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Fitch Rates Mesquite ISD, TX's $84.43MM Series 2019 ULT Bonds 'AAA' PSF/ 'AA+' Underlying

Fitch Ratings-Austin-29 August 2019: Fitch Ratings has assigned a 'AAA' rating based on the rating assigned to the Texas Permanent School Fund (PSF) and an 'AA+' underlying rating to the following Mesquite Independent School District, Texas unlimited tax bonds (the bonds or ULTs):

--$84.425 million ULT school building bonds, series 2019.

In additional, Fitch has affirmed the following ratings on the district at 'AA+':

--Issuer Default Rating (IDR);
--Approximately $613 million outstanding ULTs.

The bonds are scheduled for sale during the week of Sept. 2, 2019. Proceeds from the sale will be used to construct and equip new facilities.

SECURITY
The bonds are payable from an unlimited property tax levy and are further backed by the PSF bond guaranty program. A change in Fitch's assessment of the Texas Permanent School Fund bond guarantee program would automatically result in a change in the rating of Mesquite ISD, Texas' series 2019 unlimited tax school building bonds. For more information on the Texas Permanent School Fund see 'Fitch Affirms Texas PSF Rating at 'AAA'; Outlook Stable,' dated July 21, 2017.

ANALYTICAL CONCLUSION

The 'AA+' IDR and ULT rating reflect Fitch's expectations that the district will maintain a high level of financial flexibility throughout the economic cycle due to its solid expenditure flexibility and strong reserves. Long-term liabilities and fixed costs are expected to remain within Fitch's moderate range over the next several years.

Economic Resource Base
This mature, suburban district is located 35 miles east of downtown Dallas and serves an

estimated population of more than 185,000. The district, which ties into the Dallas-Fort Worth (DFW) metro area, encompasses portions of Mesquite, Balch Springs, Seagoville, and Garland. While the district is largely built-out, the area is experiencing residential tax base expansion. Over the past three years, taxable assessed value (TAV) has increased by 35% to $8.6 billion in fiscal 2019. While the district's wealth and income levels lag those of the larger DFW metro area, its inclusion in this broad and robust employment market, coupled with continued regional economic expansion is favorable for the district. Student enrollment has generally risen over the past decade. However, in fiscal 2019 enrollment dropped by about 2% and in fiscal 2020 management expects enrollment to drop again, albeit by less than 1%. Based on the most recent demographic information, provided by district representatives, the decline in enrollment is largely due to lower birth rates.

KEY RATING DRIVERS

Revenue Framework: 'a'

Revenue growth has historically been strong. Fitch expects future revenue growth to be more moderate but still solid based on the district's forecast for modest enrollment pressures and the state's per pupil education funding formula. The district's statutorily limited independent legal revenue raising ability is common of Texas school districts.

Expenditure Framework: 'aa'

District spending is stable and is generally expected to track revenue growth. The district maintains strong expenditure flexibility in salaries (there are no contractual obligations with employees) and pay-go capital spending. The low fixed-cost burden for debt service and retiree benefits reflects state support for long-term liabilities.

Long-Term Liability Burden: 'aa'

The long-term liability burden is moderate. The series 2019 issuance is the second installment of the voter authorized $325 million bond program from the May 2018 bond election. After this sale, the district will have $95 million in authorized but unissued debt remaining. Fitch expects that the liability burden will remain moderate even with this new debt issuance.

Operating Performance: 'aaa'

The district's strong history of operating surpluses, its maintenance of robust reserve levels and solid expenditure flexibility leave it well positioned to address any cyclical downturns.

RATING SENSITIVITIES

Revenue Prospects and Enrollment Trends: The IDR and ULT rating are sensitive to shifts in the district's revenue growth prospects, which are linked to enrollment trends. A material and sustained reduction in enrollment and revenue growth prospects could pressure the rating.

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

The tax base is primarily residential, as single-and-multifamily residences account for almost 70% of TAV. Strong recent TAV growth is being driven by residential appreciation and expansion in the industrial sector. Over the next 12 to 18 months management expects industrial development to add another $150 million to $200 million to the tax base. Residential development continues and is driven by the regional economy, which remains in growth mode. The recently released fiscal 2020 certified TAV for the district is over $9 billion or a 5.5% year-over-year increase.

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 Tier 1 component of the FSP provides districts a certain level of operational funding, and the basis for most Tier 1 allotments is called the basic allotment. The basic allotment is a per pupil dollar amount that multiplied by average daily attendance (and adjusted for specific district student characteristics) produces a district's Tier 1 allotment. 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).

The district received 74% of fiscal 2018 operating revenues from state aid, followed by property taxes at 22%.

The compound annual growth rate (CAGR) of general fund revenues has exceeded both U.S. GDP and inflation for the 10 year periods ending in fiscals 2016 and 2017. For the 10-year period ending in fiscal 2018, the general fund revenue CAGR exceeds inflation but is on par with national GDP. Over the near term, Fitch anticipates that relatively stable to moderately declining enrollment will yield solid revenue growth, absent policy action.

For the state's fiscal 2020-2021 biennium, the state is increasing Texas Education Agency (TEA) funding by roughly 20% through the provisions of House Bill 3 (HB3) which was approved by the 2019 Texas legislature and signed into law by the governor. In addition, HB3 calls for the compression of local operating tax rates and requires districts to limit annual operating tax revenue increases to 2.5% (by requiring a reduction in the maintenance and operations (M&O) rate if TAV increases by more than 2.5%). The increased funding is driven primarily by an increase in the per student basic allotment to $6,160 from $5,140. HB3 requires districts to apply 30% of annual increased funding to full-time employee compensation increases (75% of which would go to teachers, counselors, nurses and librarians). The tax rate compression, offset by the increase in state revenues, is likely to result in a net gain in district revenues.

Historically and per state statute, Texas school districts could not increase the M&O property tax rate above the state-mandated cap of $1.04 per $100 of TAV (up to a maximum rate of $1.17 per $100 TAV) without voter approval. While the property tax pledge securing the district bonds is unlimited, state law requires districts to demonstrate prior to issuance the ability to service outstanding and any proposed debt with at a debt service rate of no more than $0.50 per $100 of TAV.

The district's fiscal 2019 overall property tax rate at $1.52 per $100 includes a $1.04 M&O rate and a debt service rate of $0.48. As a result of the state legislature reworking school funding during the 2019 session (House Bill 3), school districts are now required to compress the M&O tax rate. Per the requirements of HB3, the district will reduce its fiscal 2020 M&O tax rate to $0.97 from $1.04. The debt service rate is expected to remain level in the coming year, yielding an overall tax rate of $1.45 per $100 of TAV.

Expenditure Framework

The district's main expenditure category is instruction, which accounted for about 60% of operating expenses in fiscal 2018. Fitch expects instruction costs, driven by teacher wages and benefits, to grow in line with or below revenues along with other operational costs. Historically, the district has funded some capital outlay from the general fund. While the district will likely continue to finance some capital needs through the general fund, Fitch does not expect this practice to negatively impact the expenditure framework assessment.

The pace of spending growth has somewhat trailed revenue growth due to underspending of budgeted expenditures. This trend is likely to continue, barring any changes in district policy. Moreover, in Fitch's view, the district's largely mature nature limits future growth-driven expenditure pressures.

The district's fixed cost burden is low, with carrying costs for debt, pensions and other post-employment benefits (OPEB) accounting for approximately 6% of fiscal 2018 governmental expenditure (after factoring in the 43% in annual debt service state aid). While Fitch expects the fixed-cost burden to rise with the series 2019 bond issuance, and subsequent issuances from the May 2018 authorization, it will likely remain low-to-moderate give the strong state debt service support. The district retains flexibility in staffing levels, and does not have any labor contracts or evident wage pressure.

Senate Bill 12 (SB12), which was approved by the 2019 Texas legislature and signed into law by the governor, will direct the allocation of $1.1 billion in state savings to the Texas Retirement System (TRS) over the next several years. Roughly $600 million from this allocation will be used to finance a one-time payment of $2,000 to retired teachers. The remainder will be used to gradually increase state contributions to TRS. Over the next six years, educators, school districts, and the state will incrementally ramp up their respective contributions. Districts and teachers will begin to increase their contributions in fiscal 2022, and by fiscal 2024 teachers will pay 8.25% of salary (up from 7.7% currently), with districts increasing their contributions (currently 1.5% of payroll) by 0.1% annually until reaching 2% in fiscal 2025. Between fiscal years 2020 and 2024, the state will steadily increase its contribution of total teacher payroll to 8.25% from the current 6.8%. These changes would result in a pension amortization period of less than 31 years, consistent with the current 32 years.

Fitch has consistently considered the risk that the state could increase district contributions to TRS in its assessment of each entity's expenditure framework, and believes most districts can accommodate the increases mandated by SB 12 without compromising spending flexibility.

Long-Term Liability Burden

The district's overall debt and net pension liability (NPL) represents about 15% of personal income, with the district's direct debt representing the bulk of the total liability. The district received a strong 72% voter support for its May 2018 bond program. Officials expect to price the remainder of the bond authorization within the next 12 to 24 months. After the final tranche is issued, officials have no additional debt plans over the next several years. Fitch anticipates that the long-term liability burden will remain consistent with the current assessment category.

Pension and OPEB liabilities (largely retiree healthcare benefits) are limited because of the district's participation in the state pension program administered by the Teachers Retirement System of Texas (TRS). TRS is a cost-sharing, multiple-employer plan for which the state provides the bulk of the employer's annual pension contribution. Under GASB 67 and 68, TRS's assets cover 82% of liabilities as of fiscal 2018, a ratio that falls to 65% using Fitch's standard 6% return assumption.

The state assumes the majority of TRS employer contributions and net pension liability on behalf of school districts, except for small amounts that state statute requires districts to assume.

The TRS board at its July 2018 meeting voted to lower the investment return assumption for the TRS pension plan to 7.25% from 8%. This move increases the plan's current $35.5 billion NPL by $10 billion. As noted above, contributions by the state, districts and employees will be increasing over the next six years to help address the increased NPL. This change in investment return assumption and overall increase in the NPL does not affect Fitch's analysis of the long-term liability burden given our lower 6% assumption when considering the burden.

Operating Performance

Fitch expects the district to retain the highest level of financial resilience in a moderate economic downturn based on its solid expenditure flexibility and sound financial position. The district's financial flexibility and the sufficiency of its reserves are measured against the volatility of its revenue stream in a moderate economic downturn as depicted by the Fitch Analytical Stress Test model (FAST). FAST produces a low 1% general fund revenue decline in a -1% U.S. GDP scenario.

The district has ended the past several fiscal years with an unrestricted general fund balance that accounts for no less than 30% of operating expenditures. In fiscal 2018, officials authorized a sizable general fund drawdown to finance one-time capital needs. Despite the drawdown, at the close of fiscal 2018, the district's available fund balance totaled $111 million, or 30% of general fund expenditures. With less than a week remaining in fiscal 2019, management expects to close the fiscal year with an operating surplus of no less than $1 million. The fiscal 2020 adopted budget reflects a $3.7 million general fund deficit; however, management expects to close the fiscal year with better-than-budgeted results.

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. Based on state legislative changes to school funding, management expects to receive additional state revenue and plans to implement salary increases for its employees. Fitch expects the district will continue to prudently manage its costs in order to maintain operating performance that is consistent with the current rating.

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Applicable Criteria

U.S. Public Finance Tax-Supported Rating Criteria (pub. 03 Apr 2018)

Additional Disclosures

Dodd-Frank Rating Information Disclosure Form

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