FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Philadelphia School District's (PA) IDR at 'BB+'; Outlook Revised to Positive

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Fitch Ratings - New York - 19 May 2023: Fitch Ratings has affirmed the following School District of Philadelphia (SDP) ratings:

--Issuer Default Rating (IDR) at 'BB+';

--$2.32 billion GO and GO refunding bonds at 'BB+';

--Approximately $900.6 million Pennsylvania State Public School Building Authority (PSPSBA) school lease revenue and revenue refunding bonds issued on behalf of SPDSPD at 'BB'+';

The GO and PSPSBA bonds have an enhanced rating of 'A+' with a Positive Rating Outlook, reflecting protections under Pennsylvania statutes outlining intercept of Commonwealth aid for school districts (Pennsylvania School Credit Intercept Provision) and the Positive Outlook on the commonwealth's IDR.

The Outlook for the IDR and underlying ratings is Revised to Positive from Stable.

RATING ACTIONS

ENTITY / DEBT	RATING		PRIOR
Philadelphia School District (PA)	LT IDR	BB+ Rating Outlook Positive	BB+ Rating Outlook Stable
	Affirmed		

VIEW ADDITIONAL RATING DETAILS

SECURITY

The district pledges its full faith, credit and taxing power to repayment of the GO bonds. The bonds are also subject to protections under Pennsylvania statutes outlining intercept of commonwealth aid for school districts under the Pennsylvania School Credit Intercept Provision. The commonwealth's pre-default intercept mechanism provides for full and timely payment of debt service through the ability to intercept all state revenues appropriated to the district.

ANALYTICAL CONCLUSION

The Outlook revision to Positive from Stable reflects the district's ability to maintain positive reserve balances since fiscal 2016(reversing the prior trend of negative general fund balances prior to fiscal 2015). It also reflects the recent commonwealth court ruling on Feb. 7, 2023, that found the current state funding system inadequately and inequitably. The judge in the case called on the state legislature to appropriately address the issue, which may result in comprehensive funding reforms that Fitch believes will be beneficial to the district's ability to achieve structurally balanced operations.

The 'BB+' underlying GO, lease revenue bond ratings and IDR reflect SPD's constrained budgetary environment, with limited independent ability to materially alter its fiscal profile. The district has seen improvements in its financial operations due to meaningful recurring revenue commitments enacted by the commonwealth (IDR AA-/Positive) and the city of Philadelphia (IDR A+/Stable) through tight spending controls in recent years. Federal stimulus aid provides a meaningful near-term budgetary cushion and funds other needs, including $210 million in new school construction and $75 million to update the district's teaching materials.

The 'A+' long-term rating on the bonds reflects the credit enhancement provided by the Pennsylvania School Credit Intercept Provision.

Economic Resource Base

The district is coterminous with the city of Philadelphia, which serves as a regional economic center in the Northeast with a stable employment base weighted toward the higher education and healthcare sectors. Jobs expansion had been steady and strong prior to the outbreak of the coronavirus, but comparatively low wealth levels and modest population increases persist, limiting growth prospects. The city's 2020 Census population is 1.6 million, up 3.3% from the 2010 Census. School enrollment has been declining, pressured by growth in charter schools.

KEY RATING DRIVERS

Revenue Framework: 'a'

Fitch expects SPDSPD's revenue growth will approximate the long-term rate of inflation. The district's key revenue components are property taxes and commonwealth appropriations. Under state law, SPD has the ability to levy up to 16.75 mills on taxable real estate without city council approval. The district does not intend to levy property taxes other than those authorized by the city council on the district's behalf. Fitch's revenue framework assessment focuses more on the revenue growth prospects than the ability to control revenue increases given the practical and political constraints of independently raising the millage rate.

Expenditure Framework: 'bbb'

Fixed carrying costs for debt and post-employment benefits are moderate, but Fitch views charter school spending as SPD's most critical expenditure challenge. Fitch anticipates the natural pace of spending growth to be above expected revenue growth due to cost pressures associated with employee compensation and contributions to charter schools. The labor environment poses limitations on expenditure flexibility and pressures spending growth. Statutorily-defined commonwealth reimbursements offset a significant share of pension spending.

Long-Term Liability Burden: 'aa'

Long-term liabilities present a moderate burden on the district's economic resource base. Other post-employment benefit (OPEB) liabilities are modest, with the district providing a capped healthcare subsidy for retirees through the statewide teachers' pension plan system.

Operating Performance: 'bb'

The district's financial position has improved in recent years, with increased reserve balances bolstered by federal relief aid and increased commitments from the city for new and recurring revenues. However, financial flexibility remains limited and the district continues to address longer-term structural issues. Both Philadelphia and Pennsylvania have previously stepped in to support the district and Fitch anticipates similar assistance will occur as needed in the future.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

--Significant changes in the school funding framework, as recommended by a recent commonwealth court ruling, that materially improves SPD's revenue growth prospects and mitigates ongoing spending pressures;

--Continued improvement of the district's operating performance that supports progress towards budgetary structural balance and a sustained improvement in the district's overall financial resilience.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

--Significant and sustained budgetary pressure on the commonwealth and city of Philadelphia that result in reductions in educational aid and other subsidies that impede the district's financial sustainability;

--An inability to retain budget balance after the federal relief funds expire that results in weakened budget flexibility;

--Material or sustained increases in the mandatory per-pupil payments SPD makes to charter schools or increasing charter school enrollment that results in more spending pressures.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

CURRENT DEVELOPMENTS

The general fund ended Fiscal 2022 with a $201.9 million general fund surplus primarily driven by operating revenues that was slightly above budgeted expectations and spending were below due to salary savings from staffing challenges, and reductions in facilities spending and other savings. Federal relief funds provided a substantial $736.8 million, or 18% of operating revenues and other financing sources, based on year to date results; roughly 13% less than estimates in the adopted budget.

The SPD 2023 adopted budget assumed a large operating fund surplus driven by a 31.8% increase in state aid and $459 million of federal relief funds, 12% of revenue and other financing sources. The infusion of federal funding supports the expectation for a sizable surplus for fiscal 2023. The budgeted state aid reflects the governor's budget proposal, which reflects an increase in the basic educational aid and savings in charter costs associated with the governor's revised charter school funding proposal. The budgeted expenditures assume a $226 reduction in tuition payments and transportation costs for charter school students, including roughly $145 million in reduced cyber charter school tuition and special education costs.

The governor's proposed 2024 budget includes a 7.8% increase in basic aid and the SPD is projecting a $71.8 million increase in the state basic education (5.3%) subsidy and $3.2 million (1.9%) in special education subsidy. Federal revenues including relief funds in FY24 are projected to total $528.4 million. Charter school costs are projected to account for one third of the district's budgeted expenditures and is projected to increase $235 million over fiscal 2023 due to higher charter school spending per pupil. Charter school funding is based on a per pupil formula and the district continues to see increased charter and cyber charter school enrollment.

The proposed five-year financial plan assumes the federal relief aid will be exhausted in fiscal 2025, resulting in operating deficits from fiscal 2025 through fiscal 2028. The drop-off in stimulus funds and the projected emergence of a gap between spending and revenue in fiscal

2025 will have to be addressed. If the gaps persist, the district would likely drawn down reserves although the unrestricted general fund balance would remain positive through fiscal 2026. The city of Philadelphia's Five-Year Plan assumes $1.4 billion in local grants over the five-year period, including $282 million for fiscal 2024, reflecting a 4.5% increase over the 2023 adopted budget.

CREDIT PROFILE

The district is the nation's 8th-largest school district and the largest in the commonwealth.

The 2021 enrollment totaled 197,288 students, of whom 82,221 or 41% were enrolled in charter schools or alternative education programs. Charter school enrollment including cyber-charter enrollment increased during the pandemic but the district expects enrollment to stabilize and remain relatively flat in 2024 and beyond.

Revenue Framework

Commonwealth allocations and local revenues each typically comprise about one-half of SPD's revenues. Pennsylvania's funding comes primarily in the form of direct aid for education and reimbursement for a substantial share of annual pension costs. The commonwealth has made permanent a dedication of cigarette tax revenues of at least $58 million annually, and recently provided increased basic education funding (BEF) under a more favorable funding formula.

Local revenues consist mainly of a property tax and certain other taxes collected by the city as school tax collector, an annual statutorily mandated payment of $120 million of the sales tax levied by the city and collected by the commonwealth, and direct grants made by the city.

Fitch anticipates revenue growth will be slow, in line with the long-term expectation for inflation. The commonwealth has only decreased annual funding to SPD once in the past three decades. There were multiple decreases to basic BEF, the largest component, including just after the Great Recession, but the commonwealth continued to fund a share of pension expense and overall state funding generally increased. 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.

The city worked with the commonwealth to increase school funding including a state mandated $120 million annual allocation of a local sales tax increase to SPD, the city authorized multiple increases in the district's property tax levy, and committed to more additional funding phased in over multiple years beginning in fiscal 2019. Property taxes are more than one-half of local revenue, and Fitch views prospects for growth in the city's tax base positively.

The commonwealth has granted the district authority to levy property taxes of up to 16.75 mills, although this authority was limited while the district was in distressed status between December 2001 and December 2017. This rate is more than double the 7.681 mills the city authorizes on behalf of the school district, providing high independent revenue-raising ability. SPD has indicated no intention to utilize this authority, and the city does not believe it practically available. As such, Fitch puts minimal weight on this theoretical revenue-raising ability.

Expenditure Framework

Charter school payments (including transportation) represent approximately one-third of governmental funds expenditures (excluding non-recurring programs funded with federal relief aid), and are a significant constraint on expenditure flexibility. Nevertheless, management has demonstrated its ability to implement aggressive cost-cutting measures during periods of economic downturns. Federal aid relieved the district of the need to make meaningful spending cuts during the pandemic.

Fitch anticipates expenditure growth will continue to exceed expected revenue growth in the absence of policy actions. Charter school and salary and wage pressures have been the primary growth drivers in recent years, and continue to add modest pressure.

SPD's carrying costs (debt service, actuarially determined pension contributions and actual OPEB contributions) are moderate at under 16% of spending. The carrying costs are lower when adjusted for the commonwealth's reimbursement of two-thirds of the annual pension expenses, which is based on a statutory formula tied to each school district's property values and personal income.

Fitch assesses the district's expenditure flexibility as constrained given high levels of charter school expenditures and the inflexible workforce environment. Adding charter school expenditures to carrying costs, Fitch estimates total fixed costs at over 40% of total governmental funds expenditures.

The school administrators and school safety staff (accounting for 10% of total district staff) laabor contract negotiations are governed by a state law that allows for labor or management to trigger binding arbitration in the event of an impasse. The district's fiscal and economic conditions are not a required evaluation factor. Teachers and facilities employees

(93% of the workforce) are not covered by binding arbitration but can authorize a strike. The current teachers' contract agreement expires on Aug. 31, 2024.

Long-Term Liability Burden

SPD's long-term liability burden is moderate at approximately 12% of personal income. Most debt is for capital needs, but the district has occasionally benefited from financing issued by the city to provide operating revenues for the district to manage budgetary stress.

The district's six-year capital improvement program (CIP) totals $2 billion and assumes the district will issue approximately $350 million in debt every two years. The additional debt will have a modest impact on outstanding direct debt, which totals approximately $3.2 billion. The district is in the process of beginning a three-phase facilities master plan that includes data analytics and public engagement to establish facilities and capital needs. Substantial additional debt issuance by the city (thereby increasing overlapping debt) or the district without commensurate economic growth could pressure the assessment of SPD's long-term liability burden.

The net pension liability was 37% of the total liability burden in fiscal 2022. The district's pension funding for the PSERS is determined by commonwealth statutes that dictated a ramp up to full actuarially determined levels by fiscal 2017. The pension liability has been relatively stable since then.

Terms of the pension system, including annual budgetary requirements, are wholly outside of the district's control, as the plan is statewide. The ratio of net pension assets to liabilities was 57.2% using the Fitch adjusted 6% rate of return on pension assets.

The district's solid market access reflects the credit enhancement offered by Pennsylvania's intercept provisions for school aid. Legislation provides for commonwealth general fund money to make intercept-eligible debt service payments, including for the district's Tax and revenue notes (TRANs), in the event of a prolonged commonwealth budget impasse.

Operating Performance

Despite recent improvements in operating performance, aided by successful negotiation with state and local partners, the district maintains only adequate gap-closing capacity to address economic downturns. The district anticipates that healthy surpluses in fiscal 2023 and 2024 will bolster reserves, but management will need to manage projected budget gaps in fiscal 2025 and beyond through efficiencies and other spending controls.

SPD's budgetary management practices are sound but are limited by fiscal constraints. Fitch believes that management will continue to actively address and minimize the projected budget gaps, and will continue to work with the city and commonwealth to support sufficient education funding.

SPD's narrow liquidity profile, partially resulting from the timing of the receipt of city property tax revenues nine months into the district's fiscal year, is bolstered by consistent marketplace access for cash flow borrowing, supported by the state aid intercept program.

Fiscal year-end government wide days cash on hand is typically narrow, approximating 57 days in fiscal 2022. TRAN issuance provide the district liquidity in anticipation of the bulk of property tax collections. Consistent with recent practice, the district issued $500 million in TRANs in July 2022.

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

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Fitch has revised the ESG Relevance Score for Labor Relations & Practices to '4' from '3' due to due to the impact of labor negotiations on the district's expenditure flexibility. This has a negative impact on the credit profile, and is relevant to the ratings in conjunction with other factors.

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

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APPLICABLE CRITERIA

U.S. Public Finance Tax-Supported Rating Criteria (pub. 04 May 2021) (including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

FAST Econometric API - Fitch Analytical Stress Test Model, v3.0.0 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

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