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Snohomish County School District 2 (Everett), WA

Update to credit analysis

Summary

Everett School District No. 2, WA (Aa1) is supported by a very large and growing tax base located in the Seattle (Aaa stable) metro area that benefits from the strong presence of The Boeing Company (A2 stable) and Naval Station Everett. Above-average resident wealth levels further anchor the district's credit profile. Financial operations will remain stable, though the new state funding framework requires the district to budget conservatively in order to maintain liquidity and reserves. Debt burden is modest, with notably rapid payout.

Credit strengths

» Sizeable tax base benefits from participation in the booming Seattle metro area economy.

» Resident wealth levels are above-average.

» Formal fiscal policies and conservative budgetary management stabilize the district's finances.

Credit challenges

» Reserves and liquidity remain below average compared to national peers, particularly in the General Fund.

Rating outlook

Outlooks are not typically assigned to local governments with this amount of debt outstanding.

Factors that could lead to an upgrade

» Significant and sustained increase in General Fund reserves and liquidity

» Material growth and diversification of the tax base and improved resident wealth levels

Factors that could lead to a downgrade

» Significant increase in debt burden beyond current projections

» Trend of structural imbalance resulting in deteriorated financial position

» Material contraction in tax base and weakened wealth levels

Key indicators

Exhibit 1

Snohomish County Sch Dist 2 (Everett), WA	2013	2014	2015	2016	2017
Economy/Tax Base					
Total Full Value ($000)	$11,920,033	$13,106,149	$14,541,841	$15,870,882	$17,280,849
Population	132,722	134,180	136,604	137,739	137,739
Full Value Per Capita	$89,812	$97,676	$106,453	$115,224	$125,461
Median Family Income (% of US Median)	127.2%	129.0%	127.9%	127.7%	127.7%
Finances					
Operating Revenue ($000)	$213,311	$228,003	$237,518	$261,181	$278,395
Fund Balance ($000)	$15,058	$16,213	$17,365	$26,062	$36,075
Cash Balance ($000)	$15,030	$18,099	$18,626	$29,081	$39,601
Fund Balance as a % of Revenues	7.1%	7.1%	7.3%	10.0%	13.0%
Cash Balance as a % of Revenues	7.0%	7.9%	7.8%	11.1%	14.2%
Debt/Pensions					
Net Direct Debt ($000)	$211,585	$194,140	$174,600	$158,545	$190,695
3-Year Average of Moody's ANPL ($000)	N/A	$338,592	$436,652	$485,802	$459,424
Net Direct Debt / Full Value (%)	1.8%	1.5%	1.2%	1.0%	1.1%
Net Direct Debt / Operating Revenues (x)	1.0x	0.9x	0.7x	0.6x	0.7x
Moody's - adjusted Net Pension Liability (3-yr average) to Full Value (%)	N/A	2.6%	3.0%	3.1%	2.7%
Moody's - adjusted Net Pension Liability (3-yr average) to Revenues (x)	N/A	1.5x	1.8x	1.9x	1.7x

Source: Moody's Investors Service

Profile

Everett School District No. 2 is located in western Washington, 30 miles north of Seattle (Aaa stable). The district provides K-12 educational services for a majority of the cities of Everett and Mill Creek, as well as portions of unincorporated Snohomish County (Aa2 stable). With a population of 137,739 (2016 American Community Survey), and enrollment of 19,930 in fiscal 2018, the district operates 18 elementary schools, five middle schools, four high schools, one alternative high school, and a home-school support center.

Detailed credit considerations

Economy and tax base: Sizeable tax base in the greater Seattle area; local economy anchored by presence of Boeing and Naval Station Everett

Despite continued diversification in Everett, The Boeing Company (A2 stable) will continue to be the major driver of the local economy. Comprising most of the cities of Everett and Mill Creek, Everett School District's local economy is an integral part of the expanding Seattle metro area. As the home to significant Boeing manufacturing facilities, the aerospace company is the largest employer in the area, with more than 38,000 local workers. Boeing completed several investments in Everett in the past few years, including a new 1.3 million sq. ft. wing plant estimated to cost $1 billion, which further solidify the firm's strong presence in the region. The aerospace and related industry that exists in the Everett area provide a robust local economy upon which the district can draw.

The other substantial employer in the area is Naval Station Everett (NSE), which has a reported 6,000 military personnel stationed at the facility. NSE is home to five destroyers, one nuclear-powered aircraft carrier, and a number of other Navy and Coast Guard vessels. In addition to military activity, a large civilian contractor force exists in the area, further driving the institutional importance of NSE for Everett School District.

Everett School District's $19.5 billion tax base (as of calendar year 2018) is sizeable and more than double the national median for similarly rated school districts. The county's preliminary estimate of 2019 full value is 11.1% larger, at $21.7 billion, for a second consecutive year of double-digit growth. The five-year compound annual growth rate (CAGR) is a remarkably strong 10%, and total post-recession growth has been 63%, which is notably strong even for the healthy growth throughout Puget Sound.

Wealth metrics will remain above-average compared to national measures, and in-line with medians for similarly rated school districts. Full value per capita, as of 2018 values, is a strong $141,614; using preliminary 2019 estimates, full value per capita is an even stronger $157,320. Median family income (as of the 2016 American Community Survey) is healthy at 127.7% of the U.S. measure. The poverty rate is below state and national measures, at 11.9% compared to 12.7% and 15.1% in state and national measures, respectively.

Financial operations and reserves: Capable management drives strong performance, despite reserves below national medians

Everett School District's financial performance will remain satisfactory due to capable management that will support the district as it moves through the transition to a new state funding framework. As part of the state funding changes implemented as a result of the *McCleary* lawsuit, the district will lose approximately $16.3 million in local General Fund tax revenue by fiscal 2020, due to the tax rate limitation of $1.50 per $1,000 of property values. At the same time, the district is expecting to receive $60.3 million in additional state funding annually (comparing fiscal 2018 to fiscal 2020), for total budgeted revenue growth of 16% from 2018 to 2020. Revenues are likely to modestly outperform this conservative projection, depending on tax base growth and state funding.

Expenditures are projected by management to grow substantially over the projection as well, rising 16% to $325.4 million in 2022. In the four-year forecast, the district is projecting a deficit that reaches $15.8 million, or nearly 5% of budgeted revenues. The primary variable in expenditures is teacher salaries, which were subject to recently completed labor negotiations. Management reports the agreement is not outside of existing projections.

Negative credit pressure will result if the four-year projections are achieved as stated, as total fund balance would drop to $4.9 million, or 1.5% of projected revenues, as of fiscal 2022. We expect the district will make adjustments to salaries, number of teachers, or other expenditures as necessary to match revenues to expenditures most years. Multi-year deficits, or a large single-year deficit, would signal an inability or unwillingness to manage revenues and expenditures under the new framework.

Reserves in the General Fund as of fiscal 2018 are expected to be healthy and above the district's budgeted expectations with available fund balance estimated at $21.1 million, or 7.6% of budgeted fiscal 2018 revenues. This is slightly lower than the prior year's available fund balance of $21.5 million, or 8.6% of revenues, due to planned investments in programs. Washington school districts generally are able to adequately operate at fund balances that are lower than national medians due to the timing of the fiscal year end (August 31, right before the receipt of the first payment for the next school year) and the relatively stable and predictable flow of state funding.

Given large annual debt service requirements over the next few years, we expect greater-than-average variability in operating funds balances, though this may not reflect the operating performance for the General Fund, which supports the district's primary operations. Across the operating funds, inclusive of the General and Debt Service funds, audited 2017 financials show stronger reserves, with available fund balance of $36.1 million, or 13% of revenues. Operating fund balances include reserves restricted for debt service and held with the county treasurer in a lockbox structure. This is positive for bondholder security, however annual variations in operating fund balances may reflect the timing of debt service and property tax collections.

Similar to other Washington school districts, Everett School District's revenue mix is shifting to greater state funding as a result of the resolution of the McCleary lawsuit. In fiscal 2017, enrollment-based state funding comprised 70% of General Fund revenues, with 23% from local taxes, and a small 6% from federal sources. By fiscal 2022, the district is projecting state funding will comprise 80% of revenues, with local revenues dropping to 14% of revenues.

State funding will increase over the next several years, both from state funding changes and the district's projections for growing enrollment. Fiscal 2018 enrollment was 19,930, compared to 17,760 students in fiscal 2013, for a compound annual growth rate of 2.3%, which is remarkably strong, though 2018 was the slowest growth year at 0.8%, which may indicate a leveling off of growth. District projections are for continued growth around 1% per year, which is realistic given strong economic fundamentals in the area, which will continue to draw residents.

Local revenues are in the form of a local operating property tax, called the Educational Programs & Operations (EP&O) levy, which requires approval by the district's voters at least once every four years. Voters approved a four-year levy in February 2018 for $44.2

million in 2019, growing to $53.3 million in 2022. Using the same $1.50 per $1,000 rate limit, full value would need to exceed $35.5 billion (nearly double 2018 full value) in order for the total amount to be collected in fiscal 2022.

LIQUIDITY

Net cash is somewhat better than fund balance, but remains below national averages, as is expected for Washington school districts. Net cash in the General Fund was $25.5 million, or 10.2% of revenues as of audited 2017 financials. Across the operating funds, net cash was stronger at $39.6 million, or 14.2% of revenues.

Debt and pensions: Debt relatively modest, with notably rapid payout; pensions remain manageable

With the expected issuance in September 2018 of $48 million in general obligation unlimited tax (GOULT) bonds, net direct debt of $219.4 million is modest at 1.1% of 2018 full value and 0.8-times fiscal 2017 operating revenues. After that issuance, the district will have an additional $49.7 million in authorized-yet-unissued GOULT bonds, which it expects to issue in June 2019. Including scheduled debt retirement, and the 2019 issuance, debt will reach a still-modest 1.2% of 2018 full value, and remain under 0.9-times fiscal 2017 operating revenues.

Fixed costs are manageable as a percentage of operating revenue; audited 2017 financials show pension and OPEB contributions plus debt service equaling 15.3% of operating revenues. With large debt service requirements in future years, fixed costs will grow some, but operating revenues are also growing substantially and the additional debt service will be paid using the district's unlimited taxing authority for GO bonds.

DEBT STRUCTURE

Payout is notably rapid, with a planned principal payment totaling $51.4 million in 2019, including $25.6 million (or 53%) of the 2018 GO bonds. Five-year payout is 67.6%, and ten-year payout of 78.2%. Debt service is highest in 2019, due to the large principal payment. This schedule will support future debt issuance while keeping debt levels modest. Additionally, recent double-digit increases in the tax base support the increased debt service requirements, and the reduced local EP&O levy tax rate balances the tax rate increase for debt service.

DEBT-RELATED DERIVATIVES

The district is not a party to any debt-related derivatives.

PENSIONS AND OPEB

Pension liabilities will remain manageable. Employees' pension benefits are provided through the state's Department of Retirement Systems (DRS), and the school district contributes the annual amount required by the state. According to Moody's approach to measuring pension liabilities, the district's three-year adjusted net pension liabilities (ANPL) are $459.4 million, or 1.65-times operating revenues. As a percentage of 2018 full value, the three-year average is slightly above peers at 2.4%, however this measure is improving as tax base growth exceeds the growth in liabilities. ANPL reflects certain adjustments we make to improve comparability of reported pension liabilities. The adjustments are not intended to replace the district's or each pension group's reported liability information, but to improve comparability with other rated entities.

Everett School District contributed more to their pension liability in both fiscals 2016 and 2017 than would be required to maintain the same level of liabilities according to our calculation of the "tread water" indicator. This indicator measures the annual government contribution required to prevent the reported net pension liability from growing, under reported assumptions. Contributions above this level cover all net pension liability interest plus the pay down of some principal; this is stronger from a credit perspective compared to contributions below this level.

The district's OPEB contributions are negligible compared to revenues at $1.6 million as of fiscal 2017 (0.6% of operating revenues). The district participates in the state's Public Employee Benefits Board of the State Health Care Authority. The benefit is premium support for insurance coverage for certain retirees in the state's pension system. The OPEB plan has no formal long-term contract provisions and no trust fund. Actuarial valuations are conducted biennially.

Management and governance: Strong and proactive management, adherence to fund balance policy; strong institutional framework

Everett School District benefits from a strong and proactive management team that demonstrates conservative budgeting practices, conducting multi-year forecasts, cash-flow projections, and scenario analysis. Management maintains a formal policy to keep general fund balance at a minimum of 5% of expenditures, with a target of maintaining 6% to 7% of expenditures.

Relationships with labor groups are largely positive, however the recent statewide funding framework changes has led to greater-than-average turmoil during salary negotiations across the state. Everett School District's teachers' union voted to settle the contract, and the results are reported to be manageable in district management's projections.

Washington School Districts have an Institutional Framework score of Aa, which is high. Institutional Framework scores measure a sector's legal ability to increase revenues and decrease expenditures. The sector's major revenue source is from enrollment based state funding. Although school districts do not have an operating property tax levy, they may seek voter approval for supplemental property tax levies for maintenance and operations or capital. Unpredictable revenue fluctuations tend to be minor, or under 5% annually. Across the sector, fixed and mandated costs are generally greater than 25% of expenditures. Washington has public sector unions, which can limit the ability to cut expenditures. Unpredictable expenditure fluctuations tend to be minor, under 5% annually.

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