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Minneapolis Special School District 1, MN

Update to credit analysis

Summary

Minneapolis Special School District No. 1 (Aa2 negative) benefits from a strong regional economy, a substantial tax base and relatively stable enrollment. These credit strengths are balanced against challenges including an operating reserve position that has materially weakened in recent years and elevated unfunded pension liabilities.

Credit strengths

» Substantial and growing tax base serves as the primary economic region in the state

» Stable enrollment, which supports per pupil operating revenue

» Recent budgetary controls and voter-approved operating and technology levies will help stabilize operations

Credit challenges

» Elevated unfunded pension liabilities and costs

» Multi-year trend of declining operating reserves

Rating outlook

The negative outlook on the underlying GOULT rating, the full term COPs rating, and the annual appropriation COPs rating primarily reflects the district's trend of declining reserves from budget imbalances. Without a demonstrated reversal of its recent financial trends in audited results, the district's credit quality will likely diminish. We also expect that despite state-level reforms, teacher pension funding challenges will persist for Minnesota school districts.

Factors that could lead to an upgrade

» Substantial growth in operating reserves and liquidity

» Moderation of debt and pension burdens

Factors that could lead to a downgrade

» Weakening of the tax base or socioeconomic profile

» Inability to rebuild reserves

» Increases in the debt burden or unfunded pension liabilities

Key indicators

Exhibit 1

Minneapolis Special School District 1, MN	2013	2014	2015	2016	2017
Economy/Tax Base					
Total Full Value ($000)	$33,292,590	$35,496,307	$39,218,446	$42,963,789	$47,202,909
Population	389,112	394,424	399,943	404,664	404,664
Full Value Per Capita	$85,560	$89,995	$98,060	$106,172	$116,647
Median Family Income (% of US Median)	101.8%	104.7%	105.7%	107.5%	107.5%
Finances					
Operating Revenue ($000)	$591,175	$605,181	$629,523	$672,990	$660,334
Fund Balance ($000)	$115,303	$84,107	$98,261	$95,436	$88,790
Cash Balance ($000)	$147,726	$169,035	$168,657	$153,780	$142,771
Fund Balance as a % of Revenues	19.5%	13.9%	15.6%	14.2%	13.4%
Cash Balance as a % of Revenues	25.0%	27.9%	26.8%	22.9%	21.6%
Debt/Pensions					
Net Direct Debt ($000)	$413,401	$384,061	$530,696	$576,380	$637,810
3-Year Average of Moody's ANPL ($000)	$1,698,045	$1,863,525	$1,932,696	$2,063,176	$2,653,558
Net Direct Debt / Operating Revenues (x)	0.7x	0.6x	0.8x	0.9x	1.0x
Net Direct Debt / Full Value (%)	1.2%	1.1%	1.4%	1.3%	1.4%
Moody's - adjusted Net Pension Liability (3-yr average) to Revenues (x)	2.9x	3.1x	3.1x	3.1x	4.0x
Moody's - adjusted Net Pension Liability (3-yr average) to Full Value (%)	5.1%	5.2%	4.9%	4.8%	5.6%

Source: Moody's Investors Service, US Census Bureau, district's audited financial statements

Profile

Minneapolis Special School District No. 1 is coterminous with the City of Minneapolis (Aa1 negative) and serves a resident population of more than 400,000. The district owns and operates eight high schools, seven middle schools, 44 elementary and K-8 schools, seven other academic sites, and seven locations for alternative school programs. Enrollment totals more than 35,000 students.

Detailed credit considerations

Economy and tax base: sizeable tax base coterminous with city of Minneapolis

We expect the district's sizeable and diverse tax base to remain a credit strength due to ongoing development. Coterminous with the city of Minneapolis (Aa1 negative), the district's substantial $52 billion tax base grew 10% during each of the last four years. The district's full value, as measured by economic market value, now exceeds the previous indicated market value reached in 2007 of $39 billion. Government and institutional employment opportunities in the state capital of neighboring St. Paul (Aa1 negative) and at the University of Minnesota (Aa1 stable) support economic stability in the region. A number of corporations and institutions are based within Minneapolis city limits, including Allina Health System (Aa3 stable), Fairview Health Services (A2 negative), and Target Corporation's (A2 stable) headquarters. Significant redevelopment and new development continues to occur within the district.

As of August 2018, the Hennepin County (Aaa stable) unemployment rate (2.4%) was on par with the state's rate (2.5%) and below the national rate (3.9%). Median family income is estimated at a solid 108% of the national figure. The district's population exceeds 400,000 residents, a figure that has been growing since 2000.

Financial operations and reserves: operational imbalance pressures reserves

The district's narrowed operating reserves are a key credit weakness, although recent voter approval of operating levies should help improve financial operations. The district's available General Fund balance of $63 million in fiscal 2017 reflects a significant 50% decline over the past five years. The district closed fiscal 2017 with a $16 million use in reserves primarily due to operational imbalance with expenditures exceeding budgeted revenues, in part due to contract settlements during fiscal 2016 which were more expensive than originally anticipated. The district closed fiscal 2017 with an unassigned General Fund balance of $41 million, equal to 7% of revenue which is below the district's 8% policy.

Although audited fiscal 2018 figures are not yet available, the estimated available General Fund balance totals $60 million, a $2.5 million decrease from 2017. District management had originally identified a $33 million structural imbalance in fiscal 2018. In an effort to right-size expenditures and regain structurally balanced operations, the district implemented a number of expenditure reductions and budgetary controlls in recent years including reducing the number of school days, increasing some class sizes, levying for OPEB costs and negotiating less expensive labor contracts. The district has adopted a balanced fiscal 2019 budget that does not anticipate adding to or using reserves during the year. Favorably, voters approved a $18 million increase in the operating levy and a $12 million technology levy in November 2018. Fiscal 2019 will be the first year the district will receive the new revenue, which should help rebuild reserves.

Enrollment is a key driver of state and local revenue. District enrollment is expected to remain stable, continuing the trend of the past decade. Although district enrollment figures are stable overall, the district continues to lose a greater number of resident students to charter schools and other open enrollment opportunities. The growth of new charter schools has reportedly slowed and local charters mainly serve students in lower grades, allowing the district to recapture their enrollment as they age. To combat these losses the district is conducting a comprehensive enrollment review.

LIQUIDITY

The district closed fiscal 2017 with an operating net cash position of $143 million, equal to an adequate 22% of revenue across the General Fund and Debt Service Fund.

Debt and pensions: moderate debt burden; elevated unfunded pension liabilities

The district has a moderate debt burden, but an elevated pension burden. Inclusive of the district's 2018 bonds, outstanding debt totals $800 million, equal to 1.5% of full value and 1.2x fiscal 2017 operating revenue. The district's adjusted net pension liability (ANPL) totaled $2.7 billion in fiscal 2017, equal to an elevated 5.1% of full value and 4.0x operating revenue. As a result of strong investment performance and benefit changes enacted by the state, the district's ANPL will decline in both fiscal 2018 and 2019.

The district's formal debt policy to keep total annual debt service expenditures less than 15% of operating expenditures, and structure amortization so that 70% of GO principal is repaid in ten years limits substantial growth in debt. The district typically issues at least $50 million in capital funding annually.

The district's fixed costs, inclusive of debt service, pension contributions, and other post-employment benefit (OPEB) costs, are equal to 20% of fiscal 2017 operating revenue. Minnesota school districts' pension contributions have remained relatively consistent in recent years under statutory requirements. However, these statutory contribution levels have not kept pace with funding needs of statewide plans, driving growth in unfunded liabilities.

DEBT STRUCTURE

The district's debt structure includes $532 million of GOULT (Aa2 negative) debt, $237 million of Full Term COPs (Aa2 negative), and $34 million of COPs subject to annual appropriation (Aa3 negative). All of the district's debt is fixed rate and amortizes over the long term.

DEBT-RELATED DERIVATIVES

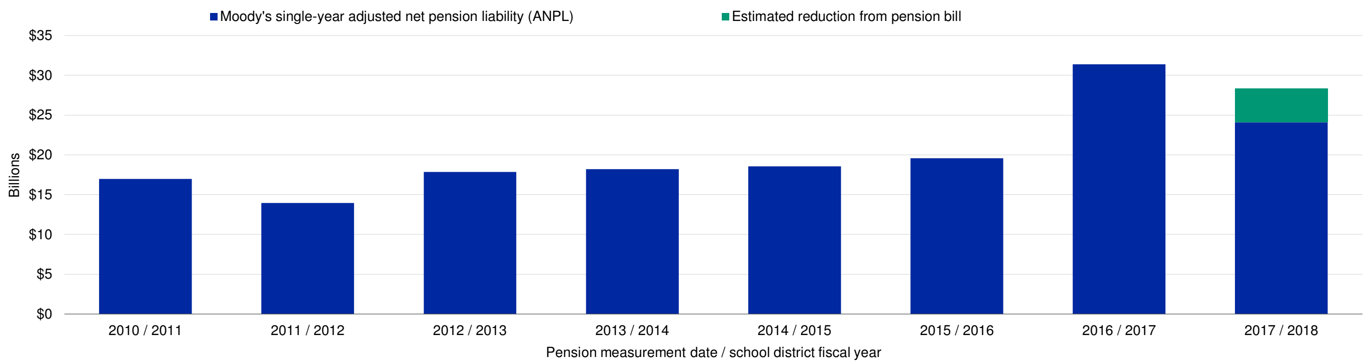
The district is not a party to any interest rate swap agreements.

PENSIONS AND OPEB

The district participates in two multiple-employer cost-sharing plans, the General Employees Retirement Fund (GERF) and the Teachers Retirement Association of Minnesota (TRA). The majority of its unfunded liabilities are attributable to the TRA. Whether measured on a reported basis or using our Moody's standard balance sheet adjustments, the district's unfunded liabilities have increased significantly. Growth in the TRA's reported Net Pension Liability (NPL) in the district's fiscal 2017 reporting was largely driven by plan depletion projections, which in turn require the use of a lower discount rate under governmental pension accounting standards. Growth in the Moody's ANPL has been driven by investment returns, weak contribution practices and falling market discount rates. Between 2014 and 2016, the ANPL for TRA increased by nearly 70%.

The TRA's ANPL decreased by 10% in its fiscal year 2017 due to strong investment performance, which will be reflected in fiscal 2018 measurements for school districts. Additionally, the state of Minnesota approved legislation in 2018 that will modify benefits, including reducing the COLA to 1% from 2%, and modestly increase contributions to TRA. An updated accounting valuation reflecting the changes has not yet been published, but we preliminarily estimate that the reforms will reduce the ANPL of TRA by approximately 15%. Despite these changes, unfunded liabilities will still remain elevated, and above 2014 levels (see Exhibit).

Exhibit 2
Legislation will reduce TRA liabilities, though pension burdens will remain high
Estimated reduction from the pension legislation on 2017 TRA ANPL



Source: Moody's Investors Service, TRA comprehensive annual financial reports (CAFRs), Minnesota Legislative Commission on Pensions and Retirement

Contributions to TRA from all participating governments in aggregate amounted to only 61% of the plan's "tread water" indicator in 2017. Our tread water indicator represents government contributions required to prevent reported unfunded liabilities from growing, under reported assumptions. As a part of the state's 2018 pension legislation, school districts will modestly increase TRA contributions to 8.75% of payroll in 2024 from 7.5% in 2018. The state will increase aid to school districts to offset the increased costs of their required employer contributions. Despite the benefit reforms and increased contributions, we expect the tread water gap will persist thus exposing participating districts to growing unfunded liabilities.

Other post-employment benefits (OPEB) obligations do not currently represent a material credit risk for the district. During fiscal 2017, the district made a $2.4 million pay-as-you-go contribution to its other post employment benefits (OPEB) plan. The district's unfunded actuarial accrued liability (UAAL) totals $46 million. The district maintains $16 million in an OPEB trust.

Management and Governance: moderate institutional framework

Minnesota school districts have an Institutional Framework score of A, which is moderate. Institutional Framework scores measure a sector's legal ability to increase revenues and decrease expenditures. Minnesota schools are highly dependent on state aid, averaging 70% of General Fund revenues. State aid is moderately predictable and is based on a per pupil funding formula, with some adjustments for wealth and need. Schools have moderate revenue raising ability and can increase operating levies through board or voter approval. The standard referendum cap increases annually with inflation and grew to approximately $1,984 per pupil in fiscal 2019 from $1,934 per pupil in fiscal 2018. Unpredictable revenue fluctuations tend to be moderate. Across the sector, fixed and mandated costs are generally moderate. Minnesota has public sector unions, which can limit the ability to cut expenditures. Expenditures are highly predictable with personnel and benefits representing the largest costs.

Minneapolis Special School District No. 1 hired a new superintendent in 2016 and a new CFO in 2015. The new CFO outlined plans for reducing district expenditures and improving budgeting and accountability. Improved financial policies is a positive management factor. However, despite these efforts, reserves have declined materially in recent years.

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