FitchRatings

Fitch Rates Riverside County (CA) $76MM Teeter Notes 'F1+'

Fitch Ratings-San Francisco-18 September 2018: Fitch Ratings has assigned an 'F1+' rating to the following Riverside County, California obligations:

--$76 million 2018 Series A Teeter Obligation Notes (Tax-Exempt).

The 2018 notes will sell via negotiation on or around October 24. Proceeds will be used to refund the 2017 series A notes and fund an advance of unpaid property taxes for agencies participating in the county's Teeter Plan.

SECURITY

The notes are payable from the delinquent property taxes and proceeds from the sale of tax-delinquent properties, and have been legally validated as a binding obligation of the county. They are additionally payable from any lawfully available moneys from the county's general fund.

ANALYTICAL CONCLUSION

The 'F1+' note rating reflects the county's long-term general credit quality correlating to the county's Issuer Default Rating (IDR) of 'AA-' and the notes' sound security structure.

Economic Resource Base

Riverside County's economy is large, diversified and well-situated for long-term growth. It has an affordable housing stock relative to the region, capacity for additional development, proximity to employment centers including San Bernardino, Orange County, and Los Angeles, and a location along a major distribution route. The county experienced considerable housing market and tax base volatility as one of the worst-affected regions in the country during the economic downturn. However, both the housing market and assessed values have improved significantly over the past several years, and a large amount of state revenue in the budget moderates the effect of this cyclicality on overall revenues.

KEY RATING DRIVERS

Revenue Framework: 'a'

Growth in discretionary general fund revenues has been above inflation but below that of the US economy, and Fitch expects that trend to continue. State law limits the county's independent ability to raise revenues to permits, fines and charges for services.

Expenditure Framework: 'aa'

Carrying costs for debt and retiree benefits are relatively low, but likely to rise given the trajectory of pension contributions. The county has demonstrated its solid flexibility to make significant staffing cuts when needed through layoffs and furloughs. Fitch expects the pace of spending growth in the absence of policy action to be above growth in revenues, driven primarily by salaries and benefit costs.

Long-Term Liability Burden: 'aa'

The county's overall debt and pension burden, the bulk of which comes from overlapping debt, is

moderate relative to personal income and Fitch expects it to remain in this range.

Operating Performance: 'aa'
The county maintains very strong gap-closing capacity as evidenced by robust reserve levels relative to solid spending flexibility and moderate expected revenue volatility. Given its limited ability to raise revenues, the county's ability to manage its expenditure growth and maintain solid reserves are critical to maintaining its strong financial resilience.

RATING SENSITIVITIES

Ability to Control Spending: Continued ability to control rising costs in light of very limited revenue flexibility and solid expected revenue growth is key to maintaining the rating at the current level.

CREDIT PROFILE

The county is the fourth largest in the state covering 7,177 square miles with a population of approximately 2.39 million. It is a high-growth region with less maturity than its coastal neighbors; as such, the county is likely to experience higher than average economic volatility over the foreseeable future.

Revenue Framework
State and federal health, social services, and criminal justice pass-through funds comprise a substantial portion of the county's budget, as is typical for California counties. The county's non-discretionary general fund revenues are primarily provided by state and federal funds, which account for an estimated 64% of the fiscal 2019 budget. Discretionary revenues comprise about 24% of the county's fiscal 2019 total general fund revenues and are primarily generated by property taxes.

Growth in total general fund revenues has been generally above U.S. economic performance. However, excluding state and federal funds, growth in general fund revenues is just in line with inflation. Property tax revenues have increased in each of the last five years, with assessed value increasing 5.5% in fiscal 2018. The county's fiscal 2019 budget includes general fund discretionary revenues of $799.5 million, including $18.5 million of general fund reserves, a roughly 4% increase over the fiscal 2018 budget.

The county has limited capacity to independently raise revenues under state law, particularly Proposition 13, which fixes the countywide property tax rate at 1% and limits assessment growth to no more than 2% per year absent a change in ownership, as well as Proposition 218, which requires voter approval for new or increased general taxes.

Expenditure Framework
Discretionary spending is focused on public safety, which accounts for about 78% of the discretionary fiscal 2019 budget, followed by public assistance at 5.5% and health and sanitation at 3%. Strong support for public safety spending, in combination with its large role in the county's discretionary budget, can challenge expenditure flexibility in periods of revenue shortfalls.

The pace of spending growth is likely to be somewhat higher than that of revenues in the absence of policy action. The county projects structural deficits through fiscal 2021, in declining amounts each year, due to rising pension costs and increased correctional operating costs arising from the opening of a new jail and the settlement of class action litigation regarding inmate health care.

The county's fixed cost burden is relatively low, with carrying costs for debt, pensions, and retiree healthcare accounting for 10% of fiscal 2017 governmental spending. However, Fitch's supplemental

pension metric, which estimates the annual pension cost based on a level dollar payment for 20 years with a 5% interest rate, indicates that carrying costs are vulnerable to significant future increases. For more information, see Fitch's special report "Revised Pension Risk Measurements (Enhancing Pension Analysis in U.S. Public Finance Tax-Supported Rating Criteria)" dated May 31, 2017.

Labor relations with some employee groups continue to be pressured. The county's employees are represented by six labor organizations; the largest two: SEIU and Laborers' International Union of North America (LIUNA), represent about 72% of all county employees. Contracts with SEIU, LIUNA and the Riverside Sheriff's Association (RSA) expired in June 2016. The county reached an impasse and is currently in the fact finding phase with SEIU and LIUNA with no firm date for resolution. SEIU implemented a two-day strike in early September 2017. Members of the Riverside Sheriff's Association (RSA) unit rejected a tentative agreement with the county in October, after which the county imposed its last, best and final offer. According to the county, the primary negotiation issues relate to merit increases. The county is also in negotiations with two smaller bargaining units whose contracts have also expired.

The county has the authority to ultimately impose terms and contracts if agreement is not reached, as occurred with RSA. In addition, the county has demonstrated its capacity to implement layoffs and furloughs in times of revenue decline; however, an inability to continue to control labor costs in light of other cost demands could put negative pressure on the rating.

The county estimates the ongoing cost of an inmate class action lawsuit settlement at about $40 million per year. This amount compares to fiscal 2019 general fund discretionary revenues of $799.5 million and overall budget of $5.6 billion. Management has identified offsets to this additional outlay, including adjusting and delaying staffing for the new John J. Benoit Detention Center and establishing a requirement for county departments to absorb any staffing cost increases. In addition, the county continues to implement recommendations from a Strategic Plan for Criminal Justice produced by KPMG Consulting for the county and a preliminary jail utilization report provided by California Forward, a bipartisan governance reform organization. The county expects implementation of both to result in considerable costs savings, as well as revenue recovery.

Long-Term Liability Burden

The county's overall debt and pension liabilities are moderate, estimated at 18% of personal income. Debt is primarily in the form of overlapping debt ($10 billion), with net direct debt of $1.2 billion.

The county offers five pension plans through CalPERS. The county's ratio of assets to pension liabilities based on a Fitch adjustment to a 6% return assumption is 58%, for an adjusted net pension liability of $5 billion (5.6% of personal income). The county's OPEB liability is negligible at just $9 million.

Operating Performance

The county's very strong gap-closing capacity is derived from its ability to manage spending, relatively low expected revenue volatility and available reserves. The unrestricted general fund balance at year-end fiscal 2017 was $251 million, or 8.1% of total general fund spending and the county expects fiscal 2018 results to show a modest increase to unrestricted balance. Fitch expects that the county would maintain reserves at solid levels throughout a moderate economic downturn, primarily by adjusting spending.

To balance the fiscal 2019 budget, most departments were directed to make 4% cuts to their allocation of discretionary county revenue by using departmental reserves and eliminating unfilled positions.

The general fund discretionary reserve was budgeted at $179 million (or about 22% of discretionary revenues) for fiscal 2019. The county expects to begin adding to reserves in fiscal 2022 to meet its board

policy reserve target of 25% of discretionary revenue. Spending restraint will be required in order to meet that target, given expected increased costs for salaries and benefits, uncertainty about future homecare worker costs, and operating costs related to the new correctional facility. In addition, the county will face the challenges of absorbing settlement costs associated with the inmate class action lawsuit mentioned earlier, additional health and mental health professional staffing, and managing exposure to its hospital operations (particularly in the evolving healthcare environment)

Fitch is concerned that several years into the economic expansion, the county is still forecasting deficits, albeit modest, through fiscal 2021. Notably, the five-year forecast does include remediation strategies. The county will need to use its expenditure flexibility to maintain its financial flexibility.

Contact:

Primary Analyst
Karen Ribble
Senior Director
+1-415-732-5611
Fitch Ratings, Inc.
One Post Street,
San Francisco, CA 94104

Secondary Analyst
Stephen Walsh
Director
+1-415-732-7573

Committee Chairperson
Steve Murray
Senior Director
+1-512-215-3729

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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.

Media Relations: Sandro Scenga, New York, Tel: +1 212 908 0278, Email: sandro.scenga@fitchratings.com

Additional information is available on www.fitchratings.com

Applicable Criteria

U.S. Public Finance Short-Term Debt Rating Criteria (pub. 01 Nov 2017) (https://www.fitchratings.com/site/re/905637)
U.S. Public Finance Tax-Supported Rating Criteria (pub. 03 Apr 2018) (https://www.fitchratings.com/site/re/10024656)

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