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Fitch Ratings: L.A. Teachers Strike Will Not Trigger Downgrade; Highlights Pressures

Fitch Ratings-San Francisco-14 January 2019: Fitch Ratings does not expect to take further rating action on the Los Angeles Unified School District's issuer rating based on the teacher union's decision to strike on Jan. 14th. The strike was postponed from Jan. 10th due to disputes about the notification period and concern about a possible court injunction.

Fitch downgraded LAUSD's Issuer Default Rating (IDR) to 'A' from 'A+' in September 2018 and assigned a Negative Outlook to the rating at that time. This action considered the ongoing labor dispute and the expectation that the issues raised in the negotiations (regardless of whether a strike occurred) would likely result in some erosion of the district's practical ability to control spending.

Fitch expects management to work to maintain financial flexibility that is consistent with the current rating, and will incorporate the eventual agreement and other implications of the labor impasse into its analysis. Aside from the immediate implications of a teacher strike, there could be longer-term negative effects if the strike results in families choosing alternatives to LAUSD, including private and charter schools, or transferring out of the district. Declining enrollment is already a significant challenge for the district. Failure to maintain reserves that provide adequate gap closing capacity in a downturn and/or deferral or non-recurring support of required spending beyond current expectations would result in negative rating pressure.

Teachers at LAUSD, the nation's second largest public school district, are striking starting Monday Jan. 14th after almost two years of negotiations failed to secure a new contract for fiscal years 2018 – 2020. The last contract expired in June 2017. Representatives from United Teachers Los Angeles (UTLA) and the district met again last week after completing the fact-finding stage to avert a strike but have still not come to agreement.

Although the district has increased its offer to include 6% raises over two years starting in fiscal 2018 plus $105 million for additional staffing, the two sides still disagree. UTLA is requesting 6.5% raises all at once retroactive to fiscal 2017, but more importantly is demanding more funds than offered to increase staffing levels at schools. Specifically, UTLA wants schools to be "fully staffed" with more teachers for lower class sizes and more counsellors to reduce caseloads. The district has stated it cannot afford such increases with ongoing revenue, given the district's sharply declining enrollment and associated per-pupil revenues from the state. Declining enrollment is due to demographic changes and competition from charter schools, which have increased their enrollment over 1000% since fiscal 2003, and currently accounts for almost 20% of total district enrollment.

Based on its fiscal 2018 audit, the district began fiscal 2019 with $714.7 million unassigned/unappropriated fund balance (excluding its reserve for economic uncertainties). In its first interim financial report dated Dec. 11, 2018, the district factored in the 6% salary increase proposed to UTLA and estimated that its unassigned/unappropriated fund balance will decline to $353.4 million at the beginning of fiscal 2021 and then to negative $4.2 million at the beginning of fiscal 2022.

The district's projections are conservative, and management typically outperforms its projections. The 'A' IDR assumes that the district will act to reduce the rate of unassigned/unappropriated general fund balance drawdown laid out in these projections. The downward trajectory is pronounced and will be difficult to counteract meaningfully without significant changes to the district's expenditure profile. Moreover, as noted above, in current labor negotiations UTLA is seeking spending increases well above those assumed in the projections.

The state's final fiscal 2020 budget could include more funding than currently projected and alter the pace of reserve drawdowns.

The Los Angeles County Office of Education (LACOE) announced on Jan. 9th that, after the district's fiscal 2019 first interim report submitted Dec. 17th did not adequately address its structural imbalance, LACOE is assigning a team of fiscal experts to work with the district to eliminate the structural imbalance and restore the required level of financial reserves.

Fitch maintains 'AAA' ratings and Stable Outlook on the district's unlimited tax general obligation (GO) bonds, which are based on a dedicated tax analysis, without regard to the district's financial operations. The distinction between the 'AAA' ratings on the GO bonds and the 'A' IDR reflect Fitch's assessment that the pledged special revenues for repayment of the GO bonds meet the definition of "pledged special revenues" under the U.S. Bankruptcy Code and therefore bondholders are legally insulated from any operating risk of the district.

For more information on Fitch's analysis of the LAUSD, see "Fitch Downgrades Los Angeles USD, CA's IDR to 'A'; Outlook Negative" dated Sept. 12, 2018.

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