FITCH RATES MESQUITE ISD, TX'S ULT BONDS 'AAA' PSF/'AA+' UNDERLYING; OUTLOOK STABLE

Fitch Ratings-Austin-23 October 2015: Fitch Ratings has assigned an 'AAA' rating to the following unlimited tax (ULT) bonds of the Mesquite Independent School District, Texas (the district):

--$82 million ULT school building bonds, series 2015E.

The 'AAA' rating reflects the guarantee provided by the Texas Permanent School Fund (PSF), whose bond guarantee program is rated 'AAA' by Fitch. Additional information on the Texas Permanent School Fund is available in Fitch's Aug. 5, 2015 press release, 'Fitch Affirms Texas Permanent School Fund at 'AAA'; Outlook Stable', available at 'www.fitchratings.com'. Fitch also assigns an 'AA+' underlying rating to the bonds.

The bonds will sell via negotiation the week of Oct. 26. Proceeds of the bonds will be used to renovate and expand district facilities.

In addition, Fitch affirms the 'AA+' rating on $293.8 million of outstanding district ULT bonds.

The Rating Outlook is Stable.

SECURITY

The bonds are payable from an unlimited ad valorem tax levied against all taxable property within the district.

KEY RATING DRIVERS

SOLID FINANCIAL PROFILE: Financial results have been consistently healthy, enabling the district to accumulate sound operating reserves and ample liquidity. General fund operations typically outperform conservative budget estimates.

DIVERSE REGIONAL ECONOMY: The district benefits from its location in the broad and stable economy of the Dallas-Fort Worth (DFW) metro area. Residents have easy access to a large employment market that continues to outperform the nation in terms of population, employment, and income growth.

STABILIZED TAX BASE: Taxable assessed value (TAV) has gained traction after a period of moderate downward pressure from declining home values. TAV growth over the near term is likely based on planned residential and industrial development.

MIXED DEBT PROFILE: Overall debt is high relative to market value. This concern is balanced against a moderate pace of principal amortization and an affordable cost structure resulting from significant state support for district debt.

EXPANDED CAPITAL PLANS: A steady pace of enrollment growth has resulted in expansion of the district's capital plans. However, the district maintains sufficient taxing margin below the state's statutory tax rate cap for new debt issuance.

RATING SENSITIVITIES

MANAGING GROWTH: The preservation of the district's strong financial position, as evidenced by positive operations and sound reserves, is critical to continuing credit quality strength.

CREDIT PROFILE

This mature, suburban district is located 35 miles east of downtown Dallas and serves an estimated population of nearly 176,000 in the cities of Mesquite, Balch Springs, Seagoville, and Garland. Current enrollment of about 40,500 is up 1% from last year. Wealth levels trail those of the larger DFW metro area.

CONSISTENTLY STRONG FINANCIAL PERFORMANCE

The district's financial performance has been strong despite large state funding cuts for all Texas school districts in fiscals 2012 and 2013. The district generated surplus operating results in each of the last five audited fiscal years (2010-2014). Unrestricted general fund balance totaled $91.3 million (30% of spending) at fiscal 2014 year-end, comfortably above the district's 25% reserve target.

The district typically outperforms its conservative projections. Unaudited fiscal 2015 results point to a $2.8 million general fund surplus, (1% of spending) despite the use of $13 million for one-time capital outlays. The positive results are well in excess of earlier deficit projections, benefiting from larger than budgeted enrollment gains.

The district's fiscal 2016 operating budget of $329 million is essentially balanced. It includes a 3% pay raise and conservatively assumes full employment. Of the $5.8 million budgeted for capital outlay, roughly $3 million is earmarked for completion of football stadium renovations begun in fiscal 2015. Fitch expects that reserves will be maintained in excess of the informal fund balance goal, preserving sufficient financial flexibility in line with the 'AA+' rating.

BROAD AND RESILIENT DFW ECONOMY

The district's proximity to Dallas and its location in the broader DFW metro area provides residents with easy access to a large and diverse labor market. Dallas is the second largest city in the state and the ninth largest in the country, with an estimated population of 2.5 million. The city is home to numerous corporate headquarters, and prominent economic sectors include transportation, financial services, wholesale trade, manufacturing, oil/gas, and education and government.

The city of Mesquite and the surrounding DFW region have added jobs at a rate faster than the nation since the recession ended in 2009. Mesquite's July 2015 unemployment rate was 4.3%, down from 5.7% the prior year due to year-over-year employment growth of 1%. City unemployment is comparable with the DFW metro (4.1%) and the state (4.6%) and below the U.S. rate (5.6%).

TAV RESUMES POSITIVE GROWTH

A trend of TAV declines reversed modestly in fiscal 2014, due in part to the growth in commercial/industrial values as well as multi-family residential construction. This trend continued in fiscal 2015 (4.8% gain) and again in fiscal 2016, with 5.8% growth reflecting solid reappraisal gains.

The district's tax base is largely residential and a weak housing market had dragged on the district's TAV, resulting in a cumulative 13% decline in fiscals 2009-2013. Home prices have improved since the low point of the recession, and Zillow reports an average listing price of $117,000 in Mesquite, up from the low point of $95,000 in 2012.

The tax base is not concentrated, with the top 10 payers comprising less than 6% of fiscal 2016 TAV. Fitch believes management's modest 2% TAV growth assumptions over the near term are reasonable given healthy industrial development in recent years and a trend of residential price gains. This industrial development, combined with renewed home construction in the district, should serve to further spur tax base growth.

The operational impact of TAV declines is largely mitigated by the state's funding formulas, which backfill lost local revenues with additional state aid; this backstop resulted in less revenue volatility in the last downturn than TAV alone would have indicated. Also, the district's debt affordability and capacity would be reduced if TAV changed course and declined further, constraining its ability to address future capital needs.

HIGH DEBT WITH MANAGEABLE CAPITAL NEEDS
Overall debt is high as a percentage of market value at 8.4% (on an accreted basis), a moderate $3,600 per capita. Despite the unfavorable debt burden, fiscal 2014 debt service was relatively low at 4.8% of governmental fund spending, reflecting substantial state debt service support (about 54% of ULT debt service in fiscal 2014). The amortization rate is moderate with 47% of non-accreted principal retiring in 10 years, including the current offering.

This offering is the first from a $280 million bond package approved by voters in May 2015 to expand classroom capacity throughout the district. It is the first of five planned issuances through 2020, which are projected to require a debt service tax rate of $0.42 per $100 of TAV, an increase of $0.05 from the current rate. This is below the state's statutory requirement that new bond issuance be serviced with a rate at or below $0.50. The tax rate projection is based on modest TAV and enrollment growth assumptions, which Fitch believes are reasonable given recent history.

OTHER LONG-TERM LIABILITIES MANAGEABLE
The district's pension liabilities are limited to its participation in the state pension plan administered by the Teacher Retirement System of Texas (TRS). The district's annual contribution to TRS is determined by state law, as is the contribution for the state-run postemployment benefit healthcare plan. Total carrying costs for debt service, pension, and other post-employment benefit (OPEB) contributions were a modest 6% of fiscal 2014 governmental fund spending, benefitting from the state's strong subsidy for both debt service and pensions. However, school districts are susceptible to future funding changes by the state--as evidenced by a new, relatively modest employer contribution requirement of 1.5% of salary effective fiscal 2015.

TEXAS SCHOOL FUNDING LITIGATION

A Texas district judge ruled in August 2014 that the state's school finance system is unconstitutional. The ruling, which was in response to a consolidation of six lawsuits representing 75% of Texas school children and was the second such ruling in the past two years, found the system inefficient, inequitable, and underfunded. The judge also ruled that local school property taxes are effectively a statewide property tax due to lack of local discretion and therefore are unconstitutional.

The Texas attorney general has appealed the judge's latest ruling to the state supreme court. If the state school finance system is ultimately found unconstitutional, the legislature would likely follow with changes intended to restore its constitutionality. Fitch would consider any changes that include additional funding for schools and more local discretion over tax rates to be a credit positive.

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Fitch recently published an exposure draft of state and local government tax-supported criteria (Exposure Draft: U.S. Tax-Supported Rating Criteria, dated Sept. 10, 2015). The draft includes a number of proposed revisions to existing criteria. If applied in the proposed form, Fitch estimates the revised criteria would result in changes to fewer than 10% of existing tax-supported ratings. Fitch expects that final criteria will be approved and published by Jan. 20, 2016. Once approved, the criteria will be applied immediately to any new issue and surveillance rating review. Fitch anticipates the criteria to be applied to all ratings that fall under the criteria within a 12-month period from the final approval date.

In addition to the sources of information identified in Fitch's Tax-Supported Rating Criteria, this action was additionally informed by information from Creditscope, University Financial Associates, S&P/Case-Shiller Home Price Index, IHS Global Insight, Municipal Advisory Council of Texas, and National Association of Realtors.

Applicable Criteria
Exposure Draft: U.S. Tax-Supported Rating Criteria (pub. 10 Sep 2015)
https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=869942
Tax-Supported Rating Criteria (pub. 14 Aug 2012)
https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=686015
U.S. Local Government Tax-Supported Rating Criteria (pub. 14 Aug 2012)
https://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=685314