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# Philadelphia School District, PA

## Update following upgrade to Baa3

## Summary

Philadelphia School District's credit position continues to improve, marked by three consecutive years of operating surpluses and a commitment of permanent tax revenues from the city of Philadelphia (A2 stable) that largely eliminates the district's previously anticipated deficits in the near term. The district's governance is now more closely tied to that of the city given the return to local control, and we anticipate a better alignment of city and school district interests as a result.

Philadelphia School District continues to face substantial challenges, including a financial position that remains somewhat strained and narrow reserves, exacerbated by material charter enrollment pressures that will persist; more than 35% of district students are enrolled in charter and alternative schools. These challenges are currently met by a very strong management team, which has developed a detailed understanding not only of the district's finances but also the ongoing operational complexities of managing a highly dynamic, large, urban school district.

On December 18, 2018, Moody's upgraded its ratings for Philadelphia School District's General Obligation and Lease debt to Baa3 from Ba2. The district's enhanced rating was affirmed at A2. The outlook is stable.

## Credit strengths

» Charter enrollment has been stable for the past four years at 33% - 36% of overall enrollment; a continued flat trend for the 2018 - 2019 school year is expected

» Structural balance and operating surpluses for last three years show a favorable improvement over years of deficits

» City's willingness to support the district with permanent new dedicated tax revenue and increased governance link between the city and school district provide material strength to the credit profile

» Experienced management brings strong control of finances and detailed management of daily school operations

» City finances continue to improve, with material benefit to city reserves

THIS REPORT WAS REPUBLISHED ON 12/18/2018 WITH A CORRECTION TO THE CREDIT CHALLENGES SECTION.

» GO debt is secured by a lock box agreement that has never been tripped (since inception in 1982) with debt service coverage of 5.29xs as of fiscal 2017 year end

## Credit challenges

» Charter costs continue to be a large, relatively fixed budget expenditure

» Conservative future projections show a return to operating deficits in 2020, though deficits are largely moderated by newly committed city revenues

» Fund balance and liquidity cushion is narrow versus peers with no expectation of reserves beyond 5% in the near term

» No ability to raise revenues independently; reliance on the state and city for revenue generation is a substantial limiting factor to the district's overall credit profile

## Rating outlook

Our outlook for the underlying credit quality of the district is stable given our expectation of continued charter stabilization and management's solid governance over school operations and finances. The stable outlook also reflects our expectation that finances will be maintained within the range of structural balance going forward.

The stable outlook further reflects the district's recent change in governance - from School Reform Commission oversight to local control - particularly given a strengthening of reserves and the stability of finances for the city.

The outlook for the enhanced rating is also stable, and mirrors the outlook of the commonwealth.

## Factors that could lead to an upgrade

» Substantial improvement in liquidity and reserves coupled with further stabilization of charter enrollment

» Further strengthening of city / district relationship; continued willingness of city to raise revenue in support of the district

» Upgrade of the Commonwealth's (Aa3 stable) rating (enhanced)

## Factors that could lead to a downgrade

» Structurally imbalanced operations; fund balance draws materially beyond current expectations

» Further expansion of charters; deterioration of district enrollment not coupled with significant expenditure cuts

» Any change in the city's commitment to and support of the district

» Downgrade of the Commonwealth's rating (enhanced)

## Key indicators

Exhibit 1

| Philadelphia School District, PA | 2013 | 2014 | 2015 | 2016 | 2017 |
|---|---|---|---|---|---|
| Economy/Tax Base | | | | | |
| Total Full Value ($000) | $42,734,769 | $43,297,732 | $42,299,104 | $46,327,695 | $54,727,596 |
| Population | 1,536,704 | 1,546,920 | 1,555,072 | 1,559,938 | 1,568,000 |
| Full Value Per Capita | $27,809 | $27,990 | $27,201 | $29,698 | $34,903 |
| Median Family Income (% of US Median) | 71.6% | 71.0% | 71.0% | 71.0% | 71.0% |
| Finances | | | | | |
| Operating Revenue ($000) | $2,209,808 | $2,366,315 | $2,505,565 | $2,603,284 | $2,720,041 |
| Fund Balance ($000) | $34,100 | $82,400 | $116,995 | $233,995 | $199,717 |
| Cash Balance ($000) | $175,968 | $217,109 | $165,444 | $335,222 | $280,785 |
| Fund Balance as a % of Revenues | 1.5% | 3.5% | 4.7% | 9.0% | 7.3% |
| Cash Balance as a % of Revenues | 8.0% | 9.2% | 6.6% | 12.9% | 10.3% |
| Debt/Pensions | | | | | |
| Net Direct Debt ($000) | $3,295,018 | $3,177,579 | $3,099,555 | $2,989,333 | $2,976,230 |
| 3-Year Average of Moody's ANPL ($000) | $1,759,065 | $1,881,846 | $2,039,970 | $1,813,309 | $1,716,961 |
| Net Direct Debt / Full Value (%) | 7.7% | 7.3% | 7.3% | 6.5% | 5.4% |
| Net Direct Debt / Operating Revenues (x) | 1.5x | 1.3x | 1.2x | 1.1x | 1.1x |
| Moody's - adjusted Net Pension Liability (3-yr average) to Full Value (%) | 4.1% | 4.3% | 4.8% | 3.9% | 3.1% |
| Moody's - adjusted Net Pension Liability (3-yr average) to Revenues (x) | 0.8x | 0.8x | 0.8x | 0.7x | 0.6x |

*Source: Moody's Investors Service, Philadelphia School District's audited financial statements*

## Profile

Philadelphia School District is the largest public school district in Pennsylvania and the tenth largest in the country. The district operates more than 200 schools with enrollment of 203,814 (includes 74,325 students in charters and alternative schools) as of June 30, 2017.

## Detailed credit considerations

### Economy and Tax Base: Strengthening tax base, continued charter pressure

Philadelphia School District's ("PSD", the district) bounds are co-terminous with the city of Philadelphia (A2 stable). PSD is the largest of the 500 school districts in the commonwealth, employing over 17,800 full time employees as of June 2017, and educating roughly 12% of the state's 1.7 million public school students. It is the 11th largest school district in the nation based on student enrollment.

Philadelphia's large and diverse tax base continues to show strong growth, particularly over the last three or four years, with a positive corresponding impact to city tax revenues especially in 2017 and 2018. With a population of roughly 1.6 million, Philadelphia is the sixth-largest city in the US by population, and is at the center of the sixth-largest metropolitan area.

The city's $164 billion tax base (2019) is substantial, and has grown by close to 20% over the past two years, which is material for a base of this size. The city continues to be anchored by some of the top higher education and healthcare institutions in the nation. Of the 10 biggest employers in Philadelphia, eight are either higher education or healthcare entities - most prominently the University of Pennsylvania (Aa1 stable) and the University of Pennsylvania Health System (Aa3 stable). The city is home to about 30 hospitals, including Thomas Jefferson University Hospital and the Children's Hospital of Philadelphia (Aa2 stable).

While current economic trends are largely positive, the city's stubbornly high poverty level is a serious concern and a persistent challenge; Philadelphia's poverty is among the highest of any large US city at 26%, and median family income is equal to just 71% of the US median. Unemployment has also lagged some of the city's other more positive economic trends, and stood at an elevated 6.0% as of August 2018, materially higher than the US rate of 3.9% for the same period.

The school district has been grappling with the challenges of charter pressure since 2002, but enrollment seems to have stabilized at roughly 33% - 36% of total enrollment over the past four years. As of June 2017, total enrollment in the district is 203,814, with more than 74,000 students attending charter or alternative schools (36%). The district manages the daily operations of more than 200 school buildings throughout the city and close to 130,000 students in district schools.

This is a substantial undertaking for management, particularly given the complexity of demographics in a dynamic city like Philadelphia. Some district schools are overflowing with students, while others have lost significant enrollment to charters. Charter pressure poses a marked operational challenge, as students do not migrate to charter schools in any uniform way. School closures and consolidation, even for under-enrolled and under-performing district schools, are difficult to accomplish. This somewhat limits the district's opportunity to realize efficiencies, despite the fact that more than 30% of students currently attend non-district schools.

Perhaps the biggest challenge of charters is that per-pupil costs for charter students are determined at the beginning of the fiscal year and are outside of district control. While the district does monitor enrollment on a daily basis, which increases the accuracy of its monthly payments to charters, it cannot change the per-pupil cost it pays out once that amount is set. The charter expenditure of $779 million in 2017 (up 9% year over year) was 36% of PSD's general fund budget - this is a substantial fixed cost, and when coupled with the district's ordinary fixed costs of debt service and pensions, severely limits the district's financial flexibility.

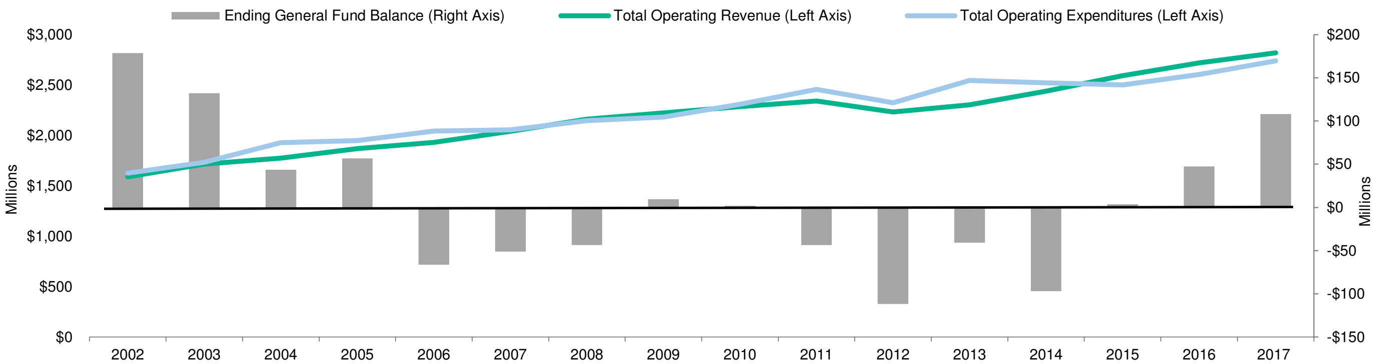
### Financial operations and reserves: Materially strengthened, though reserves remain narrow

Philadelphia School District has considerably improved its financial position over the last three fiscal years and we expect this positive trend to continue. In November 2017, the school district's state-appointed governance board voted to dissolve itself; a new board, appointed by the mayor, took control of district oversight in July 2018. Along with this change, the city also approved material new tax revenues for the district, which largely eliminate the district's previously projected budget deficits.

The district's final, unaudited results for 2018 materially outperform projections and reflect an operating surplus of $39 million, bringing ending fund balance to $164 million, or 5.4% of revenue. This is the highest fund balance the district has realized in the past decade, and reflects several positive factors. First, an improved city economy is contributing to positive revenue trends, particularly for property and income tax revenues; more than 20% of the district's total revenue is from property tax, so economic growth in the city directly impacts district finances. Second, the stabilization of charter enrollment allows for better planning and more accurate budgeting than the district was capable of in the past. Lastly, strengthened governance ties between the city and school district has contributed to some stabilization of the political relationship between these two entities, allowing for not only additional financial support for schools, but also for a more predictable operating environment. We expect all of these positive trends to continue in the near term.

Overall 2017 audited operating fund balance, which includes the general fund, the Intermediate Unit, and the debt service fund, totaled $202 million at year end 2017, or roughly 7% of operating revenue. The district, in its forward looking projections, begins with this operating fund balance figure, and then deducts certain encumbrances and near-term debt service payments. Given these adjustments, the district reports an adjusted ending fund balance for fiscal year 2017 of $125 million, reflecting a $96 million surplus for the year. Again, the past three years' financial performance has been notably positive, allowing for a stronger financial position than what the district has realized in the last several years.

Exhibit 2
**Operating surpluses 2015-2017 contributing to strengthened fund balance**




*Source: Moody's Investors Service, Philadelphia School District audited financial statements*

Though financial stability is a credit positive for the district, we note persistent challenges. While we acknowledge that the school district's sinking fund arrangement requires substantial debt service reserves well ahead of payments due, a portion of its reported fund balance is ultimately lock boxed for debt and cannot be used to support ongoing operations.

When we isolate the general and Intermediary Unit funds, the audited fund balance result is substantially more narrow, at $21.13 million, or 0.7% of revenues for 2017. Compared to other school districts in Pennsylvania, this is a particularly weak reserve level; the median general fund reserve for all school districts in the state is 19%.

### LIQUIDITY

The reported general fund cash position was a fairly weak $99.7 million at year end 2017, or 3.4% of revenue, compared to a more satisfactory $192 million (7.4%) at year end 2016. There may be some variability due to timing, as the receivable from other governments in 2017 was nearly double that of the year prior. Nevertheless, the district's liquidity position remains weak versus the median of 24% for school districts in the commonwealth.

The district issues Tax and Revenue Anticipation Notes annually to bolster liquidity during the fiscal year. The 2017 – 2018 TRAN was issued for $400 million, with an additional draw of $175 million if needed. The $400 million was fixed rate and privately placed.

## Debt and pensions: Manageable debt and pension burden, though fixed costs severely limiting when charters are included

The district's debt profile is expected to modestly increase in the near term due to a sizable capital plan. The district's debt portfolio currently consists of $2.0 billion of GO bonds and $998 million of lease revenue bonds issued through the SPSBA. Inclusive of a March 2018 GO issuance, the total debt burden will increase to $3.2 billion.

We note that on a tax base of $137 billion, which was the full value reported for the city of Philadelphia for 2017, the total debt is equal to roughly 2.3% of full value and 1.19 times revenues, a relatively moderate debt burden. However, the district's facilities are old and the district plans to invest heavily in its capital assets over the next several years, largely through additional debt issuance. In May 2016, the district adopted a six year capital improvement program for fiscal 2017 – 2022 which identified $1.128 billion in facility needs.

Debt service amounted to $268 million at year end 2017, or close to 9.6% of operating expenses, a considerable fixed cost especially when coupled with the district's pension burden and the relatively "fixed" cost of charters in any given fiscal year.

### DEBT STRUCTURE

The district's General Obligation bonds benefit from a lock-box structure, originally established in 1982. Through various credit cycles over the past 35 years, the lock box mechanism has never been tripped, and a sinking fund payment never been missed. The City of Philadelphia, as tax collector for the district's local taxes (property, business use and occupancy, liquor, and non-business income taxes), remits the district's revenues on a daily basis directly to the fiscal agent. If a given day's revenues are insufficient to meet the daily deposit requirement, the shortfall is added to the subsequent day's requirement until current. Only once the daily deposit requirement has been met do remaining local tax revenues flow to the district's operating account. These four dedicated local taxes provided debt service coverage of 5.29xs in fiscal 2017. Over the past ten years, coverage has never dropped below 3.4x.

Favorably, the General Obligation bonds are also secured by the state intercept mechanism that would be triggered 15 days prior to the debt service due date if the sinking fund was not fully funded. The state intercept mechanics only require 10 days for payment, which would ensure debt service would be paid prior to a default. Furthermore, with implementation of Act 85 in 2016, the state has ensured that intercept payments, for the benefit of bond debt service, will be made even in the absence of an appropriation budget of the state. At fiscal 2017 year end, state aid substantially exceeded sum sufficient coverage of debt service.

Debt service for the district’s State Public School Building Authority (SPSBA) bonds is paid directly from the State Treasurer to the Bond Trustee from state appropriations to the district on specified dates scheduled at least 35 days prior to each debt service payment date under a direct-pay agreement. Act 85 applies to these bonds as well.

#### DEBT-RELATED DERIVATIVES

The district is party to two basis swaps associated with the Series 2003 and Series 2016A SPSBA bonds. The swap counterparties are Wells Fargo Bank, NA (Aa1 cr) and JP Morgan Chase Bank, NA (Aa2 cr). Both require the district to pay SIFMA and receive 67% of LIBOR plus 0.2778%. The combined negative mark to market for the two swaps is -$4.554 million as of June 30, 2017.

#### PENSIONS AND OPEB

The district contributes to the Pennsylvania State Public School Employees' Retirement System, a multi-employer, defined benefit retirement plan administered by the Commonwealth of Pennsylvania. The district's annual required contribution (ARC) for the plan was $275 million in fiscal 2017, or roughly 10.2% of general fund expenditures. Half of this payment is reimbursed to the district by the state.

The district's 2017 adjusted net pension liability, under Moody's methodology for adjusting reported pension data, is $3.3 billion, or an average 1.22 times operating revenues. Moody's uses the adjusted net pension liability to improve comparability of reported pension liabilities. The adjustments are not intended to replace the district's reported liability information, but to improve comparability with contributions to the plan.

The district also provides Other Post-Employment Benefits (OPEB) to its employees. In fiscal 2016, the district's OPEB ARC was $998,000.

The total fixed cost for pension, OPEB and debt service was $503 million for fiscal 2017, or 19% of operating expenditures, which is in line with the average for Pennsylvania school districts and where PSD has trended the last few years. However, again, when charter school costs are also factored in as a cost outside of the district's control, overall “fixed” costs increase to 55% of general fund expenditures, which is a substantial burden and severely limits the district's financial flexibility.

### Management and Governance

The current management team has developed a detailed understanding of the district’s financial position as well as solid controls on managing charters and school operations. This is essential, as this is a dynamic district with a complex matrix of schools, neighborhoods, and demographics, and charters do indeed complicate planning. While management has tight control on the charter issue today and a thorough understanding of the district’s financial position, ongoing comprehensive management will be crucial given the district's fundamental complexities.

The Philadelphia School District is unique among Pennsylvania school districts in that it cannot set its own taxes. The district was deemed financially distressed district in 2001, and was moved to state governance through a five-member School Reform Commission (SRC). The SRC voted to recommend its dissolution in November 2017, and the Secretary of Education issued a declaration of dissolution and revocation of the District's declaration of distress effective June 30, 2018. District governance is now handled by a nine-member local school board, appointed by the mayor of Philadelphia, as of July 1, 2018.

Pennsylvania School Districts have an Institutional Framework score of A, which is moderate compared to the nation. Institutional Framework scores measure a sector's legal ability to increase revenues and decrease expenditures. Schools major revenue source, property taxes, are subject to an Act 1 cap, which limits property taxes above an Act 1 index subject to certain exceptions. Philadelphia School District is unique in the state in that it does not have independent taxing authority. The district is not subject to Act 1.

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