25 Sep 2020 | New Issue

Fitch Rates Pearland ISD, TX's $79MM ULT Rfdg Bonds 'AAA' PSF, 'AA' Underlying; Outlook Stable

Fitch Ratings-Austin-25 September 2020:

Fitch Ratings has assigned a 'AAA' rating based on the Texas Permanent School Fund (PSF) and a 'AA' underlying rating to the following unlimited tax (ULT) bonds for Pearland Independent School District, Texas bonds:

--$79 million unlimited tax (ULT) refunding bonds, series 2020.

Additionally, Fitch has affirmed the 'AA' underlying rating on the district's approximately $430 million in outstanding ULTs and the district's Long-Term Issuer Default Rating (IDR).

The Rating Outlook is Stable.

The bonds are expected to be sold on a negotiated basis the week of Sept. 28. Bond proceeds will be used to refund a portion of the district's outstanding series 2001B ULT schoolhouse building bonds, along with several outstanding refunding transactions (series 2011, 2012 and 2013B).

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 Pearland ISD, Texas' series 2020 unlimited tax refunding bonds. For more information on the Texas Permanent School Fund see "Fitch Affirms Texas PSF Rating at 'AAA'; Outlook Stable," dated Nov. 25, 2019.

ANALYTICAL CONCLUSION

The 'AA' IDR and underlying ULT rating reflect the district's high level of financial resilience, solid expenditure flexibility and moderate long-term liability burden. The ratings also incorporate the district's limited independent ability to raise revenues.

Economic Resource Base

Pearland ISD is situated about 20 miles south of Houston's central business district in Brazoria County and serves a 2018 population estimate of about 109,000. For several years, the district experienced continual enrollment gains as a result of the growing population in the Houston metropolitan area; however, in recent years enrollment has slowed. Since the 2015-2016 academic/ fiscal year, enrollment has remained between 21,000 and 22,000 students.

KEY RATING DRIVERS
Revenue Framework::'a'

District operations are funded through a combination of state aid and local property taxes. Despite a tapering in enrollment, revenue growth prospects remain solid, as the district is still expected to expand, albeit at a slower pace than in prior years.

Expenditure Framework::'aa'

Spending growth is expected to trend in line with to marginally above revenue growth. The moderate fixed-cost burden for debt service and retiree benefits reflects state-support for long-term liabilities. Employee contract terms enhance the district's spending flexibility and capacity to respond to unanticipated revenue stress.

Long-Term Liability Burden::'aa'

Pearland ISD's long-term liability burden including the bonds now offered is moderate at about 14% of personal income, consisting mostly of outstanding debt. Fitch expects the district's long-term liabilities will remain within the moderate range.

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 the current slowdown caused by the pandemic and any future cyclical downturns. Strong financial management practices underpin the district's history of favorable operating performance.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

--A sustained trend of strong expenditure flexibility, which reflects a natural pace of spending that is slower, or equal to, revenue growth;

--Although not expected in the near term, a sustained decline in the long-term liability burden below 10% of residents' personal income.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

--Operating pressures resulting from a material decline in state K-12 education funding that lead to notably weaker financial resilience once recovery from the coronavirus pandemic takes hold;

--Although not anticipated in the near term, a severe and prolonged decline in enrollment could lead to downward rating pressure since enrollment is a principal driver for state funding.

Best/Worst Case Rating Scenario

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit [https://www.fitchratings.com/site/re/10111579].

CURRENT DEVELOPMENTS

Sector-wide Coronavirus Implications

The outbreak of coronavirus and related government containment measures worldwide has created an uncertain global environment for U.S. state and local governments and related entities.

Fitch's ratings are forward-looking in nature, and Fitch will monitor the severity and duration of the budgetary impact on state and local governments and incorporate revised expectations for future performance and assessment of key risks.

While the initial phase of economic recovery has been faster than expected, GDP in the U.S. is projected to remain below its 4Q19 level until at least 4Q21. In its baseline scenario, Fitch assumes continued strong GDP growth in 3Q20 followed by a slower recovery trajectory from 4Q20 onward amid persisting social distancing behavior and restrictions, high unemployment and a further pullback in private-sector investment. Additional details, including key assumptions and implications of the baseline scenario and a downside scenario, are described in the report entitled, "Fitch Ratings Coronavirus Scenarios: Baseline and Downside Cases - Update" (https://www.fitchratings.com/research/sovereigns/fitch-ratings-coronavirus-scenarios-baseline-downside-cases-update-08-09-2020), published Sept. 8, 2020 on www.fitchratings.com.

The coronavirus pandemic is materially affecting state revenues and is expected to continue applying downward pressure in the coming months. While state officials have directed certain state agencies to reduce spending by 5% for the remainder of the 2020-2021 biennium, no reduction in K-12 funding was included in that directive. Changes to K-12 funding for the upcoming 2021-2022 biennium likely will be considered in the next legislative session, which convenes in January 2021.

From mid-March through the last day of the spring 2020 semester, the district was designated as "Closed, Instructing" with TEA, indicating that normal operations had ceased and children no longer came to campuses, but were instead provided support to receive instruction at home/off-site. This designation allowed the district to continue receiving state aid based on average daily attendance. TEA used the average daily attendance (ADA) of the first four six-week grading periods in the 2019-2020 academic year (or fiscal 2020) to estimate ADA during the last two six-week grading periods, accounting for historical difference in attendance rate.

For the 2020-2021 academic year (fiscal 2021), the district has adopted a hybrid approach to educating students. Parents/guardians have the option to elect remote or on-campus instruction for students, with a phased-in, return-to-campus approach for the latter option. During the first 12 weeks of the 2020-2021 academic year, TEA has instituted an ADA hold harmless measure, which is available to most school districts (including Pearland ISD). In general, this measure allows a district's projected ADA to be calculated using a three-year average trend from final ADA from the 2017 to 2020 academic years. Based on this calculation, Pearland ISD's projected ADA that exceeds 20,600 students.

CREDIT PROFILE

Pearland ISD serves most of the city of Pearland, the city of Brookside Village, and unincorporated communities in Brazoria County. District residents participate in the robust Houston area economy and employment market. Wealth and income levels exceed the county, state and national averages.

The district's taxable assessed valuation (TAV) realized strong growth for much of the past decade; however, over the past couple of years tax base expansion slowed. Fiscal 2020 TAV at roughly $8.1 billion represents a 2.4% increase over fiscal 2018 TAV. Tax base growth for fiscal 2021 reflects a healthy increase, with TAV at $8.5 billion (or 5.6% over fiscal 2020 TAV). Fitch expects the district to experience moderate growth over the next few years as management has stated that several subdivisions continue to build homes and a sizable mixed-use is currently under development.

Fiscal 2020 actual enrollment totaled 21,760 students and management expects enrollment to reach about 21,980 students by the 2022-2023 academic year. Fitch expects growth to slow from historical levels if not flatten. According to the most recent demographic study, the district will be 95% built-out by the 2027-2028 academic year.

The district consists of a total of 23 campuses, including four high schools, four junior high schools, four middle schools and 11 elementary schools. The district has no immediate plans to construct additional campuses.

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 considering 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. This is a per-pupil dollar amount, which multiplied by average daily attendance (and adjusted for specific circumstances) produces a district's Tier 1 allotment. The state of Texas' favorable revenue growth prospects bodes well for K-12 funding in the medium term.

State funding accounted for 53% of the district's fiscal 2019 general fund revenues, followed by property taxes at 43%. Federal funding accounted for the remainder of general fund revenues.

The compound annual growth rate (CAGR) for general fund revenues over the 10-year period ending in fiscal 2019 of 5.1% exceeds U.S. GDP and inflation. Fitch expects the natural pace of district revenue growth in future years to be lower than historical performance but still solid, given current enrollment trends and expectations for district build out.

For the fiscal 2020-2021 biennium, the state increased 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.

While the property tax pledge securing the district's bonds is unlimited, state law requires districts to demonstrate 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 current overall property tax rate at$1.3585 per $100 of TAV includes a $0.9329 M&O rate and a debt service rate of $0.4256. The district's M&O rate is below the $0.97 state-mandated threshold. Likewise, the debt service tax rate is comfortably below the statutory cap of $0.50 for new debt issuances. Officials have expressed plans to hold a tax ratification election to increase the operations rate by $0.0371 in November 2020. If approved, the M&O rate will reach the $0.97 state-mandated maximum.

Changes in the tax rate setting process associated with HB 3 will not affect Fitch's current assessment of Texas districts' legal ability to increase revenues, which is uniformly at the 'bb' level given the limitations to any increase in M&O rates without voter approval.

Expenditure Framework

The district's main expenditure category is instruction, which accounted for 64% of operating expenses in fiscal 2019.

Fitch expects the natural pace of spending growth to remain commensurate with revenues absent policy action, given expected moderate enrollment growth and the potential for additional capital needs.

The district retains a solid degree of expenditure flexibility in labor costs given a lack of collective bargaining and its use of individual, annual employment contracts for teachers. Carrying costs for debt service, pension and other post-employment benefits (OPEB) are moderate at about 11% of fiscal 2019 governmental spending.

The district participates in the Texas Teachers Retirement System (TRS), a cost-sharing multiple employer system. Actual contributions are fixed in statute, while the actuarially determined contribution (ADC) measures contributions needed to eliminate the unfunded liability in 30 years. Statutory rates have often been below the ADC, with the resulting funding period slipping beyond the 31-year statutory maximum. Contributions (and the net pension liability or NPL) are shared by school districts and the state. In 2018, TRS lowered its discount rate to 7.25%, from 8.0%, and in 2019 the legislature raised state, employer and employee rates over five years to bring the funding period within the legal maximum threshold. Like all Texas school districts, the district is vulnerable to future state policy changes that shift more of the contributions and liabilities onto districts, as well as to TRS' ability to achieve its funding assumptions over time.

Long-Term Liability Burden

The district's long-term liability burden, comprised primarily of its direct and overlapping debt, is currently 14% of personal income, which Fitch considers to be within the moderate range. The district has not expressed any definitive debt plans and there is no remaining bond authorization. In July 2019, the district issued its final installment of voter-approved debt from its November 2016 bond program.

Unfunded pension and OPEB liabilities are limited because of the district's participation in the state pension program administered by the TRS. Under GASB 67, TRS's assets covered 73.7% of liabilities as of the system's fiscal 2019 audit, a ratio that falls to 65.8% using Fitch's standard 6% return assumption; the district's own financial statements will reflect the reported ratio in fiscal 2020. Reported system figures are based on the lower discount rate implemented by TRS in 2018 and the statutory increase in contribution rates approved in 2019. Higher expected contributions have eliminated the depletion date reported by TRS in fiscal 2018 (and which school districts are reporting in their fiscal 2019 audits) and have brought forecast amortization to 30 years. Statutory contribution increases strengthen the likelihood of funding improvement, but future progress ultimately depends on whether actual TRS performance matches assumptions over time. At present, the state carries just over half of TRS' employer NPL on behalf of school districts and pays roughly half of contributions.

Operating Performance

Given Pearland ISD's robust fund balance position and ability to adjust expenditures, Fitch believes that the district has the capacity to reasonably absorb potential financial pressure resulting from the ongoing coronavirus pandemic and resulting economic contraction without impairing its strong financial resilience.

The district's adopted budget for fiscal 2020 reflected an operating gap of approximately $5.8 million. Due to its historically conservative budgeting practices, which include over-estimating expenditures and mid-year budget adjustments, the district typically outperforms the budget. Management expects fiscal 2020 audited results to indicate an operating surplus in excess of $7 million. According to district representatives, a portion of the surplus will be earmarked for capital needs.

The fiscal 2021 adopted operating budget includes a $1.2 million deficit. Even if the deficit is fully realized, the district has an ample reserve cushion to absorb the shortfall. Fitch expects the district will continue to prudently manage its costs in order to maintain operating performance that is consistent with the current rating.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG Considerations

The highest level of ESG credit relevance, if present, is a score of 3. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity(ies), either due to their nature or to the way in which they are being managed by the entity(ies). For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

Pearland Independent School District (TX); Long Term Issuer Default Rating; Affirmed; AA
----Pearland Independent School District (TX) /General Obligation - Unlimited Tax/1 LT; Long Term Rating; Affirmed; AA

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Additional information is available on www.fitchratings.com

Applicable Criteria

U.S. Public Finance Tax-Supported Rating Criteria (pub. 27 Mar 2020) (including rating assumption sensitivity)

Applicable Model

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).
FAST States & Locals - Fitch Analytical Stress Test Model, v2.4.0 (1)

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