FitchRatings

15 MAR 2023

Fitch Rates California's $2.6 Billion GO Bonds 'AA'; Outlook Stable

Fitch Ratings - New York - 15 Mar 2023: Fitch Ratings has assigned a 'AA' rating to the following GO bonds to be issued by the state of California:

--$1.4 billion various purpose GO bonds;

--$1.2 billion various purpose GO refunding bonds.

The bonds are scheduled to price by negotiation on April 4, 2023. The bonds will finance voter-approved capital projects, or other voter-approved projects, and pay down CP. The bonds will also refund outstanding GO bonds for debt service savings.

The Rating Outlook is Stable.

SECURITY

GO bonds are general obligations, for which the state pledges its full faith and credit, subject to the prior application of moneys to the support of public education.

ANALYTICAL CONCLUSION

California's 'AA' Issuer Default Rating (IDR) and GO rating incorporate the state's large and diverse economy, which supports strong, albeit cyclical, revenue growth prospects, a solid ability to manage expenses through the economic cycle and a moderate level of long-term liabilities. Strong fiscal management, institutionalized across administrations and demonstrated through build-up of the budgetary stabilization account (BSA) and elimination of past budgetary borrowing, allows the state to better withstand economic and revenue cyclicality.

Economic Resource Base

California's economy is unmatched among U.S. states in size and diversity, leading to consistent overall growth despite a considerable presence of the more cyclical information technology industry. Population growth historically exceeded the U.S. average, with relatively high levels of immigration partially offsetting domestic outmigration, although growth has slowed and outmigration has increased. Employment growth continues to exceed the U.S. average. Growth in California's economy between the Great Recession and the recent pandemic-related recession was among the strongest of the states. Fitch expects California's post-pandemic growth to return to this trend.

KEY RATING DRIVERS

Revenue Framework: 'aaa'

Tax revenues are dominated by personal income taxes, which are economically sensitive, particularly those related to capital gains. Long-term growth prospects for revenues are strong, driven by the state's robust economic fundamentals. The state retains the independent legal ability to raise taxes, subject to a legislative super-majority voting requirement.

Expenditure Framework: 'aa'

California has a solid ability to reduce spending throughout the economic cycle, although its flexibility is somewhat more restricted than most states due to constitutional requirements for funding education and voter initiatives that limit state discretion. However, Proposition 98 school funding requirements also decline relatively quickly when revenues decline, acting as a form of automatic stabilizer during a downturn.

Long-Term Liability Burden: 'aa'

Long-term liabilities, while above the median for U.S. states, remain a moderate burden on the resource base. The state is addressing its pension liabilities with some benefit reforms, supplemental contributions, and implemented a long-term plan to increase contributions to the teachers' system, among other changes to improve funding.

Operating Performance: 'aa'

The state's strong budget management during the extended period of economic expansion and revenue growth following the Great Recession allowed the state to materially improve its financial position and enhance its ability to address future fiscal challenges. The state eliminated budgetary liabilities, built a rainy day fund, enacted on-time, structurally balanced budgets and generally used a prudent approach to managing demands for additional spending. All of these efforts contribute to greater resilience to cyclical economic changes.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to a positive rating action/upgrade:

--A material increase in the state's financial resilience and ability to absorb volatility in revenues;

--Continued actions to maintain long-term liabilities consistently below 10% of personal income and support pension sustainability.

Factors that could, individually or collectively, lead to a negative rating action/downgrade:

--A change in fiscal approach regarding maintaining structural budgetary balance over time that leads to a reduction in budgetary resilience.

Best/Worst Case Rating Scenario

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

CURRENT DEVELOPMENTS

Economic Update

California's labor market recovery has slightly lagged the national pace through most of the post-pandemic recovery period, although the pace has picked up in recent months. Nonfarm payrolls declined by about 16% at the pandemic's start (from February 2020 to April 2020) slightly higher than the national decline of 14%. California has regained 103% of the payroll employment declines versus 107% for the U.S. as of December 2022. Headline unemployment in December of 4.1% exceeds the U.S. (3.5%) for that month. Growth in California's labor force has improved in recent months. The state's employment to population ratio (EPOP, a measure of labor force utilization) as of December 2022 was 59.6%, which remains below its pre-pandemic level and the national rate (60.1%).

California Budget Update

California Governor Newsom's executive budget proposal for fiscal 2024 addresses lower than anticipated revenues by tapping resilience built into the fiscal 2023 and previous budgets without dipping into the rainy day fund (the budget stabilization account) or taking deep cuts to ongoing spending. The budget proposal projects fiscal 2023 general fund revenues, prior to transfers, will be $12 billion (5.5%) lower than the June 2022 enacted budget estimate and down 5.6% yoy. General fund revenues are forecast to be essentially flat to fiscal 2023 at $209.7 billion in fiscal 2024, $23.7 billion (10.2%) lower than the June 2022 estimate, but still well above pre-pandemic levels.

The lower revenue forecast is driven largely by weakness in the personal income tax (PIT) that began to be evident at the start of fiscal 2023 in both withholding and estimated payments cash receipts. Lower withholding and capital gains are expected to be the main drivers of lower PIT revenues in the forecast. The PIT is highly sensitive to changes in the economy and the forecast reflects slower economic growth after the very rapid pace of growth immediately following the pandemic recession. With Fitch's revision of the global economic outlook and the economic outlook for the U.S. ("Global Economic Outlook - March 2023", March 10, 2023), the economic assumptions underlying the governor's budget proposal assumes a similar rate of growth in 2023, with the state assuming 0.9% real national GDP growth in 2023 versus Fitch's outlook of 1.0%. Fitch anticipates a mild recession beginning in 2H23 while the governor's economic forecast anticipates slower economic growth, but no recession, leaving the state's revenue forecast susceptible to downside risk.

Prior enacted budgets enhanced financial resilience that will allow the state to address the current moderate slowdown. These budgets reduced budgetary and other debt, limited growth in on-going spending, applied non-recurring revenues to one-time spending including for capital investment rather than debt issuance, placed revenue triggers on new programs, and built reserves.

The bulk of the budget balancing actions proposed by the governor involve some form of spending reduction rather than revenue enhancement and are focused on funding delays, reductions and pullbacks, and trigger reductions that can be restored if the revenue picture improves. The budget also eliminates $3 billion that was available but not allocated in the fiscal 2023 budget to address potential inflation costs, withdraws a proposal to retire $1.7 billion in GO bonds using cash, shifts anticipated cash funding of capital projects to lease revenue bond issuance, and eliminates supplemental deposits to the budget stabilization account and other reserves.

The budget proposal continues programmatic spending that was funded in the fiscal 2023 budget, although in some cases funding is delayed or subject to trigger reductions. This include initiatives in climate resilience, child care investments, transitional kindergarten, universal school meals, higher education investments, and expanding health care access. The budget continues a multi-year investment in various state-wide infrastructure projects and housing development to address homelessness and affordability. The budget also maintains the accelerated paydown of state retirement liabilities as required by Proposition 2, with $1.9 billion in additional payments in fiscal 2024.

Fitch anticipates the details of the enacted budget will vary from the governor's plan, which will be updated in May to reflect any changes in the economy. If the economic situation deteriorates, the governor may propose additional program reductions as well as use of the budget stabilization fund, which is fully funded at $21.5 billion as of fiscal 2023 (10.2% of fiscal 2023 revenues). It is Fitch's expectation that the state will continue to make decisions that support a structurally balanced budget and that it will take the steps necessary to align expenditures with revenues as the revenue outlook develops.

Federal Tax Filing Deadline Deferred

The federal government has postponed the tax filing and payment deadline for individuals and businesses affected by storms in a number of California counties, from April 18, 2023 to May 15, 2023 and in a second action, to Oct. 15, 2023, as a form of disaster relief. As the state has chosen to conform its own filing deadline to the federal filing date, receipt of a significant portion of the state's tax revenue will shift from the current fiscal year into the next fiscal year. While this is not expected to have a budgetary impact on the state, since the delayed revenues will accrue to the fiscal 2023 budget, there is potentially a significant cash flow impact. The state reports that it has sufficient internal liquidity and borrowable funds to address this anticipated impact.

Federal Aid Continues to Support State Operations

The state received $27 billion in direct ARPA aid, with local governments receiving an additional $16 billion. Uses of these funds include addressing public health issues, housing shortages and homelessness, support for energy and water suppliers that are owed utility payments in arrears, grants to small businesses, emergency financial aid to college students, and education and training for displaced workers. A portion will be used to replace $17.2 billion that the state calculates as lost revenue.

Given strong revenue performance and the state's focus on avoiding use of one-time revenues for ongoing programs, Fitch expects the state to be able to maintain structural balance in its budget as the impact of federal stimulus programs recedes.

Date of Relevant Committee

28 February 2023

In addition to the sources of information identified in Fitch's applicable criteria specified below, this action was informed by information from Lumesis.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG Considerations

Fitch notes an emerging issue related to Data Quality and Transparency, due to the lateness in production of GAAP-based audited financial statements. The state is a full year behind in producing its fiscal 2021 (FYE June 30) Annual Comprehensive Financial Report, now expected to be released in March 2023, and has not yet indicated when it will be able to release the fiscal 2022 ACFR. This is reportedly due to difficulties in implementing a new accounting program in fiscal 2019. Habitually delayed publication of audited financial results, beyond 270 days of the end of the fiscal year, can be an indication of management weakness. Fitch is currently confident that the state continues to provide transparency in its financial operations through an abundance of financial, budgetary, and revenue information that is robust and timely.

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

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Rating Actions

ENTITY/DEBT	RATING			RECOVERY	PRIOR
California, State of (CA) [General Government]					
• California, State of (CA) /General Obligation - Unlimited Tax/ 1 LT	LT	AA	Affirmed		AA

RATINGS KEY	OUTLOOK	WATCH
POSITIVE	⊕	⬘
NEGATIVE	⊖	⬙
EVOLVING	⊙	◆

RATINGS KEY OUTLOOK WATCH

STABLE ⭘

Applicable Criteria

U.S. Public Finance Tax-Supported Rating Criteria (pub.04 May 2021) (including rating assumption sensitivity)

Applicable Models

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

FAST Econometric API - Fitch Analytical Stress Test Model, v3.0.0 (1)

Additional Disclosures

Solicitation Status

Endorsement Status

California, State of (CA)	EU Endorsed, UK Endorsed

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