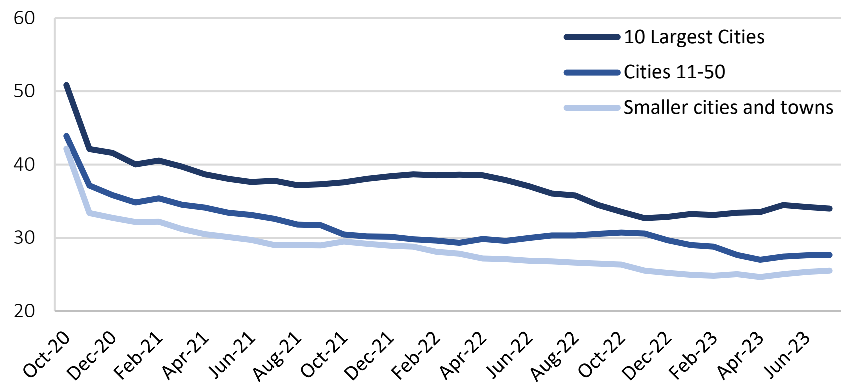
URBAN BUDGET ANALYSIS REQUIRES LOOKING BEYOND THE HEADLINES

The Work From Home Revolution Is Challenging US Business Centers

Extraordinary periods of time often introduce structural changes long after the precipitating event passes, and by many measures the impact of COVID-19 fits this pattern. The pandemic has changed many societal and economic dynamics, most notably through a dramatic increase in remote work arrangements. What was once an anomaly now looks like a permanent part of the business landscape with implications on municipal finance. **Delving into this socio-economic dynamic illustrates the very real financial impact on US cities. Nonetheless, we retain confidence in the municipal sector's overall health and, more specifically, the bonds of local governments our Municipal Research team approves.**

Working from Home is More Common in Big Cities:
% of Paid Full Days Worked from Home



Source: WFHresearch.com

A reduced need for office space has had a profound impact on vacancy rates and commercial real estate sector pressures are far from over. Furthermore, the nature of long-term leases introduces a lag effect that could accelerate these strains as leases renew unless demand for commercial office space accelerates. The consensus is that commercial real estate values face further declines, a trend that would lead to weaker appraisals and lower property tax revenue for US cities. Given the interconnected nature of workplace changes and downtown vitality, many large US municipalities will likely continue to grapple with reduced economic activity in their central business districts.

Commercial Real Estate Issues Deepen

The Wall Street Journal recently reported that the commercial office market slump is moving into a new phase as more landlords have already or are evaluating offloading properties at fire sale prices[1]. A few noteworthy examples follow:

- About $24.8 billion of US office buildings were in distress at the end of the Q2, an increase of 36% from the prior quarter according to MSCI Real Assets.
- The Trepp CMBS Special Servicing Rate, a metric that measures the percentage of CMBS in Special Servicing status (defined as distressed and transferred to a trustee with expertise is managing distressed situations), climbed 31bps month-over-month in June to 6.42%, well above 4.91% of a year ago. This represents the fifth consecutive increase and the third largest this year. Most notable was an 81bps jump in the office sector in June alone, and the office rate now stands at its highest level since 2017.
- Unibail-Rodamco-Westfield (URW) and Brookfield Properties are preparing to hand over control of Westfield San Francisco Centre to lenders, a 1.2-million-square-foot shopping center in downtown San Francisco's Union Square that is 45% vacant.
- Principal Financial Group sold a Parsippany, NJ office building for $14.3 million, a sharp decline from the $52 million it paid for the same property in 2008.
- The asking price for 350 California Street in Downtown San Francisco was $250 million when it was first listed in 2020. In a sign of the times in the struggling city, the office tower was recently sold for $60 million.
- Blackstone recently divested itself of the Griffin Towers office complex in Santa Ana, CA for $82 million, about 36% less than it paid in 2014.

1. "Rise in Distressed Sales Signals New Chapter for Beleaguered Office Market," Peter Grant, Wall Street Journal, May 16, 2023

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We Do Not Anticipate a Credit Cliff

While commercial property is clearly facing difficult times, the connection to the credit quality of bond issuers is much less direct than may be commonly thought. As in most aspects of credit analysis, context is needed. For one, individual markets are highly distinct, and the strains faced by cities such as San Francisco are not as acute elsewhere. Industry mix, the extent of work from home arrangements, regional demographic characteristics, and population migration trends all influence downtown economic recovery levels.

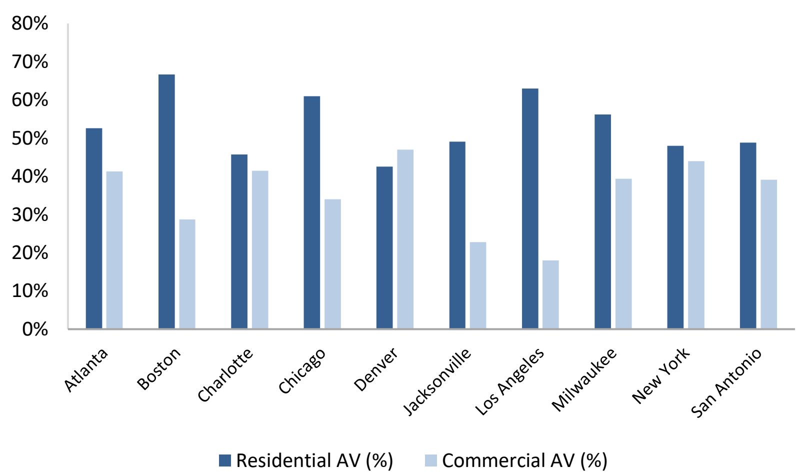
Commercial property strains take time to play out and municipalities have ample opportunity to make prudent fiscal moves in response. Revaluation of a city's property base is a multi-year process, not a sudden headline event. Although assessment practices and mechanisms vary state-by-state, there is typically a 1 to 2-year lag between market value changes and appraisal valuation. Pending tax appeals will certainly challenge prevailing valuations, although this too introduces an extended process that often takes years, not months. Commercial property tax revenue will be impacted in many US markets, although we anticipate a multi-year adjustment process, not a sudden, unanticipated shortfall.

Taxing mechanisms differ across states, and some are constructed to offset volatility in property values. Proposition 13 in California offers meaningful protection against downside revenue exposure in our nation's largest state, as the law limits annual growth in assessed values to 2%. As a result, many California property assessments remain well below market value, thereby enabling assessed values and associated property tax revenues to increase even as market values are declining.

Residential Property Remains on Much Firmer Ground

Residential housing remains a powerful stabilizing fiscal factor, particularly given the sustained strength in property values and corresponding tax revenue. Supply has been constrained for many years, creating a persistent supply/demand mismatch that has propped up residential property. The situation has been exacerbated of late as many homeowners are unwilling to sell and relinquish their low mortgage rates. In fact, over 85% of US homeowners have a 30-year mortgage rate below 5%, while the average rate for new mortgages has risen to 6.80%.[2] As a result, demand for new housing development has been durable, fortifying tax bases and revenue. **The influence of a robust housing market on municipal credit is powerful, as residential properties typically represent Local Government's largest property sub-category.**

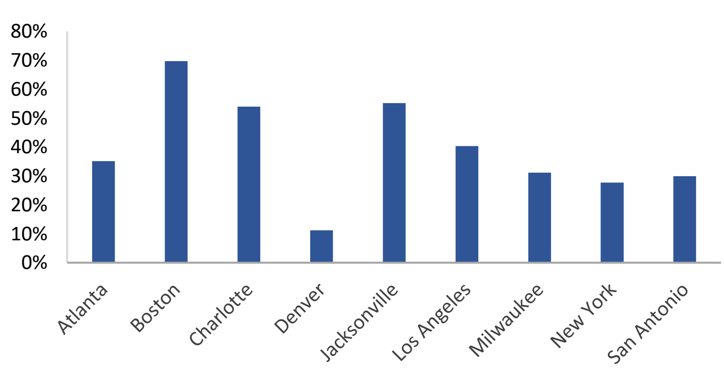
Assessed Value: Residential vs. Commercial Property



Source: Issuer Financial Disclosures

Revenue Mix & Diversity

Property Taxes Are Not Always the Primary Revenue Source (% of General Fund Revenue)



Source: Merritt Research Services, Issuer Disclosure

Astute Financial Management Matters

The demonstrated ability of municipal executives to manage changing budget dynamics has always been integral to our credit research process. When faced with uncertain revenue forecasts, it is imperative that financial managers understand and anticipate fiscal risks and subsequently move quickly to adjust out-year budget projections. **We believe the credits we approve are doing so very effectively and retain considerable flexibility to implement budget adjustments that may be needed.**

2. Freddie Mac, July 1, 2023

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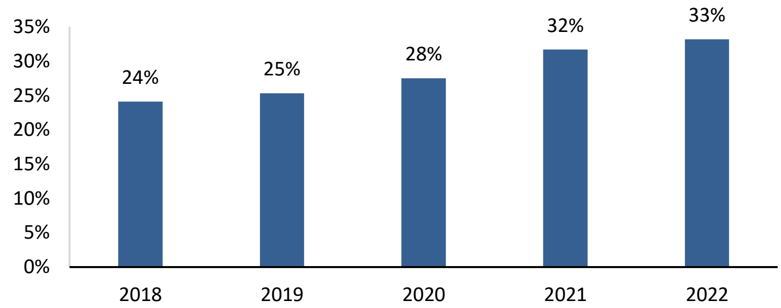
Most Municipalities Still Enjoy a Considerable Fiscal Buffer

Much like US states, most cities entered this turbulent period in solid fiscal shape, supported by pandemic aid, revenue outperformance, and conservative budgeting. As an example, Merritt Research Services reported that median reserves for the 100 largest US cities increased from 24% of revenue in 2018 to 33% in 2022.

Healthy reserve balances can provide liquidity and a short-term reprieve should property tax revenue disappoint. While the best-managed cities will adjust their expenses to match revised revenue projections, maintaining strong reserve funds provide us with greater confidence that cities have financial flexibility, supporting their ability to maintain credit quality.

Median General Fund Balance as % of Revenue: 100 Largest US Cities



Source: Merritt Research Services

Stress Test Analysis Offers Credit Comfort

Looking more closely at two of the country's most prominent urban business centers offers valuable insight into why we feel credit quality risks may be overstated.

New York City:

The City's Comptroller, Brad Lander, recently outlined revenue forecasts for a "doomsday" scenario for the Manhattan office market. His stress test included a decline in the value of office properties by 40% from 2023 to 2029, an assumption that would produce a revenue shortfall of $322.7 million in FY 2025, increasing to $1.1 billion by FY 2027. **While substantial in absolute terms, we take solace from the fact that this makes up only 3% of current total property taxes and 1.4% of overall tax revenues.**

Source: New York City Comptroller

San Francisco:

The City is experiencing a slower rebound in office and commercial activity than other urban centers, particularly within the downtown commercial district. This is driven by a greater incidence of fully remote or hybrid working schedules, a factor influenced by the prominence of the technology industry, along with finance and other "white collar" sectors.

San Francisco is facing an office vacancy rate of about 25%, the biggest increase from pre-pandemic levels among large cities according to real estate services firm CBRE. However, there are signs of recent recovery with downtown sales tax revenue increasing 19% over the last three months of 2022 compared with the same period of 2021.

Offsetting the City's struggling downtown is a large residential component (67.5% of assessed value is residential vs. 57.1% median for large cities), healthy reserves ($2.9 billion at the end of FY22, or 46% of revenues), and a diverse revenue mix.

It is worth emphasizing that office property accounts for a modest 17% of the City's assessed value and only generates 6% of total general fund revenues. Even assuming a draconian 50% reduction in office property values, the impact would be a manageable 3% of the City's budget.

Source: Issuer Financial Statements

Where Does This Leave Municipal Credit?

We acknowledge that some cities are not enjoying the full extent of recovery in their commercial centers as was anticipated only a couple years ago. **Nonetheless, we believe most tax-exempt bond issuers, particularly those approved for our clients' investments, will only experience very modest credit impact in the months and years ahead.**

Projecting issuer specific impact on credit quality requires case-by-case analysis, not simply extrapolating from disconcerting and at times only peripherally related headlines. Modeling potential impact requires understanding factors such as the relative size of an issuer's exposure to the office market, tax revenue diversity, budget discipline, and financial reserves. Some US cities will inevitably struggle more than others, and our research team is focused on differentiating between those highly likely to maintain their credit standing and issuers that may be falling behind.