Research Update:

Salinas, CA Lease Revenue Bond Outlook Revised To Negative On Weaker Internal Controls, Heightened Volatility Exposure

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Overview

- S&P Global Ratings revised its outlook to negative from stable and affirmed its 'AA-' issuer credit rating and its 'A+' underlying rating (SPUR) on Salinas, Calif.'s outstanding lease revenue bonds.
- The outlook revision reflects our view of the city's weaker internal controls of its enterprise funds--particularly in oversight and rate setting practices in the sanitary sewer fund--that introduces heightened exposure to performance volatility across governmental funds which, if not sufficiently addressed in the near term, could weaken our view of its general creditworthiness. Further, the city’s multi-year forecasts project operating drawdowns throughout the medium-term, which could be further exacerbated by the looming sunset of its major sales tax measure.
- The rating based on the application of its "Methodology For Rating U.S. Governments, Sept. 9, 2024," published Sept. 9, 2024, on RatingsDirect.

Rationale

Security

The lease revenue bonds are secured by lease payments made by the city to the Salinas Facilities Financing Authority as lessor for use of the leased asset. We have reviewed the lease under our criteria and view the lease terms as standard. Furthermore, the leased asset meets our minimum requirements for seismic resilience during the term of the bonds. We rate the bonds one notch below our view of the city's general creditworthiness to reflect our view of the risk of nonappropriation inherent to the lease structure.

The ICR reflects our view of the city’s underlying credit quality and is not related to any debt instrument.

Credit highlights

The 'AA-' rating reflects our view of Salinas' large, agriculture-based economy with income and unemployment metrics that lag national averages, but with stable growth in property values and new development that have supported an overall favorable revenue trend. The city has maintained positive operating results and a healthy general fund reserve position that we expect to be sustained in the near-term and lends to our view of credit stability despite some exposure to weaker performing enterprise funds that could warrant increased general fund support. However, rating stability will be dependent upon improvement in budget monitoring and rate-setting practices across its enterprise funds that mitigate the risk to its operating funds and indicate stronger financial management practices.

Salinas' general fund performance has been strong during the last five years, supported by conservative budget management and the receipt of $53 million in pandemic-relief aid that was largely used for one-time projects and temporary programs. The city has maintained reserves at more than 30% of revenue for the last five years, inclusive of amounts due from other funds. The general fund has a history of transferring funds to its various enterprise funds for capital projects, debt service, and operating subsidies, most of which are repayable to the general fund (dependent upon excess revenue in these funds with narrower operating margins). We note that exclusive of these amounts, the city's general fund reserve remains strong and comparable to its peers, though the perceived general fund exposure to operating risk in the other funds somewhat dampens our view of overall budgetary performance. In fiscal 2025, the city's sewer enterprise fund reported narrower coverage metrics because of delays in certain revenues and a slower implementation of rate increases. We understand that notable rate increases are expected by October 2025 (contingent upon successful public hearings and council adoption), which are projected to sustain the fund without significant general fund support, mitigating some of the risk in our view. The fiscal 2026 budget includes an ongoing general fund line item for sewer support in the annual amount of $150,000 (or less than 1% of general fund revenue) to help manage customer affordability and support the fund. We note that sewer fund operations are comparatively small, equating to less than 3% of the city's governmental operations, limiting our view of the relative exposure to the general government. For more information on our view of the sanitary sewer system enterprise and related debt, please see our article, published March 21, 2025.

The city has a track record of outperforming its budgets at year-end, with the fiscal 2025 budgeted deficit expected to be balanced at year-end, due to vacancy savings. The adopted fiscal 2026 budget anticipates moderate growth in each of its major revenue streams and a slight use of general fund reserves, though its financial position is estimated to remain strong, in our view. The budget includes a significant increase in its capital improvement program, due in large part to its sewer system needs, which management reports has been baked into its anticipated rate increases and will likely be additionally supported by an intentional spend down of its various accumulated reserves outside of the general fund. Current multiyear projections indicate general fund drawdowns through fiscal 2031 ranging between 1% and 6% of revenues, exacerbated by the potential loss of one of its sales tax measures scheduled to sunset in 2030 if not renewed by voters (Measure G sales tax accounts for roughly 20% of total governmental revenue). The city's annual budgets identify several adjustments expected to close the budget gaps by year-end that we view as likely to continue, though we note that the city's longer-term credit stability will depend on ongoing structural adjustments, particularly if the Measure G sales tax is not renewed.

The rating further reflects our view of the city's:

- Growing tax base anchored in agriculture, healthcare, and government, with a recent movement toward "AgTech," given the nexus between Silicon Valley and Salinas Valley. Typical of agriculturally based economies with a significant migrant workforce, the city and county's per capita incomes and unemployment metrics have historically lagged relative to national averages.
- Balanced operations and maintenance of a strong general fund reserve, providing a cushion to withstand some need to support enterprise funds without material deterioration to our view of its financial position. The general fund relies primarily on sales taxes at nearly 49% of general fund revenue when including the city's two separate sales tax measures (Measure G and Measure E--one of which sunsets in 2030), followed by property taxes at 20% in fiscal 2024.
- Financial management policies and practices that reflect regular budget analysis with realistic assumptions that reflect historical trend analysis and information from external consultants, with biannual budget-to-actual reports to council. Our assessment of financial management is tempered by our view of the city’s historical reluctance to adjust rates in its sewer fund contributing to its underperforming its rate covenants in the last three years and weaker oversight practices that led to a material lag in recognizing delayed payments from its system manager, which we believe exposes it to performance risks. Long-term planning consists of an annually updated five-year general fund projection included in the annual budget, as well as an annually updated six-year capital plan. The city maintains a formal reserve policy requiring at least 12% of expenditures, as well as formalized debt management and investment policies, with required quarterly review of investment holdings and earnings with the city council. Management is also taking measures to mitigate its cyber risk.
- Moderate long-term liabilities, reflective of manageable debt metrics with no additional debt plans and higher pension costs. The city participates in three plans under the California Public Employees' Retirement System (CalPERS), and a smaller single-employer defined benefit plan, each of which maintain funding levels below 80%, contributing to rising costs. The city has made excess contributions toward its CalPERS plans in the past (2018 and 2020) and has established a pension trust to address its liabilities.
- For more information on the context for how we evaluate California municipalities, see "Institutional Framework Assessment: California Local Governments," published Sept. 9, 2024.

Environmental, social, and governance

We view the city as having elevated exposure to physical risks related to wildfires, earthquakes, and extreme heat, as well as natural capital risks related to water scarcity, all of which could curb growth and effect the local agricultural sector in the longer-term if not managed. Partially mitigating the seismic activity risks, in our view, are California's strong building codes. We consider the city's social factors neutral.

We believe the utility faces elevated risk management and financial oversight risk, which we a credit weakness as evidenced by management turnover during the past several years that may have contributed to the utility's delayed cost recovery and weak financial performance. Management has emphasized the need to right-size the sewer enterprise fund and increase oversight through hiring additional staff and enhancing rate-setting practices, which we will continue to monitor.

Outlook

The negative outlook reflects the one-in-three likelihood that we could take a negative rating action within the next two years if the city's recent enhancements to its fiscal oversight and its efforts to restore structural balance in the enterprise funds is unsuccessful, resulting in increased exposure to operating risk and diminishing our view of its internal controls.

Downside scenario

We could lower the ratings if the city is unable to successfully adjust rates and implement its planned structural reforms, or if the city experiences increased budgetary pressure because of challenged enterprise funds or the loss of Measure G sales tax revenue.

Upside scenario

Should the city sustain structural balance while improving performance and internal controls across all funds, reducing the general fund exposure, we could raise the ratings.

Salinas, California--credit summary

Institutional framework (IF)	2
Individual credit profile (ICP)	2.69
Economy	4.0
Financial performance	3
Reserves and liquidity	1
Management	2.7
Debt and liabilities	2.75

Salinas, California--key credit metrics

	Most recent	2024	2023	2022
Economy				
Real GCP per capita % of U.S.	100	--	100	98
County PCPI % of U.S.	99	--	99	99
Market value ($000s)	15,228,506	14,497,926	13,832,386	13,051,286
Market value per capita ($)	93,546	89,059	84,970	81,302
Top 10 taxpayers % of taxable value	4.6	4.9	5.3	5.3
County unemployment rate (%)	7.2	7.3	7.0	6.1
Local median household EBI % of U.S.	105	--	105	103
Local per capita EBI % of U.S.	65	--	65	63
Local population	162,791	--	162,791	160,529
Financial performance				
Operating fund revenues ($000s)	--	178,785	172,348	164,208
Operating fund expenditures ($000s)	--	144,244	136,873	123,820
Net transfers and other adjustments ($000s)	--	(25,538)	(20,101)	(32,903)
Operating result ($000s)	--	9,003	15,374	7,485
Operating result % of revenues	--	5.0	8.9	4.6
Operating result three-year average %	--	6.2	6.5	4.2

Salinas, California--key credit metrics

	Most recent	2024	2023	2022
Reserves and liquidity				
Available reserves % of operating revenues	--	45.6	44.4	37.3
Available reserves ($000s)	--	81,576	76,574	61,200
Debt and liabilities				
Debt service cost % of revenues	--	5.6	5.9	9.6
Net direct debt per capita ($)	691	662	722	782
Net direct debt ($000s)	112,542	107,807	117,508	125,457
Direct debt 10-year amortization (%)	61	63	63	--
Pension and OPEB cost % of revenues	--	-	9.0	12.0
NPLs per capita ($)	--	-	1,513	1,457
Combined NPLs ($000s)	--	-	246,333	233,927

Financial data may reflect analytical adjustments and are sourced from issuer audit reports or other annual disclosures. Economic data is generally sourced from S&P Global Market Intelligence, the Bureau of Labor Statistics, Claritas, and issuer audits and other disclosures. Local population is sourced from Claritas. Claritas estimates are point in time and not meant to show year-over-year trends. GCP--Gross county product. PCPI--Per capita personal income. EBI--Effective buying income. OPEB--Other postemployment benefits. NPLs--Net pension liabilities.

Ratings List		
Outlook Action		
	To	**From**
Local Government		
Salinas, CA Lease Appropriation	A+/Negative	A+/Stable
Salinas, CA Unlimited Tax General Obligation	AA-/Negative	AA-/Stable

The ratings appearing below the new issues represent an aggregation of debt issues (ASID) associated with related maturities. The maturities similarly reflect our opinion about the creditworthiness of the U.S. Public Finance obligor's legal pledge for payment of the financial obligation. Nevertheless, these maturities may have different credit ratings than the rating presented next to the ASID depending on whether or not additional legal pledge(s) support the specific maturity's payment obligation, such as credit enhancement, as a result of defeasance, or other factors.