S&P Global
Ratings

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Summary:

San Francisco City and County Redevelopment Agency; Miscellaneous Tax

Primary Credit Analyst:
Chris Morgan, San Francisco + 1 (415) 371 5032; chris.morgan@spglobal.com

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

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San Francisco City & Cnty Redev Agy hotel tax (AGM)		
Unenhanced Rating	AA(SPUR)/Negative	Affirmed
Many issues are enhanced by bond insurance.		

Rating Action

S&P Global Ratings affirmed its 'AA' underlying rating (SPUR) on San Francisco City and County Redevelopment Agency's hotel tax revenue refunding bonds, series 2011, of which $16.2 million is outstanding. The outlook is negative.

The bonds are limited obligations of the agency, payable from revenue generated from a 12% hotel tax levied on hotel guest rooms, less all amounts payable by the agency to the city tax collector and controller for administrative costs, located within certain redevelopment project areas. Proceeds paid for the refunding of the agency's series 1994 and 1998 hotel tax revenue bonds to achieve interest expense savings. The prior issuances funded improvements to the Moscone Convention Center in the city's South of Market (SOMA) district and the nearby Yerba Buena Gardens (a public park) and Mexican Museum, the latter of which later relocated out of the district.

Under our priority-lien tax revenue debt criteria, published Oct. 22, 2018, on RatingsDirect, we factor in both the strength and stability of pledged revenue and the obligor's creditworthiness. In this case we consider the City and County of San Francisco the obligor given its managerial and governance responsibility for the agency, which was reconstituted into the Office of Community Investment and Infrastructure (OCII) after the state required redevelopment agencies to disband and reconstitute if they had enforceable obligations.

Credit overview

Long a destination for business, convention, and leisure travel, San Francisco saw its hospitality industry profoundly damaged by the COVID-19 pandemic, with public health measures resulting in a major contraction in hotel demand starting in spring 2020. Hotels generally responded with lower rates, but occupancy still dropped precipitously and we understand that some sites temporarily closed. This led to what we think will be a rollercoaster pattern in pledged revenue, with an aggregate 89% drop during the past two fiscal years followed by a bounceback in fiscal 2022. Although the virtual suspension of many activities associated with the city's urban niche, such as restaurant visits and concerts, clearly buffeted its leisure economy, and evidence is scant that office workers have returned, a high local vaccination rates and the lifting of most public health measures in March 2022 have created the conditions for a recovery in lodging activity. Market data and monthly pledged revenue performance suggest that the worst is over in terms of revenue, as it appears to us that revenue will cover maximum annual debt service (MADS) by at least 5x for fiscal 2022, or a threefold increase from 1.7x last year, although this is still below the stratospheric 15.3x ratio in fiscal

2019.

The rating further reflects our opinion of the city's:

- Adequate economic fundamentals, with a location in one of the nation's strongest economies with a long-standing role as a convention and tourism destination but a smaller patchwork taxing area that encompasses most of the city's major hotels in and around downtown;
- High concentration among hotel tax generators based on the number of rooms by site (as opposed to revenue) as of the agency's 2011 offering;
- Moderate-to-high pledged revenue volatility underlying bond payments that we now think will tend to slightly exceed historical hospitality tax revenue experience nationally; and
- Expected return to extraordinarily strong coverage in fiscal 2022, coupled with what we understand is an inability to issue additional obligations except for refunding purposes under state law.

Environmental, social, and governance

We consider the agency's hotel tax revenue pledge exposure to environmental risks, with earthquakes and sea level rise the most prominent within San Francisco. The city has managed seismic risk through the use of robust building codes, and is managing sea level rise through an assessment of vulnerable areas and capital improvements that have included debt-financed seawall construction.

Social risk is also above average, in our view, with a long-standing significant population of people experiencing homelessness and high housing costs that put more people at risk of homelessness, the visibility of which features prominently in visitors' concerns. The COVID-19 pandemic also has demonstrated the vulnerability of the local hotel market to a substantial disruption in intercity travel and reduced demand for urban activities.

We don't consider governance risk associated with this pledge material, with a well-established tax collection and distribution system. More governance risk is associated with the City and County of San Francisco, as obligor, but we see the city's governance profile as in line with our view of the sector standard, with robust political debate but a functional decision-making process and what we find is timely and public document disclosure regarding policy and budgetary challenges.

Negative Outlook

Downside scenario

Although we think a full recovery in pledged revenue will take at least two years, we could lower the rating if we saw evidence in the next year that MADS coverage were unlikely to recover substantially from fiscal 2021, which could occur in the event of a resurgence in pandemic conditions that spurred public health measures.

Return-to-stable scenario

We could revise the outlook to stable during the next year if pledged revenue increased substantially in fiscal 2022, particularly if MADS coverage exceeded our 4x threshold for extraordinarily strong coverage, and if increased travel activity and continued low ebb in COVID-19 cases pointed to room for additional growth in pledged revenue in the intermediate term.

Credit Opinion

Economic fundamentals: Adequate

San Francisco is the historical center of the nine-county Bay Area and a long-standing major convention and tourist destination, and rivaled Silicon Valley for information technology employment growth during the 2010s, but the future of local office demand is very much in question. Per capita effective buying income is very strong but housing costs have long been a barrier to growth. The COVID-19 pandemic appears to have at least temporarily reversed population gains during the past decade, with the U.S. Census listing the city, which is also a county, as seeing the sixth-largest decline among U.S. counties in gross population loss from July 2020 to July 2021. We think this loss is likely to partly reverse during the next two years, as rental rates started to creep back up in 2021 and the relaxation of public health measures appears to be bringing back demand for urban leisure activities.

Pledged revenue comes from a patchwork of six redevelopment "project areas" that the OCII's predecessor set up for focused community development investments. The project areas center on the city's downtown, including Market Street and the SOMA district, where the city's convention center is located. However, they exclude tourist anchors such as Union Square and Fisherman's Wharf and the rapidly developing Mission Bay District. The latest comprehensive hotel data in terms of number of rooms (rather than revenues) date back to 2011, when the 10 largest hotels accounted for 98% of the project areas' aggregate room count. Pre-pandemic development pipeline inventories suggested as many as 20 hotel sites could be built in the coming years, but we think taxpayer concentration likely remains high.

Volatility: Moderate-to-high

We assess the volatility of revenue to determine the likelihood of the availability of revenue during different economic cycles. We have two levels of volatility assessment: macro and micro.

On a macro level, we consider lodging tax revenue moderately volatile, with sensitivity to economic cycles. On a micro level, the COVID-19 pandemic has revealed the agency's pledged revenue volatility to be above average, with an 89% aggregate loss in fiscal years 2020 and 2021, but we also think a similar set of revenue-suppressing circumstances is unlikely to recur.

Coverage and liquidity: Very strong

Because the agency's pledged revenue relative to MADS prior to the pandemic reached one of the highest ratios among lodging tax obligations that we rate, an 86% drop in fiscal 2021 (to $8.1 million) was not sufficient to require the agency to draw on its reserve fund. We calculate coverage of MADS at 1.7x that year and, based on year-to-date actual results, we anticipate that coverage will measure at least 5x MADS for fiscal 2022 and possibly reach 8x. (The city's most recent fiscal 2022 citywide hotel tax revenue estimate suggests coverage on the low end of this range.) A full recovery is unlikely to occur before fiscal 2024, in our view, given a resurgence in COVID-19 cases in Asian countries that is likely to slow the recovery in international tourism, but a reduction in public health controls appears likely to further fuel a resurgence in hotel occupancy and room rates associated with domestic leisure and business travel in fiscal 2023.

Series 2011 bond provisions include a historical 3x MADS additional bonds test, which we consider very strong, but a more relevant constraint, in our view, is the state's redevelopment agency dissolution law, which we understand rendered OCII effectively unable to issue new hotel tax revenue bonds.

Obligor linkage: Close

Under the hotel tax ordinance and a tax administration agreement between the city and county and OCII as successor to the redevelopment agency, the city collects pledged revenue on the agency's behalf and transfers proceeds to a trustee on a monthly basis until the trustee has a sufficient amount to cover principal and interest (and to refill a reserve fund, if needed).

We consider pledged revenue subject to operating risk of the city and county because OCII operates within the city and county's administration, including treasury management, and because the city and county's mayor appoints four of its seven oversight board members. (The region's commuter rail district, the local school district, and the local community college district appoint the remaining three. A separate mayor-appointed commission oversees OCII's development projects and certain former redevelopment agency assets.)

Rating linkage to San Francisco

Although the pandemic has damaged San Francisco's hospitality industry, continued growth in owner-occupied residential real estate prices and an established recovery in residential rental rates suggest that the local economy has found its footing as public health controls are lifted. Moreover, robust investment returns that have lessened growth in anticipated pension contributions in the coming years and federal grants to local governments are making officials increasingly confident that budgetary pressures are easing. An important question is how established remote work cultures and policies have become, as the city would likely see a slow recovery in tax revenue derived from a business' locally based payroll and locally generated gross receipts if office workers don't return in large numbers.

Related Research

- Criteria Guidance: Priority-Lien Tax Revenue Debt, Oct. 22, 2018
- Through The ESG Lens 3.0: The Intersection Of ESG Credit Factors And U.S. Public Finance Credit Factors, March 2, 2022