County of Orange, CA

Update - Moody’s affirms Orange County CA’s Aa1 issuer rating; related ratings also affirmed. Outlook revised to stable.

Summary Rating Rationale

Moody’s Investors Service has affirmed Orange County’s Aa1 issuer rating, a Aa1 on the county’s 1996A Pension Obligation Bonds, and the Aa3 on outstanding COPs and lease revenue bonds, Series 1991, 2005, 2006 and 2012. We have revised the outlook on the county’s long-term ratings to stable from negative. The rating affirmations and outlook revision are based upon resumed, healthy tax base growth; improved financial performance with increases to reserves and liquidity levels beginning in 2014 and expected to continue; strong multi-year budgeting practices; and reserve policies that should support favorable future financial performance. The ratings also incorporate the county’s above average socioeconomic profile and modest debt burden.

Exhibit 1

Additions to Reserves and Liquidity Levels Beginning in 2014 Expected to Continue

Source: Moody’s Investors Service
Credit Strengths
» Exceptionally large and diverse economy with above-average socioeconomic levels
» Resumed growth in assessed valuation with recent acceleration in pace
» Conservative budgeting practices and targeted policies supporting improved results
» Modest debt burden

Credit Challenges
» Relatively narrow reserve levels compared with median levels for similarly rated credits
» Uncertain pace of economic recovery that could constrain future spending
» Exposure to federal and state funding variations supporting county services

Rating Outlook
The outlook, which as been revised to stable from negative, is based upon resumed economic expansion and tax base growth emerging from the recession, improved financial performance with continued attention to rebuilding reserves, and modest debt profile.

Factors that Could Lead to an Upgrade
» Significant and sustained increases in reserve and liquidity levels
» Significant and sustained improvement in the county’s socioeconomic profile

Factors that Could Lead to a Downgrade
» Deterioration in the county’s reserve position
» An inability to maintain balanced operations with utilization of reserves limited to one-time purposes
Key Indicators

Exhibit 2
Orange County

<table>
<thead>
<tr>
<th>Orange County</th>
<th>CA</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
<th>2014</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Economy/Tax Base</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Full Value ($000)</td>
<td></td>
<td>$427,965,596</td>
<td>$420,751,575</td>
<td>$424,769,642</td>
<td>$432,962,274</td>
<td>$447,749,156</td>
</tr>
<tr>
<td>Full Value Per Capita ($000)</td>
<td></td>
<td>133,577</td>
<td>139,774</td>
<td>139,005</td>
<td>140,470</td>
<td>143,786</td>
</tr>
<tr>
<td>Median Family Income (% of US Median)</td>
<td></td>
<td>133.0%</td>
<td>133.0%</td>
<td>131.8%</td>
<td>131.8%</td>
<td>131.8%</td>
</tr>
<tr>
<td><strong>Finances</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Operating Revenue ($000)</td>
<td></td>
<td>2,567,953</td>
<td>2,595,740</td>
<td>2,660,234</td>
<td>2,809,246</td>
<td>2,828,530</td>
</tr>
<tr>
<td>Fund Balance as a % of Revenues</td>
<td></td>
<td>18.7%</td>
<td>8.3%</td>
<td>11.0%</td>
<td>6.9%</td>
<td>7.1%</td>
</tr>
<tr>
<td>Cash Balance as a % of Revenues</td>
<td></td>
<td>18.6%</td>
<td>17.3%</td>
<td>19.2%</td>
<td>14.3%</td>
<td>16.8%</td>
</tr>
<tr>
<td><strong>Debt/Pensions</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net Direct Debt ($000)</td>
<td></td>
<td>434,803</td>
<td>741,802</td>
<td>672,934</td>
<td>542,699</td>
<td>546,400</td>
</tr>
<tr>
<td>Net Direct Debt / Operating Revenues (x)</td>
<td></td>
<td>0.2x</td>
<td>0.3x</td>
<td>0.3x</td>
<td>0.2x</td>
<td>0.2x</td>
</tr>
<tr>
<td>Net Direct Debt / Full Value (%)</td>
<td></td>
<td>0.1%</td>
<td>0.2%</td>
<td>0.2%</td>
<td>0.1%</td>
<td>0.1%</td>
</tr>
<tr>
<td>Moody’s - adjusted Net Pension Liability (3-yr average) to Revenues (x)</td>
<td></td>
<td>N/A</td>
<td>N/A</td>
<td>3.2x</td>
<td>3.3x</td>
<td>N/A</td>
</tr>
<tr>
<td>Moody’s - adjusted Net Pension Liability (3-yr average) to Full Value (%)</td>
<td></td>
<td>N/A</td>
<td>N/A</td>
<td>2.0%</td>
<td>2.2%</td>
<td>N/A</td>
</tr>
</tbody>
</table>

Source: Moody’s Investors Service

Recent Developments
Recent developments are incorporated in the Detailed Rating Considerations.

Detailed Rating Considerations

Economy: Large and Diverse Economy Demonstrates Resumed Growth
Property taxes account for over 90% of the County’s general purpose revenues, and resumed growth in assessed valuation represents a critical factor in supporting improved operating results as the county emerges from the recession. Inclusive of two years’ of modest declines in fiscal 2010 and 2011, increases in assessed valuation have averaged 4.68% over the past eleven years. While recent growth does not equal the double-digit increases seen prior to the recession, the pace of growth has accelerated, with a 6.4% increase in assessed valuation in 2015, and a second increase of 6% expected in fiscal 2016. The county’s taxbase is also diverse, with the top ten taxpayers representing a modest 3.87% of secured taxpayers. We expect that tax base growth will continue given identified development projects throughout the county.

Socioeconomic indices remain favorable. A 4.4% unemployment rate as of September 2015 is the lowest among California’s largest counties and remains below both state and national figures, with Walt Disney representing the county’s single largest employer along with a diverse array of financial, higher education, medical and service industries. However, while unemployment levels have fallen since the end of the recession, total civilian employment remains below pre-recession figures; a factor that could impose a constraint on future tax base growth. Wealth levels compare favorably, with an MFI of close to $85,000 equal to 131.8% of the U.S., and the highest among peer southern California counties. A median home value of $629,000 equals over 1.5 times a statewide figure of $389,000. In this area as well, absent the development of significant new housing stock, housing affordability may constrain future growth levels, with county population growth falling below both state and national figures. Supported by favorable wealth indices, taxable sales have demonstrated strong growth coming out of the recession with especially strong increases in car sales, although projected growth of 5.6% in fiscal 2016 may be reduced by lower fuel prices.

Finances and Liquidity: Improving Financial Performance Supported by Strong Budgeting Practices and Identified Reserve Targets
Following operating deficits during the recession, the county has demonstrated consecutive improvements in reserve levels supported by rigorous budgeting practices and a reserve policy that has become increasingly specific in its categorizations. Fiscal 2014 results reflect an available General Fund balance of $153 million or 5.3% of revenues. While still comparing unfavorably to a median figure of 20% for California Aa1-rated counties, the county is now working toward an established target of approximately 17%, or the two-
months' of operating revenues identified by the GFOA as best practice. Unaudited results for fiscal 2015 demonstrate an expected improvement in General Fund reserves to close to $271.5 million.

Although the fiscal 2016 budget anticipates the use of reserves, growth in assessed valuation is expected to again support a positive variance in property tax revenues, with a recent forecast of 6% growth in property tax revenue comparing favorably with a budgeted figure of 4%; generating in an additional $18 million in revenues. The 2016 budget identifies a $30.9 million draw on reserves, however these reductions are limited to one-time purposes including a $15 million Vehicle License Fee Adjustment Amount (“VFLFAA”) payment and $15.4 million in capital and equipment purchases. Notably, the budget includes an additional $18 million in General Fund resources previously dedicated to the county’s Series 2005A Refunding Recovery Bonds, which were fully repaid in June 2015.

County budgeting practices are strong, with annual updates of its five-year Strategic Financial Plan (“SFP”) focusing on allocations of discretionary funding or Net County Costs (“NCC”); that portion of the county’s budget that is not supported by specifically segregated revenue sources. Significantly, the SFP also incorporates the county’s reserve targets in these multi-year forecasts. While the SFP identifies a five-year, cumulative budget gap of $328 million, this represents a starting point for discussions concerning priority projects and spending that might be reduced. It should also be noted that the county limits NCC growth to 1% in each year in arriving at this gap, ensuring a continued focus on productivity and reasonable rates of expenditure growth likely to match a slower pace of economic recovery.

As actual revenue collections outpace conservative projections, the county will face the challenge of balancing the competing requirements of higher business costs, desires for increased program spending, allocations for capital and information technology projects deferred during the recession, and additions to reserves. As one example, the county maintains $130 million in available reserves for the county’s final repayment over the next three years of VFLFAA obligations associated with a legal settlement concerning prior property tax allocations. The outyear budget gap in part reflects the county’s desire to pay this amount out of its baseline budget in an effort to further grow reserve balances toward its policy objective.

**LIQUIDITY**

Similar to county reserve levels, liquidity has also demonstrated improvement with $476.2 million available in net cash in operating funds (General and Debt service) or 16.8% of revenues in fiscal 2014. Again, while demonstrating improvement, this figure remains below a median figure of approximately 30% for Aa1 counties nationally. While we expect cash balances to remain stable, the possibility of reductions exists if the county is unable to make remaining VFLFAA payments from baseline sources.

**Debt and Pensions: Modest Debt Burden with Extremely Rapid Repayment**

The county’s direct and overall debt burdens of 0.1% and 2.2%, respectively, are modest and remain in line with median figures for similarly rated credits nationally. More significantly, all of the county’s outstanding obligations, outside of enterprise obligations, will be fully repaid by 2021. Notably, the Series 2005 Lease Revenue Refunding bonds, the last piece of debt associated with the county’s bankruptcy settlement, will be fully repaid by July 2017, closing that chapter in the county’s history. In addition to a $334 million 2016 issuance of pension obligation bonds (“POBs”), the county also plans to issue approximately $68 million to upgrade the Central Utility Facility.

**DEBT STRUCTURE**

At the end of fiscal 2014, the county had $177.67 million in outstanding long-term, publicly issued debt and $43.8 million in Teeter Plan Notes issued through a direct bank placement.

**DEBT-RELATED DERIVATIVES**

The county has not entered into any derivative agreements.

**PENSIONS AND OPEB**

The county’s three-year adjusted net pension liability (ANPL) is moderate at 1.96% of AV and 3.3 times operating revenues; requirements that are slightly elevated in comparison with median figures of 0.9% and 1.1 times for all counties nationally. Moody’s ANPL reflects certain adjustments we make to improve comparability of reported pension liabilities. The adjustments are not intended to replace the county’s reported liability information, but to improve comparability with other rated entities.
Notably, the county is a regular issuer of pension obligation bonds ("POBS"), with which it has prefunded its annual contribution to the Orange County Employees Retirement System (OCERS) by January 15th of each year, allowing it to take advantage of a discounted payment requirement. Inclusive of interest and issuance costs, the 2014, 2015 and an anticipated 2016 POB issuance have resulted in combined, estimated net savings of $56.7 million. The POBS have been issued in January and fully repaid by the end of the following fiscal year.

The county’s unfunded OPEB liability equals $418 million as of the most recent actuarial valuation date of June 30, 2013. Positively, the county has paid its full Annual Required Contribution (“ARC”) beginning in fiscal 2008, and intends to continue paying this requirement, at a minimum, going forward. Notably, in fiscal years 2013 and 2014, the county made payments in excess of its minimum ARC requirement.

**Governance**

California counties have an institutional framework score of "A" or moderate. Primary sources of unrestricted revenues come from property tax and sales tax. Service charges and state aid make up significant sources of county revenues as well, however are usually restricted to specific purposes. Property taxes are fairly predictable, given the state’s constitutional formula, known as “Prop. 13”, while sales taxes are extremely sensitive, either to the local economy or the state’s financial position. Expenditure flexibility is similarly limited, although somewhat less so than revenues.

The county’s detailed planning and meticulous reporting support its initiatives to match recurring and reasonable revenue projections with Net County Costs. A five-year average in revenues as a percent of expenditures of 1.01% demonstrates the measurable success of these initiatives. We expect the county to persevere in their efforts to identify and maintain adequate reserve levels sufficient to withstand reductions during periods of weaker revenue growth.

**Legal Security**

Security for lease payments associated with outstanding COPs and lease revenue bonds is a contractual pledge of the county of all of its available financial resources, subject to abatement in the even to of reduced use of the leased property, effectively on parity with other unsecured obligations.

The Series 1996A and 1997A POBs are economically defeased with full repayment requirements held by a trustee in Aaa-rated securities.

**Use of Proceeds**

N/A

**Obligor Profile**

Located in southern California, Orange County is the third most populous county in the state with a population of over 3 million residing within 789 square miles. The county includes 42 miles of coastline and represents one of California’s major metropolitan areas.

**Methodology**

The principal methodology used in these ratings was US Local Government General Obligation Debt published in January 2014. An additional methodology used in lease-backed rating was The Fundamentals of Credit Analysis for Lease-Backed Municipal Obligations published in December 2011. Please see the Credit Policy page on www.moodys.com for a copy of these methodologies.
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