FitchRatings

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

Fitch Ratings-Austin-18 May 2017: Fitch Ratings has assigned a 'AAA' rating based on the Texas Permanent School Fund (PSF) and a 'AA+' underlying rating to the following Mesquite Independent School District, Texas unlimited tax bonds (the bonds or ULTs):

--$12.8 million ULTs refunding series 2017A
--$93 million ULTs school building bonds series 2017B.

The bonds are scheduled for negotiated sale the week of May 22, 2017. Proceeds from the sale of the series 2017 A bonds will be used to refund a portion of the district's outstanding series 2007 ULTs. Proceeds from the sale of the series 2017 B will be used for the construction, renovation, acquisition and equipment of school buildings.

The 'AAA' rating on the bonds is based on a guaranty provided by the Texas Permanent School Fund (PSF), whose bond guaranty program is rated 'AAA' by Fitch.

In addition, Fitch affirms the rating on Mesquite ISD's Long-Term Issuer Default Rating (IDR) and $583 million outstanding ULT debt at 'AA+'.

The Rating Outlook is Stable.

SECURITY
The bonds are payable from an unlimited property tax levy and are further backed by the PSF bond guaranty program. (For more information on the Texas Permanent School Fund see 'Fitch Affirms Texas PSF Rating at 'AAA'; Outlook Stable', dated Aug. 5, 2015).

KEY RATING DRIVERS

The 'AA+' rating reflects the district's sound economic underpinnings and strong gap-closing capacity from a combination of solid spending flexibility and reserves. Long-term liabilities and fixed costs will remain within Fitch's moderate range including the new debt issuance.

Economic Resource Base
This mature, suburban district is located 35 miles east of downtown Dallas and serves an estimated population of roughly 180,000 in the cities of Mesquite, Balch Springs, Seagoville, and Garland. Current enrollment is about 40,850 is up more than 1% from last year. Wealth levels lag those of the larger Dallas-Fort Worth metro area.

Revenue Framework: 'a' factor assessment
Revenue growth has been strong, averaging above GDP for the 10 years through 2016. Future revenue growth will likely track expected enrollment growth given the state funding framework, which strength is offset by the district's independent legal ability to raise revenues limited by state law.

Expenditure Framework: 'aaa' factor assessment
District spending is stable and the district maintains strong expenditure flexibility in salaries and paygo capital spending. Spending growth is expected to trend in line with revenue growth. The low

fixed-cost burden for debt service and retiree benefits reflects state support for long-term liabilities. There are no contractual obligations with employees.

Long-Term Liability Burden: 'aa' factor assessment
The long-term liability burden is moderate. After this sale, the district will have exhausted the entire bond authorization from its 2015 election. Fitch expects that the liability burden will remain moderate even with this new debt issuance.

Operating Performance: 'aaa' factor assessment
The district has a strong history of operating surpluses; reserves are robust and provide ample cushion in the case of an economic downturn given expected revenue volatility and solid expenditure flexibility.

RATING SENSITIVITIES
Financial Flexibility: The ratings are sensitive to material changes in financial flexibility, including maintenance of strong operating profile and strong reserve levels through a typical economic cycle and material shifts in enrollment trend expectations.

CREDIT PROFILE

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. The area is home to numerous corporate headquarters, and prominent economic sectors include transportation, financial services, wholesale trade, manufacturing, oil/gas, and education and government.

Revenue Framework
Funding for public schools in Texas is provided by a combination of local (property tax), state and federal resources. The state budgets the majority of instructional activity through the Foundation School Program (FSP), which uses a statutory formula to allocate school aid taking into account each district's property taxes, projected enrollment, and amounts appropriated by the legislature in the biennial budget process. The vast majority of districts are funded using a target revenue approach, whereby the combination of local and state funding for operations meets a predetermined per pupil amount (which varies from district to district).

State sources remain the largest revenue stream, comprising about three-quarters of general fund monies; property taxes account for about 20%. The compound annual growth rate (CAGR) of district revenues was 1 1/2 half percentage point higher than the U.S. GDP over the 10 years through 2016. Fitch anticipates enrollment growth will continue to drive revenue growth at least in line with national GDP.

The district's M&O tax rate of $1.04 per $100 taxable assessed value (TAV) is $0.13 below the legal limit of $1.17. The district would need voter authorization to raise the rate above $1.04 but there are no current plans to do so. The district levies a separate, unlimited debt service tax rate that stood at $0.42 per $100 TAV as of fiscal 2017 and is expected to service their bond debt obligations using modest TAV and enrollment growth assumptions. While the property tax pledge securing school district bonds is unlimited, state law requires districts to demonstrate the ability to service outstanding and any proposed debt with a debt service tax rate of no more than $0.50 per $100 of taxable value.

Expenditure Framework
The district's main expenditure category is salaries, common for local governments. Adopted budgets typically include substantial use of operating revenues for capital projects.

The pace of spending growth has somewhat trailed revenue growth due to consistent enrollment gains and underspending of budgeted expenditures. This trend is likely to continue, barring any changes in district policy.

The district's fixed-cost burden is low, with carrying costs for debt, pensions and other post-employment benefits (OPEB) equaling 11.2% of 2016 governmental expenditures. Taking into account state support for debt service, carrying costs decrease to a low 6.1% (Mesquite ISD received about 49% of the 2015-2016 annual debt service from state aid). Fitch expects the fixed-cost burden to rise slightly with this bond issuance, but to remain low given the strong state support for retiree benefits and the current debt structure. The district retains flexibility in staffing levels given the modest enrollment growth prospects, and does not have any labor contracts or wage pressure.

Long-Term Liability Burden
The district's total debt and net pension liability represents about 12.8% of personal income, with the district's direct debt representing the bulk of the total liability. The district received a strong 77% voter support for its 2015 bond program; this sale is the final installment of the program and will be used to expand classroom capacity at district facilities. Fitch anticipates the district's debt burden will rise but remain a moderate burden on resources throughout the issuance of the authorization.

The district participates in the Texas Teachers Retirement System (TRS), a cost-sharing multiple employer pension system. Under GASB 67 and 68, TRS's assets cover 78.4% of liabilities as of fiscal 2016, a ratio that falls to 70.7% using a more conservative 7% return assumption. Like all Texas school districts, Mesquite ISD is vulnerable to future policy changes that shift more of the contributions and liabilities onto districts, as evidenced by a relatively modest 1.5% of salary contribution requirement that became effective in fiscal 2015.

The proportionate share of the system's net pension liability paid by the district is minimal, representing less than 1% of personal income. The district's contributions are currently limited to 1.5% of salaries (total contribution of nearly $3 million in fiscal 2016).

Operating Performance
The district maintained a strong financial cushion despite recessionary pressures and state funding cuts. Moreover, the district retains adequate expenditure flexibility to manage well through economic downturns. Fiscal 2016 general fund reserves stood at a strong $111million (33.7% of spending), and management projects fiscal 2017 will mark another year of positive operating results due to enrollment growth beyond expectations and conservative budgeting.

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 serves to limit revenue volatility. The district benefits from an exceptionally strong gap-closing capacity. Fitch expects that the district will manage through economic downturns while maintaining ample reserves and a high level of fundamental financial flexibility.

The district has demonstrated a strong commitment to supporting financial flexibility. Budgeting is conservative and typically includes capital projects, and management has been proactive in maintaining operational balance throughout economic cycles.

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In addition to the sources of information identified in Fitch's applicable criteria specified below, this action was informed by information from Lumesis and InvestorTools.

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Applicable Criteria
U.S. Tax-Supported Rating Criteria (pub. 18 Apr 2016)
https://www.fitchratings.com/site/re/879478