CITY OF SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Julia H. Cooper
John Aitken

SUBJECT: **BOND RATING ACTIONS FOR SJC AIRPORT REVENUE BONDS**

DATE: October 28, 2020

Approved [signature] Date **10/29/2020**

INFORMATION

The Departments of Finance and Airport want to alert the Mayor and City Council to recent bond rating reviews and rating actions by two of the bond rating agencies, Standard & Poor's Global Ratings Service and Moody's Investors Service, affecting the City of San José airport revenue bonds issued for the Norman Y. Mineta San José International Airport (SJC). As noted in a webinar hosted by Citigroup Global Market's airport bond underwriting team this past week, more than 80 U.S. airport bond ratings have been downgraded this year due to the impact of the COVID-19 pandemic. Both rating agencies reached out to the City in advance of their reviews and Finance and Airport staff made presentations and answered questions from each agency. While Moody's ultimately made no change in its rating on the City's airport revenue bonds, Standard & Poor's decided to downgrade the Airport's bonds, as they have for many airports, notably including San Francisco International Airport. The third rating agency rating the Airport's bonds, Fitch Ratings, upgraded the Airport's rating in September 2019, but has not taken any recent actions.

OVERVIEW OF RATING ACTIONS

Standard & Poor's Global Ratings Service ("S&P")

S&P placed SJC, along with many other U.S. airport ratings, on CreditWatch on August 7, "to reflect the material negative impact of the COVID-19 pandemic on traffic levels, expected financial performance metrics, and overall credit quality", in a report titled "U.S. Airport Ratings Placed On CreditWatch Negative On Severe Passenger Declines And Weakening Credit Metrics," published August 7, 2020. On October 12, S&P released a credit report lowering its bond rating on SJC bonds from A to A-, and removed the rating from CreditWatch, where it had been placed with negative implications on August 7. S&P assigned an Outlook of Negative to the rating, which it explained means that S&P could lower the rating again if they come to believe that SJC's enplanements will remain materially depressed for longer than they expect, negatively affecting financial metrics for an extended period. The rating impacts approximately $1.1 billion in general airport revenue bonds (GARBs) and $51.9 million in commercial paper (CP) outstanding.

- S&P noted in their press release (attached) *"The rating action and negative outlook reflect our expectation that activity levels at SJC will be depressed, unpredictable, or demonstrate anemic growth due to the COVID-19 pandemic and associated effects outside of management's control. In our view, the severe drop in demand has diminished SJC's overall credit quality and will likely pressure financial metrics relative to historical levels. We view this precipitous decline not as a temporary disruption with a relatively rapid recovery, but as a backdrop for what we believe will be a period of sluggish air travel demand that could extend beyond our rating outlook horizon*."

<u>Moody's Investors Service ("Moody's")</u>

On October 22, 2020, Moody's completed its periodic review of its rating of the Airport bonds. The Moody's portfolio review assessed the appropriateness of the ratings in the context of the relevant principal methodologies, recent developments, and a comparison of the financial and operating profile to similarly-rated peers. The review did not involve a rating committee and did not result in any change in the Moody's rating on the airport revenue bonds. Moody's issued a press release (attached) to announce the completion of its review:

- Moody's notes "*The A2 rating reflects the airport's robust traffic performance in recent years, which along with well-controlled operating expenses has supported improvement in leverage and cost per enplanement (CPE). The airport's financial profile is further strengthened by its hybrid airline agreement which bolstered debt service coverage and liquidity. The airport is positioned to maintain a stable position given the historically strong local economy, competitive air service offering, and sufficient capacity supported in part by six new passenger gates that opened in 2019. Increasing facility constraints and the potential for additional debt for construction of a new concourse balances the airport's strengths. Despite the fact that the airport's ability to accommodate such an expansion has improved, its debt level remains elevated and the need to ensure competitive airline costs is a critical factor due to its proximity to a large hub airport and a similarly sized medium hub airport"*.

<u>Proactive City Responses</u>

As each bond rating agency contacted the Finance and Airport staff regarding their upcoming reviews, City staff requested the opportunity to formally present a coordinated presentation of the current state of the Airport's credit position with assistance from the City's municipal advisors for the Airport Revenue Bonds, Public Resources Advisory Group (PRAG) and PFM Financial Advisors. Staff advocated with each agency not to make a change in their existing bond ratings based on the following considerations:

- Staff represented analysis to support that San José remains an attractive market for airlines and remains a high-growth destination.
- Solid airport financial results for Fiscal Year 2020, contributed another $13 million in airport surplus into the Unrestricted Cash reserves.
- Airport's debt service is currently structured to decline by $12 million in FY 2023. This summer, staff also commenced work to initiate the refinancing of the Airport's outstanding 2011 Bonds in early 2021. Based on current low interest rates the refunding of the 2011A and 2011B bonds, if approved by Council in early 2021, should yield Net Present Value savings of about 30% of the refunded bonds and should offer significant near-term relief during the pandemic. The refunding of the 2011 bonds will have a significant impact on the airport as these bonds represent about 39% of the Airport's outstanding debt.
- Staff pointed to the Airport's strong liquidity position, noting that no Federal CARES funding was used in FY 2020 and that only 63% of the CARES funding is expected to be used in FY 2021.
- Finally, staff noted that SJC management has already made significant reductions in spending and will continue to closely monitor revenue and expenses.

The Departments of Finance and Airport will continue to keep Council apprised of actions affecting the Airport's bonds, and all of the City's bond ratings. Staff expects to provide detailed rating presentations to the rating agencies again in preparation for the refunding of the 2011 Bonds.

/s/
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/s/
JOHN AITKEN, A.A.E.
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For more information, please contact Nikolai J. Sklaroff, Deputy Director, Debt & Treasury Management in Finance at (408) 535-7832 or Kim Hawk, Airport Deputy Director, Finance & Administration, at (408) 392-1141

Attachments

Attachment

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San Jose International Airport, CA Revenue Bond Rating Lowered To 'A-' From 'A' On Weakened Enplanement Levels

01-Oct-2020 10:44 EDT
View Analyst Contact Information

CENTENNIAL (S&P Global Ratings) Oct. 1, 2020--S&P Global Ratings lowered its rating to 'A-' from 'A' on San Jose, Calif.'s airport revenue bonds issued for the Norman Y. Mineta San Jose International Airport (SJC), and removed the rating from CreditWatch, where it had been placed with negative implications Aug. 7, 2020. The outlook is negative.

SJC, along with many other U.S. airport ratings, was placed on CreditWatch to reflect the material negative impact of the COVID-19 pandemic on traffic levels, expected financial performance metrics, and overall credit quality.

"The rating action and negative outlook reflect our expectation that activity levels at SJC will be depressed, unpredictable, or demonstrate anemic growth due to the COVID-19 pandemic and associated effects outside of management's control," said S&P Global Ratings credit analyst Scott Shad.

Key credit strengths, in our opinion, are SJC's:

Role as the dominant provider of air service in the immediate service area, supported by a strong and affluent origin and destination demand base with exceptional historical enplanement growth prior to the COVID-19 pandemic, offset by modest air carrier concentration and regional competition;
Robust liquidity position;
Relatively large and economically vibrant service area; and
Very strong management and governance.
Key credit weaknesses, in our opinion, are SJC's:

Exposure to potentially prolonged weak or unpredictable enplanement levels as a result of COVID-19 outbreaks and lingering associated effects; and
Constrained cash flow generation ability as a result of severe enplanement declines related to factors outside of management's control, pressuring financial metrics.
Our rating action reflects health and safety risks posed by the COVID-19 pandemic and its impact on passenger activity due to mobility restrictions and behavioral changes related to travel, which we view as a social factor within our environmental, social, and governance factors, resulting in significant operating and financial pressures for the

airport. We note the airport's service area is exposed to elevated wildfire, flood, and seismic risks as an environmental risk. We consider SJC's governance factors to be generally in line with our view of the standard for the airport sector. We will continue to evaluate these risks as the situation evolves.

We could lower the rating if we come to believe that SJC's enplanements will remain materially depressed for longer than we expect, negatively affecting financial metrics for an extended period.

We could revise the outlook to stable in the next two years with improved clarity on the trajectory of SJC's enplanement recovery and stabilization of activity levels. When making this assessment, we will evaluate if the airport's ability to maintain financial metrics is achievable, sustainable, and consistent with the rating.

RELATED RESEARCH

Through The ESG Lens 2.0: A Deeper Dive Into U.S. Public Finance Credit Factors (/en_US/web/guest/article/-/view/sourceId/11355829), April 28, 2020
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MOODY'S
INVESTORS SERVICE

Announcement of Periodic Review: Moody's announces completion of a periodic review of ratings of San Jose (City of) CA Airport Enterprise

22 Oct 2020

New York, October 22, 2020 -- Moody's Investors Service ("Moody's") has completed a periodic review of the ratings of San Jose (City of) CA Airport Enterprise and other ratings that are associated with the same analytical unit. The review was conducted through a portfolio review in which Moody's reassessed the appropriateness of the ratings in the context of the relevant principal methodology(ies), recent developments, and a comparison of the financial and operating profile to similarly rated peers. The review did not involve a rating committee. Since 1 January 2019, Moody's practice has been to issue a press release following each periodic review to announce its completion.

This publication does not announce a credit rating action and is not an indication of whether or not a credit rating action is likely in the near future. Credit ratings and outlook/review status cannot be changed in a portfolio review and hence are not impacted by this announcement. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on www.moodys.com for the most updated credit rating action information and rating history.

Key rating considerations are summarized below.

The A2 rating reflects the airport's robust traffic performance in recent years, which along with well-controlled operating expenses has supported improvement in leverage and cost per enplanement (CPE). The airport's financial profile is further strengthened by its hybrid airline agreement which bolstered debt service coverage and liquidity. The airport is positioned to maintain a stable position given the historically strong local economy, competitive air service offering, and sufficient capacity supported in part by six new passenger gates that opened in 2019.

Increasing facility constraints and the potential for additional debt for construction of a new concourse balances the airport's strengths. Despite the fact that the airport's ability to accommodate such an expansion has improved, its debt level remains elevated and the need to ensure competitive airline costs is a critical factor due to its proximity to a large hub airport and a similarly sized medium hub airport.

This document summarizes Moody's view as of the publication date and will not be updated until the next periodic review announcement, which will incorporate material changes in credit circumstances (if any) during the intervening period.

The principal methodology used for this review was Publicly Managed Airports and Related Issuers published in March 2019. Please see the Rating Methodologies page on www.moodys.com for a copy of this methodology.

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