Pennsylvania School Districts
Stronger Credits Than Ratings Imply

JANNEY FIXED INCOME STRATEGY

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PA's budget impasse has strained local school district credits, with multiple negative rating actions, but intercept programs remain a strong credit feature

Pennsylvania has a long history of consistently supporting public education funding, but the current budget impasse, extending nearly seven months and counting, has damaged the state's credit reputation and more specifically led to multiple rating downgrades for many school districts.

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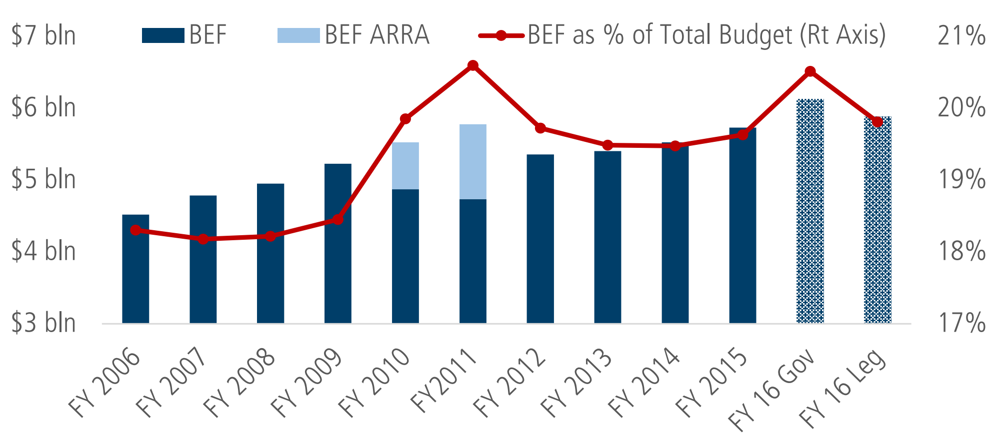
- The Pennsylvania state aid intercept programs have historically added an important layer of bondholder security to school district bonds.
- The value of the intercept programs is manifested in frequently higher ratings than underlying school district finances justify, which translates into lower borrowing costs for less wealthy, lower rated districts.
- Pennsylvania has a long history of consistently supporting public education funding, but the current budget impasse, extending nearly seven months and counting, has damaged the state's credit reputation and more specifically led to multiple rating downgrades for many school districts.
- Despite rating downgrades, we believe the intercept programs continue to add security for bondholders, which may not be reflected in recently lowered and withdrawn ratings.
- As the largest recipient of state aid and the most prolific borrower among state school districts, Philadelphia School District is a unique situation, as discussed in our appendix.

Like many states, Pennsylvania has programs that add a layer of bondholder security for local school district bond issuers. These so-called state aid intercept programs, supported by longstanding legislation, have traditionally allowed many school districts to earn ratings which are higher than they would otherwise garner based on underlying credit metrics. A key example is Philadelphia School District which carries underlying ratings of Ba3/NR/BB-, but was rated A1/A+/A+ as recently as last summer. The higher enhanced ratings have allowed Philadelphia School District and many of the state's other 499 districts, to finance capital expenditures at lower rates than they would pay if bondholders could rely only on the underlying ratings and creditworthiness of the districts (more on Philly Schools in appendix). The failure of Pennsylvania's governor and legislators to agree on a budget for the fiscal year that began on July 1, 2015, stopped the flow of critical state aid to school districts and led to several rounds of rating actions including downgrades and rating withdrawals.

PA's Basic Education Funding Appropriations are the Largest Budget Line Item



Source: Janney FIS, PA Office of the Budget, FY 2016 Gov is Governor's proposal, FY 2016 Leg is House Bill

Pennsylvania Education Funding

The largest single line item in the entire budget is K-12 basic education funding (BEF), totaling $5.7 billion in FY 2015

Funding and supporting education is one of a state's most critical functions. Pennsylvania has historically budgeted more than 40% of its general fund spending ($12 billion out of $29 billion in FY 2015) toward various educational endeavors including public schools, special education, community colleges, and state sponsored universities. The largest single line item in the entire budget is K-12 basic education funding (BEF), totaling $5.7 billion in FY 2015. This BEF aid is distributed to public school districts according to a formula which takes into account:

- Number of students
- Number of students in poverty, acute poverty and concentrated poverty
- Number of limited English proficient students
- Number of students in charter schools within the district
- Sparsity and size relative to other districts (adjusts for small rural districts)
- District's median household income index
- Local Capacity – district's ability to generate local tax-related revenue

The Intercepts

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Act 150 Program (post-default)

This is the basic program that is applicable to all school districts. In the case of non-payment of debt service by a district, the state Secretary of Education will withhold amounts from appropriated funds and remit directly to bondholders (fiscal agent) until any deficiency is cured. In theory this kicks in after a default, thus the post-default designation, but in a recent instance (April 2015), the state forwarded money for debt service to the bond paying agent for the distressed Penn Hills School District in Allegheny County before it was due, thus averting a default. The Penn Hills example notwithstanding, a risk of the post-default program is that the state learns of a problem and send funds to the paying agent after a payment is missed, so bondholders receive their payment late. Another consideration is adequacy of funds. In most if not all cases, the amount of state aid payment should be adequate to cover debt service, but the state aid distribution formula weights aid amounts towards less wealthy districts, with more poverty or lower incomes. In Philadelphia, where about 25% of the population lives below the poverty line, state aid of $1.3 billion (FY 2014) amounts to more than 4.5 times annual debt service of $271 million.

Fiscal Agent Agreement (pre-default)

Under this pre-default program, the school district agrees to pay debt service to its fiscal agent (paying agent) in advance of the bond payment date. If the payment is not made, or if it is deficient, the fiscal agent agrees to notify the state, which will then send appropriated aid directly to the fiscal agent on or before the payment due date so that bond holders are paid on time.

State Public School Building Authority (pre-default)

Under this pre-default program, used by Philadelphia and Chester Upland School Districts, the districts are obligated to make lease payments to the State Public School Building Authority conduit, but the underlying agreement requires the state to direct appropriated state aid equal to upcoming debt service directly to the Authority.

The Appropriation Fly in the Intercept Ointment

The intercept programs are strong security features that assure that appropriated state aid can be diverted to pay bondholders in the event of a default or pending default. Without a budget agreement, however, there are no appropriations. There is no money to divert. This is the morass in which many Pennsylvania school districts found themselves in the summer and fall of last year. Wealthier districts, which are less dependent on state aid to start with, typically have sufficient financial reserves to tide them over when state aid payments are delayed due to lack of a budget. Less wealthy districts, however, often faced a cash flow squeeze as expenses, including debt service continued, but revenue from state aid stopped. Some districts were forced to borrow money, usually through the issuance of short term revenue anticipation notes, which added up to about $1 billion for cash strapped districts, about half of that amount borrowed by Philadelphia SD. Several districts were considering closing schools or not reopening after the winter vacation.

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When the legislature presented the governor with a spending bill in late December, he used his line item veto authority to nix about $6.3 billion of the $29.7 billion approved by legislators, including about half of the basic education funding (BEF), releasing sufficient funds to just about cover aid for the first half of the fiscal year, but starting the clock on another negotiation and potential shortfall for the second half. The amount of BEF is one area of dispute between the Republican legislature and Democratic Governor Wolf, but there are others including tax increases and pension reforms. The governor's budget proposal included $6.1 billion of BEF, an increase of 7% over the prior year and consistent with the campaign promise to increase K-12 funding. The bill presented by the legislature for signature proposed $5.9 billion, a much smaller increase. It's important to note that neither side of this dispute proposed lowering BEF amounts.

Negative Rating Actions

During the first two months of budget impasse, the rating agencies watched. The state was able to make some small amount of aid payments to some school districts from other available funds, but this was only a band aid. Rating agency pressure began in September, culminating with three rounds of downgrade from Moody's and S&P's withdrawal of intercept based ratings entirely. Fitch rates a small number of Pennsylvania districts and took no action, leaving its intercept based rating at A+.

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Debt Service Coverage by State Aid Varies Across Districts - A Sampling

School District	Underlying Ratings M/S	Moody's Intercept Rating	Enrollment 2014-15	Annual Debt Service	State Aid	DS Coverage Ratio
Philadelphia	Ba3/NR	Ba2	200,155	$271 mln	$1,258 mln	4.64x
Pittsburgh	Aa3/A	Baa1	25,504	$53 mln	$248 mln	4.65x
Allentown	NR/A	-	18,468	$16 mln	$144 mln	8.75x
Reading	Baa2/NR	Baa1	17,303	$25 mln	$159 mln	6.48x
West Chester Area	Aaa/NR	-	11,624	$21 mln	$34 mln	1.61x
Scranton	NR/NR	-	9,598	$10 mln	$61 mln	5.95x
Pocono Mountain	Baa2/A+	Baa1	9,130	$23 mln	$51 mln	2.21x
Coatesville Area	Baa2/BBB+	Baa1	7,297	$13 mln	$41 mln	3.06x
State College Area	Aa1/AA	Baa1	6,776	$8 mln	$20 mln	2.58x
Pine-Richland	A1/AA-	Baa1	4,576	$9 mln	$14 mln	1.46x
Penn Hills	B3/NR	B1	3,903	$11 mln	$29 mln	2.61x
McKeesport Area	Ba1/A	Baa3	3,560	$3 mln	$36 mln	10.45x
Chester-Upland	NR/NR	-	3,205	$7 mln	$86 mln	11.90x

Financial data is from school district financial statements FY 2014 or FY 2015 (where available). State aid includes BEF as discussed on pages1-2 as well as special education, pupil transportation and other education related aid. Enrollment numbers include charter schools

Source: Janney Fixed Income Strategy, School District Audited Financial Statements, PA Dept of Education, Moody's, S&P

Investors who invested in A-rated securities may now have bonds rated in the Baa category or that carry no rating at all. Highly rated districts, such as West Chester and State College in our table, are perhaps inconvenienced by the aid shutoff, but have sufficient resources and carry strong enough underlying ratings to attract plenty of buyers at competitive interest rates should they need to borrow. Schools with lower underlying ratings, which had previously relied on higher intercept based ratings to borrow at economic interest rates, may face higher borrowing costs, and in some cases reduced market access, unless/until Moody's and S&P raise or reinstate intercept based ratings – which best case will take time and worst case may take a very long time.

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The PA Budget Impasse Has Generated Multiple Negative Rating Actions

Date	Action
July 1, 2015	Pennsylvania begins Fiscal Year 2016 with no budget
September 4, 2015	S&P places all intercept ratings on Watch Negative
September 10, 2015	Moody's downgrades 14 pre-default ratings to A2 from A1
September 10, 2015	Moody's downgrades 149 post-default ratings to A3 from A2.
October 16, 2015	Moody's revises the outlook on Aa3 rating of Pennsylvania GO to negative from stable
November 4, 2015	Moody's downgrades 13 pre-default ratings to A3 from A2
December 11, 2015	S&P withdraws all intercept based ratings which had been A+ (pre-default) and A (post-default).
December 22, 2016	Moody's downgrades the rating cap on most intercept based ratings to Baa1 from A3 and eliminates rating distinction between pre-default and post-default.

Source: Janney Fixed Income Strategy; Moody's, S&P

Back to the State

The fact that Pennsylvania's political leadership let the school funding situation deteriorate for six months reflects poorly on the state's "willingness" to meet obligations although we need to emphasize that no school districts defaulted on debt. To make matters worse, this was not a fight over whether to reduce school funding, but rather a dispute over whether and by how much to increase state support for K-12 public schools (among other issues such as taxes and pension reform). With some schools considering closing, the pressure from voters to resolve the problem was strong from both sides of the aisle. We suspect the state has learned a lesson and would be unlikely to let such a funding gap occur again. With the budget impasse continuing into a seventh month we may find out soon.

Municipal borrowers underlying Revolving Fund issues have average rating of A1.

Beyond the budget impasse, it would be wise for state legislators to revisit the intercept programs with an eye towards improving the mechanics in such a way that a basic education funding stream would be better insulated from budget battles. The funds have been available throughout the six months of stalemate, but the distribution mechanism failed.

Intercepts Remain a Positive Security Feature for PA School Districts

Notwithstanding the six month delay in aid distribution due to failure of the state to enact a budget, and understanding that the FY 2016 aid amount and distribution is yet to be finalized, since the budget fight continues, we believe the state's intercept programs remain strong security features for bondholders.

- Even with a late budget, the primary risk is one of when payment is made rather than if it will be made. In a worst case basis, lacking state budget agreement, if a district lacks internal liquidity to make a debt service payment, and if that district has no access to cash flow borrowing, it may miss a debt service payment, but once a budget agreement is reached, the intercept mechanics will send state aid funds to bondholders (via fiscal agent) to catch up on payments.

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- The state has a strong history of support for educational funding. Neither side of the current budget battle has proposed reducing state funding. Beyond budget battles, we believe state funding will continue to be appropriated each year (with potential delays), and if necessary, the intercept will work to assure bondholders are paid.
- Loss of ratings or the significant downgrades which many school district issuers have received may have reduce marketability, potential liquidity and more specifically valuations. Despite recent events and a few close calls (i.e. Penn Hills) there have been no defaults by Pennsylvania School Districts in recent memory.

Pennsylvania has a strong history of support for public education funding

Conclusion

Although the impact of the Pennsylvania budget fights is a serious credit issue for Pennsylvania school district investors, no payments have been missed to date, despite a six month delay in state funding. We believe the intercept mechanisms remain a solid security feature for investors and hope to see Pennsylvania political leadership resolve the budget dispute in the near future. Beyond budget resolution, we urge Pennsylvania lawmakers to revisit the legislation underlying the intercept programs with an eye to modifying them so the flow of state aid is partially or completely insulated from budget difficulties. The funds are available, but are trapped by the politics of budgeting.

Appendix – Philadelphia School District

No issuer in the Commonwealth has been more affected by the rating agency actions regarding the state intercept than the Philadelphia School District (PSD). In June of last year, before the budget impasse began to play out, PSD was rated Ba3/NR/BB- based on its underlying financial situation and A1/A+/A+ based on the intercept. Now, following three Moody's downgrades and withdrawal of the S&P rating, the underlying rating is unchanged but the intercept based rating is Ba2/NR/A+ (Fitch has taken no rating actions related to Pennsylvania's budget problems).

While this analysis does not serve as an in depth financial review of the district, we do consider Philadelphia's participation in the state intercept program and individualized collection and payment mechanics unique to the district. In doing so, it is important to note that ongoing structural deficits remain an albatross around the neck of the district and examination of underlying financials should be part of any pre-purchase due diligence. As the table shows, the PSD cumulative general fund balance, a key measure of financial reserves, have been consistently negative in recent years.

We believe the Philadelphia School District credit is significantly stronger than the current ratings imply

Until intercept based ratings are reinstated, which we believe to be unlikely near term, Philadelphia School District will incur higher borrowing costs, commensurate with their newly bestowed below investment grade rating. It is possible that the state's budget stalemate, only partially addressed by recent actions, could continue, creating more problems in the future. The primary risk is one of timing. It is not so much a matter of "if" state aid will be forthcoming but "when". Nevertheless, we believe the Philadelphia School District credit is significantly stronger than the current ratings imply.

District

The School District of Philadelphia is the 8th largest district in the US with attendance of almost 205,000 projected for the 2015-16 school year (about 60,000 of whom are in charter schools within the district), making its essentiality for the Philadelphia area apparent. The district has a long history of structural imbalances and fiscal issues. Notably, in 2001, the district was officially declared as distressed by the state and a School Reform Commission was established in lieu of a traditional school board. Philadelphia is highly dependent upon state aid for its funding, with state funding comprising almost 54% of fiscal 2014 revenues. Despite total revenues growing 4% since 2011, the district's net accumulated deficit more than doubled to -$96 million in 2014.

PSD Carries Persistently Negative Fund Balances

	2011	2012	2013	2014
State Aid	$1,220 mln	$1,208 mln	$1,223 mln	$1,258 mln
Debt Service	$276 mln	$167 mln	$259 mln	$271 mln
DS Coverage	4.42x	7.25x	4.72x	4.64x
Fund Balance	-$43 mln	-$112 mln	-$41 mln	-$97 mln

Source: Janney Fixed Income Strategy; Phila. SD Audited Financials

The district includes 218 public schools comprised of: 149 elementary schools, 93 K-8 schools, 16 middle schools, and 54 high schools. Additionally, there are 84 charter schools and 24 alternative educational programs. From an organizational standpoint, the district has faced challenges of enrollment mix as parents seek better performing alternatives. As traditional public school attendance has been decreasing, there has been a corresponding increase in charter school attendance, with much of the district's revenue following the students.

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Credit Strengths

- Taxes collected by the City, acting as the school district's tax collector, are sent directly to the fiscal agent for debt service payment on general obligation bonds.
- Under two state intercept programs, PSD debt service is paid to the fiscal agent by the state from state education aid, using a lock box mechanism whereby funds are paid directly to the fiscal agent, bypassing the school district and eliminating potential co-mingling or other diversion.
- State aid covers all debt service payments by 4.64x (FY 2014), although this coverage has declined from 7.85x in 2005.

Credit Weaknesses

- School District finances are stressed with negative fund balances and liquidity, which must be supplemented by regular cash flow borrowing.
- State aid payments, which support the intercept programs and ongoing operation, are subject to legislative appropriation. Lack of a state budget, as currently being experienced, can delay these payments and imperil timely debt service payments.
- The amount of state aid appropriated by the legislature could be reduced in future years.
- The school district has no independent taxing power, instead relying on the city to authorize tax levies.

Debt Profile

The Philadelphia School District (PSD) has approximately $3.1 billion of debt outstanding, consisting of:

- $1.63 billion fixed rate general obligation
- $0.35 billion un-hedged variable rate general obligation
- $1.12 billion fixed rate lease rental – Pennsylvania State Public School Building Authority

General Obligation Debt

The City of Philadelphia, in its role of tax collector for the school district, is required to remit property and other tax receipts, when collected, to sinking funds held by the fiscal agent for payment of general obligation debt service. Under the Pennsylvania School District Fiscal Agent Agreement intercept program, if taxes collected by the City are insufficient to pay debt service, the state will remit state aid funds to the fiscal agent to pay debt service on a pre-default basis. The taxes collected by the City on behalf of PSD are the first source of funds for debt service payments while the state's intercept program acts as a backup source of funds.

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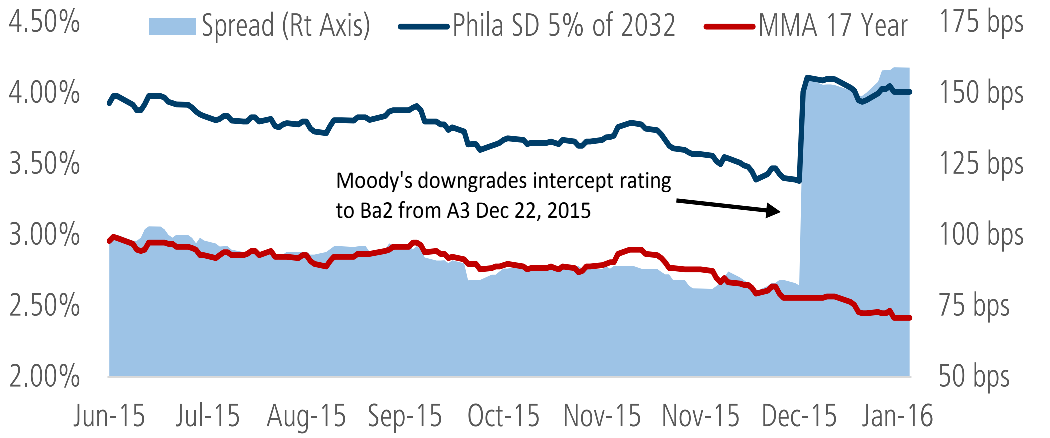
State Public School Building Authority Debt

Under the State Public School Building Authority Lease Revenue intercept program, the state withholds money from state aid appropriations in amounts equal to required debt service payments (lease rental payments), and remits directly to fiscal agent.

The Budget Impasse Led to Downgrades and Sharply Wider Spreads



Source: Janney Fixed Income Strategy, Interactive Data Corp, Municipal Market Analytics

Investment Considerations

With current ratings below investment grade, we advise caution for investors considering Philadelphia School District bonds

With current ratings below investment grade, we advise caution for investors considering Philadelphia School District bonds. As the graph show, prices (expressed as yields and spreads in the graph) fell sharply when the final investment grade rating was removed on December 22, putting uninsured PSD bonds into high yield territory. The district's underlying finances are challenged, and there is no immediate solution in sight. As with many urban districts, charter schools, while often offering attractive educational alternatives for students and parents, act as a drain on district resources. Charter schools are funded by payments from the school district as mandated by the state, but the amount of district expense associated with payments to charter schools is not easily offset by realized savings from having fewer students.

Chicago Public Schools (B1/B+/B+) offer an interesting comparison to Philadelphia School District.

Chicago Public Schools (B1/B+/B+) offer an interesting comparison to Philadelphia School District. Both Chicago and Philadelphia School issuers are rated below investment grade, and based on ratings and financial analysis, Chicago is the weaker credit, but more importantly for this report, Chicago School bonds do not benefit from an Illinois intercept. Like Philadelphia, Chicago receives a large amount of aid from the state (both Chicago and Philadelphia argue that it is not enough), but Illinois sends the aid directly to the Chicago Board of Education, which in turn is responsible for paying debt service. In contrast, the Pennsylvania aid due the Philadelphia SD is "intercepted" and sent directly to the fiscal agent to pay debt service, bypassing the school district.

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