

RATING ACTION COMMENTARY

Fitch Affirms Hayward, CA's COPs at 'AA'; Outlook Stable

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Fitch Ratings - San Francisco - 06 Oct 2020: Fitch Ratings has affirmed the following Hayward, CA (the city) ratings:

--\$64.8 million certificates of participation (COPs) (Capital Projects) at 'AA';

--Issuer Default Rating (IDR) of 'AA+'.

The Rating Outlook is Stable.

SECURITY

The COPs are repaid by the city's lease rental payments under a covenant to budget and appropriate annually. The lease rental payments are subject to abatement; however, the city maintains rental interruption insurance other than for seismic risk. The bonds are rated one notch below the city's IDR, reflecting the appropriation requirement.

ANALYTICAL CONCLUSION

The 'AA+' IDR reflects the city's strong revenue growth prospects, moderate long-term liability burden, moderately-elevated fixed costs, and consistently strong reserves relative

to expected revenue volatility and budget flexibility. Fitch expects the city will temporarily use some general fund reserves to offset near-term revenue losses, but then adjust spending to quickly rebuild reserves to current levels. The city has a strong record of maintaining reserves at approximately 20% of general fund spending while supporting its capital improvement program. An inability to quickly rebuild reserves, or sustained reserve levels below the current amount, could put negative pressure on the rating. The 'AA' COPs rating is one notch below the city's IDR to reflect the slightly higher degree of optionality associated with lease payments.

ECONOMIC RESOURCE BASE

The 63-square mile city is located in Alameda County on Interstate 880 between Oakland (14 miles north) and San Jose (26 miles south). The city has experienced modest population growth over the last decade to about 160,000 in 2019, and its residents have good access to various San Francisco Bay Area employment centers. The city's economic characteristics are mixed, particularly in relation to the wealthy region. Prior to the pandemic, the city's unemployment rate had been experiencing steady declines since the Great Recession and was recently in line with both the state and national rate.

KEY RATING DRIVERS

Revenue Framework: 'aa'

Over the long-term, Fitch expects continued strong revenue growth without tax increases or other revenue enhancements. The city's legal ability to raise revenues is constrained by state propositions which require voter approval for tax increases.

Expenditure Framework: 'aa'

Carrying costs associated with OPEB, pensions, and debt are moderate. The city has demonstrated the ability to manage spending in response to economic downturns and revenue declines. The pace of spending growth is likely to be in line with or moderately above that of revenues over time in the absence of policy action.

Long-Term Liability Burden: 'aa'

Debt and pensions are a moderate burden relative to personal income.

Operating Performance: 'aaa'

The city maintains the highest level of gap-closing capacity and benefits from low revenue volatility. Fitch expects the city to manage economic downturns while maintaining a high level of fundamental financial flexibility.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

--Substantial increase in the city's unrestricted fund balance above current levels that are sustainable through the cycle.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

--Indications of an inability to rebuild reserves following recovery from the current downturn, leading to weaker financial resilience and operating performance.

--A renewal of economic contraction, consistent with Fitch's coronavirus downside scenario, that triggers sustained and deeper than expected revenue declines and erodes the district's gap-closing capacity.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The

complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit [<https://www.fitchratings.com/site/re/10111579>].

CURRENT DEVELOPMENTS

Sector-wide Coronavirus Implications

The outbreak of coronavirus and related government containment measures worldwide has created an uncertain global environment for U.S. state and local governments and related entities. Fitch's ratings are forward-looking in nature, and Fitch will monitor the severity and duration of the budgetary impact on state and local governments and incorporate revised expectations for future performance and assessment of key risks.

While the initial phase of economic recovery has been faster than expected, GDP in the U.S. is projected to remain below its 4Q19 level until at least 4Q21. In its baseline scenario, Fitch assumes continued strong GDP growth in 3Q20 followed by a slower recovery trajectory from 4Q20 onward amid persisting social distancing behavior and restrictions, high unemployment and a further pullback in private-sector investment. Additional details, including key assumptions and implications of the baseline scenario and a downside scenario, are described in the report entitled, "Fitch Ratings Coronavirus Scenarios: Baseline and Downside Cases - Update"

(<https://www.fitchratings.com/research/sovereigns/fitch-ratings-coronavirus-scenarios-baseline-downside-cases-update-08-09-2020>), published Sept. 8, 2020 on www.fitchratings.com.

Coronavirus Effects on Hayward

Hayward provides a full range of services with roughly 70% of its general fund spending going towards public safety. The city benefits from property tax revenues approximating 30% of general fund revenues, but the city is also reliant on a sizeable amount of economically sensitive revenue sources. Sales tax, including the city's Measure C sales tax that contributes towards various capital projects, accounts for about 29% of general fund revenues. In fiscal 2019, transient occupancy taxes and real estate transfer taxes, the city's two other economically sensitive revenue sources, accounted for about 8% of general fund revenues.

The city ended fiscal 2019 with an unrestricted fund balance of about \$45 million or 22% of governmental expenditures and transfers out. Due to the pandemic, the city anticipated significant losses in its economically sensitive revenue sources and originally projected a possible \$14 million general fund reserve decline by the end of fiscal 2020. City management reports fiscal 2020 revenues performing better than expected resulting instead in a possible \$5 million reduction in available general fund reserves. Fiscal 2021 projections indicate reserves down nearly \$3 million.

Through the downturn, Fitch expects the city to maintain a high level of financial resilience by utilizing a combination of reserve spending and expenditures cuts. The city has identified spending reductions through elimination of vacant positions, hiring freezes, reduction of part time employee pay, and reducing other discretionary spending. Labor group concessions, including implementing furlough days and foregoing cost-of-living-adjustments in the pay increases, provided additional cost savings. City council also deferred transfers from the general fund to the city's capital project and OPEB funds to help close the gap. In fiscal 2021, the city has also received approximately \$2 million in CARES Act funding that was not originally budgeted. Management plans to use these funds to offset some general fund costs and FEMA reimbursements are also expected.

CREDIT PROFILE

Although the city's own employment base is somewhat narrow, it benefits from participation in the San Francisco Bay Area's diverse employment opportunities. Large city employers include government, California State University-East Bay, and midsize manufacturing firms, including bio-science, information technology firms and traditional manufacturers. The city's tax base has continuously grown since its recessionary low in fiscal 2011 and has positive growth prospects from natural AV growth and new development.

REVENUE FRAMEWORK

Approximately 85% of all general fund revenues are generated through taxes. The two largest revenue sources are property tax and sales tax, which account for approximately 30% and 29% of general fund revenues, respectively.

Fitch expects strong revenue growth consistent with historical performance. The ten-year compound annual growth rate for the city's revenues between fiscal years 2009 and 2019 was 5.7% - above both U.S. GDP growth and inflation. Much of this growth is attributed to policy action including voter-approved Measure C, a 20-year 0.5% sales tax increase enacted in fiscal 2014. In fiscal 2019, Measure C raised approximately \$15 million (9% of general fund revenues) for specific projects but the funds can be used for general fund purposes if needed. Without considering these policy changes, Fitch anticipates natural revenue growth will be near U.S. GDP based on the expectation of continued strong performance of property and sales taxes.

The city's ability to independently raise revenues is moderate. State tax limitations prohibit increases in the operating property tax rate, and other taxes can only be increased with a vote of the people. Policymakers' independent revenue raising flexibility is limited to fees and fines that make up only a moderate proportion of total general fund revenues.

EXPENDITURE FRAMEWORK

Hayward provides a full range of services including fire, police, library, parks and recreation, transportation planning and maintenance, and economic development. Public safety is the largest individual expenditure category, making up about 70% of general fund spending.

The natural pace of spending growth will likely be near to slightly ahead of natural revenue growth as a result of moderate increases in the cost of services and meeting the needs for a growing population.

The city's expenditure flexibility is adequate. Carrying costs related to debt service, pension, and other post-employment benefits (OPEB) were about 21% of governmental fund spending at the end of fiscal 2019. Nearly three-quarters of carrying costs relate to pension contributions. Fitch believes the carrying costs related to governmental spending are somewhat overstated due to the inclusion of the city's enterprise funds' pension costs. Changes in employer contribution rates enacted by CalPERS has caused pension costs to increase rapidly in recent years but year-over-year increases are expected to slow in the

near future due to employer contribution rates reaching the intended target. Nevertheless, Fitch expects carrying costs to remain moderately-elevated for the foreseeable future.

The city's labor negotiating framework is somewhat flexible. In the event of an impasse in union negotiations, the city follows state law by conducting a fact-finding process before city council imposes contract agreements on the last and best offer. Strikes are permissible for city employees except public safety workers. The city also contributes significantly to its capital project funds and to a lesser extent its OPEB fund. Transfers from the general fund could be temporarily curtailed to both the capital improvement plan and the OPEB fund, providing some level of additional flexibility if needed.

LONG-TERM LIABILITY BURDEN

The long-term liability burden (direct and overlapping debt plus the Fitch-adjusted net pension liability, or NPL) is currently moderate at approximately 18% of personal income. Overlapping debt and direct debt total roughly \$980 million, or approximately 11% of personal income. Pensions account for the remainder. Fitch expects the city's long-term liabilities to remain moderate based on increases in resident personal income and limited debt issuance plans.

The city offers fire, police, and miscellaneous pension systems administered through the California Public Employees' Retirement System (CalPERS). As of June 30, 2019, the district's combined proportionate share of the system's net pension liabilities was reported at about \$417 million. When adjusted by Fitch to reflect a 6% discount rate the NPL rises to an estimated \$596 million, or approximately 7% of resident personal income. Using this discount rate, Fitch calculates the assets to liabilities ratio currently standing at 55%.

OPERATING PERFORMANCE

The Fitch Analytical Stress Test (FAST) scenario analysis tool, which relates historical tax revenue volatility to GDP to support the assessment of operating performance under Fitch's criteria, has been adjusted to reflect GDP parameters consistent with Fitch's global coronavirus forecast assumptions. FAST is not a forecast, but it represents Fitch's estimate of possible revenue behavior in a downturn, based on historical revenue performance.

Fitch's current baseline scenario suggests the city may experience a decline of about 12% of general fund revenues during the downturn and slightly larger impacts in the downside scenario. The city has a strong record of maintaining unrestricted reserve levels at approximately 20% of general fund spending and transfers out. Fiscal 2019 unrestricted general fund reserves were approximately \$45 million, or about 23% of general fund spending. The fiscal 2019 reserves include the city's Measure C sales tax reserve fund which is set aside for capital improvement projects. The city is in the process of building a fire training center in partnership with a local community college district. A temporary use of reserves could be used for this project alongside other funds or financing opportunities.

Fitch expects the city to temporarily use some of its reserves to address the downturn and its current capital improvement program but then adjust spending accordingly to regain its existing level of financial flexibility once the economy recovers. Sustained reduced reserves after the recovery would put pressure on the rating.

The city's budget management in times of recovery is particularly strong, with increased tax revenues adding to the city's robust reserves. While much of the Measure C funds are prioritized for capital needs, upon completion of these projects the revenues collected can be used for general purposes based on the city council's discretion. The city also conducts long-range budget forecasting that focuses on maintaining structural budget balance while anticipating the long-term spending pressures from rising pension and OPEB costs.

CRITERIA VARIATION

None

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

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

RATING ACTIONS

ENTITY/DEBT	RATING			PRIOR
Hayward (CA) [General Government]	LT IDR	AA+ Rating Outlook Stable	Affirmed	AA+ Rating Outlook Stable
● Hayward (CA) /Issuer Default Rating - General Government/1 LT	LT	AA+ Rating Outlook Stable	Affirmed	AA+ Rating Outlook Stable
● Hayward (CA) /Lease Obligations - Standard/1 LT	LT	AA Rating Outlook Stable	Affirmed	AA Rating Outlook Stable

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APPLICABLE CRITERIA

[U.S. Public Finance Tax-Supported Rating Criteria \(pub. 27 Mar 2020\) \(including rating assumption sensitivity\)](#)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

[FAST States & Locals - Fitch Analytical Stress Test Model, v2.4.0 \(1\)](#)

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