Fitch Rates Denver School District No. 1, CO's COPs at 'AA'; Outlook Stable

Fitch Ratings-Austin-18 April 2017: Fitch Ratings has assigned a 'AA' rating to the following Denver School District No. 1 (the district), CO certificates of participation (COPs):

--$34 million COPs, series 2017A;
--$14.6 million COPs, series 2017B.

The Rating Outlook is Stable.

Proceeds of the 2017A COPs will fund the construction of a new elementary school. The 2017B COP proceeds will be used to purchase the school site for the new elementary school and fund a portion of the design and construction costs of a fire station near the school site. The 2017A COPs and 2017B COPs are scheduled to price on May 2 and May 17, respectively, via negotiation.

SECURITY
The COPs are payable from annual base rental payments made by the district, subject to annual appropriation.

KEY RATING DRIVERS

The Issuer Default Rating (IDR) of 'AA+' reflects Denver School District No. 1's (the district) strong revenue growth prospects, solid expenditure flexibility, moderate long-term liability burden and expectations for an adequate level of financial flexibility in a moderate economic downturn. The 'AA' COP rating reflects the slightly higher degree of optionality associated with payment of appropriation debt.

Economic Resource Base

The district is coterminous with the city and county of Denver which has an estimated 2015 population of 682,545. Denver serves as the commercial hub for a large, 10-county metropolitan area and as the seat of state government. The district's enrollment base is the largest in the state at over 92,300.

Revenue Framework: 'aa' factor assessment
Despite slower projected enrollment growth, general fund revenue growth is expected to remain in line with U.S. GDP growth due to the district's reliance on property tax levies that grow with assessed valuation (AV) rather than the state's school funding formula and expected increases in state appropriations. The district's independent legal ability to raise property tax revenues is limited by state law, which requires voter approval for tax increases.

Expenditure Framework: 'aa' factor assessment
Projected moderating annual enrollment gains are expected to ease spending pressure, enabling the pace of spending to remain generally in line with revenues. Sound expenditure flexibility stems from moderate carrying costs and the district's considerable control over workforce costs.

Long-Term Liability Burden: 'aa' factor assessment
The long-term liability burden is moderate relative to personal income. Fitch expects future growth in direct and overlapping debt to be accompanied by gains in personal income, keeping this burden moderate. The district's net pension liability is projected to grow due a state statutory reduction in pension contributions below actuarially-determined levels.

Operating Performance: 'aa' factor assessment
Fitch expects the district's financial flexibility to remain adequate through a moderate economic downturn based on its limited revenue volatility, solid expenditure flexibility and financial reserves.

RATING SENSITIVITIES
Shift in Fundamentals: The IDR and bond rating are sensitive to material change in the district's strong expenditure flexibility and sound financial position, which Fitch expects the district to maintain throughout economic cycles.

CREDIT PROFILE

The local economy continues to expand rapidly, with continued sector development in professional and business services, education and healthcare, and tourism. The expansive employment base remains resilient in the face of low oil prices and stalled exploration activity within the Front Range. A young population and highly educated workforce are expected to support healthy economic growth over the medium and long term per IHS. The district's 2015 per capita personal income of $68,299 is 134% of the U.S. average.

Rapid home price appreciation fueled a large 26% gain in assessed value (AV) in 2016, and expected additional price increases will likely lead to additional reassessment gains in 2018. Per Zillow, Denver's median home value increased to $373,600 in March 2017, a 10% gain over the prior year. An estimated $2.5 billion in new construction that is either underway or planned in the resurgent downtown area will also benefit the district's tax and employment base.

Revenue Framework

Property tax revenues accounted for 56% of general fund revenues in fiscal 2016, followed by state revenues at 38%. State revenues are primarily driven by enrollment, as Colorado seeks to ensure a certain level of per-pupil spending for all school districts. The school funding formula is based on a state-wide base of per pupil funding which is adjusted for each district to account for differences in the cost of living, school district size, personnel costs, at-risk students, and on-line instruction.

Annual growth in the resulting total program funding (TPF) is limited by state law to the rate of inflation and enrollment growth unless district voters approve a waiver. Denver School District No. 1 voters approved such a permanent waiver in 1999.

The district's general fund revenues grew at a rate above inflation and U.S. GDP growth over the 10 years ended in fiscal 2016. Historical revenue growth benefited from the various permanent, voter-approved mill levy overrides (MLO) that are not included in the state funding calculation and thus capture the growth of its rapidly expanding tax base. In November 2016, voters approved a new MLO that annually adjusts to generate the maximum total MLO revenue allowed by state law, an amount equal to 25% of TPF plus inflation. For fiscal 2017, this new MLO is projected to generate $56 million or 11% of fiscal 2016 general fund property tax revenues.

Fitch expects that general fund revenues will continue to grow at about the same rate as national GDP because growth in the MLOs will reflect expected strong TAV increases and the state has been increasing appropriations to make up for cuts during the recession. Medium-term enrollment growth is projected to remain sluggish at 1%, down from the previous average of 3% -4%. Fitch believes that slower enrollment growth is due to the rapidly rising cost of housing. District management also attributes slower enrollment growth to a lower birth rate. Charter school enrollment represents 20% of the district's total enrollment base, up from 11% in 2010.

The district's independent ability to raise property tax revenues is limited by state law. Any increase to the operating tax levy requires voter approval. Locally controlled charges and fees provide a modest amount of revenue flexibility.

Expenditure Framework
The district's main expenditure area is instruction at over 53% of general fund spending, followed by support services at 38% (which includes instructional support and pupil supporting services). Charter schools operate as component units of the district and do not directly impact the district's financial operations.

Fitch expects expenditure growth to generally align with revenue growth absent policy action. Enrollment growth pressures are easing.

The district's fixed-cost burden is moderate, with carrying costs for debt service, pensions, and other post-employment benefits equal to 13.9% of fiscal 2016 governmental expenditures. The district retains control over employee headcount and negotiates wages and benefits with its various bargaining units through a meet and confer process, providing management with significant flexibility in managing its workforce costs.

Long-Term Liability Burden

The district's long-term liability burden, comprised of debt and net pension liabilities, equals about a moderate 13% of personal income. Over 55% of the liability burden is comprised of the district's direct debt. The district has issued about three-quarters of a $572 million bond authorization approved by a high 65% of voters in November 2016. The bulk of the authorization (44%) will address deferred maintenance needs while about 25% will provide new capacity throughout the district. Fitch projects the long-term liability burden will remain moderate upon the issuance of the remaining authorization over the next 18-24 months and additional overlapping debt which Fitch expects will be accompanied by continued gains in personal income. The 10-year principal pay out rate for GO bonds and COPs is slow at 31%.

The annual base rentals for the current COP offerings are payable from all legally available funds of the district but will be supported primarily from tax increment finances (TIF) revenues derived from the large Stapleton redevelopment project in eastern Denver. The district will receive these TIF revenues via agreements with the city of Denver, Denver Urban Renewal Authority, Park Creek Metropolitan District, and the developer of the Stapleton project. The assets securing the COPs consist of a combination of district school facilities outside of the financed projects.

On Jan. 1, 2010, all employees of the district became members of the Public Employee Retirement Association (PERA) of Colorado. PERA is a cost-sharing, multiple-employer defined benefit plan, but it administers the district's pension program as a single-employer plan with its assets, liabilities and obligations separate and distinct from those of the other schools within PERA.

The district has $923 million in outstanding COPs that were issued to reduce its unfunded actuarially accrued liability (UAAL). Under GASB 67 and 68, the district's fiduciary net position equaled 79.3% of the total pension liability as of Dec. 31, 2015, a ratio that falls to 75.1% using Fitch's more conservative 7% rate of return assumption. Contributions are determined by state statute, rather than actuarially, and have historically fallen short of the actuarially determined level.

Statutory changes in the district's pension contribution levels will cause a deliberate ramp-up in its NPL but Fitch believes it will remain consistent with an 'aa' long-term liability burden assessment. Per statute, a five-year true-up calculation lowered the district's pension contribution rate from 13.75% of payroll to 10.15% as of Jan. 1, 2015. The true-up is designed to assure that the district's UAAL to payroll ratio is equal to PERA's by Dec. 31, 2039. The UAAL to payroll ratio of PERA's school division equaled 350% as of Dec. 31, 2015, compared with the district's ratio of 112%. PERA's assets to liability equals 57.5% of its total pension liability using Fitch's 7% rate of return assumption. A revised benefit structure imposed for statewide school employees hired after Dec. 31, 2006 will improve PERA's school division assets to total pension liability ratio over the long term. Fitch believes this may allow future five-year true-ups to stabilize or improve the district ratio of assets to total pension liability.

Operating Performance
The district's strong gap-closing capacity is enabled by its expenditure flexibility and healthy financial reserves, supporting Fitch's expectation that the district can readily manage through economic downturns given its moderately low revenue volatility.

The district accumulated a sound fund balance in the wake of state revenue reductions imposed in fiscal 2010 and AV declines in fiscal years 2012 and 2013. A portion of reserves was intended to fund short-term operating costs including a five-year cycle of curriculum adoption totaling $6 million - $8 million per year. The district posted a planned drawdown of $12 million (1.3% of spending) in the fiscal 2016 audit to mitigate the instructional impact of the recurring shortfall in state revenues, totaling $87 million (10% of general fund revenues). The resulting unrestricted fund balance declined to $68.8 million or 7.7% of spending from 16.7% in fiscal 2011. As expected, the district's 15% fund balance policy (which includes the required restricted 3% emergency cash reserve) was amended to include a 10% floor. Net of the 3% emergency cash reserve (which Fitch discounts due to its very restrictive conditions), the effective fund balance minimum is 7%, above the 6% threshold required for a 'aa' financial resilience assessment relative to the district's historical modest revenue volatility. Fitch expects the district to maintain reserves above this threshold, which is slightly below its policy floor, throughout economic cycles.

Due to the mill levy override approved recently, management projects the amended fiscal 2017 budget will increase unrestricted reserves by $26 million (2.8% of spending), leading to an unrestricted general fund balance estimated at 10% of spending. The district's five-year financial forecast projects balanced results through fiscal 2021, assumes state revenue cuts will not be restored, and is based on modest enrollment growth.

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In addition to the sources of information identified in Fitch's applicable criteria specified below, this action was informed by information from Lumesis and InvestorTools.

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Applicable Criteria

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