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Ratings

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Summary:

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

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Credit Profile		
US$110.0 mil GO bnds (SFID No. 1 Election Of 2018) ser A due 08/01/2049		
Long Term Rating	AA+/Stable	New
US$35.0 mil GO bnds (SFID No. 2 Election Of 2018) ser A due 08/01/2049		
Long Term Rating	AA+/Stable	New
Santa Monica-Malibu Unif Sch Dist GO		
Long Term Rating	AA+/Stable	Affirmed

Rationale

S&P Global Ratings assigned its 'AA+' rating and stable outlook to Santa Monica-Malibu Unified School District, Calif.'s 2019 series A (election of 2018) general obligation (GO) bonds, issued for Santa Monica Schools School Facilities Improvement District (SFID) No. 1 and Malibu Schools SFID No. 2.

At the same time, S&P Global Ratings affirmed its 'AA+' rating, with a stable outlook, on the district's existing GO debt.

S&P Global Ratings also affirmed its 'AA' rating, with a stable outlook, on the district's certificates of participation (COPs).

Security and purpose

The district's unlimited-ad valorem-property-tax pledge--which obligates the district to levy taxes on taxable property within the district annually, without limitation as to rate or amount such that legally available funds are sufficient to make principal and interest payments--secures the 2019 series A bonds and existing bonds.

Management expects to use the 2019 series A bond proceeds to construct and renovate district facilities in each SFID.

The district's COPs represent an interest in lease payments it makes, as lessee, for the use of district facilities. We rate the COPs one notch below our view of the district's general creditworthiness to reflect annual appropriation risk.

Proceeds deposited into an escrow fund until the crossover date of July 1, 2020, secure the district's series 2016B GO refunding crossover bonds. Proceeds in the escrow fund were invested in noncallable federal securities (the 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 long-term rating on the district's debt and the U.S. government sovereign rating until the crossover date. Afterward, the rating will reflect only the long-term rating on the district's debt.

Credit fundamentals

We view the district's recent transition into basic-aid status as a positive credit factor, making it less reliant on volatile state revenue. The district maintains several supplemental revenue streams that diversify its overall revenue structure. Moreover, the district has maintained very strong reserves despite recent fund-balance draws due to one-time payments and staff salary increases. Future financial projections show further fund-balance deterioration, which we note does not currently include salary adjustments due to unsettled bargaining-unit contracts. While the district typically budgets conservatively and finances will likely benefit from expected economic growth, we note continued fund-balance draws could negatively affect the rating.

The strength of the economy bolsters the credit rating. Past assessed value (AV) growth has been strong. While the recent Woolsey fire should have an effect on AV growth in the Malibu area, officials do not expect AV to decrease. We consider this a testament to the economy's strength. We are optimistic strong overall AV growth will likely continue due to increased permits from post-fire construction, other commercial and residential construction, and organic growth.

We understand the district has had longstanding discussions regarding institutional separation. In 2017, Malibu petitioned Los Angeles County Office of Education to create a new Malibu Unified School District, which Santa Monica-Malibu School Board objected to formally. In June 2018, however, the board adopted a resolution that created two separate SFIDs. While the two SFID's appear to create a middle ground between the district's formal division and remaining unified, we understand formal division is still a possibility as discussions resume. Based on our understanding of the institutional hurdles and management discussions, we do not expect a formal division will likely occur within the next few years.

The ratings reflect our opinion of the district's:

- Extremely strong and resilient local property tax bases, with very strong incomes, centered on 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 California's funding formula;
- Expenditure flexibility in the form of a large proportion of its student population, served at its discretion; and
- Good financial management practices under our Financial Management Assessment (FMA) methodology.

We believe somewhat offsetting factors are, what we consider, the district's:

- Inconsistent operating performance with the possibility of fund-balance drawdowns,
- High overall per capita debt, and
- Longstanding political discussion regarding the school district's division.

Economy

The district is a discontinuous district within Los Angeles County that serves a population estimate of 114,000 within its namesake cities, as well as unincorporated portions of Los Angeles County. This affluent district resides along the

Pacific Coast with Santa Monica and Malibu 16 miles and 33 miles west, respectively, 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. A host of health-care and technology companies and Santa Monica Community College, one of the state's largest community colleges, stimulate Santa Monica's economy further.

The district's tax base, as a whole, is very diverse with the 10 leading taxpayers making up 6.3% of AV. AV has grown continuously for eight consecutive fiscal years by an average of 5.6% annually to roughly $56.5 billion in fiscal 2019, or, in our view, an extremely strong $492,744 per capita. The tax base remained well insulated from the recession, decreasing by only 0.3% in fiscal 2011. In our opinion, the tax base will likely continue to improve due to persistent commercial and residential development, as well as organic growth through any potential national shifts. We expect the AV loss from the Woolsey fire to have a minimal effect on the growing tax base. In our opinion, median household and per capita effective buying incomes are very strong at 151% and 210%, respectively, of national levels.

SFID No. 1's primarily residential tax base made up more than 64% of total AV in fiscal 2019 with the remainder being commercial due to its large corporate base. Its tax base is very diverse: The 10 leading taxpayers made up roughly 8.9% of AV in fiscal 2019. AV has grown continuously for eight consecutive fiscal years by an average of 5.8% annually to roughly $37.5 billion in fiscal 2019, or, in our view, an extremely strong $363,000 per capita. We expect the tax base will likely continue to improve, especially with, what management notes as, extensive hospitality renovation and development, coupled with retail growth.

SFID No. 2's primarily residential tax base made up more than 93% of total AV in fiscal 2019. Its tax base is very diverse: The 10 leading taxpayers made up about 4.3% of AV in fiscal 2019. AV has grown continuously for eight consecutive fiscal years by an average of 5.5% annually to roughly $19 billion in fiscal 2019, or, in our view, an extremely strong $1.6 million per capita.

In late 2018, the Woolsey fire destroyed an estimated 670 structures, including 400 homes in the Malibu area. In our opinion, the Woolsey fire will have an effect on tax base figures. However, because of tax base growth strength before the fire, officials are projecting fiscal 2020 AV to improve, though not at a previously recognized rate. Nevertheless, lost housing due to the fire has opened the door to further growth through home rebuilding and sales. Homebuilding permits have increased exponentially. Therefore, in our opinion, the fire will only have a temporary effect on AV. We expect continued AV improvement through development, redevelopment, and organic growth.

Finances

A formula based primarily on average daily attendance (ADA); grade levels served; and the share of English language-learner students, low- to moderate-income families, or foster youth served determine general-purpose funding for California school districts. California funds most school districts through a combination of state general fund and local property tax revenue, up to the amount determined by the formula. For these districts, ADA increases or decreases 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 all local property tax revenue and receive little-to-no general funding from the state, resulting in state budget cuts or ADA decreases having less of an effect on revenue. The district recently transitioned to basic-aid status from state-aid status in fiscal 2019. While the current benefit of this transition is small, roughly $2 million, we expect this to grow as AV grows.

Available fund balance--a combination of assigned, unassigned general fund balance--was $26.8 million, or 17.1% of expenditures, in fiscal 2017, down from roughly $32.5 million, or 22%, in fiscal 2016. Management primarily attributes the decrease to salary increases for certificated, classified staff. It, however, reported surplus general fund results at 4.7% of expenditures in fiscal 2018, the most recent audited year available; this increased available fund balance to, in our opinion, a still-very-strong 22% of general fund expenditures, or $34.7 million. Despite a one-time off-schedule salary increase for classified staff, conservative budgeting contributed to the surplus.

For fiscal 2019, management estimates a $3.5 million use of fund balance that could decrease available fund balance to an estimated 17% of budgeted general fund expenditures. Management partially attributes fund balance use to a nearly $9 million contribution of earmarked funds to the educational-revenue-augmentation fund due to its recent transition to basic-aid status. Without this contribution, the district would have reported an operational surplus in fiscal 2019. Notably, a recent consolidation of two elementary schools for educational purposes generated savings.

The fiscal 2020 budget projects a $6.4 million general fund deficit that could decrease available fund balance to a still-very-strong 15% of budgeted general fund expenditures. We note the district has historically been conservative with budget estimates, such as underestimating sales tax revenue. We think fiscal 2020 could result in better-than-budgeted results. In addition, management believes the increased housing-permit boom and continued AV growth could provide additional revenue and close the gap. We note two bargaining-unit contracts expired more than one year ago; therefore, the current fiscal 2020 budget does not reflect salary adjustments. Management expects forthcoming contract resolutions, and interim reports would reflect salary adjustments.

Despite expected available fund-balance draws, we view the district as having high expenditure flexibility by state standards due to policies that lead to, what we consider, high levels of permitted students with about 12%-14% of enrollment including outside-the-district students. We think the district has the flexibility to reduce enrollment and expenditures by tightening transfer criteria.

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

- A parcel tax with no sunset date that generates $12 million annually, or 7.4% of general fund revenue;
- The two sales tax measures with no sunset dates that generated $16 million annually, or 9.9%;
- A facility lease through 2022 that generates $9 million annually, or 5.6%;
- The lease-rental revenue from several district-owned properties that generate $2.5 million annually, or 1.5%; and
- A foundation that, since fiscal 2015, has averaged about $2 million annually, or 1.2%.

These sources generated a combined 25.6% of general fund revenue in fiscal 2018.

Management

We consider the district's financial management practices good under our FMA methodology, indicating that financial practices exist in most areas but that governance officials might not formalize or regularly monitor all of them.

Highlights include management's:

- Compliance with a well-established state framework that requires the district to report revenue and expenditure assumptions, including ADA changes--The district uses a demographer and other outside sources to make revenue and expenditure assumptions;
- Presentations on budget-to-actual performance to the school board, at least, six times per year, coupled with budget updates in state-mandated intrayear reports;
- Maintenance of a long-term financial plan that extends a year beyond the state-required current-year-plus-two-year forecasting;
- Adherence to state investment-management requirements, including mandatory participation in the county's investment pool, coupled with annual holdings-and-performance reports in audited financial reports;
- Adoption of a debt-management policy that provides a conceptual framework for debt issuance that complies with Senate Bill 1029--For more information, please see the article, titled "California's Passage Of SB-1029's Formal Debt Management Policy Requirement Could Improve Our View Of Credit Quality," published Nov. 22, 2016, on RatingsDirect--We, however, view its guidelines as lacking significant quantitative constraints; and
- Compliance with a state-required reserve minimum at 3% of expenditures, bolstered by an informal minimum of two months, or 17%, of expenditures as a cushion against cash-flow risks of economic uncertainties.

Debt

For the district as a whole, including current bonds, overall net debt was, in our opinion, high at $14,670 per capita, or low at 3% of market value, at fiscal year-end 2019. In our view, percent of market value is a more-meaningful ratio for understanding debt compared to the district's income profile. In our view, debt service carrying charges were an elevated 17% of total governmental-funds expenditures, excluding capital outlay, in fiscal 2018, the most recent audited year available.

In our opinion, when separated, SFID No. 1's overall net debt is high at roughly $11,900 per capita, or low at 3% of market value, and SFID No. 2's overall net debt is high at roughly $38,000, or low at 3% of market value. We note per capita debt is high due to a significantly low population. Amortization is slower than average with officials planning to retire 37% of direct debt within 10 years.

In November 2018, district constituents approved $485 million of bonds for SFID No. 1 and $195 million of bonds for SFID No. 2 to improve school district instruction and facilities. After the current bond sale, SFID No. 1 will have $375 million of unissued debt remaining under the authorization and SFID No. 2 will have $195 million remaining. Management preliminarily expects to issue the remaining authorizations every two years to three years.

Due to slow debt amortization and our expectation that the district's population is likely to grow slowly during the next few years, we expect that debt will likely increase the district's per capita debt ratio materially but that it will unlikely change overall net debt significantly compared with market value due to AV growth.

Pension and other-postemployment-benefits liabilities

California Public Employees' Retirement System (CalPERS) and California State Teachers' Retirement System (CalSTRS), the nation's two leading public pension systems, have committed to lowering discount rates without changing fund-asset allocations; these reductions have significant implications for state and local budgets, increasing unfunded liabilities and total contributions required while lowering the participants' funded status. (For more information on pension increases and the potential effect on California school districts, please see our article, titled "Thanks To A Strong Economy, California's School Districts Can Face Continued Pension Increases--Though Will This Last?," published Nov. 8, 2018.)

In fiscal 2018, the district paid its full required contribution of $14.5 million, or 5.1% of total governmental expenditures, toward its pension obligations. In fiscal 2018, the district paid $2.5 million, or 0.9% of total governmental expenditures, toward its other-postemployment-benefits (OPEB) obligation. It also maintains an irrevocable OPEB trust for prefunding retiree health-care benefits. At June 30, 2019, the district has set aside roughly $7.95 million.

Using updated reporting standards in accordance with Governmental Accounting Standards Board Statement Nos. 67 and 68, the district's net pension liabilities for fiscal year-end June 30, 2018, were $118.2 million for CalSTRS and $54.9 million for CalPERS. CalSTRS, the larger plan, maintained 69% funding, using its fiduciary net position as a percent of total pension liability.

Outlook

The stable outlook reflects S&P Global Ratings' opinion of the district's very strong local economy, growing tax base, recent basic-aid-funding status, and additional revenue flexibility. We expect management will continue to adjust the budget to minimize further fund-balance deterioration. Moreover, we do not expect the district to undergo an institutional separation within the next two years; we, however, will continue to monitor developments. Therefore, we do not expect to change the ratings within our two-year outlook period.

Downside scenario

We could lower the ratings if fund balance were to deteriorate to levels we no longer consider commensurate with similar-rated peers, with management sustaining it but with no plans to regrow it; if management were to reduce local revenue flexibility; or if management were to pursue division, which we think would negatively affect its ability to repay debt.

Upside scenario

If revenue growth were to accelerate, leading to a substantial ongoing available reserve increase, particularly if accompanied by strengthening financial management policies and practices, such as the formalization of a reserve policy, or if we come to believe the district is not at risk of a credit determination associated with a potential division, we could raise the rating.

Related Research

U.S. State And Local Government Credit Conditions Forecast, Oct. 24, 2018

Ratings Detail (As Of August 21, 2019)

Ratings Detail (As Of August 21, 2019) (cont.)		
Santa Monica-Malibu Unif Sch Dist GO bnds (Election of 2006)		
Long Term Rating	AA+/Stable	Affirmed
Santa Monica-Malibu Unif Sch Dist APPROP		
Unenhanced Rating	AA(SPUR)/Stable	Affirmed
Santa Monica-Malibu Unif Sch Dist 2010 rfdg certs of part (tax-exempt)		
Long Term Rating	AA/Stable	Affirmed
Santa Monica-Malibu Unif Sch Dist 2016 GO rfdg bnds (2020 Crossover Rfdg) ser C due 07/01/2035		
Long Term Rating	AA+/Stable	Affirmed
Santa Monica-Malibu Unif Sch Dist GO		
Unenhanced Rating	AA+(SPUR)/Stable	Affirmed

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.

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