S&P Global Ratings

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Summary:

Santa Monica-Malibu Unified School District, California; Appropriations; General Obligation

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Credit Profile		
US$60.0 mil GO bnds (Election Of 2012) ser C due 07/01/2042		
Long Term Rating	AA/Stable	New
Santa Monica-Malibu Unif Sch Dist GO		
Long Term Rating	AA/Stable	Affirmed

Rationale

S&P Global Ratings assigned its 'AA' long-term rating to Santa Monica-Malibu Unified School District, Calif.'s election of 2012 series C general obligation (GO) bonds. At the same time, we affirmed our 'AA' long-term rating and underlying rating (SPUR) on the district's existing GO bonds and our 'AA-' long-term rating and SPUR on the district's certificates of participation (COPs). The outlook is stable.

The GO bonds are secured by revenue from unlimited ad valorem taxes levied on taxable property within the district. The Los Angeles Board of Supervisors has the power to levy these taxes at the district's request for the bonds' repayment. We understand that the proceeds from the sale of series C GO bonds will be utilized to finance the construction of, the modernization of, and improvements to the district's facilities.

The district's previously issued series 2016B refunding GO crossover bonds are secured by proceeds deposited into an escrow fund until the crossover date of July 1, 2020. The proceeds in the escrow fund will be invested in noncallable federal securities (State and Local Government Series). On and after the respective crossover date, unlimited ad valorem taxes levied on taxable property within the district will secure the bonds. For that reason, the rating reflects the weaker of the district's long-term rating and the U.S. government sovereign rating (AA+/Stable) until the crossover date. Afterward, the rating will reflect only the district's long-term rating.

The 2010 COPs are secured by lease rental payments made by the district. Proceeds from these certificates were used to finance the acquisition and construction of the district administration building as well as to acquire Dial Associates LLC's interest in its original lease. Under the installment purchase structure with Los Angeles County Schools Regionalized Business Services Corp., a nonprofit entity, the district has leased its 3.26-acre administration building. The district covenants to budget and appropriate lease payments for the use of the property and its improvements. The district may abate lease payments in the event of damage to or the destruction to the project, or title defect. To mitigate the risk of abatement in such a case, the district has covenanted to maintain rental interruption insurance for 2.0x maximum annual rental payments. In addition, the lease contains provisions for a debt service reserve.

The 'AA' GO ratings reflect our view of the district's:

- Participation in the broad and diverse greater Los Angeles economy;

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- Very strong income levels with extremely strong per capita property wealth levels;
- Strong community support and additional revenue flexibility in the form of a parcel tax, two sales tax, and municipal payments for the use of schools facilities; and,
- Very strong available general fund reserve levels.

Partially offsetting the above factors, in our view, are the district's planned general fund operating deficits, and high overall per capita debt levels.

Economy

Santa Monica-Malibu Unified School District is located 16 miles west of downtown Los Angeles along the Pacific Coast and serves an estimated population of 111,980 within its namesake cities, as well as unincorporated portions of Los Angeles County. Both Santa Monica and Malibu maintain tourism activity we consider strong while serving as entertainment, restaurant, and retail centers for local residents. Per capita retail sales for the district remain very strong, in our view, at about 201% of the national average. With strong access to the greater Los Angeles regional economy, we consider the district's income levels to be very strong, as demonstrated by per capita effective buying income (EBI) at 200% and median household EBI at 132% of the national levels.

We view the district's overall historical assessed value (AV) trend as strong and resilient, as demonstrated by only one year of a very slight decline of 0.3% in fiscal 2011, during the economic downturn. Since then, the district's AV has increased by an aggregate 37.1% over the last six years to $49.9 billion in fiscal 2017. On a per capita basis, we view market value as extremely strong at $445,706. The general trend in the tax base is positive due to the accelerated development of high-end residential stock and the typical AV increases due to home sales to new owners. The top 10 taxpayers in the district account for about 5.8% of the district's total AV, a level we consider very diverse. Additionally, due to the district's very strong and growing tax base, we understand from management that the district is approaching "basic-aid" status. A basic-aid district is a district that receives more in ad valorem tax revenue than it would receive under the state per-pupil funding formula due to its high property tax wealth, thus partly sheltering it from potential volatility from the state budget.

Finances

General purpose funding for California school districts is determined by a formula based primarily on average daily attendance (ADA), grade levels served, and share of students served that are English language-learners, low to moderate income, or foster youth. Most school districts are funded through a combination of state general fund revenues and local property tax revenues, 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. We understand that, due to demographic changes, the district's ADA has declined slowly during the last six years by about 3.5% to 10,711. Furthermore, the district is projecting a slight ADA decline for fiscal 2017 to 10,705. Based on the district's demographic studies and based on ongoing economic development, we understand that management is expecting ADA to remain relatively stable over the next couple of years. Providing additional stability to the district's ADA is the district's interdistrict policy of accepting transfer students from neighboring districts (representing approximately 10% of the district's enrollment), which allows the district to manage its enrollment levels.

Despite being a general purpose (or revenue-limit) district under the state funding formula, the district's finances are positively supported by various additional revenue sources. Among these revenue sources is a parcel tax that generates approximately $11.7 million annually, which is adjusted each year for inflation and has no expiration date. In addition, city voters approved two 0.5% sales tax rate increases: one in November 2010 (Measure Y) and the other in November 2016 (Measure GS), both with no expiration dates. We understand that the district is designated to receive half of the revenues, or about $16 million annually, under the sales tax increases if the city complies with the accompanying advisory measures (YY and GS) that city voters concurrently approved. Furthermore, an agreement between the district and the city generates approximately about $8.8 million annually in exchange for public use of the district's recreation facilities. We understand that the contract, which is reviewed annually, has been extended to 2022 with opportunity for extension. Finally, the school district receives up to $2 million from a community foundation and its parent-teacher association. Altogether, the district generates approximately $38.5 million in additional revenue outside of state funding, or about 26.2% of general fund revenues, which provides it with additional financial flexibility unique to most school districts across the state.

We view the district's financial profile to be historically very strong, with reported general fund surpluses in each of the last two audited years, and maintenance of very strong available general fund reserves. The district reported a $2.3 million general fund surplus (including net transfers) for fiscal 2016, resulting in an ending available general fund balance of $32.4 million, or 22.5% of expenditures, a level we consider very strong. Looking forward, we understand from management that the district is expected to enter a period of deficit spending beginning in fiscal 2017. According to its second interim budget report, the district is budgeting for a $14.6 million deficit, or 9.1% of expenditures, for fiscal 2017, due primarily to salary increases; the district's internal projections project a deficit closer $11 million due to the receipt of approximately $3 million of ongoing redevelopment revenues. Additionally, the district's multiyear projections include deficits of $3.1 million (1.9% of expenditures) and $5.1 million (3.1% of expenditures) for fiscal 2018 and fiscal 2019, respectively. Although the district is planning to deficit spend in the near term, management has historically budgeted conservatively and expects to end with better-than-budgeted results with anticipated smaller deficits. Furthermore, we understand that the district and its board are continuously working to identify areas to cut expenditures, and to reduce the district's projected operating deficits.

In March 2017, a six-member committee consisting of representatives from both Santa Monica and Malibu submitted a report proposing the reorganization of Santa Monica-Malibu Unified School District into two separate school districts. We understand that the committee addressed impactful items in the report such as the operating budget impact, division of assets, and bond- and debt-related items should the reorganization occur. While we don't anticipate any immediate impact to the district's credit profile and do not expect the district to split within the next two years, we will reassess the situation should the reorganization become finalized.

We note that changes to state law may alter the financial management landscape for California school districts, including Santa Monica-Malibu Unified School District, that have a consistent track record of maintaining fund balances in line with levels we view as very strong. Under the new reserve cap law, in years following the state's contribution to its "rainy day" school reserve, the maximum amount of reserves the district can retain is twice its minimum reserve requirement, or 6% of budgeted general fund expenditures. However, contributions by the state to the rainy day school reserve would only occur in some years when state capital gain revenues are very strong. In addition, transfers to the rainy day school reserve would be prohibited in any year that the state provides less education funding than is required under Proposition 98 or when Proposition 98 has been suspended. If the law ultimately compels the district to spend down a significant portion of its combined assigned and unassigned general fund balances, our view of the district's credit quality could change, although we would evaluate management's response.

Financial Management Assessment (FMA)

We consider the district's management practices to be good under our FMA methodology, indicating financial practices exist in most areas, but that governance officials might not formalize or monitor all of them on a regular basis. The district is required by the state to report its revenue and expenditure assumptions, including changes to ADA. The district utilizes a demographer and other outside sources to make its revenue and expenditure assumptions. Management presents budget-to-actuals performance to the board at least six times per year and makes budget amendments as needed. The district maintains a long-term financial plan that extends a year beyond the state requirement of current-year-plus two-year budgeting. Management adheres to state investment management requirements, including participating in the county's investment pool. The district is looking to update its formal 10-year master facilities plan within the next year. The district has adopted a debt management policy in compliance with Senate Bill (SB) 1029 (for more information, see "California's Passage Of SB-1029's Formal Debt Management Policy Requirement Could Improve Our View Of Credit Quality," published on Nov. 22, 2016); however the district does target about 10% of reserves, which it is significantly exceeding.

Debt

In our opinion, overall net debt is high on a per capita basis at $10,304, but low as a percentage of market value at 2.3%. Amortization is slower than average including the 2012 election series C bonds, with 37% of the district's direct debt to be retired within 10 years. In our view, the district's debt service carrying charges are elevated at 23% of total governmental funds expenditures, excluding capital outlay in fiscal 2016. With the issuance of the series C bonds, the district will have about $235 million of authorization remaining under the 2012 bond measure. We understand that the district plans to issue its fourth series of bonds under the authorization in fiscal 2020 or fiscal 2021. Lastly, we understand that the district does not have any direct purchase or private placement agreements outstanding.

Pension and other postemployment benefits (OPEB) liabilities

The district contributed its total annual required contribution (ARC) of $10.1 million toward its pension obligations in fiscal 2016, or 4.2% of total governmental expenditures. The district participates in defined-benefit pension plans managed by the State Teachers' Retirement System (CalSTRS) and the Public Employees' Retirement System (CalPERS). Using updated reporting standards in accordance with Governmental Accounting Standard Board (GASB) Statement No. 67 and 68, the district's net pension liability as of June 30, 2016, was $88.7 million for CalSTRS and $34.3 million for CalPERS. CalSTRS, its largest plan, maintained a funded level of 70%, using its fiduciary net position as a percentage of the total pension liability. The district also paid $1.2 million, or 0.5% of total governmental expenditures, toward its OPEB obligations in fiscal 2016. Combined pension and OPEB carrying charges totaled 4.7% of total governmental expenditures in fiscal 2016. We understand that the district established an irrevocable OPEB trust, with a current balance of $4 million, to fund the district's accrued liability for benefits. Since the OPEB trust was established after the district's most recent actuarial study, we understand that the funds in the account were not factored into the calculation of the district's ARC.

Outlook

The stable outlook reflects our views that the district's very strong local economy, growing tax base, and additional revenue flexibility will support the district's maintenance of available general fund reserves we consider at least strong. Additionally, the outlook reflects our expectation that ADA will remain stable or possibly improve. We do not expect to change the ratings within our two-year outlook horizon.

Upside scenario

We could raise the ratings should the district were to consistently report positive operating results significantly above its projected deficits, and maintain available general fund reserves at a level we consider very strong.

Downside scenario

We could lower the ratings should the district report operating deficits at or above its current multiyear forecast, or significantly lower its available general fund reserves to a level we no longer consider strong.

Ratings Detail (As Of May 19, 2017)		
Santa Monica-Malibu Unif Sch Dist GO bnds (Election of 2006)		
Long Term Rating	AA/Stable	Affirmed
Santa Monica-Malibu Unif Sch Dist APPROP		
Unenhanced Rating	AA-(SPUR)/Stable	Affirmed
Santa Monica-Malibu Unif Sch Dist 2010 rfdg certs of part (tax-exempt)		
Long Term Rating	AA-/Stable	Affirmed
Santa Monica-Malibu Unif Sch Dist 2016 GO rfdg bnds (2020 Crossover Rfdg) ser C due 07/01/2035		
Long Term Rating	AA/Stable	Affirmed
Santa Monica-Malibu Unif Sch Dist GO		
Unenhanced Rating	AA(SPUR)/Stable	Affirmed

Many issues are enhanced by bond insurance.

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com. All ratings affected by this rating action can be found on the S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.