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Ratings

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Summary:

Hemet Unified School District, California; Appropriations; General Obligation

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Credit Profile		
US$26.5 mil GO bnds (2018 Election) ser 2020B due 08/01/2046		
Long Term Rating	A/Stable	New
US$8.14 mil GO rfdg bnds ser 2020 due 08/01/2026		
Long Term Rating	A/Stable	New
Hemet Unif Sch Dist certs of part ser 2015 (AGM)		
Unenhanced Rating	A-(SPUR)/Stable	Affirmed

Rating Action

S&P Global Ratings assigned its 'A' long-term rating to Hemet Unified School District, Calif.'s anticipated $26.5 million series 2020B general obligation (GO) bonds, election of 2018 and the anticipated $8.3 million series 2020 GO refunding bonds. At the same time, we affirmed our 'A' underlying rating (SPUR) on the district's existing GO debt and our 'A-' long-term rating and SPUR on the district's COPs and lease revenue bonds outstanding. The outlook on all ratings is stable.

Revenue from unlimited ad valorem taxes levied on taxable property (except certain personal property that is taxable at limited rates) within the district secures the GO bonds. The county board of supervisors has the power and obligation to levy these taxes at the district's request for the bonds' repayment. Bond proceeds will be used to further fund the district's capital improvement projects and will also be used to refund the district's existing series 2010 GO bonds.

The COPs have an interest in base rental payments made by the district, as lessee, to the Hemet Unified School District School Facilities Corp., a nonprofit public benefit corporation, as lessor, for the use of various Cottonwood School facilities. The district has agreed to budget and appropriate base rental payments during the obligations' life. We note that these payments are subject to annual appropriation, as well as to abatement in the event of damage to or the destruction of the leased facilities. In our view, the lease features and terms are standard without any unusual risks regarding timely payment of debt. We note that the rating on the COPs and lease revenue bonds is one notch lower than the GO rating, in accordance with our criteria, to reflect the appropriation risk associated with appropriation-backed obligations. The 2019 refunding COPs are additionally secured by a debt service reserve fund backed by a surety bond.

Credit overview

The district has demonstrated good financial performance with an operating surplus reported in fiscal 2019, which brought available general fund reserves up to strong levels. Enrollment levels have also demonstrated modest growth during the past several years which has helped the district maintain a good financial position under the state's local control funding formula (LCFF). We understand that the district is likely to experience a reduction in per-pupil funding from the state under LCFF going into fiscal 2021 and that further reductions in per-pupil funding may continue for the next several years. The current recession has resulted in an overall loss in state revenue, which has translated to reductions in funding for school districts that receive funding under the LCFF.

Uncertainty remains regarding the magnitude of the reduction in state LCFF funding as well as state aid deferrals for the next several years. However, we understand the district has identified certain spending cuts that can be implemented in fiscal 2021, which include reductions in staffing levels through attrition and eliminating certain vacant positions. We believe the district may also utilize its existing available general fund to balance its operations for fiscal 2021 although management indicates they currently do not have plans on spending down its economic uncertainty reserve which currently holds about $14.5 million or about 5% of expenditures.

While we believe uncertainty remains regarding the magnitude of the reduction in per-pupil state funding going into fiscal 2021, we believe the district's strong level of general fund reserves will be sufficient to help them weather the current economic recession and a declining state funding environment. We do not expect reserve levels to fall below good levels and we do not expect to change the rating during the next fiscal year. Generally our rating outlook time frame is up to two years; however, given the current uncertainty around the pandemic, our view of the credit risks to the district are centered on the more immediate budget effects for fiscal 2021.

We will continue to monitor current economic conditions--particularly uncertainty related to COVID-19 and the anticipated state aid declines due to state budgetary pressures as outlined in the state's May Revision to the Governor's Budget published on May 14, 2020. For more information on the coronavirus' effect in U.S. Public Finance, please see our reports titled "The COVID-19 Outbreak Weakens U.S. State And Local Government Credit Conditions", published April 2, 2020, on RatingsDirect and "An Already Historic U.S. Downturn Now Looks Even Worse", published April 16, 2020 on RatingsDirect.

The ratings reflect our view of the district's:

- Participation in the broad western Riverside County economy, coupled with good assessed value (AV) growth in recent years;
- Strong combined available general fund reserves despite a one-time spending of general fund reserves in fiscal 2018; and
- Modestly increasing trend in enrollment and average daily attendance (ADA) levels in recent years.

Environmental, social, and governance factors

We analyzed the district's environmental, social, and governance risks relative to its economy, management, financial measures, and debt and liability profile and determined that all are in line with our view of the sector standard.

Stable Outlook

Downside scenario

Should the district draw its available general fund reserves down below levels required under the district's reserve policy of 5% of expenditures due to unmitigated deficits in the general fund that stem from reductions in per-pupil state funding without a plan in place to restore balance, then the rating could be lowered.

Upside scenario

We could raise the rating if the district is able to weather the current economic downturn while maintaining its currently strong level of reserves during the next few years. A higher rating would also be contingent on a stronger local economy with higher income and wealth levels overall.

Credit Opinion

Economy

The 740-square-mile Hemet Unified School District serves an estimated population of about 144,259 throughout the cities of Hemet, Idyllwild, Anza, Aguanga, and Winchester in Riverside County. The district is located approximately 75 miles north of San Diego, 65 miles east of Los Angeles, and 35 miles southeast of Riverside, which provides residents with access to job opportunities throughout the region. At 76% and 69% of the national averages, respectively, the district's median household and per capita effective buying income are adequate, in our view. Market value in 2020 totaled $11.6 billion, which we consider strong at $79,907 per capita. The district's tax base has also grown consistently in recent years, most recently increasing by 4.6% in fiscal 2020. The 10 largest taxpayers make up an estimated 2.9% of AV, which we consider very diverse. Overall, management indicates they have not seen a substantial effect on the local economy from the current recession and COVID-19. We believe the immediate effects of the recession may influence the district's enrollment levels, although management reports that they believe the decline in enrollment is likely to be minimal with projected declines of less than 1%.

Finances

The state's education funding, which is determined by average daily attendance (ADA), is the primary source of operating revenue for California school districts. Therefore, increases or decreases in ADA can lead to corresponding movements in revenue. After several years of ADA declines during years 2010 through 2015, the district's ADA began increasing modestly over the past several years, most recently growing by 0.6% in fiscal 2018 up to 20,148 students. For fiscal 2020, the district reports ADA will increase by another 0.8% up to 20,303 students. Management is expecting stable enrollment levels going forward, although we understand further growth in enrollment may be tempered by the current economic recession. Management indicates they plan to budget conservatively for fiscal 2021 with the assumption of flat growth in enrollment.

The district's financial position is good, in our view, despite a recent drawdown of available general fund reserves that was used on one-time textbook purchase in fiscal 2018. Based on the district's fiscal 2019 audit, the district reported an operating surplus of about $7.8 million, which brought available (assigned and unassigned) general fund reserves up to $34.7 million or 11.9% of general fund expenditures, which we consider to be strong. Included in this calculation is an economic uncertainty reserve that the district is required to maintain at 5% of expenditures based on a formal reserve policy. Additionally, management indicates they have set aside an additional $5 million toward an other postemployment benefits (OPEB) reserve, which can be used to fund general fund operations if needed. Including this additional reserve would bring the district's balance up to $39.7 million or 13.6% of expenditures. Based on the second interim report for fiscal 2020, the district shows a drawdown of about $6.7 million, which would bring available reserves down to 7.5% although management indicates this projection is conservative and actual results may end higher than reported in the second interim report. While we believe uncertainty remains regarding the magnitude of the reduction in per-pupil state funding going into fiscal 2021, we believe the district's strong level of general fund reserves will be sufficient to help them weather the current economic recession and a declining state funding environment. At a minimum, we expect the district will be able to maintain its economic uncertainty reserve at 5% of expenditures during the next fiscal year.

Management

We consider the district's management practices good under our financial management assessment methodology, indicating our view that practices exist in most areas, although not all may be formalized or regularly monitored by governance officials. Key management practices and policies include well-grounded revenue and expenditure assumptions that use historical trends, incorporation of realistic salary and benefit increase expectations into budgets, and use of outside sources of information for revenue expectations. The district uses five-year financial projections and maintains a 10-year capital improvement plan that is updated annually. The district follows state mandates for school districts investment procedures, which requires participation in the county investment pool. Budget-to-actual results are reported to the board on a quarterly basis and the district holds a policy of maintaining a minimum reserve equal to 5% of combined general fund expenditures, transfers out, and other uses in the reserve for the economic uncertainty category of the assigned fund balance.

Debt

Overall net debt is moderate, in our opinion, at 3.5% of market value and $2,781 per capita. Amortization is slower than average, with 41% of the district's direct debt scheduled to be retired within 10 years. The debt service carrying charge was 5.1% of total governmental fund expenditures excluding capital outlay in fiscal 2019.

Pension and other postemployment benefit (OPEB) liabilities

- In fiscal 2019, the district paid its full required contribution of $30.4 million, or 8.6% of total governmental expenditures, toward its pension obligations.
- We do not view pension liabilities as a near-term source of credit risk for the district, despite lower funding levels and our expectation that costs will increase.
- While the district's pension contributions are set to increase for the next few years, the statutory funding policy for the district's larger pension plan mitigates the risk of dramatic cost escalation contributions, because the state is required to absorb most of any needed future cost increases.
- The district is not making full actuarially determined contributions toward its OPEB liability, instead funding OPEB's on a pay-go basis. In our view, the district's legal flexibility to alter OPEB benefits limits adverse credit risks from its OPEB liability. The district's proportionate share of the net OPEB liability is $1.5 million in fiscal 2019.

The district participates in several pension plans. We list the two largest ones here:

- California State Teachers Retirement System (STRS), funded at 71% with a proportional net pension liability of $199 million.

- California Public Employees Retirement Fund B, funded at 71%, with a proportional new pension liability of $106.7 million.

Largely due to one-time supplemental state contributions, total actual 2019 CalSTRS contributions exceeded static funding, making some progress in reducing liabilities, but fell short of our assessment of minimum funding progress. Looking forward, the statutory funding plan requires the state, which is responsible for about a third of unfunded pension liability for school districts in the state, to raise funding up to 0.5% per year through 2046; and districts to increase contribution rates each year through 2021, to achieve full funding by 2046. We note that future required contributions toward pension costs are likely to increase due to investment returns that have not materialized as previously projected. Should pension costs rise substantially during the next several years, we believe this could place budgetary pressures on the district budget and could become a negative credit factor.

Ratings Detail (As Of June 17, 2020)		
Hemet Unif Sch Dist certs of part ser 2016A (AGM)		
Unenhanced Rating	A-(SPUR)/Stable	Affirmed
Hemet Unif Sch Dist certs of part ser 2016B (AGM)		
Unenhanced Rating	A-(SPUR)/Stable	Affirmed
Hemet Unif Sch Dist APPROP (AGM)		
Unenhanced Rating	A-(SPUR)/Stable	Affirmed
Hemet Unif Sch Dist GO (AGM)		
Unenhanced Rating	A(SPUR)/Stable	Affirmed
Hemet Unif Sch Dist GO (AGM)		
Unenhanced Rating	A(SPUR)/Stable	Affirmed
Hemet Unif Sch Dist GO (AGM)		
Unenhanced Rating	A(SPUR)/Stable	Affirmed
Hemet Unif Sch Dist GO (AGM)		
Unenhanced Rating	A(SPUR)/Stable	Affirmed

Many issues are enhanced by bond insurance.