FitchRatings

Fitch Rates San Francisco Bay Area Rapid Transit District, CA's Sales Tax Revs 'AA+'; Outlook Stable

Fitch Ratings-San Francisco-07 December 2017: Fitch Ratings has assigned a 'AA+' rating to the following San Francisco Bay Area Rapid Transit District, California (BART or the district) bonds:

--Approximately $148.4 million sales tax revenue bonds, 2017 refunding series A (green bonds);
--Approximately $67.4 million sales tax revenue bonds, 2017 refunding series B (federally taxable green bonds).

In addition, Fitch has affirmed the following ratings at 'AA+':
--The district's Issuer Default Rating (IDR);
--$571.2 million sales tax revenue bonds;
--$96.8 million general obligation (GO) bonds.

The Rating Outlook is Stable.

The 2017A and 2017B sales tax revenue refunding bonds are scheduled to sell via negotiation during the week of Dec. 11, 2017. Bond proceeds will be used to refund the district's outstanding series 2010 bonds and portions of series 2012A as well as to pay cost of issuance.

SECURITY

The sales tax revenue bonds are payable from a first lien on 75% of the 1/2 cent BART sales and use tax (sales tax) levied in Alameda and Contra Costa counties, and the City and County of San Francisco (collectively, the BART counties).

The GO bonds are backed by an unlimited ad valorem tax levied on all taxable property within the BART counties.

ANALYTICAL CONCLUSION

The 'AA+' IDR and GO ratings reflect BART's healthy financial performance, moderate but rising long-term liabilities, strong revenue growth prospects and manageable capital spending pressures in the context of an unusually vibrant economic base. The 'AA+' sales tax revenue bond rating reflects strong maximum annual debt service coverage, expectations for limited additional leveraging and solid growth prospects for sales tax revenues.

Economic Resource Base
BART provides essential public transportation services to a wealthy, diverse and growing San Francisco Bay Area economy. The district includes Alameda, Contra Costa and San Francisco counties, home to 3.7 million residents and 1.9 million jobs. Average weekday ridership was 423,395, or about 20% of local payroll employment, in fiscal 2017.

KEY RATING DRIVERS

Revenue Framework: 'aa'
The district's sales tax and passenger fare dominated revenue structure provides strong revenue growth at above both the level of inflation and overall economic growth. While the district's governing board does not have the independent authority to raise taxes, policymakers have the power to adjust fares, which make up the majority of system revenues available for operations.

Expenditure Framework: 'aa'
The district faces significant capital spending pressures, but Fitch expects the increases to track revenues over time. Expenditure flexibility is solid with moderate fixed costs and significant pay-go capital spending offsetting a somewhat restrictive labor environment.

Long-Term Liability Burden: 'aa'
Combined debt and pension liabilities are low relative to personal income and moderate relative to cash flow available for debt service (CFADS). GO debt is expected to rise significantly as the district addresses a significant backlog of capital spending needs, but overall liability levels are expected to remain consistent with the 'aa' assessment.

Operating Performance: 'aa'
Operating performance is healthy. The district is well positioned to withstand cyclical revenue variability due to healthy reserves, consistently positive margins and the ability to offset revenue losses with either spending cuts or fare increases. Budget management in times of recovery is somewhat mixed with healthy funding of

retirement liabilities and conservative, thorough financial planning offset by ongoing deferrals of needed capital spending.

RATING SENSITIVITIES

CAPITAL FUNDING RISKS: The ratings could come under downward pressure if the district fails to address its significant backlog of deferred capital needs in a sustainable manner or if the district's plan to address the capital backlog pushes leverage to a elevated level. Significant additional leveraging of the sales tax revenues could put downward pressure on the sales tax revenue bond ratings.

UNEXPECTED WEAKENING IN FINANCIAL PERFORMANCE: A sustained and unexpected weakening of financial performance could pressure the rating. A moderate weakening during a cyclical downturn is unlikely to pressure the rating so long as performance remains healthy and recovers in the subsequent expansion.

CREDIT PROFILE

Revenue Framework
The district benefits from a diverse revenue mix that includes fare revenues (55% of 2016 revenues excluding capital grants), sales taxes (27% of revenues), intergovernmental aid (8%), and property taxes (6%). Revenue volatility is somewhat higher than the typical U.S. local government because of dependence on cyclical sales taxes and somewhat cyclical fare revenues. Ridership is quite cyclical with decreases tracking changes in payroll employment; however, the district's board has generally adjusted fares to recover lost fare revenues, creating much lower volatility of fare revenues than ridership. Revenue downturns tend to be short-lived and followed by periods of very strong growth.

The natural pace of revenue growth is quite strong with revenue gains consistently outpacing both inflation and economic growth. The 10-year compound annual growth rate of revenues (excluding capital grants and the GO bond levy) through 2016 was particularly strong at 5.2%. Growth in sales taxes (about a quarter of revenues available for operations) tracks inflation fairly well on average over time. Rapid increases in fare revenues (about half of revenues available for operations) push overall revenue gains above the rate of economic growth as ridership has benefited from the region's fast growing job market. Fitch does not expect the current revenue and economic boom to continue indefinitely but does expect revenues to continue to outpace the rate of economic growth on average overtime, reflecting solid long-term population and ridership trends. The district's board has also approved multi-year fare increases (2014 to 2020) that are tied to the consumer price index, but the bulk of recent growth has been driven by underlying increases in demand. The district reports that ridership declined 2.3% in 2017, possibly reflecting greater competition from ride-hailing services particularly on discretionary, off-peak travel. Longer-term ridership trends remain very positive with average weekday ridership up by a quarter from 2007 levels. A sustained trend of declining ridership could put downward pressure on the revenue framework assessment and the overall ratings.

The district has satisfactory revenue raising flexibility due to strong fare box recoveries that offset a lack of independent legal ability to raise taxes. BART is unusual among U.S. public transit agencies in that fares cover a high proportion of operating expenses (about three-quarters in recent years). The district's elected board has the authority to increase fares without outside approval and has regularly offset revenue losses through fare adjustments. A 10% increase in fares would fully offset the revenue loss generated by the Fitch Analytical Sensitivity Tool (FAST) in a 1% decline in U.S. gross domestic product, a moderate U.S. recession scenario.

While BART's revenue framework is generally judged to be a credit strength due to strong natural growth of revenues and satisfactory revenue raising flexibility, the district does have significant exposure to outside funding that is beyond the control of the district, including significant funding for capital from local transit funding agencies, the state of California and the federal government. This is not unusual for transit agencies, but Fitch's assessment of the revenue framework could be reduced if the district's access to intergovernmental aid declines on a sustained basis.

Expenditure Framework

The primary drivers of BART's spending are capital expenditures and labor costs.

Fitch expects spending to keep pace with above-average revenue growth due to significant capital spending pressures. Other components of spending, particularly labor, are likely to track inflation more closely, though rising benefit costs could add further to cost pressures.

Expenditure flexibility appears solid. The fixed carrying costs of debt service and retiree liabilities are very manageable at 14% of spending in fiscal 2016. Fitch expects carrying costs to rise as additional debt is issued but to remain moderate (below 20%) as a percentage of expenditures. The district also benefits from significant spending flexibility due to the ability to temporarily defer pay-go capital spending during downturns or to shift funding strategies from pay-go to debt financing during periods of stress.

The district has some (but not complete) control of labor costs. It must negotiate pay and benefits levels with its unionized workforce. While management ultimately controls headcount and may ultimately impose terms after an impasse, the labor environment can be contentious and limits expenditure flexibility somewhat. District employees retain the ability to strike and have in recent years, forcing management to ultimately offer more favorable terms.

Long-Term Liability Burden

The district's long-term liability burden is low relative to its large economic base and composed primarily of general obligation bonds, sales tax revenue bonds and a moderate unfunded pension liability. The overall long-term liability burden (including district debt, pensions and overlapping debt) is low at about 8% of personal income. The direct liability burden (including $1.4 billion in district debt and estimated unfunded pension liabilities of about $960 million based on Fitch's standard 6% rate of return assumption) equals just 0.8% of personal income with the lion's share of total liabilities made up of overlapping debt. Long-term liabilities appear higher but still moderate relative to cash flows. Net debt to cash flow available for debt service was 6.2x in 2016.

Direct debt is likely to increase significantly over the next decade as the district addresses a backlog of deferred capital needs. The district has identified about $5.8 billion of funding to finance its $9.2 billion 2018-22 five-year capital improvement program. The identified funding includes capital grants, pay-go funding and approved borrowing under the district's GO bond program. District voters approved a $3.5 billion unlimited tax GO bond authorization in November 2016. The district plans to use the authorization over the next two decades, which would increase direct debt substantially. Management continues to seek additional outside funding to close the remaining capital funding gap but may have to defer some projects. While the funding gap remains sizeable, the 2016 bond authorization improves the district's position significantly, positioning it to address its most critical deferred capital needs for the first time in many years.

Long-term liabilities are expected remain low relative to the district's massive economic base with gradual use of the 2016 GO bond authorization, but debt would rise to somewhat elevated levels relative to cash flows. On net, the planned debt issuance would not be negative for credit quality if phased gradually as expected. While higher leverage carries inherent risks, Fitch believes the additional debt is less of a concern than an unaddressed and worsening capital backlog that has existed for some time and begun to cause disruptive system failures. Importantly, the GO authorization includes new property tax revenues to pay debt service, which are much more certain than the usual transit funding streams (fares and sales tax revenues).

The analysis supporting the 'AA+' IDR includes a variation from Fitch's "U.S. Public Finance Tax-Supported Rating Criteria". Enhanced analysis under the variation relates to the evaluation of the transit agency's debt profile. This evaluation is supported by Fitch's "Rating Criteria for Public Sector Revenue-Supported Debt" dated June 5, 2017

Operating Performance

The district is well positioned to withstand typical cyclical revenue variability. Fitch believes BART's margins would decline from the very robust levels of recent years in a downturn, providing less pay-go funding for capital spending but remaining positive and healthy. The district also maintains a strong reserve position to offset short-term cyclical revenue shortfalls. Unrestricted cash and investments equaled 94.6% of expenses (equivalent to 345 days cash) at fiscal 2016 year-end. The FAST model estimates that the district may experience a decrease in revenues of about 4.4% in a moderate recession. The FAST estimate is based on an analysis of the districts long-term revenue performance across economic cycles. Fitch expects the district to adjust service levels, fares and capital spending to maintain healthy cash balances through a downturn. The district may also increase debt funding of capital for a period in downturns, which is typical for capital intensive enterprises. The ability to shift between capital funding sources (locally generated pay-go, grants from higher levels of government and use of debt) is a key source of financial flexibility.

The district's budget management at times of economic recovery is mixed with strengths somewhat offset by a track record of deferral of needed capital spending. The district engages in thorough and conservative budgeting with long-term forecasting that keeps management and policymakers focused on long-term budget balance. It consistently makes full actuarially determined contributions to pensions and has begun to prefund other post-employment benefit liabilities. It also quickly rebuilds financial flexibility and its reserve safety margin after periods of stress. While historical deferrals of needed capital spending continue to limit Fitch's assessment of operating performance somewhat, the district has made significant progress in addressing this concern with the 2016 bond election, which was passed with strong support on the first attempt. Continued progress in securing sufficient funding to finance ongoing capital spending needs could lead to an increase in the operating performance assessment.

Dedicated Tax Analysis

The sales tax revenue bond rating is capped at the authority's IDR because Fitch believes debt service payments may be subject to an automatic stay in the unlikely event of a bankruptcy by BART. The sales tax revenue bonds are supported by a broad and diverse base of taxpayers across the three BART counties. Sales tax revenues are expected to grow above the level of inflation, but below the level of U.S. economic growth over time. Sales taxes have risen at a compound annual growth rate of 2.3% over the past decade.

Pledged revenue coverage is very strong (unaudited 4.8x MADS in 2017) and expected to remain strong throughout a typical, moderate U.S. recession. To evaluate the sensitivity of the dedicated tax revenue stream to cyclical decline, Fitch considers both a revenue sensitivity scenario (using a 1% decline in national GDP scenario) and the largest decline in revenues over the period covered by the revenue sensitivity analysis. Based on the district's sales tax revenue history, Fitch's analytical sensitivity tool (FAST) generates a 5.9% decline in pledged revenues during the first year of a moderate recession. The largest cumulative revenue decline historically was 17.8% over two years in the aftermath of the Great Recession in 2009 and 2010.

Assuming issuance up to the 1.5x additional bonds test (ABT), the structure could tolerate a 33% drop in revenues. Fitch does not expect the district to leverage to the ABT. The district currently has no plans to further leverage the revenue stream and needs the excess cash flows to fund its ongoing operating and pay-go capital budget. At current leverage levels, sales tax revenues could fall 78% before reaching 1x debt service coverage. The 78% coverage cushion is 13.2x the recessionary decline scenario produced by the FAST model and 4.4x the decline of the Great Recession, which Fitch views as consistent with a 'aaa' level of financial resilience.

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

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Applicable Criteria
Rating Criteria for Public Sector Revenue-Supported Debt (pub. 05 Jun 2017) (https://www.fitchratings.com/site/re/898969)
U.S. Public Finance Tax-Supported Rating Criteria (pub. 31 May 2017) (https://www.fitchratings.com/site/re/898466)

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