial statements, it ended fiscal 2019 with $3.4 billion of reserves, equivalent to 17% of general fund expenditures. Although the county was able to add to the rainy day reserve in fiscal 2020 and has budgeted to do so again in fiscal 2021, we believe that the economic recovery remains fragile and that reserves could decline if weaker economic conditions persist and the county's budget is pressured.

We believe the county remains exposed to potential significant reductions in federal and state support for medical and health services, which could further reduce flexibility in the short term if they should materialize.

### Very strong liquidity

In our opinion, Los Angeles County's liquidity is very strong, with total government available cash at 38.8% of total governmental fund expenditures and 33.7x governmental debt service in 2019. In our view, the county has exceptional access to external liquidity if necessary.

Supporting our view of the county's exceptional access to liquidity is the fact that the county has issued various types of debt in the past 15 years, including LRBs, CP, assessment debt, and tax and revenue anticipation notes. In April 2019, the county restructured the LACCAL Lease Revenue Note Program, which consists of four separate bank letter of credit and reimbursement agreements authorizing the issuance of separate series of notes by each bank up to a maximum aggregate principal amount of $600 million. The county has $384.8 million of CP outstanding under this program, although the lease revenue bonds will refinance $125 million of the CP notes.

While the state allows for what we consider permissive investments, the county's own adopted investment policy is more conservative, and its current portfolio consists primarily of investments that we consider low risk, such as U.S. Agency securities, certificates of deposit, and CP with an 'A-1' rating.

### Strong debt and contingent liability profile

In our view, Los Angeles County's debt and contingent liability profile is strong. Total governmental fund debt service is 1.2% of total governmental fund expenditures, and net direct debt is 7.4% of total governmental fund revenue. Overall net debt is low at 2.4% of market value, which is in our view a positive credit factor. Given the county's large size and rapid amortization, we do not expect that this will weaken its debt metrics.

In our opinion, a credit weakness is Los Angeles County's large pension and OPEB obligation, without a plan in place that we think will sufficiently address the obligation. Los Angeles County's combined required pension and actual OPEB contributions totaled 10.5% of total governmental fund expenditures in 2019. Of that amount, 7.0% represented required contributions to pension obligations, and 3.5% represented OPEB payments. The county made its full annual required pension contribution in 2019, which exceeded our calculation for static funding, but fell short of our calculation for minimum funding progress.

County employees participate in the Los Angeles County Employees Retirement Assn., a cost-sharing multiple-employer plan that includes six employers, including the county and the Los Angeles Superior Court. The Governmental Accounting Standards Board funded ratio is 77.2%, which we consider adequate, and is based on a discount rate of 7.38%, which is higher than the 7.25% national average and well above S&P Global Ratings' guidance for a 6.0% rate.

We expect retirement liabilities to be a growing cost pressure due largely to a high discount rate, which puts pressure on investment returns to reduce annual contributions and could add volatility and budgetary strain. The county's actuarially determined contribution (ADC) is based on a 30-year, layered, level 3.25% of payroll amortization method, which we consider very aggressive. This method creates negative amortization, which means unfunded liabilities will likely grow in the near to medium term before large deferred contributions begin to pay it down.

We believe management is addressing the rising cost of retiree benefits. The county has been prefunding an OPEB trust for the past five years, but not at full ADC levels. The plan is under 5% funded, and the county expects to fully fund its OPEB ADC by fiscal 2028, which should increase funding over time. Until the ADC is funded, costs will continue to be deferred. Management has a multiyear plan to address the county's OPEB unfunded liability, including nominal ad hoc contributions in the past as well as liability management. After negotiations regarding new employees in 2018, dependents will no longer be included in retiree health benefits, which should reduce costs significantly, although affordability is still questionable given the continuing rapid increase to health care costs.

### Strong institutional framework

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

## Related Research

- 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

| Ratings Detail (As Of October 15, 2020) | | |
|---|---|---|
| Los Angeles Cnty (dept of pub social svcs facs) (AMBAC) | | |
| *Unenhanced Rating* | AA+(SPUR)/Negative | Affirmed |
| Los Angeles Cnty (Disney Concert Hall Pkg Garage) | | |
| *Long Term Rating* | AA+/Negative | Affirmed |
| Los Angeles Cnty (LAC-CAL equip prog) | | |
| *Long Term Rating* | AA+/Negative | Affirmed |
| Los Angeles Cnty (Multi Cap Proj II) | | |
| *Long Term Rating* | AA+/Negative | Affirmed |
| Los Angeles Cnty (MLK Hosp Proj) | | |
| *Long Term Rating* | AA+/Negative | Affirmed |
| **Los Angeles Cnty Cap Asset Lsg Corp, California** | | |
| Los Angeles Cnty, California | | |
| Los Angeles Cnty Cap Asset Lsg Corp lse rev bnds (Los Angeles Cnty) | | |
| *Long Term Rating* | AA+/Negative | Affirmed |
| **Los Angeles Cnty Facs Inc, California** | | |
| Los Angeles Cnty, California | | |
| Los Angeles Cnty Facs Inc (Los Angeles Cnty) (Vermont Corridor Cnty Admin Bldg) | | |
| *Long Term Rating* | AA+/Negative | Affirmed |
| Los Angeles Cnty Facs Inc (Los Angeles Cnty) (Vermont Corridor Cnty Admin Bldg) | | |
| *Long Term Rating* | AA+/Negative | Affirmed |
| **Los Angeles Cnty Pub Wks Fing Auth, California** | | |
| Los Angeles Cnty, California | | |
| Los Angeles Cnty Pub Wks Fing Auth (Los Angeles Cnty) (Master Rfdg Proj) | | |
| *Long Term Rating* | AA+/Negative | Affirmed |
| Los Angeles Cnty Pub Wks Fing Auth (Los Angeles Cnty) (Multi Cap Proj I) | | |
| *Long Term Rating* | AA+/Negative | Affirmed |
| Los Angeles Cnty Pub Wks Fing Auth (Los Angeles Cnty) (Multi Cap Proj I) | | |
| *Long Term Rating* | AA+/Negative | Affirmed |
| **Sonnenblick-Del Rio El Monte Asset Lse Corp, California** | | |
| Los Angeles Cnty, California | | |
| Sonnenblick-Del Rio El Monte Asset Lse Corp (Los Angeles Cnty) (AMBAC) | | |
| *Unenhanced Rating* | AA+(SPUR)/Negative | Affirmed |

Many issues are enhanced by bond insurance.

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed