S&P Global
Ratings

RatingsDirect®

Summary:

Snohomish County School District No. 2 (Everett), Washington; School State Program

Primary Credit Analyst:
David Mares, Centennial + 1 (303) 721 4700; david.mares@spglobal.com

Secondary Contact:
Christopher Grant, San Francisco + 1 (415) 371 5096; chris.grant@spglobal.com

Table Of Contents

Summary:

Snohomish County School District No. 2 (Everett), Washington; School State Program

Credit Profile		
US$47.98 mil unlimited tax GO bnds ser 2018 due 12/01/2037		
Long Term Rating	AA+/Stable	New
Underlying Rating for Credit Program	AA/Stable	New
Snohomish Cnty Sch Dist No. 2 Everett unlmtd tax GO & rfdg bnds		
Long Term Rating	AA+/Stable	Current
Underlying Rating for Credit Program	AA/Stable	Affirmed

Rationale

S&P Global Ratings assigned its 'AA+' long-term rating and 'AA' underlying rating to Snohomish County School District No. 2 (Everett), Wash.'s series 2018 unlimited-tax general obligation (GO) bonds. At the same time, S&P Global Ratings affirmed its 'AA' underlying rating on the district's existing GO bonds. The outlook is stable.

The 'AA+' long-term rating reflects our assessment of the district's eligibility for, and participation in, the Washington State School District Credit Enhancement program. The rating is equal to, and moves in tandem with, the state of Washington GO rating. The 'AA' underlying rating reflects our view of the bonds' unenhanced security of the district's full faith and credit, including the obligation to levy property taxes, without limitation as to rate or amount, to repay the bonds. We understand that the series 2018 bonds, issued in a par amount of $47.9 million, will be used to finance various projects throughout the school district, including a new elementary school and improvements to a middle school and high school.

The underlying rating reflects our view of the district's:

- Very strong economy, evidenced by strong incomes and extremely strong market value per capita;
- Access to the broad and diverse Seattle metropolitan statistical area;
- Good to strong available fund balance in recent years; and
- Good Financial Management Assessment.

Partially offsetting these factors, in our view, is the district's somewhat decreased revenue flexibility under Engrossed House Bill (EHB) 2242, which limits the district's ability to levy voter-approved maintenance and operations (M&O) taxes, and escalating labor costs under recent agreements with employee unions. Together, these factors could lead operating deficits starting in fiscal 2020 unless the district implements offsetting expenditure cuts.

Economy

Located approximately 29 miles north of Seattle, Snohomish County School District No. 2 (Everett) serves an estimated population of 143,933 in the cities of Everett and Mill Creek. It provides education to students from kindergarten through 12th grade (K-12) and operates 18 elementary schools, five middle schools, four high schools, one alternative high school, and one school that serves as a support center for homeschool families.

District residents benefit from employment access throughout the greater Seattle area. At the same time, the district and greater area has a diverse economy. Median household and per capita effective buying incomes in the district are strong at 129% and 116% of national levels, respectively. With 3.4% of assessed value (AV) coming from the 10 largest taxpayers, we view the tax base as very diverse. After four years of AV declines from 2010-2013, AV has since grown by a cumulative 62.1% to $21.7 billion in 2019. Market value totaled $21.7 billion in 2019, which we consider extremely strong at $150,550 per capita. District land is available for residential development in the south west area of the district, though no major plans have been determined.

Finances

The state's K-12 funding system uses full-time equivalent (FTE) enrollment and a multiplier set in the state budget to determine the bulk of operating revenue that school districts receive. The district's enrollment has increased in each year from 2015 to 2019 and totaled 20,088 students at the start of fiscal 2019. District management expects enrollment will continue to grow in the near future.

The district's financial profile is good, with general fund surpluses over the past three audited fiscal years. Most recently in fiscal 2017, the district ended the year with a surplus of $4.5 million or 1.8% of expenditures. In the same timeframe, the district has been able to maintain its available fund balance at levels we consider between good and strong. The district's fiscal 2017 available fund balance of $21.4 million, or 8.7% of expenditures, is strong in our opinion. The district expects a general fund deficit of $1.3 million, or less than 1% of expenditures, in fiscal 2018, due in part to some one-time expenditures for professional development materials and maintenance equipment.

We understand state funding for school districts is set to increase in the coming years with the state's recent adoption of EHB 2242, a law intended to resolve the state's obligations stemming from the "McCleary vs. State of Washington" case, under which the Washington State Supreme Court found that the state was violating the constitutional rights of children within the state by not amply funding K-12 education. The law seeks to fully fund the state's program of basic education and limit districts' reliance on local excess levies to funds used for "basic education" activities. Under EHB 2242, the district's M&O levy will decrease; in 2018 the levy accounted for 21.2% of general fund revenue. The new levy cap will reduce M&O revenues to about $40.8 million in fiscal 2019, from $51 million in fiscal 2018, decreasing further to about $32.4 million in fiscal 2020. While we understand that the district's increase in state funding will offset this decline in local revenue, we believe that the associated decreased revenue flexibility could pose a risk if the state funding environment were to deteriorate.

Additionally, we understand that the district has recently reached a two-year compensation agreement with its main employee unions that will increase its instruction costs by about 9.0% in fiscal 2019 and by a further 6.1% in fiscal 2020. The district expects these revenue and expenditures increases to result in a general fund surplus of $11.3 million in fiscal 2019, but will be followed by a $5.1 million deficit in fiscal 2020 and escalating deficits thereafter. We understand that the district is currently evaluating potential expenditure cuts that it could implement starting in fiscal 2020, if necessary, in order to maintain compliance with its minimum reserve policy of 5% of expenditures and maintain structural balance. Given that the district implemented similar expenditure cuts during the Great Recession, we expect that it will be able to make adjustments in order to maintain structural balance going forward.

Management

We consider the district's management practices "good" under our Financial Management Assessment methodology, indicating financial practices exist in most areas, but that governance officials might not formalize or monitor all of them on a regular basis. Highlights include:

- A budget formation process that incorporates historical revenue and expenditure trends, state-provided revenue estimates, and independent forecasts of FTE enrollment;
- Monthly reviews of budget-to-actuals by the board;
- A formal financial forecast that covers the current budget year plus three years;
- Formal capital plan that extends five years, lists projects and funding sources, which is updated every other year;
- Holdings and earnings on district's investments are presented to the board on a monthly basis;
- Lack of a formal debt policy; and
- Formal reserve policy of minimum 5% of general fund expenditures, however it is not tied to the district's cash-flow needs.

Debt

Inclusive of the current issuance and overlapping debt, the district will have approximately $315.8 million in overall net debt outstanding. Overall net debt is low, in our opinion, as a percentage of market value at 1.5%, and moderate on a per capita basis at $2,023. With 78% of the district's direct debt scheduled to be retired within 10 years, amortization is rapid. Debt service carrying charges were 8.4% of total governmental fund expenditures excluding capital outlay in fiscal 2017, which we consider moderate. After the issuance of the series 2018 bonds, the district will have $49.7 million remaining from its 2016 authorization, which it intends to issue in 2019. The district further anticipates seeking voter approval for an authorization of approximately $400 million. We understand that the district does not have any outstanding direct purchase or privately placed debt.

Pension and other postemployment benefit liabilities

We believe that the district's pension liabilities may pose a credit risk in the future due to low funded ratios, but that its moderate current carrying charge gives it some flexibility in accommodating higher contributions. The district participates in four cost-sharing, multiemployer defined-benefit pension systems administered by the state Department of Retirement Systems: the Teachers Retirements System plan 1 (TRS 1), the Teachers Retirement System plan 2/3 (TRS 2/3), the Public Employees Retirement System plan 1 (PERS 1), and the School Employees Retirement System plan 2/3 (SERS 2/3). The district has historically made its full statutorily required contribution on an annual basis, which accounted for 6.5% of total governmental funds expenditures in fiscal 2017. The district's TRS 1 plan accounted for 66% of its total net pension liability in fiscal 2017 and had a funded ratio of 66%, which we consider quite low. The funded ratios of the district's other plans (ranked by the size of the district's share of the net pension liabilities) are 93%

for TRS 2/3, 61% for PERS 1, and 91% for SERS 2/3.

The district's OPEBs consist of health care benefits administered by the state Health Care Authority (HCA), which are funded on a pay-as-you-go basis. The district's required OPEB contribution is low at 0.5% of total governmental funds expenditures in fiscal 2017. The district has no control over the benefits offered to retirees, the rates charged to retirees, or its required contribution to the HCA.

Outlook

The stable outlook on the enhanced rating reflects that of the state.

The stable outlook on the underlying rating reflects our view of the district's strong and stable underlying economy, growing enrollment, and our expectation that it will be able to make any adjustments necessary to maintain structural balance and fund balance reserves at a level we would consider at least good. We do not anticipate changing the rating during the outlook's two-year horizon.

Upside scenario

Although we view it as unlikely given the structural balance challenges the district current faces, we could raise the rating if the district were able to withstand revenue fluctuations, maintain structural balance, and increase its available fund balance to a level we consider very strong.

Downside scenario

Should the district's rising labor costs and reduced revenue flexibility lead it to reduce its available fund balance to below its policy minimum of 5% of general fund expenditures creating a structural imbalance we could lower the rating.

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.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.