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Fitch: California School Downgrades Outpace Upgrades.

Fitch Ratings-San Francisco-07 February 2017: Most California school district ratings have been affirmed under Fitch Ratings' new criteria, though the bulk of rating changes have been downgrades, in contrast to the local government portfolio in general, which has seen significantly more upgrades than downgrades with the criteria change.

Fitch is currently conducting a portfolio review of California school districts under its revised U.S. tax-supported criteria, which was released in April 2016. Eighty percent have been affirmed to date.

CRITERIA HIGHLIGHT FINANCIAL RESILIENCE THROUGH THE CYCLE
Downgrades to date reflect certain common features of California school district credits that play a greater role in the rating analysis following the criteria revision. The revised criteria emphasize an issuer's revenue framework and financial resilience in light of an issuer's sensitivity in downturns. California school districts have little independent legal control over revenues, which are primarily driven by relative enrollment rather than the local economy, and comparatively high revenue volatility due to the state's funding framework. Expectations for elevated volatility increase the financial cushion necessary to offset future declines. This inherent volatility, when compounded by a trend of thinning reserves observed in some districts, weakens the assessment of financial resilience through the cycle.

ENROLLMENT DRIVES REVENUE GROWTH PROSPECTS
The revised criteria highlight the significance of average daily attendance (ADA) to growth prospects for California school district revenues, as total per-student revenue from state and local sources is set by the state's Local Control Funding Formula (LCFF). Most districts have experienced solid revenue growth in recent years due to LCFF's funding mechanism, which is also tied to the state's solid revenue performance. However, LCFF is near full implementation, and given the state's constitutional school funding formula, future district revenue growth is expected to be more closely tied to local ADA trends relative to overall state revenue and enrollment performance.

PROP 13 LIMITS REVENUE FLEXIBILITY
California school districts' ability to independently raise revenues is constrained by constitutional limitations under Prop 13. Districts may not raise the operating property tax rate under any circumstance, and may only raise a parcel tax with a vote of the people. In districts with ADA declines, the confluence of limited revenue flexibility and weaker revenue growth prospects has been the central credit factor in many downgrades. This includes situations where the local tax base and economy are strong but enrollment is declining due to factors such as demographic changes and competition from charter schools.

VOLATILITY AND RESERVE DECLINES HINDER FINANCIAL RESILIENCE
Fitch's assessment of financial resilience, which considers financial reserves in the context of expected revenue volatility and budgetary flexibility in the event of a typical economic downturn, has also driven some downgrades. State school aid in California historically has been notably more volatile than typical municipal revenues because of the state's tax structure and funding framework. California's funding framework is governed by Prop 98, which ties school funding, in part, to year to

year changes in state revenue (with a minimum guarantee of 40% of the state budget), thereby linking volatility in the state tax structure to local districts. While the state's tax structure remains more volatile than most (and can be exacerbated for a district by declining ADA), Fitch believes that the institutional reforms implemented during and coming out of the great recession may reduce school funding volatility somewhat going forward.

Higher expected volatility increases the level of reserves necessary to offset declines in Fitch's scenario analysis; however, the state's reforms moderate to a limited degree Fitch's expectation for districts' future volatility. Furthermore, many districts have been drawing down high fund balances to more historical levels in the improving state revenue environment, which Fitch believes reduces their financial flexibility in the event of an economic downturn.

California school districts benefit from a very strong financial oversight framework under AB 1200. For districts with limited gap-closing capacity, where financial operations could otherwise become distressed in the event of a revenue downturn in Fitch's scenario analysis, Fitch expects support by the state oversight mechanism to ensure that finances return to stable operations and recover financial flexibility. This strong oversight system supports an overall operating performance assessment that is slightly higher than the level suggested by Fitch's scenario analysis alone.

SPECIAL REVENUE ANALYSIS YIELDS STRONG RATINGS
Fitch continues to rate the general obligation securities of certain California school districts above the level of the issuer rating based on our assessment that bondholders are legally insulated from any operating risk of the district. (See 'California School Districts: Special Revenue Analysis Yields Strong Ratings' dated Sept 30, 2016.) In these cases, the general obligation bond rating is based on a dedicated tax analysis without regard to the district's financial operations because there is a reasonable basis for concluding that the tax revenues levied to repay the bonds would be considered pledged special revenues in the event of a district bankruptcy.

Fitch sets a high bar for considering local government tax-supported debt to be secured by special revenues, which provide security that survives the filing of a municipal bankruptcy (in preservation of the lien) and benefit from relief from the automatic stay provision of the bankruptcy code. Fitch gives credit to special revenue status only if, in its view, the overall legal framework renders remote a successful challenge to the status of the debt as secured by special revenues under Section 902 (2) (e) of the U.S. Bankruptcy Code. No such ratings have been affected by implementation of the revised criteria.

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