

August 14, 2018

Mr. Ben Gorzell, CPA
Chief Financial Officer
City of San Antonio
111 Soledad, 5th Floor
San Antonio, Texas 78205

Dear Mr. Gorzell:

Summary:

The City of San Antonio currently anticipates calling a charter amendment election to include the following three propositions:

One petition seeks to expand the topics of referendum in the City Charter to include referendum of any ordinance including appropriations, levying taxes, setting utility rates (which include prospective rate approval supporting the System) and zoning. It lowers the threshold of signatures for a referendum of any ordinance from approximately 70,000 to 20,000 and expands the timeframe for obtaining the signatures from 40 to 180 days.

A second petition seeks to allow the Fire Union to unilaterally declare impasse in collective bargaining and to unilaterally impose binding arbitration upon the City.

A third petition seeks to eliminate the City Council's authority to determine compensation and term of the City Manager by limiting pay to 10 times the amount of the lowest paid city employee and limiting the term of a City Manager to eight years. It further would require a supermajority (8 votes out of 11) to select the City Manager. This petition does not affect the current City Manager.

As Co-Financial Advisors to the City of San Antonio and pursuant to our fiduciary obligations, it is our opinion that passage of the three contemplated charter amendments currently before the City of San Antonio will have an adverse effect upon the general obligation credit rating by each of the national rating agencies, Moody's Investors Service, S&P Global Ratings, and Fitch Ratings. This effect will result in the ultimate downgrade of credit ratings while directly affecting the budgetary process and ability of the City of San Antonio to effectively manage and respond to continued infrastructure demands and maintenance responsibilities. Such an outcome will result in the rating agencies sequentially moving the City of San Antonio general obligation credit to negative outlook, to be followed by one or more successive credit downgrades.

Background:

As you are aware, the City of San Antonio currently remains the only U.S. city with a population over one million to hold "AAA" ratings from each of the three major rating agencies. The City has maintained such ratings for nine consecutive years with a favorable outlook except for a period of three years for which a negative outlook existed with Moody's Investors Service. This negative outlook was the result of budgetary concerns and drawdowns on fund balances. These coveted ratings, while limited in their application to major public entities, greatly affect the cost of funds and the ability of the entity to respond to economic

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factors. It should be noted that while San Antonio is the only municipality of its size to hold such simultaneous “AAA” ratings, it is joined by a very few U.S. states. Not even the U.S. sovereign debt holds three “AAA” ratings from the major rating agencies. This point was illustrated by S&P Global Ratings in its report dated July 26, 2018: *“San Antonio’s GO bonds are eligible to be rated above the sovereign because we believe the city can maintain better credit characteristics than the U.S. in a stress scenario.” For this reason, these ratings affect market accessibility, interest costs, and institutional investor acceptance, while providing maximum financial flexibility and latitude in the design and offering of any borrowings undertaken by the City of San Antonio.*”

Assessment:

As Co-Financial Advisors it is our responsibility to assess the credit perspective of the City of San Antonio as well as interface with the municipal bond rating agencies predicated upon these agencies’ published rating criteria, historical ratings analysis and contemplated ratings actions relative to significant changing economic and legal variables which will affect credit quality. While both Moody’s Investors Service and S&P Global Ratings maintain published rating criteria, Fitch Ratings does not have published scorecard criteria. It should be noted that in each of the published rating criteria, objective economic considerations are used as weighting for assessing an economic profile. Among these considerations are the full value of all property within the municipality, the full value per capita, and the median family income. San Antonio has historically and continues to score well below the level expected of a “AAA” city, given its economic profile. *“The city’s income indicators are low but consistent with large and urban areas, as well as areas that reflect high institutional presence. The 2016 median family income equalled 81.9% of the nation’s, and has remained stable over the past decade.”* Moody’s Investors Service Credit Opinion 24 July 2018.

With regard to the City of San Antonio, the most recent U. S. Local Government Scorecard of Moody’s Investors Service illustrates an unadjusted rating outcome of “Aa3” based upon its weighted rating criteria of economic and tax base – 30%, finances – 30%, management – 20%, and debt and pension – 20%. One of the primary considerations that propels the City’s rating beyond the “Aa3” category remains the City’s demonstrated management and governance. *“The city demonstrates good governance guided by an experienced team. The city’s fiscal practices includes multiyear budgeting, and five year financial forecasting, with the capital planning going out further. Additionally, the city recently increased its general fund reserve policy to maintain a minimum ending balance of 15%. Other requirements include an additional \$1 million general contingency and a \$3 million capital contingency built into the budget, as well as maintenance of reserves in other non operating funds. Management also monitors finances monthly, with quarterly updates presented to the City Council. As part of its financial monitoring, the city also takes measures to smooth CPS Energy revenue projections and match potential non-recurring spikes to one-time capital projects.”* Moody’s Investors Service Credit Opinion 24 July 2018.

Also with regard to management, S&P Global Ratings states: *“We view the city’s management as very strong, with strong financial policies and practices under our FMA methodology⁽¹⁾, indicating our view that financial practices are strong, well embedded, and likely sustainable.”*

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“San Antonio's budgetary flexibility is strong, in our opinion. The city had operating surplus of 2.6% of expenditures in the general fund and 2.2% across all governmental funds in fiscal 2017.”

“The city has a history of conservative budgeting practices and has historically exceeded budgeted projections. The city has a predominantly locally derived revenue base, has demonstrated a broad and well-embedded culture of fiscal discipline, and has very little dependence on the federal government for revenue composition.” July 26, 2018.

According to Fitch Ratings: *“The combination of the city's expenditure cutting flexibility, revenue raising authority, and minimal revenue volatility positions it well to address cyclical downturns. The city has demonstrated a commitment to prudent fiscal practices.”*

“Diverse resources include utility revenues, property taxes, and sales taxes that support the city and are expected to yield continued strong gains due to rapid population growth and economic expansion. The city's independent legal ability to raise property tax revenues provides ample flexibility.” July 30, 2018

A component of our role as Co-Financial Advisors is to assess rating criteria, historical ratings analysis and contemplated ratings actions relative to significant changing economic and legal variables which will affect credit quality.

While the rating agencies refrain from reacting to prospective actions, each of the rating agencies identifies certain considerations which may result in negative impacts to credit assessment. The identification of these issues should serve as a precursor to rating actions which will occur if and when these certain economic or legal changes become effective. For this reason, it is the role of the rating agencies to identify those actions which may lead to negative credit consideration. As Co-Financial Advisors and fiduciary agents of the City of San Antonio, it is our role to assess these implied prospective pitfalls and identify their ultimate outcome should they be implemented. The rating agency observations of the prospective charter amendments are clear. There can be no misinterpretation of the relative rating agencies' positions with respect to the potential passage of the charter amendments:

Fitch states: *“Voter-petitioned city charter amendments that are expected to be on the Nov. 2018 ballot are likely to limit the city's revenue and expenditure flexibility if approved. City responses that erode its superior financial resiliency could lead to negative rating pressure.” July 30, 2018*

S&P Global states: *“If voters approve the proposed changes to the city's charter in the upcoming November 2018 election, we believe the changes to the referendum process in particular could have a material negative impact on the city's finances, as such initiatives could effectively limit San Antonio's ability to manage its budget.” July 26, 2018*

In summary, it is our belief that the national rating agencies have identified the potential charter amendments as significant reason for concern due to their potential to limit financial flexibility, impede the budgetary process and diminish managerial control. Such an outcome will result in the rating agencies sequentially moving the City of San Antonio general obligation credit to negative outlook, to be followed by one or more successive credit downgrades.

Implications:

The potential immediate impact of such a downgrade on the City’s anticipated general obligation debt costs are represented in the following chart, which is based upon future general obligation debt issuances of \$2.5 Billion. As ratings decrease and funding for continued infrastructural development continues, the significance of such downgrades will certainly be exacerbated.

1 level drop	\$ 17,500,000 -37,500,000
2 level drop	45,000,000 - 75,000,000
3 level drop	112,500,000 -132,500,000

While the benefit of the “AAA” ratings relates directly to the cost of general obligation debt, it should be noted that such ratings provide the City additional latitude in achieving market acceptance for various credits not directly paid from ad valorem taxes. This additional benefit, resulting from the strong financial management and controls of the City, has allowed these non-ad valorem tax credits to achieve ratings and related debt service structures that would not otherwise be obtained. Recent examples of transactions that have benefitted in such a manner include:

\$550,373,642 City of San Antonio Improvement and Refunding Lease Revenue Bonds, Series 2012 (Convention Center Refinancing and Expansion Project)

\$123,900,000 City of San Antonio Customer Facility Charge Revenue Bonds, Taxable Series 2015 (Consolidated Rental Car Special Facilities Project)

In each case, the structures utilized clearly benefited from the City’s “AAA” ratings.

We look forward to our continued discussion in this regard.

Sincerely,



Jorge Rodriguez
Senior Vice President, Head of Texas Public Finance
FTN Financial Municipal Advisors



Anne Burger Entekin
Regional Managing Director
Hilltop Securities, Inc.

(1) On June 27, 2006, S&P published its Financial Management Assessment report. It included the following language:

- a. The rigor of a government’s financial management practices is an important factor in Standard & Poor’s Rating Services analysis of that government’s creditworthiness. Managerial decisions, policies and practices apply directly to the governments financial position and operations, debt burden, and other key credit factors. A government’s ability to implement timely and sound financial and operational decisions in response to economic and fiscal demands is a primary determinant of near-term changes in credit quality.
- b. If a government is unable or unwilling to employ its authority in a timely manner to address events that impact its budget or financial condition, its credit rating can be adversely affected.