California Municipal Bond Market: 2014 Credit Outlook and Investors' Perspectives

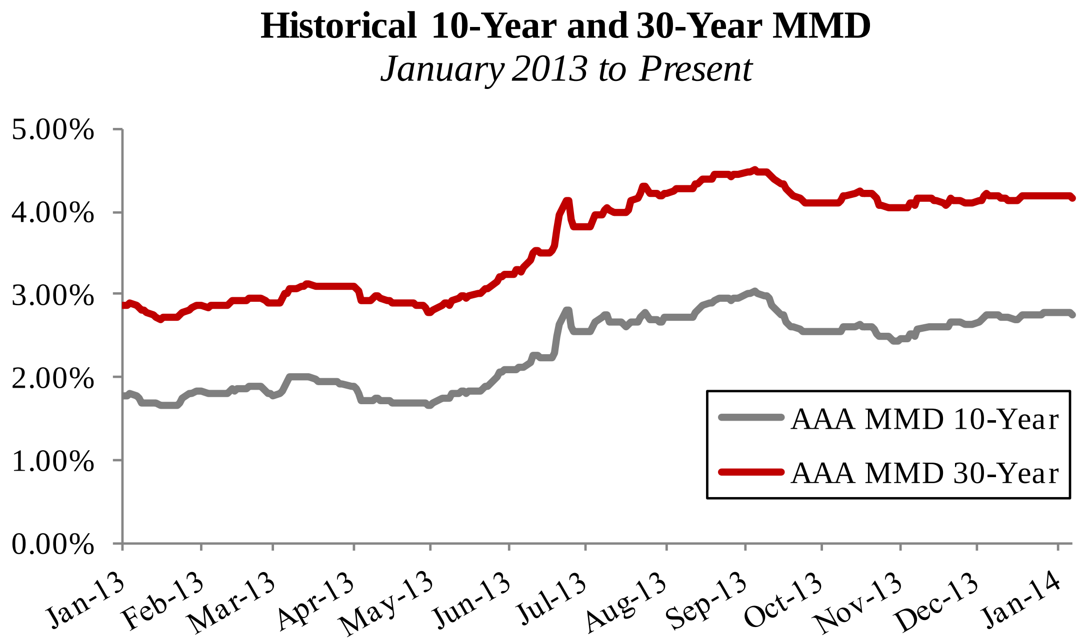
Presentation to San Diego County Economic Roundtable

January 17, 2014

Introduction: Outlook for 2014

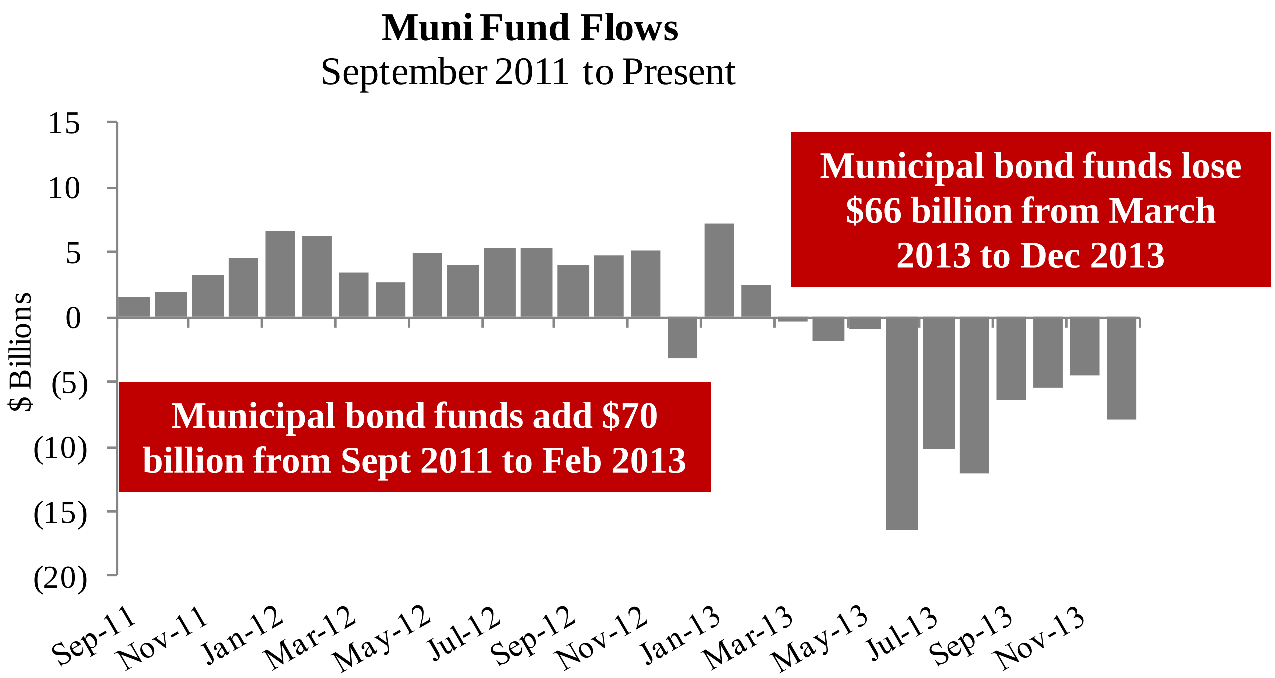
- Slowly improving economy has bolstered state and local government financial outlook, and strengthened credit standing of California municipal bond issuers.
- Prevailing trend in 2014 for California credits is for credit rating stabilization with upgrades outpacing downgrades.
- Investor sentiment towards California (the State, local government, enterprise departments and special districts) is generally positive.
- San Diego area credits enjoy strong reputation among investors and credit analysts, and issues are generally well received when they come to market.
- Despite the generally positive environment for California municipal bond credits, significant fiscal, political and market challenges loom large in the new year:
  - Accumulated debt, unfunded pension liabilities, and retirement health care benefits;
  - Rising interest rate environment;
  - Significant infrastructure needs and limited borrowing capacity;
  - Tax reform proposals;
  - ACA implementation.

Market Update



- Interest rates rose dramatically during the summer of 2013 on speculation that an improving U.S. economy would lead to less Fed support of the market.
- In September, the Fed's decision not to "taper" bond purchases led to a rally in the market.
- On December 18th, the Fed announced the beginning of their tapering program with a $10 billion per month reduction in bond purchases.
  - MMD has remained stable following the announcement.
  - Relatively light muni supply has helped keep rates low despite investor outflows.

Market Update



- Municipal bond funds have seen 31 weeks of outflows totaling $66 billion since March 2013
- The market will likely be very data-driven over the next several months, as investors look for signs of future Fed support reductions

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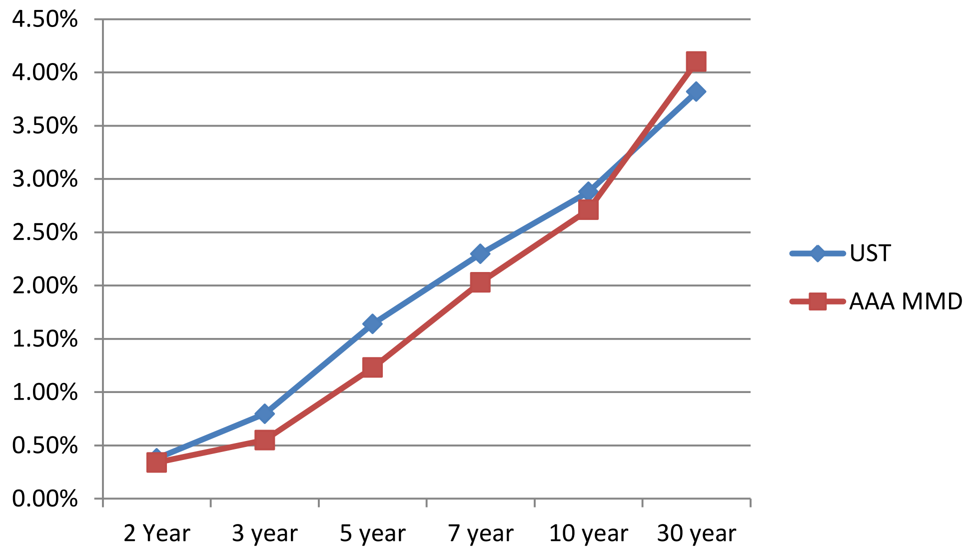
- Despite the consensus outlook toward rising interest rates in 2014, which would limit refunding opportunities and dampen new issue net proceeds, the current interest rate environment is still attractive for borrowers.



Prevailing Interest Rate Environment: Jan. 10, 2014

Tenor	UST	AAA MMD
2 Year	0.38%	0.34%
3 year	0.80%	0.55%
5 year	1.64%	1.23%
7 year	2.30%	2.03%
10 year	2.88%	2.71%
30 year	3.82%	4.10%

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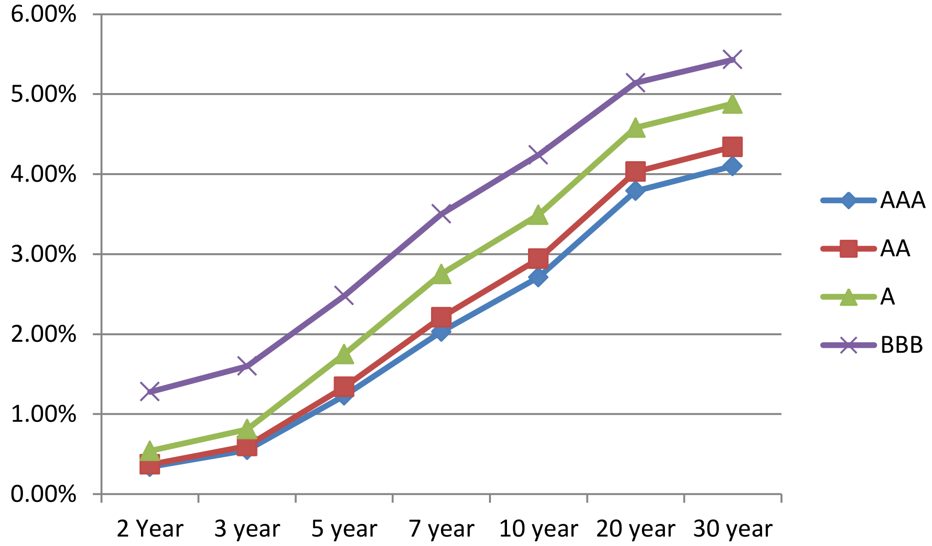
- Credit spreads for municipal issuers have widened out as a result of the financial crisis that began in 2008.



Prevailing Interest Rate Environment: Municipal Market Data Indices

Tenor	AAA	AA	A	BBB
2 Year	0.34%	0.37%	0.54%	1.28%
3 year	0.55%	0.60%	0.81%	1.60%
5 year	1.23%	1.34%	1.75%	2.48%
7 year	2.03%	2.21%	2.75%	3.50%
10 year	2.71%	2.94%	3.49%	4.24%
20 year	3.79%	4.03%	4.58%	5.14%
30 year	4.10%	4.34%	4.88%	5.43%

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Credit Overview: State of California

- Outlook for the State of California has improved dramatically over the course of the prior year.
  - Economy is improving illustrated by modestly rising employment levels, real estate valuations and retail sales.
  - 2012's Proposition 30 approval, with increased sales and personal income tax rates in upper income brackets, has strengthened cash flow and improved net operating results.
  - RDA dissolution decreased the State's K-14 spending requirements.
- Significant challenges remain.
  - PERs and STRs unfunded pension liabilities.
  - Relatively large amount of bonded indebtedness.
  - Deferred payments owed to schools.
  - ACA implementation.

Credit Overview: State of California

- State's General Obligation Bond credit rating trend is improving.
- Of the states with General Obligation bond ratings, only Illinois has lower ratings (A3/A-/A-)

Agency	Rating	Outlook	Last Action
Moody's	A1	Stable	Outlook upgraded to stable in 2010
Standard & Poor's	A	Stable	Upgrade from A- in 2013
Fitch	A	Stable	Upgrade from A- in 2013

State of California: LAO Outlook

- Fiscal Year 2013-14 General Fund operating surplus projected at $2.2 billion based on expenditure base of approximately $100 billion.
- Fiscal Year 2014-15 General Fund operating surplus projected at $5.6 billion.
- Despite positive operating results, the LAO recommends “caution” given daunting amount of what the Governor describes as the “wall of debt.”
  - Actuarially-estimated unfunded pension fund liabilities reported by PERS and STRS to currently equal 74% and 67%, respectively, of accumulated retirement requirements.
  - Deferred payments owed to schools of over $18B
  - Future operating surpluses predicated on continued economic growth.
  - Limited borrowing capacity based on current amount of bonded debt with significant infrastructure needs currently unaddressed (water, power, higher education, prisons, highways, airports).
    - State has $74.5B of GO bonds outstanding and $11.B of Lease Revenue Bonds with $30B of GOs and $7B of LRBs authorized but unissued.
    - Debt service equaled an estimated 7.7% of 2013 General Fund expenditures, a decrease from 8.8% in 2012.

Credit Overview: San Diego Credits

- Credits are typically well received by investors reflecting relative scarcity of San Diego area paper, strong local economy and historically good management practices.
- Intergovernmental and program funding responsibility issues loom large in 2014.
  - Federal tax reform proposals and potential impact on interest income exemption for municipal bonds.
  - Federal fiscal reforms and impact on education, transportation, health care, water and power sectors.
  - State fiscal and economic development reforms:
    - RDA dissolution;
    - Criminal justice/ public safety spending realignment;
    - ACA implementation.

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Credit Overview: San Diego Credits

- San Diego area bellwether credits enjoy strong ratings, both on an absolute level and relative to peers.

Comparative Issuer Credit Ratings

	Moody's	Standard and Poor's	Fitch
State of California	A1	A	A
Cities			
Los Angeles	Aa2	AA-	AA-
San Diego	**Aa3**	**AA**	**AA-**
San Francisco	Aa1	AA+	AA
San Jose	Aa1	AA+	AA+
Counties			
Alameda	Aa1	AA+	AA+
Los Angeles	Aa2	AA+	AA-
San Diego	**Aa1**	**AAA**	**AAA**
Santa Clara	Aa2	AAA	AA+

Representative San Diego Area Credit Ratings

	Moody's	Standard and Poor's	Fitch
City of San Diego	Aa3	AA	AA-
County of San Diego	Aa1	AAA	AAA
San Diego Reg. Trans. Comm.	Aa2	AAA	NR
San Diego Regional Airport Auth.	A1	A+	A+
San Diego Unified School District	Aa3	AA-	NR
San Diego County Water Authority	Aa2	AA+	AA+

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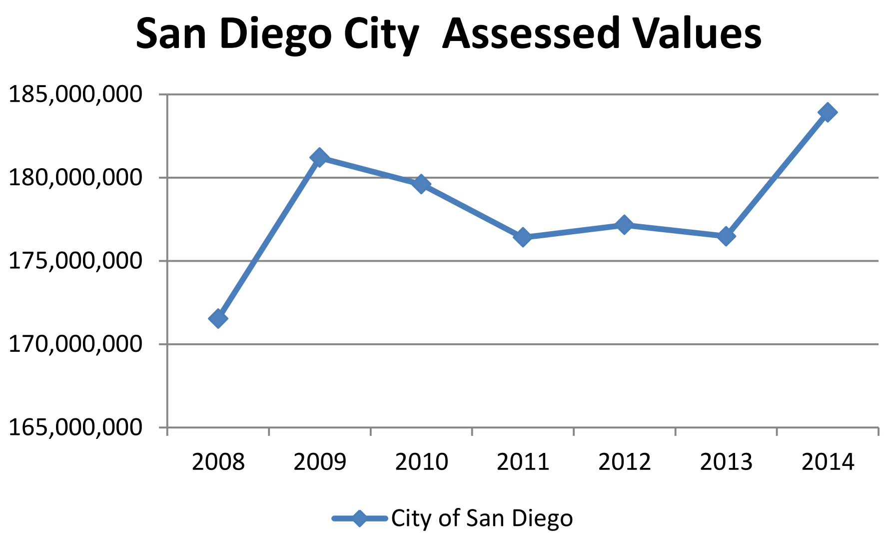
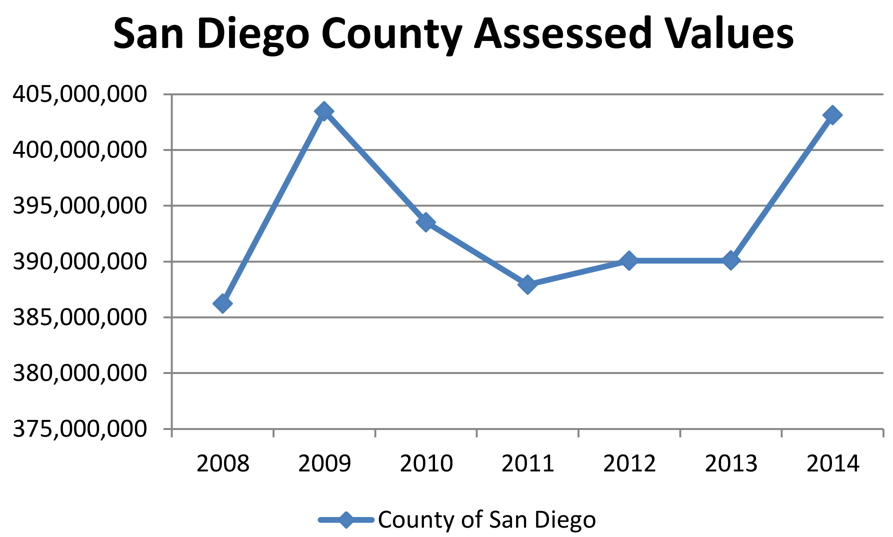
Credit Overview: San Diego Credits

- Property tax receipts are on the rise as property values improve, sales increase and valuation appeals decline.





Assessed Valuation History

Fiscal Year	City of San Diego	% Change	County of San Diego	% Change
2008	171,522,330,535	9.35%	386,233,372,724	9.45%
2009	181,191,012,684	5.64%	403,466,775,618	4.47%
2010	179,596,440,003	-0.88%	393,510,950,176	-2.48%
2011	176,399,248,071	-1.78%	387,915,278,148	-1.42%
2012	177,153,572,791	0.43%	390,068,038,331	0.55%
2013	176,469,487,982	-0.39%	390,085,431,631	0.00%
2014	183,898,801,134	4.21%	403,103,199,803	3.34%

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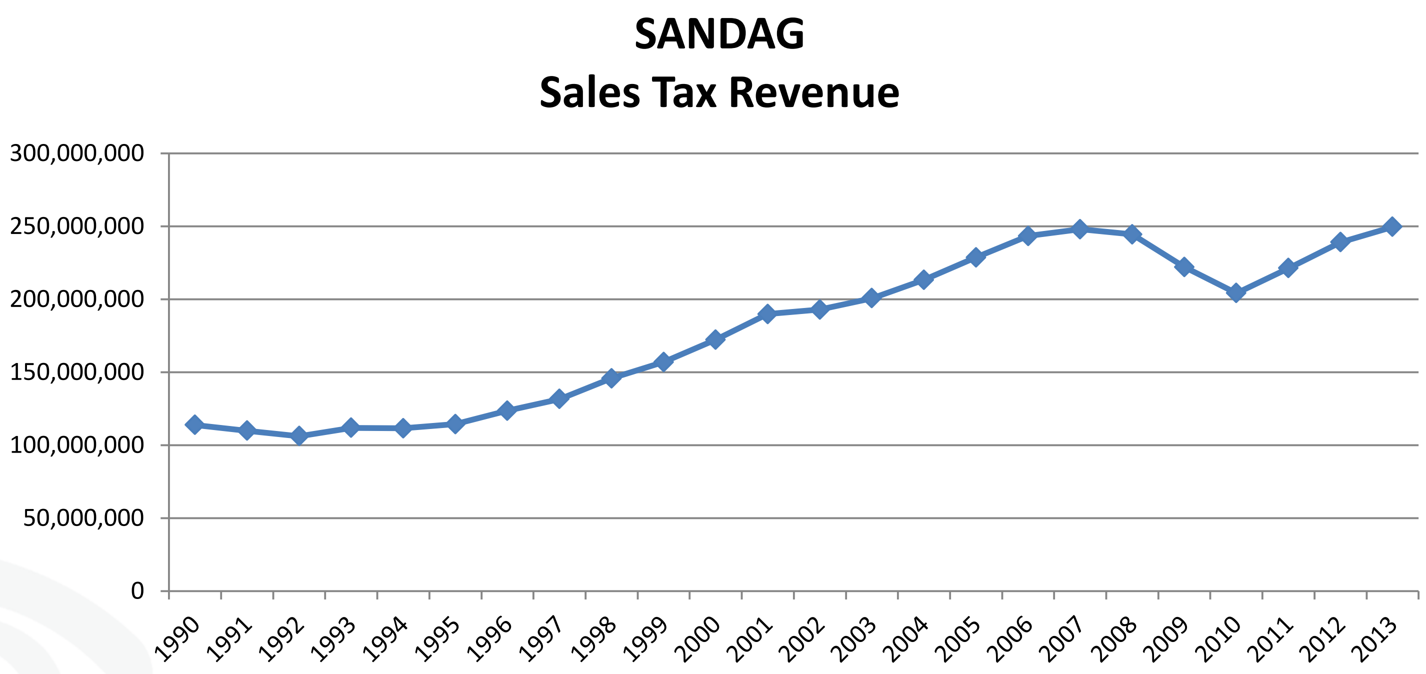
Credit Overview: San Diego Credits

- Sales tax revenues, as measured by SANDAG's county-wide $0.50 sales tax levy, are similarly improving.



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Credit Overview: San Diego Credits

- Largest property taxpayers concentrated in high tech, tourism and real estate development.

City of San Diego	County of San Diego
Qualcomm	San Diego Gas & Electric
Kilroy Realty	Southern California Edison
Host Hotels and Resorts	Qualcomm
One Park Boulevard	Kilroy Realty
OC / SD Holdings	Pacific Bell
Fashion Valley Mall LLC	Host Hotels and Resorts
SeaWorld Parks	OC / SD Holdings
Solar Turbines Inc.	One Park Boulevard
Arden Realty	B S K Del Partners
Irvine Co.	Fashion Valley Mall

Conclusion

- California municipal bond outlook for the 2014 is generally positive with improving balance sheets, revenue / income statements, and stabilizing credit ratings.
- Continued improving trend, however, is subject to highly uncertain variables:
  - Continued economic growth;
  - Successful resolution and implementation of important public policy issues such as health care reform, tax reform, fiscal reforms, and intergovernmental program funding responsibilities;
  - Impact of the significant amount of unmet infrastructure improvements;
  - Large debt burdens;
  - Rising interest rate environment.