MOODY'S
INVESTORS SERVICE

Rating Update: Moody's downgrades rating on City of Sunnyvale's COPs to Aa2

Global Credit Research - 18 Jan 2013

Aaa Issuer Rating confirmed; Outlook is stable

SUNNYVALE (CITY OF) CA
Cities (including Towns, Villages and Townships)
CA

Opinion

NEW YORK, January 18, 2013 --Moody's Investors Service has downgraded to Aa2 from the Aa1 the rating on the City of Sunnyvale's certificates of participation. We have also confirmed the city's Aaa Issuer Rating.

RATING RATIONALE

The downgrade creates a two-notch distinction between the COP rating and the city's Issuer Rating and reflects our changed view of the pledge supporting COPs versus general obligation bonds. We believe this pledge is relatively less secure than our prior estimates, both in terms of probability of default and likely losses in the event of default. Security for the underlying COP payments is a contractual pledge by the city backed by all of their available financial resources assuming the use and occupancy of the leased assets. This promise is notably in contrast to the stronger, voter approved general obligation pledge that provides a baseline for our estimate of the city's credit quality. Under California law, a city's GO pledge is an unlimited ad valorem property tax pledge. The city must raise property taxes by whatever amount necessary to repay the obligation, irrespective of the city's general financial position. The relative performance of California cities' property tax bases and their financial profiles through the recent economic cycle, and likely continued divergence going forward, has resulted in our creating a greater distinction between these different types of pledges than we had previously.

The city's Issuer Rating reflects what the city's secured, general obligation rating would be if the city issued such debt. The confirmation of the Aaa Issuer Rating is driven by the city's large, growing, and dynamic tax base that features a wealthy population and a strong recovery from the economic downturn. It also incorporates the city's exceptionally strong budget management and financial profile, which notably includes paying pensions costs above its annually required actuarial contribution to more fully reflect what the city expects to be its actual long term costs.

STRENGTHS

-Large and wealthy Silicon Valley tax base

-Sound prospects for continued near-term economic growth

-Strong fiscal operations featuring healthy reserves

CHALLENGES

-Still uncertain statewide economy

-Taxpayer and industry concentration

DETAILED CREDIT DISCUSSION

LARGE SILICON VALLEY ECONOMY BENEFITING FROM A STRONG TECH SECTOR TO ACCELERATE FROM THE RECESSION

Sunnyvale is in the heart of the Silicon Valley 44 miles south of San Francisco and is in the midst of a robust acceleration from the recession. Much of this growth has been fueled by continued growth needs of large technology companies that have been expanding in the area. Companies such as Linkedin, Apple, Juniper Networks, and Microsoft all underwent significant office expansions or renovations. As a result, fiscal 2012 developer fee revenue was actually higher than it has been in any prior year at $14 million. The city estimates that it will receive about the same level of developer fee revenue in fiscal 2013, a strong turnaround from the nadir of this revenue category of about $5 million in fiscal 2010. Approximately 6.4 million feet of commercial development is in process for 2013 not including 179 new residential units, an indication that the city continues to be a desirable commercial area of the Silicon Valley. Not surprisingly, each of the city's top ten employers are technology companies with Lockheed, Yahoo, and Apple comprising the top three. The city's unemployment rates, though elevated from its exceptional low of just under 3% in 2007, still remains well below both the state and national marks at 7.8%.

We anticipate that the city's already very large $25 billion tax base will continue to grow in the short to mid-term. In 2013, assessed valuation grew by 3.7%, its second consecutive year of growth after absorbing a small 1.2% drop in 2011. A minimum growth rate of 2.5% is expected for 2014. However, we note that the city's exposure to the technology industry makes it susceptible to the type of sector-wide downturn that occurred in the early 2000's when unemployment exceeded the state mark. In addition, though the city and Silicon Valley as a whole are economically outperforming the state and nation, they are not immune to macro-economic fluctuations at the national or international level that could dampen future growth. Still, it is a strong credit positive that the city's economy, is exiting the recession at a faster rate than most portions of the country.

STRONG TRADITION OF CONSERVATIVE LONG TERM PLANNING RESULTS IN CONSISTENTLY ROBUST RESERVES

The city has long maintained very sound long term fiscal policies that set parameters for all elements of its financial operations. This includes 20-year budget and capital improvement plans that are continually revised to make sure the city is properly funding operations over the long term. The result of this consistent focus on conservative long range planning is that the city maintains exceptionally strong reserves. In fiscal 2012, the city's $88.4 million in total reserves was 77.7% of total general fund revenues, an exceptionally strong level of reserves even for the rating category.

Like its property taxes, the city's sales taxes grew in fiscal 2012, at 4.3%, after falling sharply in 2009 and undergoing minimal growth in 2010. These revenues are also trending up for fiscal 2013 though they remain vulnerable to the capital spending of business, which can start and stop abruptly. Given the ongoing strength of the commercial sector and recovering home prices, the city 's revenue base is likely to remain strong through fiscal 2013.

The city's largest expenditure component is public safety, accounts for 54% of the city's budget. The city uniquely employs "public safety officers", which means that all police officers are also trained firefighters and serve both purposes. Though this model costs marginally more to employ than traditionally separated fire and police operations, the city believes that it results in a much higher level of service, thereby making the community more supportive of public safety functions and their attendant costs. Sunnyvale has been the only city in the county to not undergo any layoffs or furlough days during the recession. Headcounts were reduced entirely though attrition, which has dropped the total number of employees from 918 in 2007 to 822 in 2012.

Reflective of its conservative approach to long-term fiscal management, the city is contributing 19% more than its ARC for its pension costs. The city adopted this approach to hedge against the possibility of future change in CalPERs, which the city does not think is conservative enough. The city also established an irrevocable trust to pay OPEB costs in 2009 and transferred $10 million from its reserves to establish the fund. Despite this transfer, the city's general fund reserves remain exceptionally healthy.

VERY LOW DIRECT DEBT BURDENS AND MINOR VARIBALE RATE DEBT EXPOSURE

The city has two COPs that are ultimately obligations of the city's general fund, though in practice the general fund has had little exposure to debt service. These obligations create a direct debt burden of a very low 0.10% of total assessed value. The city's overall debt burden is more typical at 2.8%.

The city's 2009 Government Center COPs mature in 2031 and have total annual debt service of just $433,000 or just 0.3% of total general fund revenues. Debt service has been paid from lease revenues and contributions from utilities and not encumbered the general fund. The leased asset is two parcels adjacent to the city hall complex. One parcel contains several buildings that are occupied by city staff and leased to commercial tenants. The other parcel is vacant.

The city also has a 1998 Parking COP that will mature in 2023. The total annual debt service payment of $1.2 million is only 0.8% of the total general fund revenues, but had been paid from tax increment revenues from the city's redevelopment agency. With the dissolution of the state's RDAs, the state has determined the 1998 Parking COP was not an enforceable obligation of the former RDA, and therefore has not permitted tax increment revenue to be made available for debt service. Absorption of debt service on the obligation is easily manageable by the city.

OUTLOOK

The stable outlook reflects our expectation that the city will continue to maintain an exceptionally strong fiscal profile, stable and wealthy economy and modest debt profile.

WHAT COULD CHANGE THE RATING UP

N/A

WHAT COULD CHANGE THE RATING DOWN

-Significant decline in cash and general fund reserves

-Significant and protracted deterioration of the city's economy

KEY STATISTICS

Assessed value, 2013: $25.8 billion

Direct debt: 0.1%

Overall debt: 3.0%

General fund reserves as a percentage of general fund revenues: 77.7%

General fund cash as a percentage of general fund revenue: 63.1%

RATING METHODOLOGIES

The principal methodology used for the Certificates of Participation rating was The Fundamentals of Credit Analysis for Lease-Backed Municipal Obligations published in December 2011. The principal methodology used for the Issuer rating was General Obligation Bonds Issued by U.S. Local Governments published in October 2009. Please see the Credit Policy page on www.moodys.com for a copy of these methodologies.

REGULATORY DISCLOSURES

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