

FITCH DOWNGRADES SAN YSIDRO SCHOOL DISTRICT, CA GOS TO 'BB+', COPS TO 'BB-'; ON NEGATIVE WATCH

Fitch Ratings-San Francisco-18 November 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 'BB+' from 'BBB+';

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

The bonds and COPs are placed on Rating Watch 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

HEIGHTENED FINANCIAL RISKS: The downgrade to 'BB+' for the GOs and 'BB-' for the COPs reflects the district's inability to restore operating balance in its fiscal 2014 budget, as well as continuing liquidity challenges. Management projects that absent an emergency state loan, the district will deplete its cash balances in May 2014, which Fitch considers plausible based on current expenditure patterns and available reserves.

STATE TAKEOVER LIKELY: The downgrade also reflects the increasing likelihood that the state will appoint an outside administrator to manage the district's finances and operations. The granting of an emergency loan would trigger such an appointment, reducing the district's governing board to an advisory role. The Negative Watch is based on the potential for additional downgrades in the event a state takeover is not completed in a timely manner. Fitch expects the takeover would need to occur, and the Rating Watch to be resolved, by next May.

COPs RATING LOWER: The steeper downgrade for the district's COPs reflects the reduced availability of resources for payment of appropriations debt as a result of the district's current financial strains.

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 former superintendent.

MIXED ECONOMIC RESULTS: The district participates in the broad and diverse San Diego regional economy, which has seen sustained employment growth in recent years. However, taxable assessed values (TAV) for the district fell sharply in fiscal 2013 and its 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. An emergency loan from the state is likely to further weaken the district's debt profile.

RATING SENSITIVITIES

STATE LOAN REQUIRED: The district's inability to maintain sufficient resources to continue operations through a state loan or other means would likely result in further downgrades. The successful receipt of a state loan would be unlikely to trigger an upgrade, but could result in a resolution of the Rating Watch.

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 5,100 students from pre-school through eighth grade.

HEIGHTENED FINANCIAL RISKS

Fitch's prior rating action on the district preceded the adoption of a budget for fiscal year 2014, and cited the importance of substantial new budget adjustments to prevent cash shortfalls and maintain reserves at state-required levels. The district was unable to complete such adjustments, and now faces a sizable deficit that adds to its existing financial challenges. Management reports that the district has not negotiated concessions with employees for the current academic year, while its board has been unable to impose cuts unilaterally. The district now expects that its general fund balance will turn negative in fiscal 2014, which Fitch considers reasonable based on the district's history of operating deficits and dwindling reserves.

The district's finances have deteriorated due to a growing gap between general fund expenditures and revenues over several consecutive years. Unrestricted fund balance fell to 5.1% of general fund spending in fiscal 2012 as compared to 16.5% in fiscal 2011. Management projects ongoing deficits in fiscals 2015 and 2016 based on current expenditure patterns, which would reduce fund balances still further.

A projected cash shortfall beginning in May 2014 poses the chief immediate threat to the district's finances. 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. An advance of property taxes from the county treasurer has helped to delay the district's insolvency, but management sees no long-term resolution to the district's financial challenges absent a state takeover.

STATE TAKEOVER LIKELY

The district's pending insolvency will likely necessitate an emergency state loan, which in turn will trigger the appointment of a state administrator. Such actions are provided for under California's fiscal oversight procedures for local educational agencies, as codified under AB1200. Fitch acknowledges the stabilizing impact of AB1200, which has been utilized in nine California school districts since 1991, but does not presume such support will be available before an emergency loan is granted. Fitch is unaware of any circumstances in which such support has been withheld, but the Negative Watch reflects the risk that a state loan and takeover, if needed, might not be completed in a timely manner.

COPs RATING LOWER

The larger downgrade for the district's COPs than for its GOs, results from the district's heightened financial risks and reduced flexibility. Fitch typically maintains a one-notch distinction between GO and appropriation debt for higher-rated credits, but this distinction can increase at lower rating levels. The steeper downgrade for the district's appropriation debt reflects the reduced availability of general fund resources pledged towards repayment of these obligations.

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.

MIXED ECONOMIC RESULTS

The district is part of the broad and diverse San Diego regional economy, which has seen sustained employment growth in recent years. San Diego's unemployment rate fell to 7.4% in August 2013, just above the national rate of 7.3% and substantially lower than the state's 8.8% 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 and a 0.1% decline for fiscal 2014. San Ysidro home values, as reported by Zillow.com, increased by 20% year-over-year as of September 2013, suggesting a return to TAV growth in future years.

WEAK DEBT POSITION

Overall debt levels for the district are high at 7.0% of TAV and \$7,345 per capita. Amortization of direct debt is very slow with only 12% of outstanding principal and accreted interest retired in 10 years. An expected state loan is likely to weaken such metrics further. 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 are moderate but appear likely to rise due to escalating debt service and proposed pension rate increases.

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In addition to the sources of information identified in the Tax-Supported Rating Criteria, this action was additionally informed by information from Creditscope and Zillow.com.

Applicable Criteria and Related Research:

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

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