

FITCH DOWNGRADES SAN YSIDRO SCHOOL DISTRICT, CA GOS TO 'BBB+', COPS TO 'BBB'; OUTLOOK NEGATIVE

Fitch Ratings-San Francisco-21 May 2013: Fitch Ratings takes the following rating actions on San Ysidro School District, California (the district):

--\$82 million election of 1997 general obligation (GO) bonds series B, C, D, E and F downgraded to 'BBB+' from 'A+';

--\$29.1 million certificates of participation (COPs) series 2001, 2005, and 2007 downgraded to 'BBB' from 'A'.

The Rating Outlook on the bonds and COPs remains Negative.

SECURITY

The GO bonds are general obligations of the district, payable solely from the proceeds of ad valorem taxes, without limitation as to rate or amount. The COPs are limited obligations secured by the district's covenant to budget and appropriate lease rental payments for the use of certain district properties, subject to abatement.

KEY RATING DRIVERS

RECURRING DEFICITS; CASH SHORTFALL: The downgrade to 'BBB+' for the GOs and 'BBB' for the COPs is based on the district's continued structural imbalance, with recurring deficits that have reduced reserves and cash balances over the past several years. Projected deficits have rendered the district ineligible for cashflow borrowing strategies it has used in prior years and management has identified a cash shortfall beginning in April 2014 based on current expenditure and revenue trends.

BUDGET ACTIONS KEY: The Negative Outlook is based on the district's need to make substantial new budget adjustments for the upcoming 2014 fiscal year if operating balance is to be restored. The district faces limited options for such adjustments apart from furloughs and salary reductions for employees, which could prove difficult to achieve through negotiation. Proposed increases in state funding may offset the size of needed reductions, but await legislative action as part of the 2014 state budget.

COUNTY ADVISOR APPOINTED: The county superintendent of schools has recently appointed a fiscal advisor to the district with stay-and-rescind authority over board actions. Direct state oversight may also be required if the district is unable to restore operating balance and is forced to seek a state loan.

CORRUPTION SCANDAL COMPOUNDS CHALLENGES: The district faces added challenges from a corruption scandal that has led to the indictment of a school board member and its long-time superintendent, who has recently resigned.

MIXED ECONOMIC RESULTS: The district benefits from its location in the broad and diverse San Diego regional economy, which has seen sustained employment growth in recent years, but taxable assessed values (TAV) for the district fell sharply in fiscal 2013. Wealth and income levels remain well below average.

WEAK DEBT POSITION: Overall debt levels are high and amortization of direct debt is slow, while pension costs are likely to rise.

RATING SENSITIVITIES

CONTINUED FISCAL DECLINE: The district's inability to balance its fiscal 2014 budget would result in additional downward rating pressure.

CASH SHORTFALL: A failure to address projected cash shortfalls, either through budget adjustments or a request for a state loan, would further add to downward rating pressure.

CREDIT PROFILE

The San Ysidro School District is located primarily within the southeastern portion of the city of San Diego, adjacent to the international border with Mexico, and includes 42,000 residents within 29 square miles. The district serves approximately 5,300 students from pre-school through eighth grade.

RECURRING DEFICITS; CASH SHORTFALL

The downgrades for the GOs and the COPs is based on the district's continued structural imbalance, with recurring deficits that have reduced reserves and cash balances over the past several years. Unrestricted fund balance fell to 5.1% of general fund spending in fiscal 2012 as compared to 16.5% in fiscal 2011. The decline resulted from a \$2 million operating deficit in 2012 (equal to 5% of general fund spending) in combination with a \$1.3 million fund balance reduction due to an accounting restatement.

If recent deficit spending practices continue, the district will exhaust its remaining unrestricted general fund reserves in fiscal 2014, reducing unrestricted fund balance to a negative 7% of general fund spending. A projected cash shortfall beginning in April 2014 adds to the district's fiscal challenges and increases the likelihood of a state takeover. The district managed its cashflow in prior years through pooled short-term borrowings and internal borrowing of bond proceeds, but recent negative budget certifications have rendered it ineligible to participate in such transactions.

BUDGET ACTIONS KEY

The Negative Outlook is based on the district's need to make substantial new budget adjustments for the upcoming 2014 fiscal year to prevent cash shortfalls and maintain reserves at state-required levels. The district faces limited options for such adjustments apart from furloughs and salary reductions for employees, which could prove difficult to achieve through negotiation. Management has sought to limit the impacts of cuts on classroom activities in recent years and, in contrast to many districts in the state, implemented no furloughs or school year reductions prior to the current fiscal year. The district will be challenged to maintain this approach in light of a deficit projected at 14% of expenditures for fiscal 2014 and 18% in the following year.

Proposed increases in state funding could offset the size of needed reductions, but await legislative action as part of the 2014 state budget. The May revision of the governor's budget calls for across the board increases in per-pupil funding based on higher state revenue levels, as well as targeted funding increases as part of a new Local Control Funding Formula (LCFF). The district would benefit disproportionately from the LCFF as currently proposed due to its high share of English-language learners, but funding levels remain uncertain prior to adoption of the state budget, which is expected in June.

COUNTY INTERVENTION

The county superintendent of schools recently appointed a fiscal advisor to the district following the negative certification of its budget due to a projected inability to meet financial obligations. The fiscal advisor holds stay-and-rescind authority over actions of the district's board, and is assisting the district to develop a plan to meet its financial obligations. Direct state oversight may also be required if the district is unable to restore operating balance and is forced to seek a state loan.

CORRUPTION SCANDAL COMPOUNDS CHALLENGES

The district faces added challenges from a local corruption scandal alleging pay-to-play practices for school construction projects. Fifteen officials in three school districts have been indicted to date, including San Ysidro's long-time superintendent and a school board member. The superintendent has resigned and an assistant superintendent is filling this role on an interim basis.

Efforts to recall three board members who approved the superintendent's resignation appear to have stalled, but with a trial date set for February 2014, the controversy could prove to be a distraction

from more pressing fiscal matters. In addition, the district may be required to bear the cost of the superintendent and board member's legal defenses if they are not found guilty.

MIXED ECONOMIC RESULTS

The district benefits from its location in the broad and diverse San Diego regional economy, which has seen sustained employment growth in recent years. San Diego's unemployment rate fell to 8.0% in February 2013, just below the national rate of 8.1% and substantially lower than the state's 9.7% rate. Large employment gains over the past four years have contributed to these results and current employment levels exceed pre-recession peaks.

District-level employment statistics are not available but census data portray a relatively impoverished area within this generally wealthy region. Household income levels for the district are approximately three-fourths of regional averages and poverty rates are notably higher.

The district's tax base retained much of its value during the recent downturn, but experienced a 5.7% decline in TAV for fiscal 2013. Countywide TAV also declined in 2013, but at much lower levels. San Ysidro home values reported by Zillow.com increased by 19% year-over-year as of March 2013, suggesting a return to TAV growth in future years.

WEAK DEBT POSITION

Overall debt levels for the district are very high at 7.0% of TAV and \$7,345 per capita. Amortization of direct debt is slow with only 11% of outstanding principal and accreted interest retired in 10 years. Capital needs are limited apart from the planned construction of a new elementary school, which the district intends to fund from \$48 million in remaining GO and COP proceeds.

The district participates in two state-sponsored employee pension plans and is likely to face ongoing increases in contribution rates to address current low funding levels. Funding for CalSTRS is a particular concern, as current contribution rates are substantially below the level required to amortize existing obligations. Carrying costs for debt service and retirement benefits were moderate at 21% of non-capital governmental expenditures in fiscal 2012 but appear likely to rise due to escalating debt service and proposed pension rate increases.

Contact:

Primary Analyst
Stephen Walsh
Director
+1-415-732-7573
Fitch Ratings, Inc.
650 California Street 4th Floor
San Francisco, CA 94108

Secondary Analyst
Karen Ribble
Senior Director
+1-415-732-5611

Committee Chairperson
Richard Raphael
Managing Director
+1-212-908-0506

Media Relations: Elizabeth Fogerty, New York, Tel: +1 (212) 908 0526, Email: elizabeth.fogerty@fitchratings.com.

Additional information is available at 'www.fitchratings.com'.

In addition to the sources of information identified in the 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, and Zillow.com.

Applicable Criteria and Related Research:

--'Tax-Supported Rating Criteria' (Aug. 14 2012);

--'U.S. Local Government Tax-Supported Rating Criteria' (Aug. 14 2012).

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Tax-Supported Rating Criteria

http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=686015

U.S. Local Government Tax-Supported Rating Criteria

http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=685314

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