MOODY'S
INVESTORS SERVICE

Rating Update: Moody's downgrades Vandalia-Butler City School District, OH to Aa3 from Aa2

Global Credit Research - 25 Sep 2013

Downgrade affects $58.6 million of debt

VANDALIA-BUTLER CITY SCHOOL DISTRICT, OH
Public K-12 School Districts
OH

Opinion

NEW YORK, September 25, 2013 --Moody's Investors Service has downgraded Vandalia-Butler City School District, OH's rating to Aa3 from Aa2, affecting $58.6 million including the district's general obligation unlimited (GOULT) and limited tax debt (GOLT), and the district's special obligation current expense tax anticipation notes. The GOULT debt is secured by the district's general obligation unlimited property tax pledge. The district's GOLT debt is secured by the district's general obligation limited tax pledge, subject to the State of Ohio's (GO rated Aa1/Stable outlook) 10-mill limitation. The special obligation TANs are secured by an irrevocable pledge of a property tax levy approved by voters in May 2011. All of the district's debt is currently rated on parity.

RATING RATIONALE

The downgrade reflects the district's diminished cash position as a result of unexpected revenue losses and the district's poor recent election history which has constrained the district's ability to offset those losses with new revenue. The Aa3 rating is supported by the district's moderately sized tax base near Dayton (GOLT rated Aa2/Stable Outlook), average wealth levels, strong management exemplified by long-term planning and a willingness to make aggressive expenditure reductions, projected improvements to cash reserves contingent on voter support for a new levy in November 2013, and an above average but manageable debt burden.

STRENGTHS

-Strong management

-Stable local economy near the City of Dayton, OH

-Proximity to the Wright-Patterson Air Force Base

CHALLENGES

-Diminished cash reserves and fund balance

-Weak recent election history

-Exposure to two underfunded statewide pension plans

DETAILED CREDIT DISCUSSION

DIMINISHED FINANCIAL POSITION DUE TO DECLINING REVENUES

Four years of operating deficits driven by unexpected revenue losses have weakened the district's financial position, and reserves are expected to decline further absent a near-term budgetary improvement. GAAP-basis General Fund balance declined sharply from $13.9 million in fiscal 2009, or 40.3% of fiscal 2009 revenues, to $3 million in fiscal 2012, or 9.9% of fiscal 2012 revenues, inclusive of a $5.2 million operating deficit in fiscal 2012. The ongoing deficits were driven by a decline in revenues due to the state's phase out of the tangible personal property tax, state aid cuts in FY10-12, and declining property valuations. While the district's GAAP-basis fund balance was diminished, it is important to note that due to the timing of property tax receipts and the accrual of personnel costs through the end of August, state-required accrual practices can lead to understated GAAP reserves for all Ohio districts. As a result, we typically look to audited General Fund net cash figures, or the General Fund cash carryover as reported in the districts' five year forecasts, which are updated and submitted to the state semi-annually. Net cash reserves fell from $16.6 million in fiscal 2009, or a very healthy 48.2% of fiscal 2009 revenues, to $5.6 million in fiscal 2012, or a narrowed but sufficient 18.8% of fiscal 2012 revenues.

Although fiscal 2013 audited financial statements are not yet available, the district reports a cash basis operating deficit of approximately $726,000, decreasing cash reserves to $4.0 million, or 13.23% of fiscal 2013 receipts. This is an improvement over the district's May 2013 projection of $2.3 million in cash reserves, or 8.3% of receipts. The positive variance can be credited to district management for taking aggressive action to reduce expenditures by eliminating certain programming, finding operating efficiencies, and reducing personnel through attrition, voluntary retirement incentives, and a reduction in force. Over the past five years, the district has reduced total staff by 26%. The positive variance was also due to a one-time cash infusion, as the district transferred $2 million of interest earnings from the Building Fund to the General Fund for operations.

DISTRICT'S FINANCIAL RECOVERY CHALLENGED BY WEAK RECENT ELECTION HISTORY

The district depends on voter-approved levies for operating revenues and over 60% of the district's total general fund revenue is derived from property taxes. Although voters have supported new and renewal levies in the past, they have rejected the district's last three levy requests (November 2011, August 2012, and November 2012). On each request, the district has lost by approximately 5% of the vote. These defeats have limited the district's financial flexibility and have constrained the district's ability to regain operating balance. The district plans to return to voters in November 2013 to request a 5-year 6.99 mill emergency levy. If successful, the levy is expected to raise approximately $3.9 million annually, with half-year's worth of collections in fiscal 2014 and full-year's worth of collections in fiscal 2015. If the levy fails a fourth time, the district will likely be on the ballot again in May 2014, with collections beginning in fiscal 2015.

While an updated forecast will not be available until late October, in unofficial projections the district has made the levy passage a critical assumption for realizing operating balance and replenishing reserves. If the levy passes, the district projects to increase cash reserves to a target level of 25% of expenditures by fiscal 2015. However, if the levy fails, it is likely that the district will continue to draw down cash balances. To maintain its credit rating, we would expect the district to effectively manage its levy cycle, and to make necessary budgetary adjustments in order to avoid further depletion of reserves. The district's ability to replenish cash reserves and maintain positive operations will be important considerations in future rating reviews.

MODERATELY SIZED AND MATURE TAX BASE LOCATED NEAR DAYTON

The district is located in Montgomery County (GO rated Aa1/No outlook) near Dayton (GOLT rated Aa2/Stable outlook) and serves the City of Vandalia (GO rated Aa2/no outlook) and the Township of Butler (GOLT rated A1/No outlook). The district's moderately sized tax base, with a full valuation of $1.67 billion, has declined 9.2% since 2009, or an average annual rate of 1.8%. Management reports the district's largest employers are currently stable, although Montgomery County's unemployment rate remains elevated. At 8.1% in July 2013, the county's unemployment rate exceed state and national levels, at 7.3% and 7.7% respectively. The district benefits from proximity to Wright-Patterson Air Force Base, which serves as a major primary employer as well as a driver for many ancillary businesses in the region. Although federal budget pressures may impact defense related spending, Wright-Patterson is likely to remain a significant contributor to the regional economy. The district's full value per capita remains sound at $72,401 and socioeconomic indices just above national levels, with per capita and median family income levels at 111% and 103% of national medians, respectively.

ABOVE AVERAGE DEBT BURDEN WITH SLOW PAYOUT; NO NEAR TERM BORROWING PLANNED

The district's debt profile is above average relative to other peer rated entities. Current direct debt levels are 3.5% of full valuation. Amortization of direct debt is below average with only 25.9% of principal paid out in the next ten years. The district has no plans for any new borrowing and is not a party to any variable rate debt or interest rate swaps.

ELEVATED PENSION LIABILITIES COMPARABLE TO OTHER OHIO SCHOOL DISTRICTS

The district has a high employer pension burden, based on the unfunded liabilities of two multiple-employer plans administered by the state in which it participates. The district's share of unfunded pension liabilities allocated by Moody's on a reported basis consist of an estimated $7.2 million for the district's portion of the statewide School Employees Retirement System (SERS) and an estimated $59.5 million for the State Teachers Retirement System (STRS) as of as of the actuarial valuation dates of June 30, 2011 and July 1, 2011, respectively. We have allocated the plan liabilities based on the district's pro rata share of annual contributions to each plan, compared to total annual plan-wide contributions. The district's annual contribution to the retirement systems in fiscal 2011 was approximately $2.7 million, equal to 7.85% of operating revenues, inclusive of the General Fund and the Debt Service Fund. Moody's adjusted combined net pension liability (ANPL) for the district, under our methodology for adjusting reported pension data, is $120 million, or a high 3.38 times operating revenues, compared to less than 1 times on average across all local governments. Moody's ANPL reflects certain adjustments we make to improve comparability of reported pension liabilities. The adjustments are not intended to replace the district's reported liability information, but to improve comparability with other rated entities.

We note that the state implemented retirement system benefit reforms effective January 2013 are expected to result in lower unfunded pension liabilities than they otherwise would have been, although updated actuarial valuations are not yet available. While the district's exposure to the unfunded liabilities of these cost-sharing plans poses a substantial long-term risk, the reform legislation held statutory employer contributions constant, at 14% of covered payroll, while focusing most changes on employee benefits and contribution rate increases. As a result, we do not believe the district's exposure to these unfunded liabilities will represent a near-term budgetary risk.

What Could Move the Rating Up

- Material expansion of the district's tax base and/or socioeconomic profile

- Significant and sustained improvement in General Fund balances and cash reserves.

What Could Move the Rating Down

- Operating deficits yielding material declines in reserve levels

- Continued material declines in enrollment placing additional operating pressures on the General Fund

- Failure to successfully enhance revenues or reduce expenditures in order to replenish cash reserves to levels commensurate with the Aa rating category

- Significant deterioration of the district's tax base and/or socioeconomic profile

KEY STATISTICS:

Population (2010 census): 23,930 (+1.5% since 2000)

2013 Estimated full valuation: $1.67 billion (-9.2 % since 2009, average annual change of -1.8%)

2013 Estimated full value per capita: $72,401

Median family income: $64,607 (108% of state and 103% of US)

Per capita income: $30,419 (121% of state and 111% of US)

FY2012 General Fund balance (audited): $3 million (9.9% of revenues)

FY2012 Net Cash and Investments (audited): $5.6 million (18.8% of revenues)

Direct Debt burden: 3.5% of full valuation

Principal payout (10 years), as of June 2013: 25.9%

Total debt outstanding: $58.6 million

Fiscal 2011 Moody's Adjusted Net Pension Liability: $120.0 million (3.38 times operating revenues)

RATING METHODOLOGY

The principal methodology used in this rating was General Obligation Bonds Issued by US Local Governments published in April 2013. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

REGULATORY DISCLOSURES

For ratings issued on a program, series or category/class of debt, this announcement provides certain regulatory disclosures in relation to each rating of a subsequently issued bond or note of the same series or category/class of debt or pursuant to a program for which the ratings are derived exclusively from existing ratings in accordance with Moody's rating practices. For ratings issued on a support provider, this announcement provides certain regulatory disclosures in relation to the rating action on the support provider and in relation to each particular rating action for securities that derive their credit ratings from the support provider's credit rating. For provisional ratings, this announcement provides certain regulatory disclosures in relation to the provisional rating assigned, and in relation to a definitive rating that may be assigned subsequent to the final issuance of the debt, in each case where the transaction structure and terms have not changed prior to the assignment of the definitive rating in a manner that would have affected the rating. For further information please see the ratings tab on the issuer/entity page for the respective issuer on www.moodys.com.

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