

RatingsDirect®

Summary:

Berkeley, California; Appropriations; General Obligation

Primary Credit Analyst:

Savannah Gilmore, Centennial + 1 (303) 721 4656; savannah.gilmore@spglobal.com

Secondary Contact:

Li Yang, San Francisco + 1 (415) 371 5024; li.yang@spglobal.com

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Credit Profile

US\$45.0 mil GO bonds (2016 election: infrastructure and facs imp) (Berkeley) ser 2021 due 09/01/2051

<i>Long Term Rating</i>	AA+/Stable	New
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US\$3.725 mil lse rev bonds (2010 animal shelter financing) (Berkeley) ser 2021 due 10/01/2039

<i>Long Term Rating</i>	AA/Stable	New
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Berkeley GO

<i>Long Term Rating</i>	AA+/Stable	Affirmed
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Berkeley GO (BAM)

<i>Unenhanced Rating</i>	AA+(SPUR)/Stable	Affirmed
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Berkeley APPROP

<i>Long Term Rating</i>	AA/Stable	Affirmed
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Berkeley Jt Pwrs Fing Auth, California

Berkeley, California

Berkeley Jt Pwrs Fing Auth (Berkeley) 2012 rfdg lse rev bonds

<i>Long Term Rating</i>	AA/Stable	Affirmed
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Many issues are enhanced by bond insurance.

Rating Action

S&P Global Ratings assigned its 'AA+' long-term rating to Berkeley, Calif.'s 2021 general obligation (GO) bonds (2016 election: infrastructure and facilities improvements) (\$45 million in planned par). Additionally, S&P Global Ratings assigned its 'AA' long-term rating to the city's series 2021 lease revenue bonds (2010 animal shelter financing) (\$3.7 million in planned par). Finally, S&P Global Ratings affirmed its 'AA+' long-term rating and underlying rating (SPUR) on Berkeley's general obligation (GO) debt outstanding, and its 'AA' long-term rating on the city's certificates of participation (COPs) and lease revenue bonds (LRBs) outstanding. The outlook on all ratings is stable.

The 2021 GO bonds and outstanding GO bonds are secured by an unlimited ad valorem pledge on all taxable property in the city. The city has the power and obligation to annually levy these taxes for the bonds. Proceeds from the 2021 GO bonds will be used to repair, renovate, replace, or reconstruct existing infrastructure and facilities, including sidewalks, storm drains, parks, streets, senior and recreation centers, and other facilities and buildings. Following this issuance, the city will have \$20 million remaining under the 2016 Measure T1 authorization.

The series 2021 LRBs, as well as the LRBs and COPs outstanding, are payable from any source of available funds from the city to the Berkeley Joint Powers Financing Authority for use of real property in the city. The LRBs are a lease-leaseback agreement, whereby the city leases the property to the authority and the authority leases it back to the city. As provided in the lease for the LRBs and the 2010 COPs, payments are triple net, without right of set-offs, and

the city is responsible for maintenance, taxes, and utilities of the leased property. Base rental payments may be abated in the event of damage to, or the destruction of, the assets. To mitigate the risk of abatement in such a case, the city has covenanted to maintain at least 24 months' rental interruption insurance coverage, except with respect to earthquake coverage. In addition, insurance against loss or damage, for certain causes of loss equal to the lesser of 100% outstanding aggregate principal amount of the bonds or 100% replacement cost of all structures, is required under the lease. The transaction documents do not require the city to fund a debt service reserve. In accordance with our criteria, we do not view the lack of a debt service reserve as a significant credit weakness because the three-month lag between the start of the city's fiscal year (July 1) and the debt service due date (Oct. 1) mitigates late budget adoption risk. Our ratings on the city's LRBs and COPs are one notch below the city GO rating to reflect appropriation risk. Proceeds from the series 2021 LRBs will be used to primarily refund the city's outstanding 2010 COPs and related lease payment obligation. The city is planning to redirect the savings, which will be frontloaded, to the city's section 115 pension trust.

Credit overview

The city of Berkeley's credit quality is anchored by the city's desirable location on the San Francisco Bay in Alameda County, which helps strengthen its robust local economy with its participation in the broad and diverse San Francisco-Oakland-Hayward, CA MSA. Additionally, the presence of University of California Berkeley's campus serves as a stabilizing institutional influence for the local economy. Over the last decade, the city recognized significant growth in its assessed value, which also benefited the city's financial position. However, the COVID-19 pandemic led to direct impacts on various revenue streams and increased costs. In response to the budgetary impacts, the city worked to identify savings across numerous areas and utilize a portion of its reserves for fiscal 2021. Despite using a portion of its reserves, we expect the city will still maintain its very strong reserve position moving forward. The stable outlook reflects our expectation that reserves will remain very strong and that the city will continue making budgetary adjustments to navigate any further impacts from COVID-19 and the corresponding recession. While we expect the outlook to remain stable given the positive trend with vaccine rollouts, we recognize the potential for downside risk because of the uncertainty that COVID-19 presents during the next 12 months, specifically with its impact on certain city revenues and expenditures. For more information on the coronavirus' effect on U.S. public finance, see "Economic Outlook U.S. Q2 2021: Let The Good Times Roll," published on March 24, 2021 on RatingsDirect.

The ratings further reflect our view of the following credit characteristics of the city:

- Very strong economy, with access to a broad and diverse metropolitan statistical area (MSA) and a local stabilizing institutional influence;
- Strong management, with good financial policies and practices under our Financial Management Assessment (FMA) methodology;
- Adequate budgetary performance, with an operating surplus in the general fund and break-even operating results at the total governmental fund level in fiscal 2020;
- Very strong budgetary flexibility, with an available fund balance in fiscal 2020 of 46% of operating expenditures;
- Very strong liquidity, with total government available cash at 101.3% of total governmental fund expenditures and 27.7x governmental debt service, and access to external liquidity we consider strong;

- Very weak debt and contingent liability profile, with debt service carrying charges at 3.7% of expenditures and net direct debt that is 62.8% of total governmental fund revenue, as well as 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 factors

We believe that the city and county has elevated exposure to environmental risks, specifically in regard to earthquakes and sea level rise. The city has managed seismic risk through the use of robust building codes along with a program that allows residential property owners to use certain taxes payable to the city to retrofit properties, and is managing sea level rise through a project that will consider responses to various sea level rise scenarios. Social risk is also above average, in our view, with individuals experiencing homelessness and high housing costs that put more people at risk of homelessness, especially during economic downturns. We believe that housing and services for individuals experiencing homelessness will continue to impact expenditures and that it will remain a factor in the city's budget decisions, and expect affordable housing to be a use of debt proceeds, such as through the remaining amount under the city's Measure O authorization, in the future. We consider the city's governance risks in line with the sector standard.

Stable Outlook

Downside scenario

We could lower the ratings if the city's financial performance remains pressured by the effects of the COVID-19 pandemic, resulting in reoccurring operating deficits and a drawdown of reserves that are no longer in line with similarly rated peers.

Upside scenario

We could raise the ratings if the city significantly reduces its unfunded pension liability, while maintaining strong financial performance and its very strong reserves.

Credit Opinion

Very strong economy

We consider Berkeley's economy very strong. The city, with an estimated population of 122,580, is located in Alameda County in the San Francisco-Oakland-Hayward MSA, which we consider to be broad and diverse. The city also benefits, in our view, from a stabilizing institutional influence. The city has a projected per capita effective buying income of 165% of the national level and per capita market value of \$182,595. The county unemployment rate was 2.9% in 2019. Overall, the county's unemployment rate jumped to 14% in April, but dropped consistently through November 2020. Including preliminary data for December 2020, the annual average unemployment rate was 8.7% for the year.

Berkeley is located on the east side of the San Francisco Bay, approximately 10 miles northeast of San Francisco. The University of California, on the eastern side of the city, acts as a stabilizing institution and serves as a major

component of the city's economy, serving as one of the largest employers. In our view, the University of California's student population lowers income levels within the city.

The shelter-in-place orders in response to the COVID-19 pandemic led to direct impacts on the city's local economy. Negative impacts were felt on sectors such as performing arts, hospitality, and retail, but the city's innovation and tech sector smoothly transitioned to remote work requirements and even recognized growth in 2020. Management also indicated that the vaccine rollout has been smooth, which could help further increase economic activity moving forward. The University of California is also anticipating having many students return for in-person learning in fall 2021, which will likely allow the city to continue its trend of increasing economic activity that has been recognized through the spring.

Despite the pandemic, the city did not recognize any material changes in its property tax delinquencies, and assessed value grew by 7.7% from 2020 to 2021 to \$22.4 billion. Management indicated that purchasing activity for single family residences has remained strong, while rental prices have dropped. On a macro-level, S&P Global Economics expects the strong housing market may moderate in the future after the increase in mortgage rates and as higher building costs impact demand. For more information, see "Economic Outlook U.S. Q2 2021: Let the Good Times Roll" published on March 24, 2021 on Ratings Direct.

Strong management

We view the city's management as strong, with good financial policies and practices under our FMA methodology, indicating financial practices exist in most areas, but that governance officials might not formalize or monitor all of them on a regular basis. We revised our view of the city's management practices to good from strong, reflecting our understanding that management closely monitors budget-to-actuals on an internal basis, but that council does not review the information on a quarterly basis.

Highlights of the city's approach to financial management include:

- A budget formation process that incorporates historical revenue and expenditure trends, as well as some independent revenue forecasts;
- A biannual budget process with formal revision twice per calendar year, coupled with management monitoring of budget-to-actual results on a monthly basis;
- A five-year financial forecast that is updated annually;
- A five-year capital improvement plan, updated annually as part of the budget process, that identifies all known revenue sources to support potential projects;
- A formal investment policy that details permitted instruments and portfolio objectives and includes monitoring requirements with quarterly presentations to the council;
- A basic debt policy that includes some quantitative limits but does not include robust quantitative measures or benchmarks; and
- A minimum reserve and fund balance policy of 13.8% of general fund revenue, with a longer-term goal of 30%.

Adequate budgetary performance

Berkeley's budgetary performance is adequate in our opinion. The city had surplus operating results in the general fund of 2.4% of expenditures, and balanced results across all governmental funds 0.4% in fiscal 2020. The city has been operationally balanced, largely due to the city's robust economic growth in recent years. The city has experienced sizable positive net general fund results due to positive variation in revenue and lower than budgeted expenditures. The city's general fund is primarily made up of property taxes (47%), followed by business license taxes (10%), and sales taxes (8%).

However, the COVID-19 economic impact highlighted earlier led to direct financial impacts on the city. Revenue sources, such as transient occupancy taxes and sales taxes, recognized declines beginning in 2020. While the city adopted a formal biennial budget for the 2020 and 2021 fiscal years, its formal mid-biennial budget update incorporated specific adjustments in response to the projected \$39 million deficit for 2021. Specifically, the city instituted a hiring freeze for noncritical staff, cost deferrals, worked with departments to identify savings that range from 10-15%, and allocated \$11.4 million from reserves to help resolve the shortfall. Additionally, the city received roughly \$22 million in COVID-19 related funds to alleviate costs related to the pandemic. Given that the city anticipates revenue to be stronger than originally budgeted, it now anticipates that the use of reserves will drop to about \$8 million, but will still be at very strong levels according to our calculations.

Additionally, the city is expecting to receive \$68 million over the next two fiscal years from the American Rescue Plan, which we view as a positive credit factor given the flexibility associated with these funds. The city is also expecting to receive an additional \$2.7 million specifically for affordable housing and rental assistance programs.

In order to capture a clearer picture of routine governmental fund operations, we have adjusted general fund expenditures upward and the corresponding net transfers downward to reflect ongoing transfers out to various special funds to support operations and maintenance. We also adjusted general fund revenue and the corresponding net transfers in the past three audited years to reflect ongoing transfers in from the parking enterprise fund. Finally, we have adjusted one-time capital outlay out of total governmental fund expenditures.

Very strong budgetary flexibility

Berkeley's budgetary flexibility is very strong, in our view, with an available fund balance in fiscal 2020 of 46% of operating expenditures, or \$93.2 million. We expect the available fund balance to remain above 30% of expenditures for the current and next fiscal years, which we view as a positive credit factor.

The city maintains very strong reserves, and although management expects to use \$8 million for fiscal 2021, they will remain at very strong levels according to our calculations. Given that the city's reserve policy requires replenishment if reserves are used, management anticipates that it will focus on meeting that replenishment requirement over the next three years and does not have any additional plans to spend them down further.

Very strong liquidity

In our opinion, Berkeley's liquidity is very strong, with total government available cash at 101.3% of total governmental fund expenditures and 27.7x governmental debt service in 2020. In our view, the city has strong access to external liquidity if necessary.

We believe the city's investment policy restricts its ability to maintain an aggressive investment portfolio, and we have not identified any contingent risks that would jeopardize the city's liquidity. The city invests in money market funds, medium-term notes, commercial paper, and municipal bonds. We do not expect the city's liquidity position to deteriorate over the medium term, based on historical performance and a lack of identified material risks to liquidity.

Very weak debt and contingent liability profile

In our view, Berkeley's debt and contingent liability profile is very weak. Total governmental fund debt service is 3.7% of total governmental fund expenditures, and net direct debt is 62.8% of total governmental fund revenue.

The city's 2021 GO bonds are the second issuance under the 2016 Measure T1 authorization. Following this issuance, the city will have \$20 million left under this authorization. Currently, the city is planning to issue the remaining amount in 2024.

Additionally, the city has \$97 million remaining under its 2018 Measure O authorization, which was passed by voters specifically to address the city's housing challenges. According to management, the city will likely issue the remaining amount over three issuances, every other year, beginning in 2022. However, the sizing has not been determined, and will likely be finalized based on the city's capital needs.

Management also confirmed that the city has no alternative financing obligations.

Pension and OPEB highlights

- In our view, the city has a large pension and OPEB liability that is pressuring the city's operations, and while the city has made progress planning—including establishing a Section 115 trust—we don't yet believe the city has adequately planned for expected cost escalation.
- The city's pension funded status, combined with recent changes to assumed discount rate and amortization methods, will likely lead to accelerating costs in the medium term. However, we believe this approach will help the city make timely progress reducing pension liabilities.
- While the city is not making full actuarially determined contributions (ADCs) toward its OPEB liability, which will lead to significant contribution volatility over time, we believe Berkeley's pension costs represent a more urgent source of adverse credit pressure.

The city participates in the following plans funded as of June 30, 2019:

- California Public Employees' Retirement System (CalPERS) miscellaneous plan: about \$305 million in net liability, or 72% funded;
- CalPERS police plan: \$162 million in net liability, or 62% funded;
- CalPERS fire plan: \$80 million in net liability, or 72% funded; and
- Retiree Health Plan: single-employer OPEB plan with about \$61 million in net liability, or 33% funded.

In our opinion, a credit weakness is Berkeley's large pension and OPEB obligation, without a plan in place that we think will sufficiently address the obligation. Berkeley's combined required pension and actual OPEB contributions totaled 15.6% of total governmental fund expenditures in 2020. Of that amount, 14.6% represented required

contributions to pension obligations, and 1.0% represented OPEB payments. In our view, a discount rate higher than our 6.0% guideline could lead to contribution volatility that could stress the city's budget. We view recent funding discipline changes positively from a credit perspective, as CalPERS recently adopted a 20-year, level dollar amortization approach for new gains and losses, in line with our guidelines. While this will lead to more immediate contribution increases, a shorter amortization period that no longer defers costs going forward will provide a faster funding recovery following years of poor investment performance and upward revisions to the liability.

Strong institutional framework

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

Related Research

- SeismiCat Earthquake Model, May 4, 2018
- S&P Public Finance Local GO Criteria: How We Adjust Data For Analytic Consistency, Sept. 12, 2013
- Criteria Guidance: Assessing U.S. Public Finance Pension And Other Postemployment Obligations For GO Debt, Local Government GO Ratings, And State Ratings, Oct. 7, 2019
- Through The ESG Lens 2.0: A Deeper Dive Into U.S. Public Finance Credit Factors, April 28, 2020

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