



Tagging Info

Fitch Rates Cleveland MSD, OH's Qualified ULTGO School Improvement Bonds 'AA'; Outlook Stable

Ratings Endorsement Policy

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Fitch Ratings-New York-17 April 2015: Fitch Ratings has assigned the following program rating of 'AA' to the following Cleveland Municipal School District OH's (CMSD, or the district) unlimited tax general obligation (ULTGO) qualified school improvement refunding bonds:

- \$150,797,000, school improvement bonds, series 2015A;
- \$49,203,000, school improvement bonds, series 2015B (federally taxable).

In addition, Fitch assigns an underlying rating of 'A-' to the series 2015A and 2015B bonds.

The bonds are expected to sell via negotiation on May 5, 2015. Proceeds are being used to finance the costs of constructing, renovating, remodeling, enlarging, furnishing, equipping and otherwise improving school district buildings and facilities.

In addition, Fitch affirms the following ratings:

- Outstanding ULTGO bonds, series 2010, 2012, 2013, and 2014 underlying rating at 'A-'.

The Rating Outlook is Stable for the program and underlying ratings.

SECURITY

The bonds are voted general obligations of the district secured by the district's unlimited ad valorem tax pledge.

The Ohio School District Credit Enhancement Program requires the ODE to forward state foundation program payments to the bond registrar if, prior to the bond payment date, the district has not transmitted funds sufficient to cover required debt service payments.

KEY RATING DRIVERS

BELOW-AVERAGE ECONOMIC PROFILE: The district continues to struggle with declining population and enrollment, low wealth indices, above-average unemployment, and weak property tax collection rates.

IMPROVING BUT STILL STRAINED FINANCES: Proactive management in reducing expenses combined with the approval of a four-year property tax levy in November 2012 has provided some financial flexibility with reserves increasing to an adequate level in 2014.

HIGHLY RELIANT ON STATE FUNDING: State funding represents the majority of district revenue. As a property and income-poor district, it is scheduled to receive small increases under the governor's proposed 2016-17 biennium budget, which has to work through the legislative process before final determination.

MODERATE LONG-TERM LIABILITIES: Overall debt is expected to remain moderate with consideration of this bond issue, although amortization will slow significantly. Pension costs are currently manageable but could rise depending on how the state manages future payments to the underfunded system. Additional debt is not expected in the near term.

STRONG PROGRAM ESSENTIALS: The bonds qualify for the Ohio School District Credit Enhancement Program, which is characterized by stringent requirements and strong program mechanics.

RATING SENSITIVITIES

LONG-TERM STRUCTURAL BALANCE: Fitch believes that long-term structural balance and the building of reserves to stronger levels will remain challenging. Continued cost cutting in alignment with enrollment declines and the success of the transformation plan remain essential to the district's financial health.

VOTER APPROVAL: The underlying rating could be downgraded if the district fails to receive voter renewal for a 15-mill levy in November 2016 or to identify offsetting measures. Fitch believes spending cuts needed to offset potential revenue losses from a failed renewal would be quite challenging given that the levy totals approximately 10% of the district's operating budget.

PROGRAM RATING: The program rating is sensitive to changes in the state's 'AA+' GO bond rating on which the program rating is based, as well as changes in the statutes, regulations, or administrative procedures governing the program.

CREDIT PROFILE

Of the district's area of approximately 82 square miles, 99.3% is located within the city of Cleveland (GO bonds rated 'A+' with a Positive Outlook by Fitch).

Historically, large declines in enrollment have plagued the district due primarily to the declining city population, the expansion of charter and private schools, and weak academic performance. Average daily enrollment declined by 33% from 2005-06 to 2012-13. Declines appear to have moderated with declines of 1.94% in 2013-14 and 0.52% in 2014-15. Management projects current enrollment of 37,771 will increase by 1.50% in 2015-16 possibly due in part to people moving back into the city along with significant reform to charter schools which makes poorly performing ones easier to close. Nevertheless, Fitch believes the district will continue to face enrollment challenges from charter schools (enrollment has increased by 67% since 2005-06) and a state program that provides students with tuition vouchers that may be used to attend qualifying private schools or schools in contiguous public school districts.

DIVERSE ECONOMY; WEAK SOCIOECONOMIC PROFILE

As one of Ohio's largest metropolitan areas, Cleveland benefits from a measure of scale and diversity. Over the last two decades, the city has diversified its economy from dependency on manufacturing towards the more stable education and health care sectors. The Cleveland Clinic is the largest private employer with approximately 15,000 employees, providing stability. Other large employers include University Hospitals of Cleveland, Metro Health System, and Case Western Reserve University.

Despite diversification, and characteristic of an urban population, the city continues to struggle with above-average unemployment rates and weak socioeconomic indicators. For February 2015, the city recorded an unemployment rate of 8.3%, higher than the 5.6% and 5.8% for the state and nation, respectively. District income levels, as measured on a 2013 per capita income basis, are well below state and U.S. levels at 65% and 60%, respectively. The district's poverty rate remains high at more than double state and national levels.

A county-wide revaluation in 2012 resulted in a 13.5% decline in assessed value (AV) in 2013. Valuation has stabilized as evidenced by modest increases of 0.59% and 1% in 2014 and 2015, respectively. Fitch expects AV to remain stable to modestly increasing given ongoing commercial development and some moderation from high foreclosures. The tax base is somewhat concentrated, with the top 10 taxpayers accounting for 13.2% of AV. Property tax collections remain weak with total collections averaging only 87% over the last three years.

SUMMARY OF DISTRICT TRANSFORMATION PLAN

In July 2012, the Governor signed education reform legislation for the district known as 'The Cleveland Plan' (the transformation plan). The legislation provides the district greater flexibility and more authority as to how teachers are evaluated and allows the district to intervene in lower performing schools, reassign teachers and require them to work more hours, outside the confines of labor agreements. Additionally, the district has the legal authority, via agreements, to share state funds with high-quality charter school partners.

To show support of the transformation plan, in November 2012 district voters passed a four-year (collection through calendar 2016) 15-mill property tax levy. The levy generates approximately \$66 million (10% of operating budget) annually for the district including \$4.4 million (or one mill) which is distributed to charter

school partners. The levy was structured as a four-year renewal to provide for accountability, allowing voters to evaluate the district's success under the transformation plan and whether tax dollars should continue. In November 2016, a Presidential election year, the district expects to position the levy as a renewal of the 15 mills on either a temporary or permanent basis. Preliminary polls, conducted by district management, indicate good voter support for the levy given positive results to date. Under the plan, failing schools have declined by 22%, the graduation rate has increased to 64% from 56% and student satisfaction has increased to 66% from 58.5%.

Fitch views the renewal of the levy as key to the district's on-going financial health. With the exception of the 15-mill levy, all property tax revenues are derived from non-expiring levies. Property taxes comprise approximately 30% of general fund revenues.

FINANCES HIGHLY RELIANT ON STATE FUNDING

Primary support for operations comes from state foundation aid which is 64% of general fund revenues. Under the governor's proposed 2016-17 biennium budget, the district is forecast to benefit modestly with increases of 1.7% in 2016 and 3.0% in 2017 with the phase-out of tangible personal property taxes taken into account. Fitch expects the increasing number of students attending charter schools will continue to negatively impact state funding. The district receives state funding for students who are residents of the district and attend charter schools with such aid transferred to the charter schools for operations. In fiscal 2014 (year-end June 30) the amount transferred was \$141.1 million or about 33% of total district state funding.

For fiscal 2014, the district reported a general fund operating surplus of \$12.2 million from on-going operations. Including transfers out (\$2.3 million) and other sources of \$17.9 million related to the inception of a capital lease for school buses, the surplus totaled \$27.8 million. The unrestricted general fund balance totaled \$70.3 million or an adequate 10.2% of general fund spending, much improved from a low of \$10.3 million or 1.6% of spending in 2012.

On a cash basis, management is estimating better than projected results for 2015 due to lower salary expenses and slightly higher revenues. The unencumbered cash balance at June 30, 2015 is projected at \$69.2 million, or 9.5% of expenses, and \$10 million higher than the October 2014 although lower than FYE 2014. The district's updated October 2014 five-year (2015-2019) cash-basis forecast projects budgetary pressures with annual deficits starting in fiscal 2015. Unencumbered cash balances remain positive through fiscal 2016 with a \$26.4 million cash deficit projected in 2017, increasing to a large \$260.8 million deficit in 2019 (33% of expenses).

The district's strong and experienced management team has taken aggressive steps over the past several years to address the budget imbalance by successfully implementing sizeable spending reductions including the closing of schools, the elimination of teaching positions and labor union concessions. Fitch expects management to continue prudent management of expenses in order to sustain budgetary balance and maintain reserves at adequate levels.

MANAGEABLE DEBT PROFILE

The district's debt burden is moderate at \$1,742 per capita and 4.79% of market value with inclusion of the current \$200 million bond issue. A below-average amortization rate of 39% retired in 10 years (down from approximately 76% prior to the new issue) will moderate the budgetary impact of the new debt.

The district contributes to the School Employees Retirement System (SERS) and the State Teachers Retirement System (STRS) to fund both pension and other post-employment benefits (OPEB). Both SERS and STRS are cost-sharing, multiple-employer defined pension plans with poor funded ratios. Based on a 7% rate of return, Fitch-estimated system-wide funded ratios at June 30, 2013 were 60.3% for SERS and 61.3% for STRS. The district regularly contributes 100% of state-required payments (on a one-year lagged basis), which are actuarially determined. Carrying costs for debt service, pensions and OPEB are modest at 7.8% of total government expenditures but are likely to rise given added debt service costs and possible state-wide pension solutions.

STRONG PROGRAM ESSENTIALS

The 'AA' program rating is based on the qualification of the series 2015A and 2015B bonds for participation in the Ohio School District Credit Enhancement Program. Participation requirements are stringent; including 2.5x coverage of maximum annual debt service (MADS) by unrestricted state foundation aid on proposed bonds and any outstanding obligations covered by the program. Fiscal 2015 estimated state foundation aid to the district is

7.8x MADS for debt to which state aid is pledged.

Program mechanics are strong. Ohio law requires the ODE to forward to a bond paying agent or registrar state foundation payments otherwise due to a participating school district if, prior to the bond payment date, the district has not transmitted funds sufficient to cover a required debt payment. For more information on the Ohio School District Credit Enhancement Program, see Fitch's report dated April 26, 2013 at www.fitchratings.com.

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In addition to the sources of information identified in Fitch's Tax-Supported Rating Criteria, this action was additionally informed by information from Creditscope, University Financial Associates, CoreLogicCase-Shiller Index, IHS Global Insight, Zillow.com and, National Association of Realtors.

Applicable Criteria and Related Research:

- 'Tax-Supported Rating Criteria', dated Aug. 14, 2012;
- 'U.S. Local Government Tax-Supported Rating Criteria', dated Aug. 14, 2012.

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Tax-Supported Rating Criteria
U.S. Local Government Tax-Supported Rating Criteria

Additional Disclosure
Solicitation Status

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