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Ratings

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Summary:

Santa Monica-Malibu Unified School District, California; Appropriations; General Obligation

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Table Of Contents

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Credit Profile		
US$120.0 mil GO bnds (Election Of 2012) ser D due 08/01/2043		
Long Term Rating	AA+/Stable	New
Santa Monica-Malibu Unif Sch Dist GO		
Long Term Rating	AA+/Stable	Upgraded
Santa Monica-Malibu Unif Sch Dist APPROP		
Unenhanced Rating	AA(SPUR)/Stable	Upgraded

Rationale

S&P Global Ratings raised its long-term rating to 'AA+' from 'AA' on Santa Monica-Malibu Unified School District, Calif.'s 2018 series D (election of 2012) general obligation (GO) bonds. At the same time, we raised our long-term rating and underlying rating (SPUR) to:

- 'AA+' from 'AA' on the district's existing GO bonds and
- 'AA' from 'AA-' on the district's certificates of participation (COPs).

In addition, S&P Global assigned its 'AA+' rating to the district's series 2018D (election of 2012) GO bonds. Management indicates the district will use the bond proceeds to build new facilities and renovate existing facilities. The outlook is stable.

The positive rating action reflects our view of the district's recent transition to basic-aid status, whereby it is less reliant on volatile state revenue, and a tax base that grew by half over the past decade. Furthermore, this action reflects sustained growth in local supplemental revenue streams--such as a parcel tax and sales tax--that make the district less reliant on volatile state funding.

Security and use of proceeds

The bonds are secured by the district's unlimited ad valorem property tax pledge, which obligates the district to annually levy taxes on taxable property within the district without limitation as to rate or amount such that legally available funds are sufficient to make principal and interest payments. Management indicates the series 2018D (election of 2012) bond proceeds will be used to both build new facilities and renovate existing facilities.

The district's previously issued GO bonds are also secured by an unlimited ad valorem property tax pledge, while the district's previously issued COPs represent an interest in lease payments that the district makes, as lessee, for use of district facilities. The COPs are rated one notch below our view of the district's general creditworthiness to reflect appropriation risk.

The district's previously issued series 2016B refunding GO crossover bonds are secured by proceeds deposited into an escrow fund until the crossover date of July 1, 2020. The proceeds in the escrow fund will be invested in noncallable federal securities (state and local government series). On and after the respective crossover date, unlimited ad valorem taxes levied on taxable property within the district will secure the bonds. For that reason, the rating reflects the weaker of the district's long-term rating and the U.S. government sovereign rating (AA+/Stable) until the crossover date. Afterward, the rating will reflect only the district's long-term rating.

The ratings reflect our view of the district's:

- Extremely strong and resilient local tax base, with very strong incomes, focused in one of Southern California's main economic centers;
- Substantial, diverse array of supplemental revenue streams not common to most school districts in the state, such as the ability to realize property tax revenue above what is constitutionally allowed under the California funding formula; and
- Expenditure flexibility in the form of a large proportion of its student population that it serves at its discretion; and
- Good financial management practices.

Partially offsetting these strengths are the district's:

- Inconsistent operating performance, with recent drawdowns of its fund balance;
- High overall per capita debt; and
- Longstanding political discussion of the division of the school district.

Very strong economy

Santa Monica-Malibu Unified School District is a discontinuous district within Los Angeles County that serves an estimated population of 111,980 within its namesake cities, as well as unincorporated portions of Los Angeles County. The district is located along the Pacific Coast, with Santa Monica located 16 miles west of downtown Los Angeles and Malibu located 33 miles west of downtown Los Angeles. Both Santa Monica and Malibu maintain tourism activity we consider strong while serving as entertainment, restaurant, and retail centers for local residents. Santa Monica also hosts an emerging technology sector known as Silicon Beach and one of the state's largest community colleges, Santa Monica Community College.

With access to the greater Los Angeles regional economy--as demonstrated by a recently completed light rail line from Santa Monica to downtown Los Angeles--we consider the district's income levels to be very strong. The district's per capita effective buying income (EBI) is 202% and median household EBI is 144% of the national levels. The district's total $52.2 billion market value in fiscal 2018 was extremely strong, in our view, at $452,630 per capita, and based on current momentum, including new construction, we anticipate further growth for fiscal 2019. Assessed value (AV) grew by a total of 11.4% since 2016 to $52.2 billion in 2018. The tax base is very diverse, with the 10 largest taxpayers accounting for approximately 6.0% of AV.

Strong budget performance with highly independent revenue streams

General purpose funding for California school districts is determined by a formula based primarily on average daily attendance (ADA), grade levels served, and share of students served that are English language-learners, low to moderate income, or foster youth. Most school districts are funded through a combination of state general fund revenue and local property tax revenue, up to the amount determined by formula. For these districts, increases or decreases in ADA can lead to increases or decreases, respectively, in general purpose funding under the formula. In some districts, however, the property tax base generates local revenue in excess of the formula-determined amount. These districts, known as "basic aid" or "local funding" districts, keep virtually all of the local property tax revenue and receive little to no general funding from the state, resulting in revenues that are less affected by state budget cuts or declines in ADA. Santa Monica-Malibu Unified School District recently transitioned from state-aid status to basic-aid status in fiscal year 2019. While the current benefit of this transition is small--about $1 million--we expect this to grow as the district's AV continues to grow.

The district reported a deficit general fund result of 4.3% of expenditures in fiscal 2017, but the district's current actuals show that it broke even in fiscal 2018. The fiscal 2019 budget projects a deficit of $963,000 (0.6% of expenditures.) We note that the district has historically been conservative in its budget estimates (such as by under-estimating sales tax revenue), and believe fiscal 2019 could also be breakeven.

Although the district's available fund balance as of fiscal 2017 was $26.8 million, or 17.1% of expenditures, preliminary fiscal 2018 results show an increase to $29.0, or 18.0%, which we consider very strong. Under the fiscal 2019 budget, the district's available reserves would fall midway between these two ratios, at 17.4% of expenditures.

In addition to the fund balance, we view the district as having high expenditure flexibility by state standards due to policies that lead to what we consider a high percentage of transfer students, with about 20% of enrollment consisting of students living outside the district. We believe that the district has the flexibility to reduce enrollment--and expenditures--by tightening its transfer criteria.

In addition to its basic-aid status, we view its supplemental revenue, which are unusual in the state, as representing a credit strength. The district currently has the following revenue streams available to it:

- A parcel tax with no sunset date generating $12 million per year (7.3% of general fund revenue);
- Two sales tax measures with no sunset dates generating $16 million per year (9.6%);
- A facility lease through 2022 generating $9 million per year (5.5%); and
- A foundation that, since fiscal year 2015, has averaged about $2 million per year (1.2%).

Together, these sources comprised 23.6% of the district's preliminary general fund revenue in 2018.

Good management practices

We consider the district's management practices to be good under our FMA methodology, indicating financial practices exist in most areas, but that governance officials might not formalize or monitor all of them on a regular basis. Elements of the district's financial policies and practices include:

- Compliance with a well-established state framework that requires the district to report its revenue and expenditure assumptions, including changes to ADA, and the district utilizes a demographer and other outside sources to make its revenue and expenditure assumptions;

- Presentations of budget-to-actuals performance to the board at least six times per year with occasional board amendments as needed;
- Maintenance of a long-term financial plan that extends a year beyond the state requirement of current-year-plus two-year forecasting;
- Lack of recent updates to its master facilities plan;
- Adherence to state investment management requirements, including mandatory participation in the county's investment pool, and annual reports on holdings and performance in its audited financial report;
- Adoption of a debt management policy that provides a conceptual framework for debt issuance in compliance with Senate Bill (SB) 1029 (for more information, see "California's Passage Of SB-1029's Formal Debt Management Policy Requirement Could Improve Our View Of Credit Quality," published on Nov. 22, 2016), although we view its guidelines as lacking significant quantitative constraints; and
- Compliance with a state-required reserves minimum of 3% of expenditures, bolstered by an informal minimum goal of two months (17%) of expenditures as a cushion against the cash flow risks of economic uncertainties.

Potential division of district

We understand that the district has had longstanding discussions regarding institutional separation. The school board has explored the division of the district since at least 2012, forming a subcommittee to explore the issue in 2016. In response to these discussions, the district in recent years has taken steps to shift operating and capital financing into its two geographic areas--Santa Monica and Malibu.

For a California school district to divide, state law requires the district to first gain approval from its local County Office of Education and then submit a petition to the State Board of Education, which assesses a variety of factors such as how the division will affect enrollment, management practices, and whether the property division is equitable. If the State Board of Education approves the district's request, the district must then gain approval from local voters. (Based on conversations with the California Legislative Analyst's Office, no school district divisions have occurred in California within at least two decades.)

In 2017, the city of Malibu petitioned the Los Angeles County Office of Education to create a new Malibu Unified School District, of which the Santa Monica-Malibu school board formally objected. We understand that that action accelerated some of the efforts of the district to devolve operating and capital financing. In June of 2018, the board adopted a resolution creating two separate school facilities improvement districts and discussed separating the district's single foundation into two separate foundations. Based on our understanding of the institutional hurdles involved and discussions with management, we do not anticipate that a formal division will occur within the next five years.

High per-capita debt profile

In our opinion, overall net debt is high on a per capita basis at $12,282, but low as a percentage of market value at 2.7%, the latter of which we think is a more meaningful ratio for understanding the district's debt burden given its income profile. Amortization is slower than average, including the 2018 series D bonds (election of 2012), with 31% of the district's direct debt to be retired within 10 years. In our view, the district's debt service carrying charges are elevated at 23% of total governmental funds expenditures, excluding capital outlay in fiscal 2016. With the issuance of the series D bonds, the district will exhaust its authorization under the 2012 bond measure. We understand that the district does not have any direct purchase or private placement agreements outstanding.

The district board approved requesting GO authorizations from voters in November 2018 in its newly-created school facilities improvement districts, with $485 million requested for Santa Monica schools and $195 million for Malibu schools. Due to the district's slow debt amortization and our expectation that the district's population is likely to grow slowly for the foreseeable future, we anticipate that these ballot measures--if approved and quickly exercised--could materially increase the district's per-capita debt ratio but are unlikely to significantly change overall net debt relative to market value due to the pace of AV growth.

Pension carrying charge and other postemployment benefits (OPEB)

Combined pension and OPEB carrying charges totaled 5.7% of total governmental expenditures in fiscal 2017.

The district contributed its total annual required contribution (ARC) of $12.6 million toward its pension obligations in fiscal 2017, or 4.9% of total governmental expenditures. The district participates in defined-benefit pension plans managed by the California State Teachers' Retirement System (CalSTRS) and the California Public Employees' Retirement System (CalPERS). CalSTRS, its largest plan, maintained a funded level of 70%, using its fiduciary net position as a percentage of the total pension liability. Based on CalSTRS' and CalPERS' advice, we anticipate that the district's pension carrying charges will increase in the coming five years.

As of its most recent evaluation, we understand that the district has an actuarial accrued OPEB obligation of $36.4 million, of which it has set aside $5.6 million into an irrevocable trust. In fiscal 2017, the district paid $2.1 million (0.8% of total governmental expenditures) toward its OPEB obligations.

Outlook

The stable outlook reflects our view that the district's very strong local economy, growing tax base, recent basic-aid funding status, and additional revenue flexibility will translate into revenue growth that will support the district's ability to maintain available general fund reserves we consider at least strong. We do not expect district to undergo an institutional separation within the next two years, but we expect devolution of some sort, such as by the passage of GO authorization by voters in one or both of the newly-created school facilities improvement districts this fall. We do not expect to change the ratings within our two-year outlook horizon.

Upside scenario

Should the district experience a major acceleration in revenue growth that we think will lead to a substantial increase in available reserves on an ongoing basis, particularly if accompanied by strengthening financial management policies and practices (such as the formalization of its reserve policy), or if we come to believe that the district is not at risk of a credit determination associated with a potential division, we could raise the rating.

Downside scenario

We could lower the ratings should a major economic downturn lead to substantial deterioration in the district's fund balance, if it were to reduce its local revenue flexibility, or if it were to pursue a path to division that we think would negatively impact its ability to repay its debt burden.

Ratings Detail (As Of August 8, 2018)		
Santa Monica-Malibu Unif Sch Dist GO bnds (Election of 2006)		
Long Term Rating	AA+/Stable	Upgraded
Santa Monica-Malibu Unif Sch Dist 2010 rfdg certs of part (tax-exempt)		
Long Term Rating	AA/Stable	Upgraded
Santa Monica-Malibu Unif Sch Dist 2016 GO rfdg bnds (2020 Crossover Rfdg) ser C due 07/01/2035		
Long Term Rating	AA+/Stable	Upgraded
Santa Monica-Malibu Unif Sch Dist GO		
Unenhanced Rating	AA+(SPUR)/Stable	Upgraded

Many issues are enhanced by bond insurance.

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.