FitchRatings

Fitch Upgrades Chicago Board of Education, IL's IDR & $857MM ULTGO Bonds to 'BB-'; Outlook to Stable

Fitch Ratings-New York-27 October 2017: Fitch Ratings has assigned a 'BB-' rating to the following Chicago Board of Education, IL (CBOE) unlimited tax general obligation bonds (ULTGOs):

--$360.4 million ULTGO refunding bonds (dedicated revenues) series 2017C [statutory refunding];
--$81.3 million ULTGO refunding bonds (dedicated revenues) series 2017D [statutory refunding];
--$22.5 million ULTGO refunding bonds (dedicated revenues) series 2017E [AMBAC 2005B refunding];
--$168.3 million ULTGO refunding bonds (dedicated revenues) series 2017F [AMBAC 2007BC refunding];
--$225 million ULTGO bonds (dedicated revenues) series 2017H [new money].

Fitch has also upgraded to 'BB-' from 'B+' the following ratings for the CBOE:

--Long-Term Issuer Default Rating (IDR);
--Approximately $7 billion of outstanding ULTGO bonds.

The Rating Outlook is revised to Stable from Negative.

SECURITY
The general obligation bonds are unlimited tax general obligations of the CBOE payable from dedicated CBOE revenues in the first instance and also payable from unlimited ad valorem taxes levied against all taxable property in the city of Chicago.

ANALYTICAL CONCLUSION

The IDR and ULTGO upgrade to 'BB-' from 'B+' reflects improved prospects for financial balance and eventual restoration of a positive reserve position. The district is slated to receive significantly more ongoing state aid under the new state funding framework, both for operations and for pension expenses. This higher funding level will be ongoing, and the risk of funding declines will be largely tied to state-wide funding levels, mitigating the risk of funding cuts targeted to CBOE. Financial pressures will remain, but the additional funding and revised funding framework should improve the amount, timing and potential volatility of state aid to CPS and allow for reversal of the previous downward trajectory.

Economic Resource Base
The Chicago Board of Education provides preK-12 education to over 370,000 students within the city of Chicago. Its taxing jurisdiction is coterminous with the city of Chicago. The Chicago Public Schools (CPS) manages the school system, which is composed of 661 school facilities.

KEY RATING DRIVERS

Revenue Framework: 'bbb'
Fitch expects natural revenue growth, absent new revenue action, to keep pace with inflation, given expectations for property tax growth and relatively flat state aid growth following the initial increase associated with new funding formula, CPS has no independent legal ability to raise revenues.

Expenditure Framework: 'bbb'
Fitch expects the natural pace of expenditure growth to exceed that of revenues, necessitating ongoing budget management. CPS has made significant cuts in recent years, and Fitch believes that the practical ability to cut spending throughout the economic cycle is limited.

Long-Term Liability Burden: 'a'
The long-term liability burden is elevated, but still in the moderate range, relative to the resource base.

Operating Performance: 'bb'
The district's accumulated general fund deficit resulted from years of structurally imbalanced operations. Fitch expects budgetary balance to improve over time, given expected gains under the new state funding formula. The new formula should also improve cash flow timing and liquidity from current very weak levels.

RATING SENSITIVITIES
Structural Balance: Demonstrated progress toward structural balance would mark a departure from recent experience and signal improved credit quality. Conversely, continuation of deficit operations despite improved state funding would trigger a downgrade.

Reemergence of Liquidity Pressure: Liquidity remains narrow, albeit improved under the new school funding structure, and the district remains highly dependent upon external cash flow borrowing. The rating is sensitive to the reemergence of liquidity pressures, which could stem from state funding cuts, expenditure pressures or an economic downturn.

CREDIT PROFILE

Chicago acts as the economic engine for the Midwestern region of the U.S. The city's residents are afforded abundant employment opportunities within this deep and diverse regional economy. The city also benefits from an extensive infrastructure network, including a vast rail system, which supports continued growth. The employment base is represented by all major sectors with concentrations in the wholesale trade, professional and business services and financial sectors. Socioeconomic indicators are mixed as is typical for an urbanized area, with above average educational attainment levels, above average per capita income and elevated individual poverty rates.

CPS relies on state funding for a significant amount of support. The state legislature recently passed a new 'evidenced-based funding model' for schools. CPS is slated to receive a material increase in state support relative to prior years beginning with the current fiscal year and should benefit from a hold-harmless provision that protects the district from demographic-related cuts in state aid. The hold-harmless provision should be particularly beneficial given the trend of declining enrollment.

Illinois (IDR of 'BBB'/Negative Outlook) is a large, wealthy state with a diverse economy centered on the Chicago metropolitan area. The passage of a fiscal 2018 budget that incorporates a permanent increase in taxes to more closely align revenues with spending was an important step in stabilizing the state's operations and should significantly reduce the liquidity stress that had threatened its investment-grade rating. However, the state's financial resilience has been materially weakened by the two-year period in which it spent far in excess of tax revenues while accumulating an extraordinary level of budgetary liabilities, adding to the strain presented by the state's large unfunded retiree benefit liabilities and rising contribution burden, and implementation risks to the budget remain.

Revenue Framework
Property taxes provided 47% and state aid 29% of general fund revenues in fiscal 2016 but the new state funding formula should increase the share of support derived from state aid beginning in fiscal 2018.

Growth prospects for revenues are slow, absent policy action. Revenues were budgeted to rise significantly in fiscal 2017, as the result of both local and state policy action, but actual results fell short, particularly with respect to state aid. Fiscal 2018 (amended) budgeted revenues are $312 million (6%) ahead of fiscal 2017 budget and $603 million (11%) above fiscal 2017 estimated actuals. Following that large jump in base funding levels, Fitch anticipates subsequent years' revenue growth will be about the level of inflation, taking into account property tax revenue trends and expectations of flat state aid over time.

Independent legal ability to raise revenues is limited, like many school districts in the U.S. Annual growth in the property tax levy is limited by the Property Tax Extension Limitation Law (PTELL) to the lesser of 5% or the rate of inflation.

Expenditure Framework
The district devoted 55% of fiscal 2016 general fund spending to instruction, 28% to support services, and 12% to pensions.

Fitch expects the natural pace of spending growth to be above natural revenue growth, given rising pension contributions and assumed wage increases. Management has actively managed expenditure growth, with a series of substantial cuts over the past several years including administrative cutbacks, school closures and layoffs.

CPS's practical ability to make future expenditure cuts is limited, with cuts likely to meaningfully but not critically reduce core services at times of economic downturn. Such cuts could include those for programs and labor costs. The moratorium on school closing expires at the end of this fiscal year, which may present an opportunity for efficiencies. Fixed carrying costs for debt service and actuarially-determined pension contributions are currently moderate at almost 20% of governmental spending in fiscal 2016; however, Fitch's supplemental pension metric, which estimates the annual pension cost based on a level dollar payment for 20 years with a 5% interest rate, indicates that carrying costs are vulnerable to significant future increases. For more information, see "Revised Pension Risk Measurements (Enhancing Pension Analysis in U.S. Public Finance Tax-Supported Rating Criteria)" dated May 31, 2017.

Long-Term Liability Burden
The long-term liability burden is elevated but still moderate relative to the resource base. The adjusted net pension liability plus

overall debt represents about 26% of personal income. Overlapping debt accounts for 37% of the long-term liability burden, with net pension liability representing 44% and direct debt approximately 20%. Amortization of direct debt is slow with 25% of debt scheduled for retirement in 10 years. Fitch anticipates that the long-term liability burden will remain solidly within the 'a' category.

Pension benefits for teachers are provided through the Public School Teachers' Pension and Retirement Fund of Chicago (CTPF), a cost-sharing multi-employer defined benefit plan in which CPS is the major contributor. Under GASB 68 reporting, the plan reported a 48% asset to liability ratio as of June 30, 2016. Fitch estimates the ratio to be lower at about 39% when adjusted to reflect a 6% return assumption. The weak ratios stem from several years of pension payment holidays and poor investment returns. The district dramatically increased pension funding in fiscal 2014 to comply with a state law requiring payments sufficient to reach a 90% funding level by 2059. Fitch expects pensions to continue to be a pressure, particularly given the longer than typical amortization period.

Pension benefits for other personnel are provided through the Municipal Employees' Annuity and Benefit Fund of Chicago (MEABF), a cost-sharing multi-employer defined benefit plan whose major contributor is the city of Chicago. The MEABF plan also has a weak asset to liability ratio of 19%, both on a reported basis and when adjusted by Fitch to reflect a 6% return assumption. CPS does not directly contribute to the plan and has no liability for it.

The other post-employment benefits (OPEB) liability is limited.

Operating Performance
Financial resilience is weak as CPS lacks sufficient cushion and is ill-prepared to withstand even a moderate economic downturn. However, prospects for restoration of operating balance and reserves have improved with the passage of a new state funding framework. The state legislature recently passed SB1947, which included an evidence-based funding model for schools state-wide that improves the amount, timing and potential volatility of state aid to CPS.

SB1947 will benefit CPS in several ways. It provides $320 million in additional state funding in fiscal 2018, including $221 million for state assumption of the normal cost for pensions, $76 million in new formula funding, and $23 million in early childhood and other funding. It also includes authorization for a new $130 million property tax levy for pensions which will not be subject to PTELL restrictions as is the operating levy.

These new revenues are in addition to the new funding procured in fiscal 2017 including a $250 million new pension levy which is not subject to PTELL restrictions and $204 million in additional state aid, which will be included in the base funding level for the evidence-based funding model going forward. The new formula also delivers more of CPS's aid in the form of general state aid, rather than categorical block grants. This is favorable to CPS as block grants are scheduled for disbursement less frequently than general state aid and were greatly delayed during the state budget impasse, contributing to CPS's financial distress. The new funding formula also includes a hold harmless clause which should protect CPS from state aid declines based on demographic factors (enrollment, poverty rate, etc.) and therefore reduce potential revenue volatility in the future.

Much of the historical structural imbalance stems from the lack of actuarial funding of pensions, including state-authorized reduced pension payments during the recession, and the subsequent shift in fiscal 2014 from statutory to actuarially-based pension payments, which presented a dramatic rise in spending without a corresponding revenue increase until recently. Recent budgets have also relied upon unsustainable practices including appropriated reserves, scoop and toss restructurings for budgetary relief and optimistic budgeting of revenues, and lengthening the accrual period for property tax collections.

A series of large consecutive operating deficits in recent years underscored CPS's structural budgetary imbalance and eroded its financial reserves. Reserves were completely exhausted in fiscal 2016 which ended with an accumulated general fund deficit of $127 million (2.3% of spending) or $227 million (4.2% of spending) on an unrestricted basis. Estimated fiscal 2017 results suggest the accumulated general fund deficit deepened to $271 million (5% of spending). The fiscal 2018 budget has been amended to reflect the effects of the new state funding framework, the end to the state budget impasse which may allow payment of delayed block grants, and the current refinancing high interest variable rate notes. It targets an ending general fund balance of $178 million, or about 3% of spending. That ending fund balance could rise to $383 million (7% of spending) if CPS executes a tentative debt restructuring. If achieved, such a cushion would represent a material improvement over past performance but would still provide only limited gap-closing capacity in a downturn or other unexpected operating, funding or liquidity stress.

Liquidity is extremely weak, with five days of cash on hand at the end of fiscal 2016. CPS' general fund cash position declined dramatically from $1.1 billion at the close of fiscal 2013 to $57 million at the end of fiscal 2016. Fiscal 2018 cash flows project improved liquidity provided by new revenue sources and improved timing of state aid, with the maximum expected draw on the cash flow line of credit falling to a still-high $1.125 billion in fiscal 2018 from $1.55 billion in fiscal 2017.

Contact:

Primary Analyst
Arlene Bohner
Senior Director
+1-212-908-0554
Fitch Ratings, Inc.
33 Whitehall Street
New York, NY 10004

Secondary Analyst
Laura Porter
Managing Director
+1-212-908-0575

Committee Chairperson
Amy Laskey
Managing Director
+1-212-908-0568

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.

Media Relations: Matthew Robinson, Sydney, Tel: +61 2 8256 0326, Email: matthew.robinson@fitchratings.com.

Additional information is available on www.fitchratings.com

Applicable Criteria
U.S. Public Finance Tax-Supported Rating Criteria (pub. 31 May 2017) (https://www.fitchratings.com/site/re/898466)

Additional Disclosures
Dodd-Frank Rating Information Disclosure Form (https://www.fitchratings.com/site/dodd-frank-disclosure/1031417)
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