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Ratings

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Summary:

Fremont Unified School District, California; Appropriations; General Obligation

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Table Of Contents

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Credit Profile		
US$126.5 mil election of 2014 GO bnds ser 2020D due 08/01/2043		
Long Term Rating	AA-/Stable	New
US$126.045 mil GO rfdg bnds ser 2020 due 08/01/2035		
Long Term Rating	AA-/Stable	New

Rating Action

S&P Global Ratings assigned its 'AA-' long-term rating to Fremont Unified School District, Calif.'s $126.5 million series D (election of 2014) general obligation (GO) bonds, and its approximately $126 million series 2021 GO refunding bonds. At the same time, S&P Global Ratings affirmed its 'AA-' rating on the district's existing GO debt and its 'A+' rating on the district's existing certificates of participation (COPs). The outlook is stable.

Unlimited ad valorem taxes levied on taxable property in the district secure the GO bonds. The Alameda County Board of Supervisors has the power and obligation to levy these taxes at the district's request for the bonds' repayment. The county is required to deposit such taxes, when collected, into the bonds' debt service fund. Bond proceeds will be used to finance various district facility improvements, as well as to refund various outstanding obligations.

The district's appropriation debt outstanding represents an interest in lease rental payments made by the district, as lessee, to the Fremont Unified School District Financing Corp., as lessor, for the use and possession of three leased assets, one elementary school, one high school, and one adult school. Under the agreement, the district can abate lease payments in the event of damage or destruction to the leased assets. To mitigate the risk of abatement in such a case, the district has agreed under the lease-purchase agreement to maintain at least two years of lease interruption insurance and has established a debt service reserve fund equal to 10% of COPs principal, 125% average annual lease payments, or maximum annual lease payments, whichever is less. Due to appropriation risk, however, we rate the COP one notch below the unlimited-tax GO debt.

Credit overview

The rating reflects the district's proximity to the diverse San Francisco Bay Area and Silicon Valley economies, which provide the foundation for the district's extremely strong tax base and very strong income levels. Despite these strengths, in recent years enrollment has fallen, which has led to mixed operations, with the district reporting three general fund deficits in the past five audited fiscal years, while available reserve levels have been maintained at levels that we consider good. Although our rating outlook is generally for two years, we see some downside risk because of the COVID-19 pandemic and the related recession during the next six to 12 months. For more information on the coronavirus' effect on U.S. public finance, see "The COVID-19 Outbreak Weakens U.S. State And Local Government

Credit Conditions," published April 2, 2020, and "The U.S. Economy Reboots, With Obstacles Ahead," published Sept. 24, 2020, both on RatingsDirect.

The rating further reflects our view of the district's:

- Increasing tax base, with cumulative assessed value (AV) increasing by 21.7% since fiscal 2018;
- Significant community support, as reflected by a large parcel tax, and community foundation that raises significant revenues; and
- Strong management, with good financial policies and practices under our Financial Management Assessment (FMA) methodology.

Environmental, social, and governance factors

We analyzed the district's ESG risks relative to its economy, management, financial measures, and debt and liability profile. We view the district as having elevated environmental risk given its exposure to recent fires and poor air quality. We also view the district as having elevated exposure to seismic risk, but we believe that strong state building codes have helped substantially manage this risk. Our rating also incorporates our view regarding the COVID-19-related social and governance risks, which could weaken budgetary performance and liquidity if sustained.

Stable Outlook

Downside scenario

We could lower the rating if the district's average daily attendance (ADA) continued to decrease, leading to sustained negative operations and a subsequent drawdown of reserves below the district's 3% minimum reserve policy.

Upside scenario

Although unlikely given current economic conditions, we could raise the rating should the district stabilize its fund balance and increase reserves to a level that we consider very strong, or if the district were to lessen its dependence on state funding for operating revenue.

Credit Opinion

Economy

Fremont Unified School District, coterminous with the city of Fremont, is located in the East Bay's Alameda County, midway between Oakland and San Jose, in Silicon Valley. Serving an estimated population of 237,593, the district consists of 41 schools, in addition to a charter school and an adult school. While the city is largely residential, it also hosts the headquarters of businesses including Tesla, which comprises 4.4% of total fiscal 2021 AV, and is the district's largest taxpayer. In addition to its proximity to the tech sector, Fremont is situated close to several universities, including Stanford University, California State East Bay, and San Jose State University, which we view as a stabilizing factor. Finally, the city is well connected to the Bay Area through the Bay Area Regional Transit system, which opened a new Warm Springs station within district boundaries in fiscal 2017, contributing to ongoing development near the station.

The tax base has continued to grow in recent years, with aggregate market value increasing by 6.2% to $57.9 billion in fiscal 2021, which we consider extremely strong on a per capita basis of $242,823. Approximately 7.8% of district AV comes from the 10 largest taxpayers, representing a very diverse tax base in our opinion. The Alameda County preliminary October unemployment rate was 7.9%, which is a decrease from its 2020 high of 14% in April, but an increase from its pre-pandemic 2019 annual rate of 2.9%.

Finance

General purpose funding for California school districts is determined by a formula based primarily on ADA, grade levels served, and share of students served who 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 fiscal 2021, the district projects additional funding from the state due to approximately 27% of its students qualifying. This provides more financial flexibility, though it also entails mandated spending to increase or improve services for targeted students in proportion to the supplemental funding. For fiscal 2021, the district projects an ADA of 33,900 students. This represents a decline of 0.3% from fiscal 2020, and a cumulative decline of 1.2% from fiscal 2018. Management expects ADA to continue to slowly decrease over the next several years, and has attributed this trend to shifting demographics, with fewer families moving into district boundaries.

Operating performance has been mixed in recent years. In fiscal 2019, the district reported an operating surplus of 1.6% of expenditures, which may be attributed to a one-time transfer into the general fund for the reimbursement of capital projects. This operating surplus led to an increase in available reserves to 5.7% of expenditures, which we consider good. In fiscal 2020, unaudited actuals indicate an operating deficit of approximately 1.2% of expenditures, decreasing available reserves to 5.4% of expenditures, which we consider good. Management has attributed this deficit to decreased ADA levels.

For fiscal 2021, the 45-day revised budget calls for an operating deficit of 0.5% of expenditures, which may be attributed to continued ADA decreases, and projected year-end available reserves of 4.8% of expenditures, which we consider good. The state's adopted budget calls for significant cash flow deferrals in the second half of fiscal 2021, which could lead to liquidity challenges for certain districts. Management plans to manage this low period by issuing approximately $40 million in tax revenue anticipation notes (TRANs). Beyond fiscal 2021, we see uncertainty regarding statewide economic performance and underlying tax revenues that will influence future state budget decisions.

In addition to its state revenue, the district benefits from a variety of local funding sources. In June 2016, it passed a nine-year parcel tax that is projected to bring in approximately $4.3 million in fiscal 2021. In addition, it benefits from several foundations, including the Parent Teachers Association, which management says brings in approximately $5.5 million annually.

Management

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

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 use of third-party sources to estimate changes in ADA;
- Compliance with state requirement to present the preliminary budget, two interim budgets, and final budget to the school board;
- Maintenance of a long-term financial plan that does not make structural balance a clear goal;
- Maintenance of a 10-year master facilities plan that identifies both total need and funding sources;
- Adherence to state investment management requirements and quarterly reports on holdings and performance; and
- Maintenance of a formal 3% minimum reserve policy, above the state minimum of 2%.

Debt

We consider net debt high on a per capita basis at $7,199, but low as a percentage of market value at 3.0%, which we consider a more meaningful metric given the district's extremely strong AV. With 31% of the district's direct debt scheduled to be retired within 10 years, we view amortization as slow. Debt service carrying charges were 9.4% of total governmental fund expenditures excluding capital outlay in fiscal 2017, which we consider moderate.

Following the current issuance, the district plans to issue approximately $127 million of additional debt in fiscal 2022 under its measure E authorization. It also has authorized a $40 million TRAN that will be used to manage cash flows during the state's fiscal 2021 deferral period. Finally, management has confirmed that the district does not have any alternative financings outstanding.

Pension and other postemployment (OPEB) highlights

- We do not consider the district's pension and OPEB liabilities to be a significant source of budgetary pressure.
- Although the district's pension contributions are set to increase for the next few years, the statutory funding policy for the larger pension plan mitigates the risk of significant cost escalation contributions, because the state is required to absorb most of any needed future cost increases.
- The district currently administers a single-employer, defined-benefit OPEB plan that is funded on a pay-as-you-go basis, and provides medical, prescription, dental, and vision benefits to eligible retirees.

Fremont Unified School District participates in the following plans as of June 30, 2019:

- California State Teachers' Retirement System (CalSTRS): 73% funded with a net pension liability of $324.3 million;
- California Public Employees' Retirement System (CalPERS): 70% funded with a net pension liability of $133.1 million; and
- Single-employer OPEB plan: 0% funded with a net OPEB liability of $122.9 million.

Largely as a result of 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. The statutory funding plan requires the state, which is responsible for about a third of districts' unfunded pension liability, to raise funding by as much as 0.5% per year through 2046, and requires districts to raise contribution rates each year through 2021, to achieve full funding by 2046. In fiscal 2021, the state redirected its supplemental contribution to instead reduce employer contributions for the year. Given that the legal discretion for CalSTRS to increase rates caps district contributions only slightly above the 2021 level, we believe the state would absorb most rate increases, if necessary, beyond the current schedule. This limits the risk of future cost increases to districts. However, if actuarial assumptions are not realized, existing authority to increase state contributions may not be sufficient to eliminate new unfunded liabilities generated before 2046 without additional increases to district contribution rates beyond the existing legal limit.

We see CalPERS' recent adoption of a 20-year, level-dollar amortization approach for new gains and losses as a turning point, in that contribution increases from a shorter amortization period will provide faster recovery to plan funding following years of poor investment performance or upward revisions to the pension liability. However, we believe costs will continue to rise for the next several years to retire existing unfunded liability, much of which is amortized over 30-year periods using a level-percent-of-payroll approach. In our view, the discount rate of 7.15%, which is well above our pension guidance of a 6% assumed earnings rate, could lead to contribution volatility.

Related Research

- Through The ESG Lens 2.0: A Deeper Dive Into U.S. Public Finance Credit Factors, April 28, 2020

Ratings Detail (As Of December 10, 2020)		
Fremont Unif Sch Dist GO		
Long Term Rating	AA-/Stable	Affirmed
Fremont Unif Sch Dist GO		
Long Term Rating	AA-/Stable	Affirmed
Fremont Unif Sch Dist APPROP		
Unenhanced Rating	A+(SPUR)/Stable	Affirmed

Many issues are enhanced by bond insurance.