THE REDEVELOPMENT AGENCY OF THE CITY OF SAN JOSE

MEMORANDUM

TO: HONORABLE MAYOR, CITY COUNCIL, AND AGENCY BOARD	FROM: HARRY S. MAVROGENES DEBRA FIGONE
SUBJECT: SEE BELOW	DATE: APRIL 22, 2011

INFORMATION

SUBJECT: UPDATE ON THE REDEVELOPMENT AGENCY'S BOND RATINGS FROM MOODY'S

Moody's Investors Services is one of three national credit rating agencies that have provided ratings to the Agency's tax allocation bonds since 1983. Rating agencies periodically review and assess issuers' assigned ratings. On April 18, 2011, based on this periodic review, Moody's downgraded the Agency's bonds, both those secured by 80% tax increment (non-housing bonds) and 20% tax increment (housing bonds), with a negative outlook. The report is attached as well as an article published on April 18, 2011 in the Bond Buyer (a daily newspaper of public finance).

The extent of the downgrades depends on whether the bonds were secured by 80% revenues (the Agency Program, non-housing) or 20% revenues (the Housing Program) and how the debt service required for each series of bonds was met. The rating for the 80% (non-housing) tax allocation bonds with cash-funded debt service reserves or reserves that are met with sureties from investment grade providers have been reduced from A2 to Baa1. This accounts for approximately $1.08 billion of the Agency's outstanding debt. The Agency's 80% (non-housing) tax allocation bonds with debt service reserve requirements met with below investment grade surety policies have been reduced from A2 to Baa2, on approximately $671 million of outstanding debt.

Key areas highlighted in the Moody's rating downgrade include:

- Falling property values which have "cut into debt-service coverage", primarily reflecting a "significant deterioration of debt-service coverage levels", which has resulted in a reduced senior lien coverage of 1.09x and the expected continuing decline in assessed values in 2012.

- High concentration of incremental assessed value in the top 10 taxpayers in the area was noted as an area of concern. Cisco, as the largest taxpayer, contributes 16% of the incremental assessed value and the top 10 payers together made up 36%.

Moody's also noted that low debt-service coverage levels may lead the Agency to ask the City to meet debt-service requirements for the convention center and the parking garage bonds.

The unfavorable factors noted in the Moody's Report are offset by Moody's acknowledgement of the "basic strengths of the Agency's Project Area, including its enormous size and importance to the Silicon Valley economy, which is showing measurable signs of improvement and may lead to resumption of AV growth in the mid-to-long term."

The Key Credit Strengths noted by Moody's include the following:

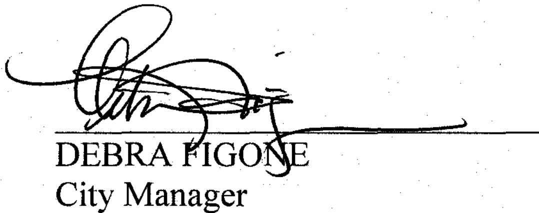
- Very large project area tax base spanning most of downtown San Jose
- Very large total and incremental Assessed Value (AV)
- Incremental to total AV ratio is very high
- Largest tax payers are well known successful firms
- Signs of improving economy, including lower unemployment and higher sales tax receipts
- For housing bonds, strong debt-service coverage levels

Moody's review of the Agency's 20% housing set-aside senior tax allocation bonds resulted in a downgrade of the bonds from A2 to A1 reflecting the reduced debt service coverage levels, which stand at a still strong 1.86x coverage factor for the senior lien and 1.49x for senior and junior lien debt service combined. Other factors of concern mirror those mentioned above.

Moody's negative outlook reflects continued concern regarding the significant contraction of incremental revenue in 2011. This, combined with the likelihood that the 2012 increment will be even lower, may result in reduced senior lien coverage to just 1.04x and the first and second lien coverage to 1.0x.

The two other rating agencies, Standard and Poor's and Fitch, assigned ratings to the Agency's 80% tax allocation bonds of "BBB+" and "BBB-", respectively, and the housing set-aside tax allocation bonds are rated higher at "A" and "A", respectively. Fitch most recently reviewed the Agency's credit in January 2011 and assigned the current ratings. Standard and Poor's review of the Agency's credit was completed the first week of April 2011.

The S&P downgrade earlier this month triggered a fee increase for the $97 million Letters of Credit provided by JP Morgan in connection with the Agency's 1996 and 2003 Merged Area Revenue Variable Rate Bonds. Agency staff confirmed with JP Morgan that the Moody's rating will not trigger any additional fee increases. Terms of these Letters of Credit are expected to be renegotiated later this year.



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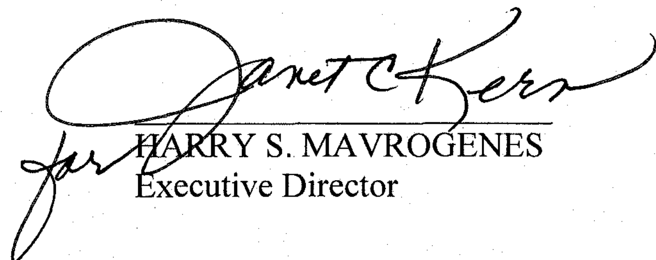
City Manager



HARRY S. MAVROGENES
Executive Director

Attachments

MOODY'S
INVESTORS SERVICE

Rating Update: **MOODY'S DOWNGRADES TO Baa1 AND Baa2 THE NON-HOUSING BONDS OF SAN JOSE REDEVELOPMENT AGENCY, CA**

Global Credit Research - 18 Apr 2011

MOODY'S DOWNGRADES TO A2 FROM A1 THE RATINGS OF THE AGENCY'S HOUSING BONDS. THE OUTLOOK ON ALL RATINGS IS NEGATIVE

Municipality
CA

Opinion

NEW YORK, Apr 18, 2011 -- Moody's Investors Service has downgraded the ratings of San Jose Redevelopment Agency's Merge Project Area tax allocation bonds. The extent of the downgrades depends on each bond series' specific pledged revenues-whether housing or non-housing-and how the debt service reserve requirement is met. Bonds benefitting from the pledge of low-and-moderate income housing tax increment revenues have been downgraded to A2 from A1. The Agency's non-housing tax allocation bonds with cash funded debt service reserves or reserves that are met with sureties from investment grade providers have been downgraded to Baa1 from A2. These include: Series 1993, Series 1997, Series 2003, Series 2004, Series 2005A, Series 2006C, Series 2008A, and Series 2008B, which total approximately $1.08 billion in total outstanding debt. The Agency's non-housing tax allocation bonds with debt service reserve requirements met with below investment grade surety policies have been downgraded to Baa2 from A2. These include: Series 1999, Series 2002, Series 2005 B, Series 2006 A, Series 2006 B Series 2006 D and Series 2007, which total approximately $671 million in total outstanding debt. The outlook on all these ratings is negative.

RATINGS RATIONALE

The downgrades of the non-housing bonds primarily reflect the significant deterioration of debt service coverage levels brought about by contraction of the Assessed Valuation (AV) within the Agency's Merged Project Area and the expected continuing AV decline in 2012. The downgrade of the housing bonds also reflects the reduced debt service coverage levels, which now stand at a still strong 1.86x for senior lien and 1.49x for senior and junior lien debt service coverage. Other factors weighing on the ratings include the relatively high concentration of incremental AV in the top ten tax payers, as well as the dominance of the single largest tax payer, and the relatively large share of total AV represented by unsecured assets.

Key Credit Strengths

- -Very large project area tax base spanning most of downtown San Jose

-- Very large total and incremental Assessed Value (AV)

-- Incremental to total AV ratio is very high

-- Largest tax payers are well know successful firms

-- Signs of improving economy, including lower unemployment and higher sales tax receipts

-- For housing bonds, strong debt service coverage levels

Key Credit Weaknesses

-- For non-housing bonds, very narrow debt service coverage levels

-- Likely AV decline in 2012

-- High tax payer concentration

-- Most debt service reserves are non-cash sureties

-- For lower rated bonds, reserves funded by below investment grade sureties

--Weak 1.15 Additional Bonds Test

VERY NARROW DEBT SERVICE COVERAGE WITH POTENTIAL ADDITIONAL DECLINE

The downgrades of the non-housing bonds primarily reflect the significant deterioration of debt service coverage levels brought about by contraction of the Assessed Valuation (AV) within the Agency's Merged Project Area and the expected continuing AV decline in 2012. These likely AV declines could reduce senior lien coverage to just 1.04x, and combined first and second lien coverage to a mere 1.0x. In 2011 total AV declined by 7.6%, resulting in an 8.1% decrease in incremental revenues, and a reduced senior lien coverage ratio of only 1.09x. The debt service coverage ratio for the combined first and second lien obligations was reduced to only 1.04x. These extremely narrow debt service coverage levels provide notably weaker bond holder security than our prior expectations and the Agency's 1.15x additional bonds test. Also a factor in the downgrade is the overall financial weakening of the San Jose Redevelopment Agency. Other factors weighing on the ratings include the relatively high concentration of incremental AV in the top ten tax payers, as well as the dominance of the single largest tax payer, and the relatively large share of total AV represented by unsecured assets. Expected AV decline is also a key negative factor. These unfavorable factors continue to be offset by the basic strengths of the Project Area, including its enormous size, and importance to the Silicon Valley economy,

which is showing measurable signs of improvement and may lead to resumption of AV growth in the mid-to-long term.

The rating distinction between the parity non-housing bonds is based on the fact that the debt service reserve requirements on the lower rated bonds are met by sureties from providers rated below Baa3. The low creditworthiness of these surety providers raises significant uncertainty with regard to the availability of these debt service reserves if they need to be drawn upon, which further weakens bond holder security. The debt service reserve requirements on Series 1993, Series 1997, Series 2004, Series 2005 A and Series 2006 C are provided by NPFG (rated Baa1). The debt service reserve requirements on Series 2003, Series 2008 A, and 2008 B are met with cash funded reserves. The debt service reserve requirements on Series 1999, Series 2005 A, and Series 2006 D are met with sureties from Ambac (rating withdrawn). The debt service reserve requirements on Series 2002 and Series 2007 are met with sureties from Syncora (rated Ca). The Debt service reserve requirements for Series 2006 A and Series 2006 B are met with Sureties from Radian (rated Ba3).

The downgrade of the housing bonds also reflects the reduced debt service coverage levels, which now stand at a still strong 1.86x for senior lien and 1.49x for senior and junior lien debt service combined. The other factors, such as AV concentration and composition, and the economic importance of the Project Area also support the ratings on the housing bonds.

FOLLOWING FOUR CONSECUTIVE YEARS OF AV EXPANSION, ASSESSED VALUES DROP IN 2011; FURTHER DROP COULD ERODE COVERAGE TO VERY NARROW LEVELS

Between 2006 and 2010 total AV in the Merged Project Area increased by 33.2% and incremental AV grew by 35.8%. The total 2010 AV of $20.0 billion was a new high for the Agency, yielding incremental AV of $18.9 billion and gross incremental revenues of $202 million, also record levels. For the current year, total AV decreased by $1.52 billion or 7.6%. The biggest driver of the decrease was $1.79 billion in Proposition 8 reductions. AV of properties reduced under Proposition 8 will not be subject to the same strict AV growth limits that would result from successful assessment appeals or market turnover, unless/until the former, adjusted base AV is reestablished. As the total AV decline was less than the aggregate of the Proposition 8 rollbacks, some AV growth due to new construction and value appreciation is implied. In fact, seven of the 20 largest tax payers experienced AV increases.

In the upcoming year the AV trend is difficult to estimate as opposing factors are evident. On the positive side, the Agency estimates nearly $390 million in new properties or development, which will represent 2.1% of the base. On the negative side, pending appeals at the end of 2010 amounted to $10.7 billion, although much of these potential reductions are likely to be already included in the Proposition 8 reductions mentioned above. So while a liability for tax refunds might arise from successful appeals, the appellants' current assessed valuations might not be further reduced. The Agency's overall retention rate of appealed properties between 2001 and 2010 is approximately 96%. If the total appeals are resolved at the same rate, which may or may not turn out to be the case, the estimated decrease would be $380 million or 2.3% of 2011 AV. The assessor also estimates an increase of 0.75% in secured value due to the Proposition 13 inflation factor. The large concentration of unsecured assets in the overall AV (20.9% in 2011) may also play a positive role in the 2012 figure. In the last quarter of fiscal year 2010 and first two quarters of 2011, countywide sales tax receipts have increased 17.7%, 6.3% and 10.5%, respectively. Much of the increase is due to business to business sales which bodes well for the unsecured portion of the AV. Other indicators of an improving economy include a slightly lower unemployment rate and higher absorption rate for commercial real estate.

Despite these signs of improvement, as of March the Assessor's preliminary estimate shows a 2012 secured AV decrease of more than 4%. Although some of this decrease may be offset in the final AV based on the positive trends mentioned above, a decrease of 4% would reduce senior lien coverage to 1.04x, and combined senior and second lien debt service coverage to just 1.0x. This would also force the Agency to rely on sources other than tax increment to meet its other obligations. For example, subordinate non-housing obligations include $94 million of second lien tax allocation bonds and Agency support for a combined $200 million of City of San Jose Convention Center and the 4th and San Fernando parking garage financings. Under the above scenario, the Agency may ask the city of San Jose to meet the debt service requirements for the Convention Center and the Parking garage, which are currently paid by the Agency but which the city also secures.

The housing bonds are secured with 20% set-asides of total incremental revenues. The 2011 tax increment revenues cover peak, senior lien debt service on the housing bonds by approximately 1.86x and the total senior and junior lien bonds by approximately 1.49x. These coverage levels continue to provide much higher bond holder security than the non-housing bonds.

THE PROJECT AREA REMAINS A VITAL COMPONENT OF THE ECONOMIC BASE OF SAN JOSE AND THE DYNAMIC BUSINESS ACTIVITIES OF SILICON VALLEY

Implicit in the current ratings on the Agency's merged area tax allocation bonds is Moody's belief that the project area represents a critical component of the fundamentally sound and dynamic, though highly cyclical, Silicon Valley economy. The Merged Project Area consists of 8,110 acres located within the heart of Silicon Valley and, as such, represents a significant component of the Santa Clara County economic base. Land within the Project Area is primarily dedicated to light industrial usage, and is one of the major light industrial centers in the Silicon Valley network of electronics and communications companies. Major high- technology companies such as Cisco Systems, Adobe, Hitachi, Agilent Technologies and Novellus Systems have substantial facilities located within the Merged Project Area. The project area benefits from excellent access to major transportation corridors, given the proximity to a diverse highway system, light rail and the San José International Airport. The substantial size of the Project Area provides a significant level of geographic diversification as well.

Further, diversification within the high-tech industry is demonstrated by companies whose business operations include manufacturing, research and development, computer networking, consumer electronics, internet activities and a host of developing technologies. Moody's believes that over the long term the significance of Silicon Valley to the high tech industry as a whole will have a positive influence on the demand for space within the Project Area.

A SUBSTANTIAL PORTION OF TAX INCREMENT REVENUES ARE ATTRIBUTABLE TO THE PROJECT AREA'S LARGEST TAXPAYERS

Cisco Systems is the Agency's largest taxpayer, representing a significant 16.1% of fiscal 2011 incremental AV. Together, the ten largest taxpayers represent a significant 36.9% of 2011 incremental AV. Moody's expects that reliance on the largest taxpayers will lessen over time given ongoing, though slowed, construction in the area and the significant amount of land which is available for further development.

Outlook

The negative rating outlook reflects the significant contraction of incremental revenues in 2011 combined with the likelihood that the 2012 increment will be even lower. These likely AV declines could reduce senior lien coverage to just 1.04x and first and second lien coverage to a mere 1.0x.

What could change the rating-UP

- - Long term growth of the Merged Project Area AV

-- Higher debt service coverage structured to be maintained over the long term

What could change the rating-DOWN

-- Decline in debt service coverage

-- Extended, material decline in AV

-- Increased concentration among the top taxpayers

KEY STATISTICS:

Merged Project Area acreage, 2009: 8,110

Merged Project Area total AV, 2011: $18.5 billion

Merged Project Area incremental AV, 2011: $17.4 billion

Peak debt service coverage by FY 2011 revenues:

Sr. Lien Non -Housing Bonds, 1.09x

Sr. and second lien non-housing bonds, 1.04x

Sr. lien housing bonds: 1.86x

Sr. and Jr. housing bonds, 1.49x

Largest taxpayer (Cisco Systems) as % of incremental AV, FY2011: 16.1%

Ten largest taxpayers as % of incremental AV, FY2011: 36.9%

The principal methodology used in this rating was Moody's Analytic Approach To Rating California Tax Allocation Bonds published in December 2003

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THE BOND BUYER
THE DAILY NEWSPAPER OF PUBLIC FINANCE

Moody's Drops San Jose RDA Tax-Allocation Debt

Tuesday, April 19, 2011

By Randall Jensen

SAN FRANCISCO — Moody's Investors Service downgraded $1.7 billion of San Jose Redevelopment Agency tax allocation bonds after falling property values cut into debt service coverage.

Moody's downgraded several series of the Redevelopment Agency's non-housing tax allocation bonds to either Baa1 or Baa2 from A2, depending on their debt-service reserve provisions.

It also downgraded the SJRA's housing set-aside bonds one notch, to A2 from A1. The rating agency set its outlook on all of the bonds at negative.

"The downgrades of the non-housing bonds primarily reflect the significant deterioration of debt-service coverage levels brought about by contraction of the assessed valuation" in the agency's project area, Moody's analyst Kevork Khrimian said in a note released Monday.

The non-housing bonds includes series sold from 1993 to 2008. The lower rating for some of the non-housing bonds reflects surety policies to meet debt-service reserve requirements from providers rated below Baa3, including Ambac Assurance Corp.

In California, a redevelopment agency is required to use 20% of its revenue for affordable housing development. The remaining 80% is normally used for economic development. This usually creates two different revenue streams backing bonds: housing and non-housing.

San Jose's redevelopment housing bonds are secured by the 20% of revenue, sending debt-service coverage ratios to 1.86 times for the senior liens.

That compares to much lower coverage ratios for the non-housing paper.

Khrimian said the decline in property values could reduce senior-lien coverage on the non-housing bonds to just 1.04 times and combined first- and second-lien coverage to just 1.0 times.

"These extremely narrow debt service coverage levels provide notably weaker bond holder security than our prior expectations," Khrimian said.

Subordinate non-housing tax allocation bonds include $94 million of second-lien bonds, and the Redevelopment Agency also supports $200 million of city financing for its convention center and a parking garage.

Moody's said low debt service coverage levels may lead the SJRA to ask the city to meet debt service requirements for the convention center and the parking garage.

Assessed values in the redevelopment project area declined 7.6%, or $1.52 billion, in fiscal 2011, falling from a total value of $20 billion in 2010, according to the note.

Khrimian said $1.79 billion in Proposition 8 reductions was the main driver of the decrease.

The proposition requires a county assessor to reassess a property down to market value if that market value falls below its assessed value.

Moody's said a high concentration of incremental assessed value in the top 10 taxpayers in the area, particularly the largest taxpayer, Cisco Systems Inc., also weighs on the ratings. Cisco's contribution made up 16% of the incremental assessed value, while the top 10 payers together made up 36%.

Khrimian said that the agency still benefits from its enormous size — more than 8,000 acres — and the strength of the Silicon Valley economy. The analyst said over the long term, the tech hub will add to demand for property with the SJRA's boundaries.

Earlier in the year, Fitch Ratings downgraded $1.7 billion of the Redevelopment Agency's tax allocation bonds to BBB-minus from A, and dropped its housing set-aside tax allocation bonds to A from A-plus.

Moody's report makes no reference to Gov. Jerry Brown's proposal to eliminate redevelopment agencies. The fate of Brown's RDA proposal is unclear, though he says all outstanding redevelopment debt would be honored.

San Jose Redevelopment Agency non-housing bonds sold in 2006 with a maturity of 2035, which initially sold for $98 with a 4.5% interest rate, last traded on Monday morning at a price of $68 with a yield of 7.24%.

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