CITY OF COSTA MESA

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FROM THE OFFICE OF THE INTERIM DIRECTOR OF COMMUNICATIONS

PRESS RELEASE

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Moody's downgrades City of Costa Mesa's ratings, citing volatile sales tax revenue and low reserves

COSTA MESA, CALIF.—Moody's Investor Services announced today that it had downgraded the City of Costa Mesa's issuer and lease ratings because of volatile sales tax revenue and erosion of the City's reserves funds in recent years.

Moody's last reviewed the City's finances in 2006.

The City's issuer rating for bonds dropped from "Aa1" to "Aa2," which is still considered high grade. Costa Mesa's lease rating was downgraded from "Aa2" to "A1," which is considered upper medium grade.

"The downgrade reflects the city's weakened financial profile, which includes above average exposure to volatile sales tax revenues and low reserves given its revenue structure," Moody's concluded in its report. "The city's ratings also reflect its manageable debt burden, and economic profile with moderate socioeconomic indicators."

For more details, please see Moody's report below.

MOODY'S INVESTORS SERVICE

Rating Update: MOODY'S DOWNGRADES TO Aa2 FROM Aa1 ISSUER RATING OF THE CITY OF COSTA MESA (CA) AND TO A1 FROM Aa2 CITY'S GENERAL FUND LEASE OBLIGATIONS

Global Credit Research - 13 May 2011

$40.4 MILLION OF DEBT AFFECTED

Costa Mesa (City of) CA
Municipality
CA

Opinion

NEW YORK, May 13, 2011 -- Moody's Investors Service has downgraded to Aa2 from Aa1 the Issuer Rating of the City of Costa Mesa, CA. Concurrently Moody's has downgraded to A1 from Aa2 the rating on the city's 2007 Certificates of Participation (Police Facility Expansion Project), 2003 Certificates of Participation, and Lease Revenue Bonds 1998 Series A (Public Facilities Project).

RATINGS RATIONALE

The downgrade reflects the city's weakened financial profile, which includes above average exposure to volatile sales tax revenues and low reserves given its revenue structure. The city's ratings also reflects its manageable debt burden, and economic profile with moderate socioeconomic indicators.

The downgrade of the city's lease rating to A1 from Aa2 reflects two changes, the downgrade of the Issuer Rating, and a widening of the difference between the lease rating and the Issuer Rating. Most lease ratings in California are two-notches lower than the issuer's general obligation or Issuer Rating. The one-notch distinction between the city's Issuer Rating and the prior ratings on its lease obligations reflected the city's previously above average financial strength. However, the city's financial profile has eroded, which represents a fundamental change to the city's credit position. The current and expected financial profile of the city is now comparable to other California cities. Accordingly, the standard two-notch lease distinction is the more appropriate one. With the Issuer Rating downgraded to Aa2, the lease rating has therefore been downgraded to A1.

STRENGTHS

Large metro area tax base

Operations expected to be balanced in short-term

CHALLENGES

Reliance on volatile sales tax revenues

Low reserve levels for level of revenue volatility

DETAILED CREDIT DISCUSSION

EXPOSURE TO VOLATILE SALES TAX REVENUES WITH LOW RESERVES FOR REVENUE STRUCTURE

The city's historically strong financial profile has eroded due to an above average exposure to volatile tax revenues, which declined dramatically in recent years. In fiscal year 2007 sales taxes were at a high 44% of total revenues, and transient occupancy tax (TOT) represented 5.8% of total revenues. Starting in fiscal 2009 sales tax and TOT revenues began to decline. By the end of fiscal year 2009 the city realized a combined sales tax and TOT revenue decline of 15.9% from 2007 levels. During fiscal 2009 the city realized a $4 million loss in investments in Lehman Brothers Inc., and suffered an unexpected $19.4 million General Fund operating deficit. In that same year General Fund expenditures remained relatively level. Expenditure reductions began in earnest in fiscal year 2010, however, the year ended with a $7.3 million General Fund operating deficit. The General Fund balance was drawn down to $41.5 million, 44.9% of revenues. This is a notable decline from the strong 2007 level of $73.4 million, 70.6% of revenues. The fiscal year 2010 levels are near the median for Moody's Aa2 rating category but represent a comparatively weaker financial position given the city's above average exposure to volatile revenues.

Despite notable expenditure reductions in fiscal year 2011, Moody's does not expect the city to rebuild its reserves to historic levels for several years. The city budgeted a $9.5 million General Fund operating deficit for fiscal year 2011, but due to several expenditure reductions, an unexpected increase in sales tax and TOT revenues, and a 2% increase in TOT rates enacted in fiscal year 2010, the city expects to end the year with a much smaller $1.5 million deficit. The fiscal year 2012 budget is still incomplete but the city expects to balance the budget with no operating deficit. The city is continuing to make expenditure reductions and use conservative revenue assumptions in planning its 2012 budget. It currently has no official plans to rebuild reserves to historic levels, but is pursuing several strategies to raise revenues, and curtail long-term liabilities and expenditures. Moody's expects that the city will maintain a financial profile consistent with its Aa2 Issuer Rating at least in the near future.

The city has maintained its policy of annually reserving $14.1 million of General Fund balance for economic uncertainties. The city has also noted that $3.5 million in the Capital Improvement Fund and $6.5 million in the Equipment Replacement Fund are available to the General Fund if necessary. This remains a credit positive and is reflected in the current rating.

RETAIL AND RESIDENTIAL TAX BASE WITH MODERATE SOCIOECONOMIC INDICATORS

This city of 116,341 (2010) residents is located in Orange County approximately 35 miles south of Los Angeles, less than five miles from the

Orange County (John Wayne) airport, and one mile from the Pacific Ocean. The city is best known for its retail activities, which drive the city's sales tax and TOT revenues. Sales have increased locally in 2011 year to date by 7%, similarly to the trends observed nationally. Many of the city's largest commercial developments such as South Coast Plaza and various auto malls have remained open, with other small retailers opening and under construction.

Home prices in the city have continued to decline. March 2011 home sales were 8.4% lower than March 2010 prices, whereas prices in Orange County overall declined by only 0.23%. Fiscal year 2011 assessed value (AV) declined 2.9% from the prior year to $14 billion. Limited assessed value growth is expected in the near-term, and AV could in fact contract further if home prices continue to decline.

The city has a residential socioeconomic profile that is comparable to other Moody's Aa2 rated cities. As of the 2000 census, per capita income in the city stood at $23,342, representing 108.1% of the US median. Similarly, median family income in the city stood at $55,456 or 110.8% of the US median. The median per capita income for Moody's rated Aa2 cities was 119.2% of the US median, and median family income was 129.3% of the US median. The city benefits from a March 2011 unemployment rate of 8.1%, below the state figure of 12.3% and the US figure of 9.2%.

LEASE RATING DOWNGRADE REFLECTS DECLINE IN CREDIT STRENGTH; LARGE LEASE BURDEN REMAINS MANAGEABLE

The city's leases are standard, California abatement leases. The two notch rating distinction between the city's lease ratings and its Issuer (General Obligation equivalent) Rating represents Moody's standard notching for essential purpose, fixed asset leases relative to a California issuer's general obligation rating. Broadly speaking the two notches reflect the risk of abatement (and the related lack of seismic insurance coverage) and the narrower, general fund security pledge for leases compared to the unlimited property tax pledge securing general obligation bonds. In prior years, the city had maintained a cash position sufficient to completely prepay its general fund lease obligations (total cash was 102.1% of outstanding general fund lease obligations). That factor was integral to the lease rating. A one-notch distinction between the city's Issuer Rating and the rating on its lease obligations had been made to reflect this credit strength. However, the city's financial profile has eroded and its cash in fiscal year 2010 declined to 56.8% of its outstanding lease debt. While these levels of cash are sound, they represent a fundamental change rendering the city's credit profile comparable to other California cities with a standard two-notch lease distinction. These factors are reflected in the current downgrade of the city's lease rating.

The city's direct debt level is typical of California cities, although its leases burden of 5.2% is above the median for California cities. With 69.7% of principal repaid in ten years, payout is rapid by comparison with other California issuers. The city's direct debt at 0.3% of AV is low and typical of California issuers. The city noted no near-term plans to issue new debt and its current levels should remain manageable.

WHAT COULD MAKE THE RATING GO UP

Significant appreciation of socioeconomic indicators

High reserve levels consistent with revenue structure

Material diversification and/or stabilization of revenue sources

WHAT COULD MAKE THE RATING GO DOWN

Continued operating deficits

Further tax base declines

KEY STATISTICS

Population: 116,341 (2010 California State Department of Finance)

Assessed value (AV), fiscal 2007: $14 billion

Top ten property tax payers, fiscal 2011: 11.5%

Per capita income, 1999: $23,342 (102.8% of State)

Median family income, 1999: $55,456 (104.6% of State)

Total fund balances as % of general fund revenues, fiscal 2010: 44.9%

Net cash as % of general fund revenues, fiscal 2010: 24.9%

Direct debt as % of AV, including current issue: 0.3%

Net Lease Burden as % of expenditures: 5.2%

Payout, % of principal in 10 years: 69.7%

The principal methodology used in this rating was The Fundamentals of Credit Analysis for Lease-Backed Municipal Obligations published in October 2004.

REGULATORY DISCLOSURES

Information sources used to prepare the credit rating are the following: parties involved in the ratings, public information, and confidential and proprietary Moody's Investors Service information.

Moody's Investors Service considers the quality of information available on the credit satisfactory for the purposes of assigning a credit rating.

Moody's adopts all necessary measures so that the information it uses in assigning a credit rating is of sufficient quality and from sources Moody's considers to be reliable including, when appropriate, independent third-party sources. However, Moody's is not an auditor and cannot in every instance independently verify or validate information received in the rating process.

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Please see the Credit Policy page on Moodys.com for the methodologies used in determining ratings, further information on the meaning of each rating category and the definition of default and recovery.

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