Fitch Assigns 'AA' IDR to Pima County Community College District, AZ; Rates 2019 Rev Bonds 'AA-'

Fitch Ratings-Austin-20 December 2018: Fitch Ratings has assigned a 'AA-' rating to the $57,600,000 revenue bonds, series 2019 issued by Pima County Community College District of Pima County, Arizona (the district).

The bonds are scheduled for a negotiated sale the week of Jan. 14. Proceeds will be used to acquire, construct, equip, expand and renovate certain college facilities for the expansion of various workforce, vocational, and technical training programs.

Fitch has also assigned the following rating to the district:

--Issuer Default Rating (IDR) 'AA'.

The Rating Outlook is Stable.

SECURITY
The series 2019 revenue bonds are payable from a gross revenue pledge of and first lien on the district's tuition and fees, rental and contract revenues, interest earnings, and other certain operating revenues.

ANALYTICAL CONCLUSION

The 'AA' long-term IDR reflects Fitch's expectation of the highest level of operating flexibility and anticipated financial resilience to be maintained by the district throughout the economic cycle. This expectation is largely attributable to its solid expenditure flexibility, ample revenue-raising ability, and a strong reserve cushion. Fitch expects the long-term liability burden to remain low as regional capital and debt needs should remain balanced against further population and income gains.

Fitch's assignment of a 'AA-' rating to the district's pledged revenue bonds reflects application of Fitch's tax-supported criteria for U.S. state and local governments. The criteria highlight Fitch's assessment, utilizing the Fitch analytical sensitivity tool (FAST]) - states and locals, that the structure will maintain very strong resiliency through a typical economic cycle and as compared to the worst historical revenue performance. Fitch anticipates flat pledged revenue growth based on stabilizing enrollment and recognizes management's ability to increase pledged fees and charges. The revenue bond rating is capped at the district's IDR because it is exposed to the general operating risks affecting the district as a whole.

Economic Resource Base
Pima County has a population of roughly 1 million and is home to Tucson, AZ's second largest city. The county's diverse economy features higher education, healthcare, government, technology, tourism and manufacturing as primary anchors. The top 10 taxpayers represent retail, healthcare, utility and mining

sectors and comprise a modest 7% of total fiscal 2018 taxable values.

KEY RATING DRIVERS

Revenue Framework: 'a'
Fitch believes the district's revenue growth prospects are largely flat and below inflation. They are expected to improve upon the current downward trajectory. The superior ability of the district to independently raise tuition and fees to offset the effects of a normal, cyclical economic decline underpins the 'a' assessment.

Expenditure Framework: 'aa'
The natural pace of spending will likely exceed the flat revenue growth projected over time. The district retains solid expenditure flexibility, even after right-sizing in recent years to a declining enrollment trend, due to its ability to further adjust academic programs and labor costs, if needed. Expenditure flexibility is also bolstered by modest fixed carrying costs.

Long-Term Liability Burden: 'aaa'
The long-term liability burden is estimated at a low 4% of 2017 resident personal income. Further growth in county population and income levels should remain largely aligned with potential increases in overlapping local government debt, which is the predominant driver of the liability burden.

Operating Performance: 'aaa'
A high level of operational flexibility is derived from the district's ample revenue-raising ability, solid budgetary control, and a strong reserve cushion. Fitch expects the district will maintain the highest level of financial resilience in a moderate economic decline.

Slow Growth Prospects for Pledged Revenues: Fitch anticipates essentially flat pledged revenue growth, but recognizes the district's ability and mandate to raise pledged revenues if needed. Revenue prospects will be aided by expected enrollment stability from the expansion of the district's workforce, vocational, and technical programs.

Resilience of Security: Pledged revenues are highly resilient and provide a strong coverage cushion against potential revenue declines in a moderate economic downturn.

RATING SENSITIVITIES
Shift in Fundamentals: The 'AA' IDR and 'AA-' pledged revenue bond ratings are sensitive to material change in the district's solid expenditure flexibility and revenue growth prospects. The IDR also retains sensitivity to a materially weakened tax base trend, although this is not deemed likely to occur in the near to intermediate term.

Leverage a Key Factor: The pledged revenue bond rating assumes the structure's resilience will remain at or near current levels. Material increase in leverage or declines in pledged revenues that diminish the coverage cushion outside of Fitch's expectations would likely result in downward rating action.

CREDIT PROFILE

The district serves the residents of Pima County, AZ (IDR AA+). The district operates multiple comprehensive campuses throughout its taxing jurisdiction of the county. County population has expanded by a healthy 4% since 2010, comparable to the nation, but below the state's rate of growth.

District revenues are primarily influenced by local trends, including enrollment and taxable assessed

valuation (TAV). Enrollment typically runs counter-cyclical to local economic conditions. Full-time equivalent (FTE) students peaked in fiscal 2011 during the depths of the Great Recession, but since then a trend of enrollment decline has persisted. Enrollment losses totaled a higher than average 3% annually over fiscals 2007-2017, and essentially held flat in fiscal 2018 at about 14,784 in FTE students. Year-to-date trends to date in fiscal 2019 suggest flat enrollment may be maintained.

Pima County's economy continues a slow but steady recovery from the effects of the Great Recession. Expansion is evidenced by four consecutive years of gains in countywide market values, including a 3% increase in fiscal 2018 to nearly $85 billion. Fitch anticipates additional near-term tax base growth based on current reported construction activity, new development, and appreciation of existing properties. Public and private investment in downtown Tucson continues, due in part to a street car rail system that extends from downtown to the university campus. Recent Caterpillar and Raytheon expansions highlight a list of commercial and industrial project announcements in Tucson that should boost employment, taxable values and economically sensitive revenues. Steady declines in the local unemployment rate since 2011 further support the expectation for additional economic expansion.

Major southern Arizona employers include the University of Arizona, Raytheon Missile Systems, Davis-Monthan Air Force Base, state and local government, Wal-Mart Stores Inc., Tucson Unified School District, U.S. Customs & Border Protection/U.S. Border Patrol, Freeport-McMoRan Copper and UA Healthcare.

Revenue Framework

Property taxes for operations provided just over half (about 58%) of total revenues in fiscal 2017, followed by federal revenue (largely Pell grant) at 21%. The local tax base provides an increasing portion of total revenues; property taxes equaled about 47% of total revenues in fiscal 2002. Additional tax revenue has served to largely offset declines in enrollment-related revenues, which includes federal funding and tuition, in addition to the reduction and eventual phase-out of the district's state appropriation.

Average annual revenue growth was just under 1% in the 10-year period of fiscal 2007 to 2017. This historical performance was muted in part due to the disproportionately large impact of the Great Recession throughout Arizona on both the county property tax base and state funding levels.

Fitch expects the district's future revenue performance will likely improve slightly but remain generally stagnant, below the rate of inflation. This assessment is based on the district's resolution of prior management and accreditation issues, the likelihood of further, modest tax base expansion, and the reasonable potential of a slow return to stable enrollment due to expanded workforce/technical training contracts with local employers supported by larger, state-of-the-art facilities.

State law limits community colleges' ability to make changes to certain revenues. Primary property tax levies, used for operations, are limited to a 2% per annum increase over the maximum allowable levy in the prior year plus taxes on any new construction. Additionally, the state allows banking and carry forward of the 2% maximum levy increase, to the extent not fully used, although Pima County Community College District has fully used its prior levy capacity. Fitch notes that there is no limitation on annual secondary property tax levies, used for voter-approved bonded indebtedness; such levies are not available to support operations. The district does not currently levy a secondary tax rate as it has no voter-authorized tax-supported debt outstanding.

Tuition/fee revenue accounts for about 16% of Pima CCCD's total revenue; the district retains the full ability to independently raise its tuition and fee charges (including differential tuition for high-demand, high-cost academic programs) without any legal limit, which provides an ample offset to the district's

moderately high revenue volatility.

Expenditure Framework
Instruction, student services, and administrative expenses consumed about 64% of total spending in fiscal 2017.

Fitch expects the natural pace of spending will likely exceed the flat revenue growth projected over time.

The district navigated the recent recession and subsequent trend of enrollment decline despite the revenue constraints mentioned above. Management focused on spending reductions, and employed a variety of measures, including salary freezes, layoffs and reduction of positions, as well as departmental cuts and reorganizations. The district retains strong control over its workforce costs and can adjust employee headcount and compensation accordingly, enabled by the absence of multi-year, contractual agreements or collective bargaining with labor. This expenditure flexibility is tempered by the district's need to recruit and retain a sufficient number of highly educated professionals for instructional and leadership purposes.

While the magnitude of these adjustments suggests that remaining financial flexibility is limited, management reports future changes to academic programing that are yet to occur and are likely to result in further cost savings. The district retains sound flexibility to adjust instruction (its largest operating expense at roughly $52 million in fiscal 2017) to evolving enrollment trends. In addition, the district plans to close and sell one of its campuses (Community Campus) in early 2019 to better meet the evolving educational needs of the community and workforce.

Fitch defines fixed carrying costs as the combination of total annual debt service, the actuarially required annual pension funding amount, and the annual spending for other post-employment benefits (OPEB). These costs remain low for the district, due in part to slow debt amortization (31% of principal retired within 10 years), and are estimated to consume about 7.5% of total operating/non-operating expenses once annual debt service for this issuance is factored in. Potential increases to carrying costs from further growth in district's net pension liability (NPL), could pressure this metric in the future, although Fitch does not anticipate this to exceed the range of expectation for the 'aa' expenditure flexibility assessment.

Long-Term Liability Burden
The long-term liability burden is low at an estimated 4% of 2017 Pima County personal income. Nearly all of the overall liability burden (about 88%) is derived from overlapping debt of the City of Tucson, Pima County, and local school districts. The district may consider approaching voters for a general obligation (GO) debt authorization in the intermediate term to fund the next phase of its capital improvement plan. Nonetheless, Fitch expects the burden to remain consistent with the current assessment, as the district and regional debt and capital needs should remain aligned with further population, income, and economic growth.

The majority of district employees participate in the Arizona State Retirement System (ASRS), a cost-sharing multiple employer pension system. Under GASB 67 and 68, the district reports a fiscal 2017 ASRS net pension liability (NPL) of nearly $132 million with fiduciary assets covering 67% of total pension liabilities at the plan's 8% investment return assumption (which falls to 56% based on a lower 6% investment return assumption). Assuming a more conservative, 20-year amortization would require more than doubling actuarial contributions under Fitch's benchmark pension contribution methodology.

Operating Performance
Fitch believes the district maintains the highest level of financial resilience to manage challenges

associated with an economic downturn. This assessment is underpinned by the district's history of maintaining high levels of unrestricted cash/investments (net of bond proceeds and debt service reserves). The district's fundamental financial flexibility and strong reserves are a product of various budgetary tools at management's disposal, which include solid expenditure flexibility, revenue-raising authority, and the ability to use its historically high reserve cushion in excess of Fitch's calculated reserve safety margin.

The district's financial flexibility and the sufficiency of its reserves are measured against the volatility of its revenue history in a moderate economic downturn as depicted by FAST. The FAST scenario indicates a moderately high 3.6% total revenue decline for the district in a negative 1% U.S. GDP scenario.

District leadership has actively worked to close recent budget gaps that arose largely from the trend of annual enrollment losses and the reduction and eventual phase-out of its state appropriation, in addition to management's efforts to realign spending with the state's expenditure limitation framework that is based on current enrollment. Negative operating margins over fiscals 2013-2016 were also attributable to planned spend-downs by management to fund pay-go capital spending for key facility projects, which typically totaled about $10 million/year (or approximately 6% of fiscal 2017 spending). The district's right-sizing efforts produced positive results in fiscal 2017, with operations posting a modestly positive 3% operating margin. Near-final, unaudited fiscal 2018 operating results suggest another positive margin of 9%, outpacing the year's flat enrollment performance. The district's unrestricted cash and investments (net of bond proceeds and the district's debt service reserve) totaled roughly $111 million or about 62% of spending at fiscal 2017 year-end, well above Fitch's calculated reserve safety margin. The near-final, unaudited fiscal 2018 position points to further increase in the district's unrestricted cash and investments to approximately $123 million or 70% of spending. Fitch expects the district will continue to maintain the highest level of financial resilience based on historical fiscal performance.

Pledged Revenue Growth Prospects

Tuition and fees provide the majority of pledged revenues at about 80%, inclusive of periodic increases in rates and charges. Steady enrollment loss since counter-cyclically peaking during the Great Recession has led to historically declining pledged revenues over the last two decades, most recently at an average annual rate of a negative 2% over fiscals 2008-2018. Over the same decade, average annual enrollment as measured by FTE students was down by about 3%. Pledged revenues totaled $34 million in fiscal 2018, which was a decline of just over 1% from the prior year.

Given the district's recent enrollment history, Fitch believes natural pledged revenue growth prospects (absent management action to periodically increase tuition and fees) will at best be flat. Fitch's assessment of stagnant rather than declining pledged revenue is based on the reasonable potential of modest enrollment gains given the district's expanding vocational and technical programs as well as skill training workforce contracts with local employers in a growing local economy. The mandate to increase the rate at which pledged revenues are charged also positively affects the 'bbb' assessment. The district covenants in its bond documents to maintain rates and charges sufficient to produce sum sufficient pledged revenue coverage of aggregate annual debt service.

Revenue Stream Sensitivity

To evaluate the sensitivity of pledged revenues to cyclical declines, Fitch considers both the revenue sensitivity results provided by FAST and the largest historical cumulative decline in pledged revenues over fiscals 2002-2018. Based on this 17-year pledged revenue history, FAST generates a 5.3% decline in pledged revenues during the first year of a moderate recession (1% GDP decline scenario). The largest cumulative pledged revenue decline during this time period has been the recent eight-year decline of 18.3% over fiscals 2011-2018.

Fitch assumes pledged revenues will not be leveraged down to the 2.0x ABT, but that coverage will be maintained a higher minimum threshold of 6.3x given the support residual revenues provide to operations and in line with management's initial thoughts regarding an additional $20 million in revenue bond issuance at some point in the medium term. Under this assumption, a significant revenue decline of 84% would still allow for payment of debt service; this cushion is strong at 15.8x the 5.3% revenue decline produced by FAST in a 1% GDP decline scenario and 4.6x the largest cumulative revenue decline, which Fitch views as consistent with an 'aaa' resilience assessment.

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U.S. Public Finance Tax-Supported Rating Criteria (pub. 03 Apr 2018) (https://www.fitchratings.com/site/re/10024656)

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