S&P Global
Ratings

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Summary:

Minneapolis Special School District No. 1; Appropriations; School State Program

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Credit Profile		
US$55.07 mil GO L-T fac maintenance bnds ser 2018B dtd 12/05/2018 due 12/05/2038		
Long Term Rating	AAA/Stable	New
Underlying Rating for Credit Program	AA/Stable	New
US$42.12 mil GO sch bldg bnds ser 2018A dtd 12/05/2018 due 12/05/2039		
Long Term Rating	AAA/Stable	New
Underlying Rating for Credit Program	AA/Stable	New

Rationale

S&P Global Ratings revised its outlook to stable from negative and affirmed its 'AA' underlying rating on Minneapolis Special School District No. 1's previously issued general obligation (GO) debt. At the same time, we assigned our 'AAA' enhanced long-term rating and 'AA' underlying rating to the district's series 2018A GO school building bonds and series 2018B GO long-term facilities maintenance bonds. The outlook on all ratings is stable.

Additionally, we affirmed our:

- 'AA' underlying rating on the district's existing certificates of participation (COPs), for which it has an unconditional obligation to make rentals that, although not supported by its full faith and credit pledge, are not subject to annual appropriation and are supported by a special levy; and
- 'AA-' long-term rating on the district's series 2010A and B COPs that are subject to annual appropriation, a rating that is one notch below the GO rating, given the limited nature of the security.

The outlook revision reflects what we view as the district returning to structural balance in the fiscal 2019 budget, one year earlier than previously projected. Additionally, it closed the budget gap, not including a recently passed operating referendum that will bring in an additional $30 million annually beginning in fiscal 2020. With the additional revenue and structural reforms that should aid in controlling expenditures, we view the structural balance as sustainable.

The series 2018A and B and outstanding parity bonds are secured by the district's unlimited ad valorem tax GO pledge. The district will use the series 2018A bond proceeds for various capital improvements, equipment, and bus replacements. The series 2018B bond proceeds will be used to provide funds for deferred maintenance and facility projects at selected school sites.

The 'AAA' long-term rating reflects the additional security provided by the district's eligibility for and participation in Minnesota's School District Credit Enhancement Program, a state standing appropriation program to prevent a default on the district's bond issues as authorized by Minnesota State Statutes, Section 126C.55. Under the program, the state will pay debt service on behalf of the district from the state's general fund if the district fails to meet its debt service

obligations for the qualified debt. Payments from the state represent a standing appropriation from the state's general fund. We view this standing appropriation pledge as equivalent to a general fund pledge because the standing appropriation does not require adoption of a budget or any action of the legislature to make payment. Furthermore, the standing appropriation is not subject to executive unallotment authority. Additionally, the credit enhancement program supports projects that are central to the state of Minnesota's operations and purpose. In our opinion, there is no unusual political, timing, or administrative risk related to the debt payment. The rating on obligations that have received enhancement under the program is on par and moves in tandem with the rating on the state.

Certain outstanding COPs are not secured by its unlimited-tax GO pledge, but the district has an unconditional obligation to make rentals that are not subject to annual appropriation and are supported by a special levy. We rate this security on par with our view of the district's general creditworthiness.

The district's finances have been pressured, but proactive management has lessened the impact. With stable enrollment, controlled expenditures, and a new revenue source through a successful operating referendum, finances are on a more stable footing, in our view. We expect management to continue to close budget gaps and not use any additional general fund reserves and thus remain in compliance with its 8% fund balance policy. Longer term pressures include special education costs and a large capital footprint that requires active management making difficult decisions to maintain strong finances.

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

- Participation in the broad and diverse Minneapolis-St. Paul metropolitan statistical area (MSA) economy, including access to employment opportunities throughout the MSA;
- Good incomes and extremely strong market value per capita;
- Strong general fund available reserves, albeit weaker than in previous years; and
- Low overall debt burden as a percentage of market value.

Partially offsetting those strengths is our view of the recent use of general fund reserves and our belief that the level of available reserves, although strong, is not commensurate with higher rated peers. Additionally, the weak pension funding levels and the large proportionate share of the net pension liability—approaching $200 million—associated with the Teachers' Retirement Association (TRA) multiple-employer pension plan, which, in our view, suggest some likelihood of accelerating payments in the coming years.

The district, which is coterminous with Minneapolis, is home to roughly 422,000 residents. It experienced steep enrollment losses from the fall of 2003 to the fall of 2008, with the student count decreasing by a total of more than 20%. Management attributed the decline to increased charter schools, the resurgent popularity of parochial schools, and reduced inflows from overseas migration. As a result of fewer students, officials closed more than 20 school buildings to reduce expenditures to better match state aid, which is tied to enrollment. The trend appears to have reversed and enrollment was 35,774 in the 2018-2019 school year. There was a two-year increase in 2017 and 2018 due to a pre-K state initiative. Officials attribute the recent growth to strong programming and students choosing the district over charter and private schools. District projections show declines annually through 2027-2028. Enrollment stabilization and growth during the past few years are positive credit factors, in our opinion, as most of the district's

state aid is tied to enrollment.

Economy

As part of the regional economy, district residents have a wide variety of employment opportunities, including very large employers in the public and private sectors. Therefore, Minneapolis' unemployment level has historically been below average and was 3% in 2017.

The University of Minnesota is the largest employer in the city (20,000 employees), and the district (7,000) and Hennepin County (6,600) are also top employers. Leading nongovernment-affiliated employers in Minneapolis include Allina Health (20,000), Target Corp. (8,300), Hennepin Health Care Systems (7,100), Wells Fargo Bank (7,000), Ameriprise Financial Services (4,900), and U.S. Bancorp (4,700).

Incomes in the city are good, in our view, as measured by median household and per capita effective buying incomes at 96% and 113% of the national levels, respectively. In 2016, economic market value, sourced directly from the Minnesota Department of Revenue, was a sizable $52.3 billion or $124,000 per capita, which we consider extremely strong. Given the district's deep and broad tax base, the city has no concentration among its 10 leading taxpayers, which make up a very diverse 7.3% of total net tax capacity. Property tax revenue accounted for 20% of general fund revenue in fiscal 2017, so although enrollment is the driving factor for revenue, we believe that the tax base and voter support remain relevant credit factors.

Finances

The district's available fund balance of $62.8 million is strong, in our view, at 10.4% of general fund expenditures at fiscal year-end (June 30) 2017. The district reported a deficit operating result of 2.4% of expenditures in 2017.

Management has been modestly successful in reducing past budget gaps but performance has been mostly negative over the past five years. For fiscal 2016, preliminary figures indicated a return to balanced operations with an estimated $771,000 surplus resulting in an available fund balance of 13% of expenditures. However, this result was achieved after a $16 million transfer in from the internal service funds. The fiscal 2016 audit matched preliminary figures—but we note the source of the one-time $16 million transfer to balance the general fund (the internal service fund) now has an unrestricted net position of negative $12.1 million. This indicates that source of funding is unlikely in the near future. The fiscal 2017 budget of $586 million was originally balanced with no use of reserves. However, management now indicates it expects to report a $13 million use of reserves—similar to the fiscal 2016 gap without the one-time transfer. The fiscal 2018 budget was also structurally imbalanced with a $16.5 million gap. However, after midyear expenditure controls including freezing traveling and supply budgets, and leaving positions open, management indicates a smaller $2.5 million use of reserves. If this holds, the available general fund balance will be approximately 10.2% of expenditures.

Most notably, the district was able to balance its budget in fiscal 2019 at roughly $604 million. This original budget did not include roughly $30 million in additional revenue beginning in fiscal 2020 from a successful operating referendum. This additional revenue, coupled with tight expenditure controls, should allow for sustained structural balance in the near term.

The district had 189 days of expenditures in cash at fiscal year-end 2017 and does not require cash-flow borrowing.

In November 2016, the voters overwhelmingly approved renewal of the existing referendum revenue authorization of approximately $1,600 per pupil for nine years beginning in 2017. Also, in November 2018, voters approved two ballot questions that will result in additional $30 million in annual revenue.

Financial Management Assessment: Good

We consider Minneapolis Special School District No. 1's financial 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. When forming revenue and expenditure assumptions, the district uses five-year historical analysis and factors inflation into its variable costs. Management provides the board with monthly budget-to-actual reports. The district's five-year master facilities plan is updated annually and informs board decisions on issuing debt for capital improvements. The debt policy guides the board on the types of debt to issue and sets a limit that annual debt costs may not exceed 15% of total operating revenue. We understand the district views its amortization schedule as in compliance with its debt management policy, according to its own calculations. It has an investment policy that adheres to state guidelines, and the board receives monthly reports on investment holdings. The district's fund balance policy calls for a year-end minimum unassigned balance of no less than 8% of the estimated general fund expenditures for the following year, a level it is currently meeting. It lacks a formalized long-term financial plan but we understand one is currently being developed.

Debt

In our view, the district's overall debt burden is low at 2.1% of market value and moderate at $2,912 per capita. The portion of total expenditures dedicated to debt service has historically ranged from 10% to 12%, which we consider moderate. We understand the district will issue debt annually in accordance with its capital plan.

Pension and other postemployment benefits

In fiscal 2017, the district paid $42.8 million toward its pension obligations, equal to 100.0% of the full required contribution. Its full required pension contribution totaled 5.3% of total governmental expenditures. In fiscal 2017, the district also paid $2.8 million, or 0.3% of total governmental expenditures, toward its other postemployment benefit (OPEB) obligations. Combined pension and OPEB carrying charges totaled 5.7% of total governmental fund expenditures in 2017.

Prior to 2013, the district funded its OPEBs on a pay-as-you-go basis. In fiscal 2013, it contributed $19.3 million, more than its $9.3 million annual required contribution to establish an irrevocable trust account for OPEBs, with an initial funding of about $15 million. The unfunded actuarially accrued liability, reported as of July 1, 2015, totaled $46.5 million and was 23.9% funded.

The district participates in the Minnesota Teachers' Retirement Assn. (TRA) and the General Employees Retirement Fund (GERF) that is administered by the Public Employees' Retirement Association (PERA). Both are statewide cost-sharing, defined-benefit pension plans. Required pension contributions to these plans are determined by state statute as a percentage of payroll. Statutory contributions rates have generally not kept pace with actuarially determined contribution rates, indicating potential for future payment acceleration. TRA and GERF were 51.6% and 75.9% funded, respectively, in fiscal 2017. The district's proportionate share of the net pension liability was a combined $196 million, which is sizable, in our view.

The state recently passed pension legislation that will marginally increase contributions for TRA, reduce the investment rate of return to 7.5% (from 8%), and reduce some employee benefits (primarily cost-of-living adjustments). The increased employer contributions were coupled with additional state aid such that it would have a neutral budgetary effect on the district. While we view these as positive changes for future plan funding levels, the lack of an actuarial funding policy remains a weakness in these plans. (For more information about the reforms included in the 2018 omnibus retirement bill and the potential for future cost increases, see our bulletin, "Minnesota's New Pension Bill Is A Positive Step Toward Sustainable Funding," published on June 7, 2018, on RatingsDirect.)

Outlook

The stable outlook on the 'AAA' program rating reflects the rating outlook on the state of Minnesota; both the rating and outlook move in tandem with the state rating and outlook.

Downside scenario

We could lower the rating if the district's estimates for the fiscal 2018 year prove inaccurate and if any unexpected variances result in the fiscal 2019 budget falling out of balance. If reserves are reduced with no immediate replenishment planned, the rating would be pressured. Also, if enrollment returns to a declining trend and if balanced budgets prove unsustainable, we could lower the rating.

Upside scenario

Although unlikely, we could raise the rating after a period of surplus operational results building reserves to levels commensurate with higher rated peers, all while other credit characteristics remain unchanged or improve.

Ratings Detail (As Of November 7, 2018)		
Minneapolis Spl Sch Dist #1 taxable certs of part (recovery zone econ dev bnds)		
Long Term Rating	AA-/Stable	Outlook Revised
Minneapolis Spl Sch Dist #1 taxable certs of part (Build America bnds)		
Long Term Rating	AA-/Stable	Outlook Revised
Minneapolis Spl Sch Dist #1 COPs State Credit Enhancment		
Long Term Rating	AAA/Stable	Current
Underlying Rating for Credit Program	AA/Stable	Outlook Revised
Minneapolis Spl Sch Dist #1 GO alternative facs bnds		
Long Term Rating	AAA/Stable	Current
Underlying Rating for Credit Program	AA/Stable	Outlook Revised
Minneapolis Spl Sch Dist #1 GO rfdg bnds		
Long Term Rating	AAA/Stable	Current
Underlying Rating for Credit Program	AA/Stable	Outlook Revised
Minneapolis Spl Sch Dist #1 GO sch bldg bnds		
Long Term Rating	AAA/Stable	Current
Underlying Rating for Credit Program	AA/Stable	Outlook Revised
Minneapolis Spl Sch Dist #1 GO sch bldg bnds (Qualified School Construction Bnds Taxable)		
Long Term Rating	AAA/Stable	Current

Ratings Detail (As Of November 7, 2018) (cont.)		
Underlying Rating for Credit Program	AA/Stable	Outlook Revised
Minneapolis Spl Sch Dist #1 GO taxable rfdg bnds		
Long Term Rating	AAA/Stable	Current
Underlying Rating for Credit Program	AA/Stable	Outlook Revised
Minneapolis Spl Sch Dist #1 GO State Credit Enhancement		
Long Term Rating	AAA/Stable	Current
Underlying Rating for Credit Program	AA/Stable	Outlook Revised
Minneapolis Spl Sch Dist #1 SCHSTPR		
Long Term Rating	AAA/Stable	Current
Underlying Rating for Credit Program	AA/Stable	Outlook Revised
Minneapolis Spl Sch Dist #1 SCHSTPR		
Long Term Rating	AAA/Stable	Current
Underlying Rating for Credit Program	AA/Stable	Outlook Revised
Minneapolis Spl Sch Dist #1 SCHSTPR		
Long Term Rating	AAA/Stable	Current
Underlying Rating for Credit Program	AA/Stable	Outlook Revised
Minneapolis Spl Sch Dist #1 GO		
Underlying Rating for Credit Program	AA/Stable	Outlook Revised
Unenhanced Rating	AAA(SPUR)/Stable	Current

Many issues are enhanced by bond insurance.

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