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Summary:

San Luis Obispo County Community College District, California; Appropriations; General Obligation

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Credit Profile		
US$75.0 mil Election of 2014 GO bnds ser 2017B due 08/01/2043		
Long Term Rating	AA-/Positive	New
San Luis Obispo Cnty Comnty Coll Dist APPROP		
Long Term Rating	A+/Positive	Outlook Revised
San Luis Obispo Cnty Comnty Coll Dist GO		
Long Term Rating	AA-/Positive	Outlook Revised

Rationale

S&P Global Ratings revised the outlook to positive from stable and affirmed its 'AA-' long-term rating on San Luis Obispo County Community College District, Calif.'s previously issued general obligation (GO) bonds and its 'A+' long-term rating on the district's previously issued certificates of participation (COPs). S&P Global Ratings also assigned its 'AA-' long-term rating to the district's series 2018B (election of 2014) GO bonds. The outlook is positive.

The outlook revision reflects our view of the district's enhancement of its minimum reserves policy in 2017 by adding a 6%-of-unrestricted-expenditures contingency in its budgeting practice to accompany its existing 6% reserve policy. (Our calculation of the district's available general fund balance ratio includes all general fund expenditures, restricted and unrestricted, and thus in most cases will be slightly lower than the district's calculation.) We view this policy as reinforcing a strengthening trend in the district's available general fund balance to a level we consider very strong as of fiscal 2017 from strong levels during the prior five years. The district, in its five-year financial forecast as part of its adopted fiscal 2018 budget, laid out a vision for maintaining reserves through fiscal 2022 at levels comparable to those of fiscal 2017 on the assumption of modest changes to its revenue and cost drivers other than scheduled pension contribution rate increases. Judging by the district's recent inauguration of a trust to begin prefunding its long-term pension liability, we think the district's focus on long-term structural balance positions it to consolidate its recent reserves gains. We will monitor the extent to which the district consolidates its recent reserves gains and could raise our rating in the medium term if we come to view its available general fund balance as likely to remain very strong.

Security and use of proceeds

Revenue from unlimited ad valorem taxes levied on taxable property within the district secures the series 2018B and previously issued GO bonds. The $75 million series 2018B represents the second of a planned four series under a $275 million authorization passed by voters in 2014--the first in 40 years, according to the district--and the district plans to use the proceeds for a variety of replacements and upgrades to aging facilities, as well as to refund the district's series

2009 COPs to achieve interest expense savings.

The rating on the district's COPs is set one notch below our view of the district's general creditworthiness to reflectour view of appropriation risk. The COPs represent an interest in lease payments from the district, as lessee, for the use of district facilities and the district's covenant to budget and appropriate lease payments during the life of the obligations. Indenture provisions include the covenant to budget and allocate lease payments, subject to abatement in the event of damage to the leased facilities, but the district has also covenanted to maintain 24 months of rental interruption insurance to partly mitigate this risk.

Credit overview

The ratings reflect our view of the district's:

- Economic base largely coterminous with San Luis Obispo County, which is focused on agriculture but anchored by a major state university;
- Maintenance of an available general fund balance that we have considered at least strong since fiscal 2010, with a recent enhancement to its reserves policies and management statements suggesting the district will sustain a recent strengthening to a very strong level;
- Good financial policies and practices, including financial planning covering a five-year horizon and monthly analytical updates to supplement quarterly budget-to-actual reports to the board; and
- Low-to-moderate overall net debt burden, with the series 2018B eliminating virtually all of the general fund's responsibility for debt service by shifting debt service to a dedicated property tax.

Partly offsetting the above strengths, in our view, are the district's:

- Limited revenue flexibility under the state funding framework, with a per-full-time-equivalent (FTE) enrollment funding formula, a funding cap, and state-set tuition rates, although the district has considerable expenditure flexibility, with discretion to add or remove programs and sections; and
- Slow debt amortization, which is unlikely to improve for the foreseeable future as the district issues additional debt under the 2014 authorization in the next six years.

Operating profile

The district operates under the brand name Cuesta College and has a tax base and service area largely coterminous with San Luis Obispo County. San Luis Obispo (the city) is home to its main campus, which dates back to 1970 and serves about 68% of its gross enrollment. The district serves the northern portion of its service area with a "center" in Paso Robles and its southern portion witha "site" in a high school in Arroyo Grande.

Economy

San Luis Obispo County's economic base is focused on agriculture, with grapes and berries the largest crops, and is anchored by California Polytechnic State University, with roughly 3,100 employees and 21,300 students. Other sectors include (largely wine-focused) tourism, county government, technology, corrections, and health, and its population has been largely stable in the current decade, most recently at 280,100 for 2017 according to state estimates. The county's unemployment rate, which is below that of the state, has been inching downward from an already sub-5% level in 2015, and most recently averaged 3.8% for the 12 months through October 2017. The county's median household and per capita effective buying income are good, in our view, at 111% and 106%, respectively, of the national levels. Assessed value (AV), which is the best available measure of market value in the state, is also improving, with 6%

annual growth in the past three fiscal years through 2018 to $50.9 billion. Based on building permit data provided by management, what we have observed elsewhere in the state, and our forecast of real GDP growth in the western U.S. states through fiscal 2018, we anticipate that AV growth will continue in some form through fiscal 2020.

Finances

FTE enrollment--formally dubbed "FTES" in community college district jargon in the state--drives the bulk of the district's operating revenue under a state funding framework that uses an equalization formula consisting of property tax revenues and state aid coupled with tuition rates that the state sets for all districts. Adding complexity are a state-set funding cap for each district above which the district's per-FTE enrollment revenue is largely restricted to tuition, which is dwarfed by funding formula revenue, and the district's ability to shift summer FTE enrollment between fiscal years for funding formula purposes.

We understand that the district has generally managed its educational offerings to maximize the revenue it can receive under the state formula, which has meant a declining trend early in the decade and a stabilization since. Using comparable figures that exclude any summer shifts between fiscal years, the district's FTE enrollment declined by 22% in aggregate in fiscal years 2009 to 2014 as the state lowered its funding cap. FTE enrollment has hovered within 50 students of the 7,704 average since then, including a projected 7,700 for fiscal 2018. For planning purposes, the district anticipates that state funding will remain virtually unchanged through fiscal 2022 and, using a different measurement, anticipates a 143-student increase in fiscal 2020.

As with many other districts that faced state aid cuts at the end of the Great Recession, the district drew on reserves during fiscal years 2012 and 2013 as it sought to moderate the loss of programs and capacity. This resulted in a decline to what we consider a still strong available general fund balance of 10% of expenditures from 13% in fiscal 2011 after a three-year growth trend. Management reports that the district has since added to its reserves on the strength of state funding increases. But because the state has classified much of these as one-time in nature, in fiscal 2017 the district formally added a 6%-of-unrestricted expenditures contingency policy to its 6% reserve policy to cushion the district against the next funding downturn and has not significantly added to its educational offerings. Higher state revenue and spending restraint has translated into reserves gains to an available general fund balance of 16% of expenditures ($9.8 million), which we view as very strong, for fiscal 2017.

We think the district has the tools to maintain its reserves at very strong levels but with a limited track record. The state's revenue forecast suggests to us that community college district funding for fiscal 2019 is likely to be comparable to that of fiscal 2018 and the district has, for planning purposes, set a course of maintaining balanced operations through fiscal 2022. This is based on assumptions of higher pension contributions, modest changes to state funding and compensation levels, largely stable FTE enrollment, and slight efficiency improvements to its ratio of FTE enrollment to instructors. Because these assumptions include largely status quo conditions, we will monitor the extent to which the district uses monthly budget monitoring and its five-year forecasting model to create the conversations necessary to maintain structurally balanced operations should conditions change.

Also potentially supporting the district's financial operations at the margin by supporting demand is a state effort to largely eliminate the direct cost of tuition for students in the first year of community college. Likewise, a local foundation's effort to provide scholarships to local high school students has supported a pipeline from one of the district's key demand sources, and the foundation also provides heretofore limited grants to the district for operations. The foundation's assets appear to have plateaued since 2014 but more than doubled to $26 million in 2010 to 2014.

Management

We consider the district's management practices good under our Financial Management Assessment (FMA) methodology, indicating our view that practices exist in most areas, although not all may be formalized or regularly monitored by governance officials.

Our assessment of the district's policies and practices reflects its:

- Use of trend analysis and available external information on state budgets to build revenue and expenditure assumptions and transparency in budget documents regarding the context for such assumptions;
- Quarterly budget-to-actual reporting, supplemented by monthly analytical updates;
- Five-year financial forecasting model with what we view as supportable assumptions and clear use to support decisions that help the district maintain structural balance;
- Comprehensive master facilities plan last updated in 2016 that includes funding sources and a horizon through fiscal 2026, although it is not updated annually;
- Mandatory investment in a county pool that is governed by conservative policies, although reporting to the board occurs only as part of the annual audit adoption;
- Debt management policy that outlines principals for debt issuance but lacks material quantitative constraints; and
- Two-prong reserve policy that includes 6% of unrestricted expenditures as a minimum reserve and another 6% contingency requirement for budgeted expenditures.

Debt

The overall net debt burden is moderate relative to its population, in our view, at $2,800 per capita and a low 1.5% of market value. Because amortization is slow, with 31% of principal scheduled to be retired for the 10 years ending 2028, we expect that the district's planned next issuances of $65 million in 2021 and $60 million in 2024 are likely to keep the district's debt ratios comparable to current levels. Management has confirmed that the district has no alternative financing outstanding, which we find can represent a source of contingent liquidity risk depending on its terms and conditions.

Pension and other postemployment benefit liabilities

The two largest public pension systems in the U.S.--California Public Employees' Retirement System (CalPERS) and California State Teachers' Retirement System (CalSTRS)--both have committed to lowering their discount rates without changing their funds' asset allocations. These reductions have significant implications for state and local budgets, increasing both the unfunded liability and total contributions required while lowering the funded status for all fund participants.

The district participates in both CalPERS and CalSTRS, and in fiscal 2016 the district paid its full annual required contribution (ARC) equating to 4.5% of total governmental expenditures. With lowered discount rates, we are expecting this ratio to increase and the district is planning for encroachment on its operations, although in December 2017 it also launched an irrevocable trust to which it contributed $3 million against a net pension liability of $48 million as of the end of fiscal 2016. Although the district lacks a timetable for making additional contributions and its five-year forecast does not show surpluses that would facilitate such contributions, we view this proactive measure as a credit strength insofar as it reflects a frank discussion regarding this liability among stakeholders and creates the potential for setting aside future one-time resources to moderate annual required pension contribution increases over time.

In addition, the district funds other postemployment benefits (OPEBs) through pay-as-you-go financing for an implicit subsidy for retirees who elect to remain on the district plan after retirement for constrained periods. In fiscal 2016 the district's OPEB contribution represented 49.0% of its annual required contribution (ARC), but with the contribution at less than 0.1% of total governmental expenditures, we do not consider this liability to a material credit factor.

Outlook

The positive outlook reflects our view that the district's expenditure management in the context of one-time revenue, good financial policies and practices that could help it identify and respond to challenges, and an informal plan to further build reserves after a period of growth suggest that it could retain what we consider very strong reserves during our two-year outlook horizon. We could raise the rating in the context of this new, higher level, either if we view the district's gains in reserves as sustainable because its assumptions prove accurate or if the district is able to make timely and effective adjustments in response to adverse changes. We could revise the outlook to stable if the district's reserves subside below very strong levels, particularly if we come to view the district as having difficulty adjusting its operations to compensate for weaker-than-expected state funding growth, upward adjustments to its compensation structure, or a failure to improve instructor-student efficiencies.

Related Research

- S&P Public Finance Local GO Criteria: How We Adjust Data For Analytic Consistency, Sept. 12, 2013
- California Pension Giants Lower Their Discount Rates To Preserve Long-Term Plan Sustainability, March 15, 2017