FitchRatings

RATING ACTION COMMENTARY

# Fitch Upgrades Philadelphia School District, PA's IDR to 'BBB-' on Criteria Change; Outlook Stable

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Fitch Ratings - New York - 08 May 2024: Fitch Ratings has upgraded the Philadelphia School District, PA's Issuer Default Rating (IDR) to 'BBB-' from 'BB+'.

Additionally, Fitch has upgraded the underlying rating on approximately $2.2 billion of outstanding general obligation (GO) bonds and Pennsylvania State Public School Building Authority (PSPSBA) school lease revenue and revenue refunding bonds, issued on behalf of the district, to 'BBB-' from 'BB+'.

Fitch has also affirmed the 'F1+' rating on the school district of Philadelphia, Pennsylvania tax and revenue anticipation notes (TRANs), series A of 2023-2024, based on provisions of the statutory intercept of commonwealth revenues.

Fitch also maintains an 'A+' rating on the district's outstanding general obligation debt based on the intercept provisions of the Pennsylvania School Code of 1949.

The Rating Outlook is Stable. The ratings have been removed from Under Criteria Observation.

## RATING ACTIONS

| ENTITY / DEBT | RATING | | | PRIOR |
| --- | --- | --- | --- | --- |
| Philadelphia School District (PA) | LT IDR | BBB- Rating Outlook Stable | Upgrade | BB+ Rating Outlook Positive |
| Philadelphia School District (PA) /General Obligation - Unlimited Tax/1 LT | LT | BBB- Rating Outlook Stable | Upgrade | BB+ Rating Outlook Positive |
| Philadelphia School District (PA) /General Obligation - Unlimited Tax/1 ST | ST | F1+ | Affirmed | F1+ |

VIEW ADDITIONAL RATING DETAILS

The upgrade of Philadelphia School District's IDR and underlying GO ratings to 'BBB-' from 'BB+' reflects the implementation of Fitch's new 'US Public Finance Local Government Rating Criteria'. Fitch assesses the district's financial resilience at 'bb' with upside potential if it is able to maintain reserves consistently equal to or higher than 5% of spending and demonstrate progress addressing sizable out-year budget gaps. The rating also incorporates the district's weak long-term liability burden composite (35th percentile of Fitch's local government portfolio. The district's population trend (22nd percentile), unemployment rate (12th percentile), median household income (13th percentile) are all well below the portfolio median, mitigated somewhat by the district's strong educational attainment (60th percentile) and its large and diverse local economy.

The ratings also incorporate key rating factors specific to 'BBB-' and below ratings, and the application of three negative additional analytical factors for risk to non-recurring support for operations, and resource constraints due to the combination of enrolment declines and charter school expenditure pressures.

The GO bonds also have an 'A+' rating based on the credit enhancement (CE) provided by the Pennsylvania School Credit Intercept Provision that provides protections under Pennsylvania statutes outlining intercept of Commonwealth aid for school districts (Pennsylvania School Credit Intercept Provision).

The 'F1+' short-term note rating is mapped to the Commonwealth's long-term general credit quality, given the credit enhancement provided by the intercept program. The notes ratings map to the appropriation-backed rating on the Commonwealth, as the pledged state aid revenues are subject to annual appropriation. Furthermore, with implementation of Act 85 in 2016, the state has ensured that intercept payments, for the benefit of bond debt service, will be made even in the absence of an appropriation budget of the state. The ratings consider the sufficiency of the undisbursed portion of pledged commonwealth revenues appropriated to the school district and district tax revenues held in the custody of the state treasurer that are available for intercept in the event the district is unable to repay note holders.

## RATING SENSITIVITIES

### Factors that Could, Individually or Collectively, Lead to Negative Rating Action/Downgrade

--A sustained increase of approximately 15% in long-term liability metrics due to additional debt issuance and/or increased net pension liabilities and carrying costs, absent a commensurate increase in personal income or governmental resources;

--Lack of progress addressing out-year structural budget imbalances, actual or projected accumulated deficits, and increased liquidity pressures.

### Factors that Could, Individually or Collectively, Lead to Positive Rating Action/Upgrade

--A sustained approximate 20% reduction in long-term liabilities;

--Meaningful progress to address out-year budget gaps while maintaining unrestricted general fund reserves consistently at or above 5% of general fund spending, that results in an improved level of financial resilience consistent with an assessment of 'bbb' or greater;

--Improved demographic and economic trend and level metrics.

## SECURITY

The district pledges its full faith, credit and taxing power to repayment of the GO bonds and benefit from a lock-box structure, originally established in 1982. The bonds are also subject to protections under Pennsylvania statutes outlining intercept of commonwealth aid for school districts (Pennsylvania School Credit Intercept Provision). The commonwealth's pre-default intercept mechanism provides for full and timely payment of debt service through the ability to intercept all state revenues appropriated to the district. Furthermore, with implementation of Act 85 in 2016, the state has ensured that intercept payments, for the benefit of bond debt service, will be made even in the absence of an appropriation budget of the state.

## FITCH’S LOCAL GOVERNMENT RATING MODEL

The Local Government Rating Model (LGRM) generates Model Implied Ratings (MIR) which communicate the issuer's credit quality relative to Fitch's local government rating portfolio (the MIR will be the IDR except in certain circumstances explained in the applicable criteria). The MIR is expressed via a numerical value calibrated to Fitch's long-term rating scale that ranges from 10.0 or higher ('AAA'), 9.0 ('AA+'), 8.0 ('AA'), and so forth down to 1.0 ('BBB-' and below). Model Implied Ratings reflect the combination of issuer-specific metrics and assessments to generate a Metric Profile (MP), and a structured framework to account for Additional Analytical Factors (AAFs) not captured in the Metric Profile that can either mitigate or exacerbate credit risks. AAFs are reflected in notching from the MP and are capped at +/-3 notches.

## RATINGS HEADROOM & POSITIONING

Philadelphia School District Model Implied Rating: 1.41 ('<=BBB-')

-- Metric Profile: 4.41 ('A-')

-- Net Additional Analytical Factor Notching: -3.0Individual Additional Analytical Notching Factors:

-- Non-Recurring Support or Spending Deferrals: -1.0

-- School District Enrollment: -2.0

Philadelphia School District's Model Implied Rating of 1.41 is in the middle of the 1.0 to 2.0 range for its current 'BBB-' rating.

## KEY RATING DRIVERS

## FINANCIAL PROFILE

### Financial Resilience - 'bb'

Philadelphia School District's financial resilience is driven by the combination of its 'High' revenue control assessment and 'Low' expenditure control assessment, culminating in a 'Low Midrange' budgetary flexibility assessment.

-- Revenue control assessment: High

-- Expenditure control assessment: Low

-- Budgetary flexibility assessment: Low Midrange

-- Minimum fund balance for current financial resilience assessment: <5.0%

-- Current year fund balance to expenditure ratio: 16.5% (2023)

-- Five-year low fund balance to expenditure ratio: 1.5% (2020)

### Revenue Volatility - 'Strong'

Philadelphia School District's weakest historic three-year revenue performance is neutral to the Model Implied Rating.

The revenue volatility metric is an estimate of potential revenue volatility based on the issuer's historical experience relative to the median for the Fitch-rated local government portfolio. The metric helps to differentiate issuers by the scale of revenue loss that would have to be addressed through revenue raising, cost controls or utilization of reserves through economic cycles.

-- Lowest three-year revenue performance (based on revenues dating back to 2005): 0.4% increase for the three-year period ending fiscal 2012

-- Median issuer decline: -4.2% (2023)

Financial Profile Additional Analytical Factors and Notching: -1.0 notch (for Non-Recurring Support or Spending Deferrals)

Fitch applied a -1 notch on the district's financial profile to reflect the recent history of reliance of nonrecurring support for operations including the pandemic related state and federal funds.

## DEMOGRAPHIC AND ECONOMIC STRENGTH

**Population Trend - 'Weak'**

Based on the median of 10-year annual percentage change in population, Philadelphia School District's population trend is assessed as 'Weak'.

Population trend: 0.3% 2022 median of 10-year annual percentage change in population (22nd percentile)

**Unemployment, Educational Attainment and MHI Level - 'Weak'**

The overall strength of Philadelphia School District's demographic and economic level indicators (unemployment rate, educational attainment, median household income [MHI]) in 2023 are assessed as 'Weak' on a composite basis, performing at the 28th percentile of Fitch's local government rating portfolio. This is due to very low median-issuer indexed adjusted MHI and high unemployment rate offsetting midrange education attainment levels.

-- Unemployment rate as percentage of national rate: 150.0% Analyst Input (12th percentile) (used 2022 data as 2023 unemployment is unavailable), relative to the national rate of 3.6%

-- Percent of population with a bachelor's degree or higher: 33.6% (2022) (60th percentile)

-- MHI as a percent of the portfolio median: 75.3% (2022) (13th percentile)

**Economic Concentration and Population Size - 'Strongest'**

Philadelphia School District's population in 2022 was of sufficient size and the economy was sufficiently diversified to qualify for Fitch's highest overall size/diversification category.

The composite metric acts asymmetrically, with most issuers (above the 15th percentile for each metric) sufficiently diversified to minimize risks associated with small population and economic concentration. Downward effects of the metric on the Metric Profile are most pronounced for the least economically diverse issuers (in the 5th percentile for the metric or lower). The economic concentration percentage shown below is defined as the sum of the absolute deviation of the percentage of personal income by major economic sectors relative to the U.S. distribution.

-- Population size: 1,567,258 (2022) (above the 15th percentile)

-- Economic concentration: 39.9% (2023) (above the 15th percentile)

Demographic and Economic Strength Additional Analytical Factors and Notching: -2.0 notch (for School District Enrollment)

Fitch has assigned a negative 2-notch additional analytical factor to reflect the pressures posed by the significant size of the spending obligation associated with charter school competition. The model's demographic and economic strength metrics provide an incomplete view of the factors that can affect school district expenditures and revenues, which are largely determined by state budget appropriations that often include enrollment as a key driver. Enrollment patterns have been adversely impacted by a rise in the number of students attending charter schools and cyber charter schools over the past decade. This shift has led to an increase in spending to fund charter schools., which accounts for a significant portion of the district's spending. The financial support provided to a charter school is contingent upon its enrollment figures and is calculated using a formula that considers the per-student expenditure from each student's home school district for the preceding fiscal year. PSD payments to charter schools, which include transportation costs, account for roughly one-third of the school district's government fund expenditures, excluding one-time programs financed by federal aid. These charter school payments pose a significant limitation on the district's ability to manage its expenses.

## LONG TERM LIABILITY BURDEN

**Long-Term Liability Burden - 'Weak'**

Philadelphia School District's carrying costs to governmental expenditures has deteriorated while liabilities to personal income remain moderately weak and liabilities to governmental revenue remain midrange. The long-term liability composite metric in 2023 is at the 35th percentile, indicating somewhat elevated liability burden relative to the Fitch local government rating portfolio.

-- Liabilities to personal income: 8.8% Analyst Input (25th percentile) (vs. 8.6% 2023 Actual)

-- Liabilities to governmental revenue: 166.9% Analyst Input (55th percentile) (vs. 164.1% 2023 Actual)

-- Carrying costs to governmental expenditures: 17.5% Analyst Input (31st percentile) (vs. 17.1% 2023 Actual)

Liabilities to personal income and debt to revenues were adjusted to reflect amortization of principal through fiscal end 2023. Carrying costs were adjusted to 17% from 16.2% in fiscal 2023 to reflect scheduled increases in debt service from the fall 2023 bond issuances.

## PROFILE

The district ranks as the nation's eighth-largest school district and is the largest within the Commonwealth of Pennsylvania. Coinciding geographically with the city of Philadelphia, the district serves a key economic hub in the Northeast, with an above-average concentration in personal income driven by the higher education and healthcare sectors relative to the national norm. Job growth was consistent and robust prior to the coronavirus pandemic. However, the area faces challenges due to comparatively low wealth levels and modest population growth, which constrain its growth prospects. According to the 2022 Census, Philadelphia's population reached 1.57 million, marking a 2.7% increase since the 2010 Census. Despite this, school enrollment has been on the decline, in large part due to the rise in charter schools. In 2023, the district served 196,200 students, with 82,76 (42%) enrolled in charter schools or alternative education programs.

## REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

## ESG CONSIDERATIONS

The highest level of ESG credit relevance is a score of '3', unless otherwise disclosed in this section. A score of '3' means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. Fitch's ESG Relevance Scores are not inputs in the rating process; they are an observation on the relevance and materiality of ESG factors in the rating decision. For more information on Fitch's ESG Relevance Scores, visit https://www.fitchratings.com/topics/esg/products#esg-relevance-scores.

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## APPLICABLE CRITERIA

U.S. Public Finance Local Government Rating Criteria (pub. 02 Apr 2024) (including rating assumption sensitivity)

## APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

U.S. Local Government Rating Model, v1.2.0 (1)

## ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

## ENDORSEMENT STATUS

| | |
|---|---|
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The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Fitch also provides information on best-case rating upgrade scenarios and worst-case rating downgrade scenarios (defined as the 99th percentile of rating transitions, measured in each direction) for international credit ratings, based on historical performance. A simple average across asset classes presents best-case upgrades of 4 notches and worst-case downgrades of 8 notches at the 99th percentile. For more details on sector-specific best- and worst-case scenario credit ratings, please see Best- and Worst-Case Measures under the Rating Performance page on Fitch’s website.

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