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Rating Update: MOODY'S DOWNGRADES TO A2 FROM Aa2 THE CITY OF FRESNO'S LONG TERM ISSUER RATING; REVISES OUTLOOK TO NEGATIVE FROM STABLE. MOODY'S ALSO DOWNGRADES THE CITY'S PENSION OBLIGATION BONDS TO A3 FROM Aa3 AND LEASE REVENUE BONDS TO Baa1 FROM A1

Global Credit Research - 19 Oct 2011

AFFECTS $477 MILLION OF RATED DEBT

Municipality
CA

Opinion

NEW YORK, Oct 19, 2011 -- Moody's Investors Service has downgraded to A2 from Aa2 the Issuer Rating of the City of Fresno. Moody's has also downgraded the City's pension obligation bonds to A3 from Aa3 and the City's lease revenue bonds to Baa1 from A1. The outlook on the ratings has been revised to negative from stable.

RATING RATIONALE

The downgrade reflects the city's materially weakened financial position, exposure to a fragile local economy and limited ability to absorb additional budgetary pressure. The city's high fixed cost burden and increasing general fund subsidy for underperforming enterprise assets further constrain its flexibility. The A2 rating incorporates the city's favorable position as the economic center of the San Joaquin Valley, comparatively resilient assessed valuation and well-funded pension system. The city's moderate post-employment benefit obligation is also a positive consideration. The negative outlook reflects the emergence of a general fund budget gap in the current fiscal year, the possibility of continued economic weakness and the city's now limited options for managing continued financial pressures given its very weak financial reserves.

STRENGTHS

- Sizable, comparatively resilient assessed valuation relative to market prices

- Increased transparency and financial discipline with regard to enterprise risks

- Economic center of the San Joaquin Valley

CHALLENGES

- Significantly limited financial flexibility

- High general fund fixed cost burden

- Weak economic base, with unfavorable demographic and economic trends

NARROW FINANCIAL POSITION WITH LIMITED ABILITY TO ABSORB BUDGETARY PRESSURE

The city's low general fund cash and reserve levels leave it with limited financial flexibility. FY 2011 general fund cash of $1.5 million represents just 0.7% of general fund revenues. The city's total fund balance of approximately $40.2 million (15.5% of general fund revenues) includes $31.8 million of non-current receivables that are unlikely to be repaid. Almost all of these receivables are due from distressed component units (primarily the city's redevelopment agency) and enterprise funds (the convention center fund, parking fund and stadium fund) that have limited or potentially no ability to make repayment.

The city has entirely depleted its reserves. The city's unreserved general fund balance stood at more than $30.6 million at the end of FY 2008 and included a $16.6 million emergency reserve set-aside. In FY 2009, the city's core revenues began experiencing significant pressure from the recession, resulting in actual revenues far below budget estimates. Also in FY 2009, the city paid $18 million for two defaulted loan obligations it had guaranteed, which drove the unreserved general fund balance into a deficit. In FY 2010, the city repaid itself through a private placement lease financing. The city has balanced budgets the last three fiscal years through a combination of reserve draws and cuts to operations, with large reductions in authorized positions, mandatory furlough days, eliminations of non-mandated services, franchising of city activities and other expenditure saving actions. Several of these actions - primarily related to reduction in force - drove costs higher in the short-run, as the city had to fund severance payments and unemployment benefits for involuntary reductions, and fund early retirement incentives for voluntary reductions. The city used available reserves to balance its budgets in FY 2009, FY 2010 and FY 2011, and appropriated its remaining reserves in FY 2011 to repay inter-fund debts incurred by certain general fund-supported enterprise operations.

The result is an extremely weak balance sheet with little capacity for additional budgetary pressures or unanticipated shocks. The city's narrow financial position is made riskier by the local economy's continued weakness and above-average risk of reentering recession.

WEAK FINANCIAL POSITION UNLIKELY TO IMPROVE MATERIALLY IN THE SHORT-TERM

The city's finances are unlikely to improve materially in the immediate future. Recent budget deficits have been managed with one-time sources, including the sale of capital assets and draws on reserves, and the city is yet to have sufficiently aligned ongoing revenues with ongoing expenditures. Notably, budget assumptions still do not reflect the level of conservatism necessary to insure the city's thin finances against unanticipated pressures. For example, despite sales taxes falling a combined 23% from FY 2008 - FY 2010, the city's five-year general fund budget assumes 4.4% sales tax growth for FY 2012 and 4% growth per year for FY 2013 - FY 2016. The FY 2012 budget assumed a 2.0%

increase in assessed value (AV) and 3% salary concession from all employees, while actual AV decreased by 2.6% and the city was only able to achieve a 1% salary concession, resulting in a more than $2 million budget shortfall.

While management has incorporated the general fund's subsidy of underperforming enterprise assets into the general fund budget - an action that both clarifies the city's support for these operations and increases transparency with regard to the subsidy - budget balance continues to be predicated on continued sharp cuts to services and less-than-conservative assumptions for revenue growth.

The city's ability to manage liquidity will also prove critical as the city did not issue a $58 million planned Tax and Revenue Anticipation Note (TRAN). However, there is ample available cash in the city's investment pool, with $71.4 million unrestricted cash held under governmental activities and $81.8 million held under business-type activities.

WEAK ECONOMY RISKS LOWER REVENUES, LIMITS TO EXPENDITURE CUTS

Fresno is located in central California and serves as the financial, retail and service center of the San Joaquin Valley. It is the fifth most populous city in the state. Fresno's economy is predominantly agriculture based, with Fresno County the most productive agricultural county in the nation by crop value (total crop value in excess of $5 billion). The majority of employment is concentrated in agribusiness, crop processing and distribution and comprises low-skilled, low-wage jobs, reflected in the area's below-average personal and family income levels. The economy has diversified over the last decade, adding jobs in financial services, healthcare and technology, helping to lower Fresno's consistently above-average unemployment rate relative to the state's.

The city's relatively older housing stock, which is typically assessed substantially below market value, has helped cushion AV against declines in home prices. Median home prices have declined in excess of 50% from 2005 to 2010, but AV has only declined a combined 9% from 2010 - 2012, with a 5.6% decline in 2010 the result of active reassessment by the county assessor. The city's 2012 AV of $26.9 billion is significantly above the median for A2-rated cities.

Fresno's economy is currently at above-average risk of reentering recession, with weak housing and labor market activity a drag on growth and susceptible to further deterioration. The weak economy should continue to limit sales taxes, property taxes and motor vehicle in-lieu revenues, Fresno's three largest revenue sources (and approximately 85% of total tax revenues).

HIGH GENERAL FUND DEBT BURDEN OFFSET BY FAVORABLE PENSION AND OPEB STATUS

The city's debt burden is comparatively high and is now a greater burden on the city's general fund than had been expected, since related, leased facilities do not generate supporting revenues as originally anticipated. The city's FY 2012 general fund debt burden (including the assumption of certain enterprise fund debt service) of $30.8 million represents 14.1% of general fund revenues, significantly above the median for A2-rated cities.

The debt securities themselves include relatively strong protections. The city's pension obligation bonds (POBs) are supported by a dedicated tax override of $0.032 per $100 of assessed value, which in FY 2012 is projected to contribute $8.6 million toward debt service of $16.2 million. Debt service is level to maturity for the POBs. The city's lease revenue bonds are fixed asset, abatement leases governed by master lease agreements, which provide a measure of added security from the cross-collateralization of assets in the pools. The city's peak gross lease payment of $25.9 million in FY 2012 represents 13.7% of budgeted general fund revenues. Combined peak gross lease payment and net pension obligation bond payment in FY 2012 of $36.9 million represents 17.1% of budgeted general fund revenues.

Fresno does not participate in the state pension system, rather it administers its own retirement systems. The city has two retirement systems - one for police and fire, one for all other employees - both of which are overfunded relative to their actuarial liabilities. Also, the city's OPEB liability is comparatively small at $84 million.

OUTLOOK

The negative outlook reflects the city's narrow financial position and limited prospect for improvement in the near-term, amid the ongoing risk for added financial pressure from a weak local economy. The city's depleted reserves limit its financial flexibility and ability to absorb additional budgetary pressure. Like all California cities, Fresno's ability to raise revenues is highly constrained; its primary budget balancing option is cost reduction. However, with services already significantly reduced, further cuts could prove more difficult.

WHAT COULD MOVE THE RATING UP

Improved liquidity

Improved reserve levels

Increased self-sufficiency/decreased subsidy of troubled enterprise operations

Structural operating adjustments to align ongoing expenditures with ongoing revenues

WHAT COULD MOVE THE RATING DOWN

Weakened liquidity

Weakened reserve levels

Deterioration of/increased subsidy of troubled enterprise operations

Inability to align ongoing expenditures with ongoing revenues

KEY INDICATORS

FY 09-10:

Net general fund cash, % of revenue: 4.1%

Total general fund balance, % of revenue: 15.5%

Unreserved general fund balance, % of revenue: -1.2%

Net lease and general fund obligation burden, % of revenue: 11.6%

Net lease burden, % of revenue: 5.6%

2000 Census:

Median Family Income: $35,892 (72% of U.S. average)

Per Capita Income: $15,010 (70% of U.S. average)

Median Home Value: $97,300 (81% of U.S. average)

% below poverty level: 26.2% (211% of U.S. average)

Total population: 427,652

The principal methodologies used in this rating were General Obligation Bonds Issued by U.S. Local Governments published in October 2009, The Fundamentals of Credit Analysis for Lease-Backed Municipal Obligations published in October 2004. Please see the Credit Policy page on www.moodys.com for a copy of these methodologies.

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Analysts

Moses Kopmar
Analyst
Public Finance Group
Moody's Investors Service

Eric Hoffmann
Backup Analyst
Public Finance Group
Moody's Investors Service

Contacts

Journalists: (212) 553-0376
Research Clients: (212) 553-1653

Moody's Investors Service, Inc.
250 Greenwich Street
New York, NY 10007
USA

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