FITCH AFFIRMS PHILADELPHIA SCHOOL DISTRICT'S IDR AT 'BB-'; OUTLOOK STABLE

Fitch Ratings-New York-20 September 2017: Fitch Ratings has affirmed the underlying 'BB-' rating on the following bonds issued for the school district of Philadelphia (SDP, or the district):

--$989 million Pennsylvania State Public School Building Authority school lease revenue and revenue refunding bonds issued on behalf of SDP;
--$1.8 billion school district of Philadelphia general obligation (GO) and GO refunding bonds.

Fitch also affirms the district's IDR at 'BB-.'

The Rating Outlook for the IDR, underlying district and authority debt is Stable. The enhanced rating of 'A+' with a Stable Outlook on the bonds reflects protections under Pennsylvania statutes outlining intercept of commonwealth aid for school districts (Pennsylvania School Credit Intercept Provision).

SECURITY
The bonds issued by the authority are special limited obligations of the authority. For these bonds, payments from the State Treasurer are made directly to the Trustee on the last Thursday of April and October of each year, in advance of lease rental payments due on May 15 and Nov. 15, and debt service payments on June 1 and Dec. 1. The district has covenanted that it will include in its budget appropriations for payments to the authority. For these payments, the district irrevocably has pledged its full faith, credit and taxing power. All of the authority and GO bonds are secured by protections under the Pennsylvania School Credit Enhancement Law as well as the district's full faith and credit and taxing power.

SDP's underlying GO rating is based on the district's full faith and credit pledge. The rating on the GO bonds is enhanced by the Pennsylvania School Credit Enhancement Law.

ANALYTICAL CONCLUSION

The 'BB-' IDR reflects SDP's constrained budgetary environment with limited independent ability to materially alter its fiscal profile. The current rating level implies an elevated vulnerability to default risk, particularly in the event of adverse changes in conditions. Fitch believes that a consistent history of support from other levels of government provides a modicum of comfort that the district will continue to meet its financial obligations.

Over the past several years, the district has taken multiple steps to reduce recurring spending and has worked with external stakeholders to boost revenues. But further expense reductions are likely to materially affect core service delivery; in fact, the district has taken steps to use new revenues to restore some prior year cuts to address such concerns. SDP's management is taking important steps to address these limitations. But the district's options are limited absent external cooperation, particularly from the commonwealth and city, given constraints including a challenging labor environment.

Economic Resource Base
Philadelphia serves as a regional economic center in the northeast, with a stable employment base weighted toward the higher education and healthcare sectors. Jobs expansion since the recession

has been steady and strong, but comparatively low wealth levels and weak population increases persist and limit growth prospects. The population is estimated at 1.6 million.

KEY RATING DRIVERS

Revenue Framework: 'bbb'
Fitch expects SDP's revenues will grow annually near the rate of inflation with key components including the property tax and subsidies from the commonwealth. SDP's lack of any material independent legal revenue-raising capability limits the revenue framework assessment.

Expenditure Framework: 'bbb'
Expenditure pressures are significant with debt service and charter school payments in particular driving Fitch's expectations. Fitch views charter school spending as SDP's most critical expenditure challenge, and will closely monitor progress in moderating the current growth trajectory. The labor environment also poses limitations on expenditure flexibility. Commonwealth reimbursements, which Fitch anticipates will continue, offset a significant share of pension spending.

Long-Term Liability Burden: 'aa'
Debt and unfunded pension liabilities present only a moderate burden on the district's economic resource base. Other post-employment benefit (OPEB) liabilities are minimal, with the district providing no healthcare benefits for retirees or dependents.

Operating Performance: 'bb'
The district has built up modest budgetary, cash-basis reserves in recent years with expense management and successful negotiation of revenue support from the city and commonwealth. But those reserves will likely be drawn down within several years absent structural changes in the level of support from the city and commonwealth. SDP retains very limited financial flexibility with little room for additional expenditure cuts, and would be stressed in the event of an economic downturn, absent external assistance. Both Philadelphia and Pennsylvania have previously stepped in to support the district. Fitch anticipates similar support going forward, but the timing and extent is uncertain as the city and commonwealth face their own fiscal constraints.

RATING SENSITIVITIES
Sustainable Revenue Improvement: SDP has successfully negotiated several revenue increases in recent years with the city and commonwealth including a permanent cigarette tax, the first $120 million of the city's 1% sales tax, and increases in the property tax rate. Establishment of a long-term revenue solution that more fully addresses the district's expenditure demands could improve Fitch's assessment of the district's revenue framework and operating performance.

Shift in Charter School Expenditures: Payments to charter schools have been, and will likely continue to be, the most significant driver of the district's expenditures. A material change in the mandatory per pupil payments SDP makes to charter schools, either through changes in enrollment patterns or in the structure of the payments themselves, could alter Fitch's view of the district's expenditure growth and financial resilience.

CREDIT PROFILE

The School District of Philadelphia is the nation's eighth largest school district and the largest in the commonwealth, with fiscal year 2017 enrollment of 201,822 students, including charter school students. Total enrollment has been relatively stable in recent years. Charter school enrollment has grown approximately 6% on average annually since fiscal 2012, while district public school enrollment declined an average 2% each year. Recent data indicate some stabilization in enrollment trends across both categories with charter and district public schools both seeing more modest annual changes. Fitch will continue to monitor enrollment data to assess whether there is a sustainable and material shift in enrollment patterns.

Revenue Framework

Commonwealth subsidies comprise the majority of SDP's revenues, with various locally provided revenues also making up a significant share. Pennsylvania's funding comes in the form of direct aid for education and reimbursement for a substantial share of annual pension costs. Local revenues consist mainly of a property tax and certain other taxes collected by the city of Philadelphia, and an annual statutorily mandated payment of $120 million of the sales tax levied by the city and collected by the commonwealth which remits it to the district.

Fitch anticipates commonwealth subsidies to the district will grow modestly, near the rate of inflation. Unlike in many other states, the vast majority of local school aid in Pennsylvania is not distributed on a per pupil basis and is not directly tied to enrollment. Pennsylvania has only decreased annual funding to SDP once in the past three decades. There were multiple decreases in basic education funding (BEF, the largest component) including just after the last recession, but the commonwealth continued to fund a share of pension expense and overall state funding generally increased. Pennsylvania faces its own fiscal challenges to restore structural balance, tempering the trajectory of future increases in district subsidies.

Local revenues should grow at a similar pace, particularly following recent increases agreed to by the city and commonwealth. Property taxes are the main component (roughly two-thirds) and Fitch views prospects for growth in the city's tax base positively. Some local sources are more volatile, and others flat such as the $120 million annual share of the city sales tax.

SDP retains essentially no independent legal ability to raise revenues, relying on external stakeholders (primarily the commonwealth and city) to authorize and collect funds that are transferred to the district.

Fitch notes that SDP has been able to negotiate increases in revenues with both the commonwealth and city, particularly in the last several years. Most recently the commonwealth permanently extended a cigarette tax collected for the school district by the state department of revenue that would have expired at the end of fiscal 2019 and added a floor of $58 million for district receipts to offset the volatility of the narrow base. These changes will provide fiscal support for SDP, but will address only a fraction of the projected five-year financial plan cumulative budget gap. The district's total annual operating revenues are approximately $3 billion.

Expenditure Framework

The district's largest expense is for personnel, particularly teachers. Charter school payments are the second largest item. Through aggressive expenditure reduction, SDP reports it brought down central office costs which now represent approximately 3% of spending - according to SDP the remainder goes towards direct support for individual schools, including debt service, teachers, and school-based administrators.

The district's five-year plan projects expenditure growth at nearly twice the rate of revenue growth, incorporating effects of a new teachers' contract settled in late June. Fitch anticipates expenditure growth will exceed expected revenue growth by a wide margin, absent significant policy changes from external stakeholders. Pension expenses and charter schools have been the primary historical growth drivers in recent years. Growth in pensions will continue but should moderate as the district's contributions to the commonwealth-wide Public School Employees Retirement System (PSERS) contributions reached full actuarially recommended levels last fiscal year after several years of steep ramp-up. SDP currently projects charter school enrollment to increase steadily. Under current law, the district makes a per-pupil payment to charter schools for each resident student enrolled in a charter. Fitch views the growth in charter school enrollment as the district's most pressing expenditure challenge.

While SDP's carrying costs remain moderate, Fitch assesses the district's expenditure flexibility as constrained given high levels of charter school expenditures and the workforce environment. Fitch anticipates recent growth in pension expense to continue, but at a slower pace in coming years based on the district's five-year financial plan projections, which are in turn based on guidance from PSERS. The carrying cost metric (17.4% of fiscal 2016 governmental fund expenditures) somewhat overstates the district's burden as the commonwealth reimburses SDP for at least 50% of annual pension expense. The reimbursement is based on a long-standing statutory formula tied to each school district's property values and personal income.

As noted earlier, charter schools pose an additional limitation on expenditure flexibility. Per-pupil charter school payments are generally outside of the district's direct control and are likely to continue their steady escalation in the current statutory framework. When adding charter school expenditures to carrying cost, Fitch's estimation of fixed costs is over a third of total expenditures.

A challenging labor environment, despite recent settlement of a teachers' union contract, is a negative factor. After several years without a contract, both sides reached a settlement in late June with the representatives from the city reportedly playing an important role in final negotiations. The new contract adds substantial costs for SDP with steady salary increases over the three year term, but also provides a measure of predictability and adds an employee contribution for healthcare costs. The district estimates the net cost of the contract at $395 million over its five-year financial plan, which exceeds the $150 million labor reserve that had been incorporated into the original five-year financial plan. The additional cost adds to the fiscal challenges the district faces over the next several years, as reflected in the district's revised five-year financial plan released in June that incorporates all contract costs. Most other unionized employees are also now under contract.

A decline in charter school enrollment in fiscal 2016 and a modest increase in fiscal 2017, and similar stabilization in traditional public school enrollment, could signal some relief in the rapid growth in charter school payments. But it is too early to determine if the enrollment stabilization will become a long-term trend. Fitch views as a credit positive that SDP continues to engage with charter school leaders in an effort to craft a sustainable statutory and regulatory framework that could provide more fiscal stability for the district. Fitch will monitor the district's progress and determine whether any such changes materially improve the agency's assessment of SDP's expenditure framework and operating performance.

Long-Term Liability Burden

SDP's long-term liability burden is moderate at 14.3% of personal income as of fiscal 2016 (year ended June 30), weighted towards direct and overlapping debt (issued by the coterminous city). Most debt is for capital needs, but the district has occasionally pursued explicit deficit financing to manage budgetary stress. The current five-year plan envisions no deficit bonds and moderate capital issuance in line with historical trends. Regarding overlapping debt, Fitch anticipates the current mayoral administration will moderately increase the city's outstanding debt to support specific initiatives - newly approved revenues will largely support debt service. Substantial issuance without commensurate economic growth could pressure the assessment of SDP's long-term liability burden.

The unfunded pension liability is roughly one-third of the total liability burden. The district's pension funding for the Public School Employees Retirement System (PSERS) is determined by commonwealth statutes that dictated a ramp-up to full actuarially determined levels over several years - fiscal 2017 was the first year the statutes provided for a full actuarially determined contribution to PSERS. The pension liability could moderate over the long term if actuarial assumptions are met and the statutory requirements for full actuarially-determined funding remain in place.

Terms of the pension system, including annual budgetary requirements, are wholly outside of the district's control as this is a statewide plan. Earlier this year, the commonwealth enacted changes to its major pension systems, including PSERS, which will gradually slow growth and then reduce the long-term liability and annual funding requirements by changing the level of benefits for new employees. Fitch does not anticipate these changes will reduce the liability to a level that would improve Fitch's assessment of the district's long-term liability burden.

The district eliminated all variable rate debt exposure with the refunding components of a 2016 transaction, eliminating an element of risk in its debt portfolio. SDP does remain counterparty to two basis swaps related to series 2016A State Public School Building Authority lease revenue bond transaction. The district's exposure is limited as it retains sole authority to terminate the swaps and faces no collateral posting requirements.

Operating Performance
With minimal inherent budget flexibility, the district retains very little gap-closing capacity. SDP has built up its budgetary basis and GAAP basis fund balances across all operating funds, but anticipates drawing the balances down quickly over its five year financial plan. Operating deficits begin in the current fiscal year and accelerate quickly leading to a projected negative fund balance by fiscal 2019. The district would face significant difficulty operating during a downturn without assistance from external stakeholders. Fitch notes the commonwealth, city, and federal government (through the federal stimulus act) have historically stepped in to provide the district with sufficient resources to maintain operations. Similar responses are likely in the event of another downturn, particularly from the commonwealth and city. But both entities face their own fiscal challenges and Fitch anticipates their capacity to provide assistance would be adequate but limited in scope.

SDP's budgetary management practices are sound but limited by fiscal constraints. The district generally meets demands for required funding such as statutory pension requirements. Even during the fiscal 2016 commonwealth budget impasse when SDP was without most state funding for nine months, the district made all payments, including sizable charter school payments, on time. To achieve balance in recent years and establish a budgetary reserve, the district relied primarily on a mix of significant structural expense reductions and successful negotiation of recurring revenue increases from the commonwealth and city.

The district's comparatively narrow liquidity profile is bolstered by the need for consistent marketplace access for cash flow borrowing given the timing difference of revenues and expenses in a fiscal year. SDP has issued public or privately placed tax and revenue anticipation notes for many years, supported by taxes, revenues, and state aid payments that provide multiples of coverage. The district relies heavily on the credit enhancement offered by Pennsylvania's intercept provisions for school aid when accessing credit markets. The fiscal 2016 commonwealth budget impasse led some marketplace participants to question the value of the provisions. 2016 legislation addressed those concerns and provides for commonwealth general fund money to make intercept-eligible debt service payments in the event of another budget impasse.

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In addition to the sources of information identified in Fitch's applicable criteria specified below, this action was informed by information from Lumesis and InvestorTools.

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Applicable Criteria
U.S. Public Finance Tax-Supported Rating Criteria (pub. 31 May 2017)
https://www.fitchratings.com/site/re/898466