FITCH UPGRADES DAYTON CITY SCHOOL DISTRICT, OH IDR TO 'A-'; OUTLOOK STABLE

Fitch Ratings-New York-03 October 2019: Fitch Ratings has upgraded the ratings on the following Dayton City School District, OH obligations:

--The district's Issuer Default Rating (IDR) to 'A-' from 'BBB+';
--$133.6 million unlimited tax general obligation (ULTGO) bonds to 'A-' from 'BBB+';
--$3.1 million limited tax general obligation (LTGO) bonds to 'A-' from 'BBB+';
--$11.1 million certificates of participation (COPs) series 2012 to 'BBB+' from 'BBB'.

The Rating Outlook is Stable.

SECURITY
The ULTGO bonds are voted general obligations of the district payable from an unlimited ad valorem tax levy on all taxable property within the district.

Additional security for the series 2014 and 2013A ULTGO refunding bonds is provided by the Ohio School District Credit Enhancement Program (AA/Stable).

The LTGO bonds are non-voted general obligations of the district payable from an ad valorem tax levy within the 10-mill limitation.

The COPs are backed by the district's obligation to make lease rental payments subject to annual appropriation. The COPs carry a leasehold interest for the benefit of certificate holders in the leased assets.

ANALYTICAL CONCLUSION

The rating upgrades reflect Fitch's assessment of the district's improved operating performance, which includes an improved gap closing capacity due to the increased reserve levels that partially offset the limited revenue raising and adequate expenditure flexibility. The upgrades also recognize the improvements in budget management over the past several years of the economic recovery. The ratings reflect the slow pace of revenue growth without revenue-raising measures, the limited ability of the district to independently increase revenue, and moderate long-term liability levels. The one-notch distinction between the IDR and the appropriation-backed bond rating at 'BBB+' reflects the slightly higher degree of optionality associated with the certificate payments subject to appropriation.

Economic Resource Base
The district has experienced significant declines in enrollment as a result of population outflow and competition from charter schools. The city of Dayton's population has declined, but has remained more stable recently.

KEY RATING DRIVERS

Revenue Framework: 'bbb'
Fitch expects revenue growth to be slow going forward. The district's independent legal ability to raise revenue is restricted by the state.

Expenditure Framework: 'a'

Fitch expects that the natural pace of spending growth will be above that of expected revenue growth. Fitch believes that the district's expenditure flexibility is adequate, with moderate carrying costs offset by practical limitations on the ability to reduce spending.

Long-Term Liability Burden: 'aa'
Long-term liabilities for pensions and overall debt are moderate relative to the resource base.

Operating Performance: 'bbb'
Despite improvement, Fitch expects the district's financial operations could become stressed in an economic downturn, although they would recover financial flexibility in a recovery. The district may be required to defer some required spending or use fund balance to support operations even during times of economic recovery.

RATING SENSITIVITIES
Change in Financial Resilience: The rating is sensitive to the ability of the district to maintain available reserve levels that are adequate to maintain a level of financial resilience consistent with the current rating through an economic cycle.

State Aid Changes: The district's rating is sensitive to changes in state aid funding policies, including changes in the state aid formula, as state aid represents the bulk of the district's revenues.

Increased Competition: The rating is also sensitive to increased charter school and open enrollment competition, which could heighten expenditure pressure and reduce financial flexibility.

CREDIT PROFILE
The district is in Montgomery County including Harrison and Jefferson townships and portions of the cities of Dayton, Riverside and Trotwood. The city's unemployment rate is high compared to state and national rates, but is improving. Per capita money income and median household income are well below state and U.S. averages and the poverty level is more than double that of the state and nation. The current property tax collection rate has been below 90% over the last 10 years.

The area's traditional manufacturing base in automobile parts and assembly was devastated by the recession but is showing signs of recovery. The region has established itself as a hub for aerospace research and development, and Wright-Patterson Air Force base provides some stability to the local economy. The weakness in the local economy and competition from charters and other schools in the last decade have contributed to significant enrollment declines. Management reports that there have been improvements in both housing demand and enrollment expectations.

Revenue Framework
Ohio school districts operate within a restrictive revenue environment. Partially due to its low wealth levels, the majority of Dayton City school district's general fund revenue comes from state aid as opposed to property tax revenue. The district has benefited from state aid increases under the state funding formula since it incorporates relative wealth and income, factors that have offset enrollment declines in the district. The district's revenue growth is boosted by the inclusion of amounts passed through to alternative school options including charters, voucher programs and other school districts (when students elect to attend other schools through open enrollment).

The district's outside mill levies, which account for almost all property tax revenues, are fixed rate. These levies capture growth due to new construction but not assessed value increases. The levy declines if assessed value declines, limiting growth potential without reducing downside risk. All of the district's property tax levies are continuous and do not require a renewal vote.

Fitch expects revenue growth to approximate inflation going forward with state aid growth and pass-throughs to alternative school options offsetting continued enrollment declines. Enrollment trends have been negative, with declines between 2006 and the current school year. The district receives less than the full amount of funding that the state formula calculates that it should receive due to the 3% cap on annual state funding increases to the district. This should partially shield the district from decreases in state funding in a downturn and the impact of enrollment declines since the state would likely provide funding at a level higher than the capped amount.

The district has no ability to independently increase its main revenue sources as any new property taxes must be approved by voters.

Expenditure Framework
The district's main expenditure item is instruction with support services making up most of the remainder.

Fitch expects the natural growth of expenditures will be above the slow natural growth rate of revenue. The district projects a fiscal year (FY) 2019 to FY 2023 five-year expenditure CAGR of about 3% for all of its expenditures except for school choice programs. For those programs (vouchers, open enrollment and charter schools), the district assumes growth in expenditures to be 5%, which Fitch believes is a reasonable expectation given recent trends of higher growth in students attending alternate schools.

The district projects some increasing competition from voucher programs, but stable open enrollment and charter school pressure. These pass-throughs reduce the portion of the expenditure base that the district can control. Under the district's projections, the proportion of the district's budget comprised of state aid pass-throughs to competing school options would remain high at approximately 28% of total spending. The district recently underwent a school consolidation program in an effort to cut costs due to the declining enrollment trend.

The district maintains adequate control over its expenditures. Moderate carrying costs for debt service, other post-employment benefits (OPEB) and pension contributions bolster flexibility, although that flexibility is limited due to the aforementioned large portion of the student population enrolling in alternative school options. Pension reforms in 2017 reduced the risk of increasing required pension contributions and improved the prospects for longer-term funding improvement.

The district maintains moderate control over its workforce-related spending. Management reports that the district's collective bargaining agreement with its teachers (50% of the unionized workforce) was amended for the next three years and that the relationship with the teacher union has improved significantly after the previous negotiation almost culminated in a teacher strike. The district has planned for a high level of cash-funded capital projects in its five year plan to catch up with some deferred maintenance, some of which it could further delay or cancel. To avoid use of recently increased reserves, the district may issue a moderately sized bond issue to pay for capital costs instead of funding them on a pay-go basis.

Long-Term Liability Burden
The district's moderate long-term liability burden is a credit strength for the district. The bulk of the liability (about 67%) consists of the district's proportionate share of the net pension liabilities of the Ohio State Teachers' Retirement System (OSTRS) and Ohio School Employees' Retirement System (OSERS). The district's combined net pension and other post-employment benefits (OPEB) liability for the plans was reported at $216 million in 2018, based on 2017 actuarial data. Fitch estimates a higher net pension liability of $355 million using its standard discount rate assumption of 6%. The plans reported a combined assets-to-liabilities ratio of 74% as of June 30, 2018. Using its 6% rate of return assumption, Fitch calculates a combined assets-to-liabilities ratio of 63% for the plans for the same year. As mentioned under 'Expenditure Framework,' the district may issue

a moderate amount of debt in the near future to fund various planned capital projects, but Fitch expects the long-term liability burden to remain in the 'aa' assessment category.

Operating Performance
The district had a surplus of almost $17 million in fiscal 2018, increasing available reserves to 28% of expenditures. This is a significant improvement from the accumulated available general fund deficit in 2014. Fitch expects the district's financial operations could still become stressed in a financial downturn, given its limited degree of inherent budget flexibility and the cyclical nature of the Ohio school district revenue framework in which districts must go to taxpayers to approve new revenue if expenditure growth begins to outpace revenue growth. The district maintained an additional unrestricted $31 million in its internal service funds in fiscal 2018, $29 million of which was in its self-insurance fund, which may provide additional flexibility but Fitch does not include this reserve in its consideration of financial resilience.

The district has rebuilt reserves to a level that partially offset its limited revenue and expenditure controls in a moderate economic downturn scenario. District administration has managed its budget conservatively in the last several years, while also benefitting from increased state aid amounts. The district's new superintendent has also implemented several reforms and developed a detailed strategic plan aimed at improving academics and student retention. Reforms include enhancing teacher training and curriculum, improving student and teacher attendance, and creating more college and career opportunities. The district received a 'D' on its state report card for the 2018-2019 school year, which was an improvement after 2 consecutive 'F' ratings. The improvement, as well as a one-year moratorium, forestalls the risk of state takeover, which is prompted by three consecutive grades of 'F'. Continued improvements in academic performance and student retention could lead to improved revenue trends.

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ESG CONSIDERATIONS
Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of 3. 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.

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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.

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Additional information is available on www.fitchratings.com

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