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New Issue

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# Gallup-McKinley County School District No. 1, NM

## New Issue - Moody's Assigns A1 Underlying & Aa1 Enhanced to Gallup-McKinley CSD No. 1, NM's $7.8M in GOULTs, Ser. 2016

### Summary Rating Rationale

Moody's Investors Service has assigned an A1 underlying rating to Gallup-McKinley County School District No. 1, NM's $7.8 million General Obligation School Building Bonds, Series 2016. Concurrently, Moody's has affirmed the A1 on $34.1 million in outstanding parity debt. The district has an additional $7.5 million not rated by Moody's. Moody's has also assigned a Aa1 enhanced rating to the Series 2016 GO bonds based on the New Mexico School District Enhancement Program (NMSDEP) - Post March 30, 2007.

The A1 rating reflects the district's large tax base, which is concentrated in coal, oil and gas. Risks associated with exposure to market volatility associated with that concentration are somewhat offset by the district's manageable debt burden and healthy financial position, with almost 90% of operating revenues derived from state and federal sources. The rating further incorporates the district's below average socioeconomic profile and elevated pension burden.

The Aa1 enhanced rating on the Series 2016 General Obligation Bonds is based on our assessment of the NMSDEP - Post March 30, 2007 and the amount of state aid available for intercept relative to debt service. For additional information on the program, please see Moody's report on the NMSDEP dated May 4, 2008.

### Credit Strengths

» Healthy financial operations and improving reserve levels

» Stabilizing enrollment levels

» Manageable debt profile with above average principal amortization

### Credit Challenges

» Economic concentration in coal, oil, and gas

» Below average resident income levels

» Elevated pension burden

## Rating Outlook

Moody's generally does not assign outlooks to local government credits with this amount of debt outstanding.

## Factors that Could Lead to an Upgrade

» Expansion and diversification of the tax base

» Improvement of the socioeconomic profile

## Factors that Could Lead to a Downgrade

» Failure to maintain balanced operations resulting in a material decline in reserves

» Significant contraction of the tax base; loss of student enrollment

## Key Indicators

Exhibit 1

| Gallup-McKinley County School District 1, NM | 2011 | 2012 | 2013 | 2014 | 2015 |
|---|---|---|---|---|---|
| Economy/Tax Base | | | | | |
| Total Full Value ($000) | $ 2,201,921 | $ 2,273,400 | $ 2,297,356 | $ 2,477,073 | $ 2,478,063 |
| Full Value Per Capita | $ 34,615 | $ 37,585 | $ 37,397 | $ 40,323 | $ 40,339 |
| Median Family Income (% of US Median) | N/A | 58.7% | 57.0% | N/A | N/A |
| Finances | | | | | |
| Operating Revenue ($000) | $ 97,657 | $ 96,341 | $ 99,873 | $ 100,337 | $ 109,409 |
| Fund Balance as a % of Revenues | 17.8% | 9.5% | 21.3% | 22.6% | 33.2% |
| Cash Balance as a % of Revenues | 16.0% | 12.4% | 16.0% | 21.3% | 30.5% |
| Debt/Pensions | | | | | |
| Net Direct Debt ($000) | $ 69,062 | $ 69,685 | $ 63,130 | $ 65,090 | $ 67,410 |
| Net Direct Debt / Operating Revenues (x) | 0.7x | 0.7x | 0.6x | 0.6x | 0.6x |
| Net Direct Debt / Full Value (%) | 3.1% | 3.1% | 2.7% | 2.6% | 2.7% |
| Moody's - adjusted Net Pension Liability (3-yr average) to Revenues (x) | N/A | 3.3x | 3.5x | 3.6x | 3.1x |
| Moody's - adjusted Net Pension Liability (3-yr average) to Full Value (%) | N/A | 13.8% | 15.1% | 14.7% | 13.7% |

*Source: Gallup-McKinley County School District No. 1, NM; Moody's Investor Services*

## Detailed Rating Considerations - Enhanced

Moody's has assigned an enhanced rating of Aa1 to the Series 2016 General Obligation School Building Bonds, equivalent to the NMSEP-Post March 30, 2007 programmatic rating. Ratings on individual intercept financings depend on the programmatic rating as well as the evaluation of additional rating factors. These factors include the sufficiency of interceptable revenues as determined by specific coverage tests, the timing of the state's fiscal year as it relates to scheduled debt service payment dates, and the transaction structure.

Based on the district's state equalization guarantee (SEG) funds for fiscal year 2015, interceptable state-aid provides an ample minimum of 9.72 times coverage of maximum periodic debt service. Further, state revenues provide an adequate minimum 8.91 times maximum periodic debt service coverage when coverage is stressed by deducting the state's final monthly state aid payment within a fiscal year. State-aid funding levels for New Mexico school districts have been stable in recent years, but have experienced mid-year cuts to address fiscal stress at the state level within the last decade. This weakness is somewhat mitigated by a continued level of ample debt service coverage as previously discussed. Principal payments are scheduled for August, early in the State's fiscal year, and is considered an average interval that mitigates the risk of late budgets. The program requires the appointment of a third-party fiscal agent, who is required to notify the state if an intercept of SEG is required. The Bank of Albuquerque is the fiscal agent for the current sale.

## Detailed Rating Considerations - Underlying

### Economy and Tax Base: Sizeable Tax Base with Concentration in Coal, Oil and Gas

The size of the district's tax base will likely fluctuate in the near-term, given concentration in the energy industry. However, given that a majority of the district's funding is derived from the state and federal governments, financial operations should remain largely unaffected by possible future contractions. The district encompasses nearly 5,000 square miles and is adjacent to the Navajo Nation and the Zuni Pueblo in northwestern New Mexico. Interstate 40 is the main transportation corridor and passes through the city of Gallup, which is the only incorporated city within the district and represents about one-third of total district population. Gallup is located 140 miles west of Albuquerque (Aa1 stable) and 15 miles east of the Arizona (Aa2 stable) border.

The local economy is supported primarily by coal mining, electricity generation, oil and natural gas extraction, refining and pipelines. The tax base has grown an average of 2.8% annually over the last five years, with only one moderate annual decline in fiscal 2011. Fiscal 2016 assessed value (AV) is $833.4 million, derived from a moderately-sized equalized value of $2.5 billion. Approximately 45.7% of AV is centrally assessed, representing coal mines and pipelines. Residential properties account for 31.9% and oil and gas reserves are a modest 0.32%. Additionally, the district has high taxpayer concentration, with top ten taxpayers representing 41.9% of fiscal 2016 AV. The top three, El Segundo Coal Company, Tri-State Generation and Western Refinery, account for 29.1% of the total.

El Segundo Coal Mine is owned by Peabody Energy Corp. (Caa3 negative); however, in November 2015, the company agreed to sell the asset to Bowie Resource Partners LLC (B2 ratings under review - downward pressure). The sale has not been finalized. El Segundo opened in 2008, and has long-term coal agreements with Arizona Public Service Company (A2 stable) and Tucson Electric Power, a credit positive. Tri-State G&T Association Inc. (Baa1 stable) owns Plains Escalante Generating Station, a coal-fired power plant, opening in 1984. Coal is supplied by El Segundo mine. The plant employs 120 people. Western Refining, Inc. (B1 stable) is the only crude oil refinery within the Four Corners region, and employs 389 people. Officials report that production at these companies has not slowed, and there are no concerns regarding job loss, either from the decline in oil and gas prices or potential future cost of environmental compliance.

District enrollment stabilized in fiscal 2016 increasing .4% to 11,173, and will likely improve over the next several years. Since fiscal 2012, enrollment has declined by 584 students in aggregate. The district attributes annual losses to out-migration and competition from charters and federally-managed schools. The district is focused on maintaining, if not increasing, current enrollment levels, and is modernizing schools, developing cyber academies and leveraging partnerships with universities and local businesses to attract and retain students. For fiscal 2017, officials anticipate enrollment growth of 0.4% to 1%.

Resident income levels remain weak relative to national medians with median family income that is equal to 57% of the US median according to the 2013 American Community Survey. McKinley County's 9.3% unemployment rate in November 2015 is high relative to the state's 6.5% and nation's 4.8% during the same timeframe.

### Financial Operations and Reserves: Strong Financial Performance; Majority of Revenues from State and Federal Sources

The district's strong financial position will likely remain stable over the mid-term given management's conservative budgeting practices and substantial financial reserves. The district has reported sizeable surpluses four of the past five years, increasing General Fund balance to $23.8 million or 23.2% of revenues as of fiscal 2015 year-end. Approximately $5.6 million of the $8.7 million surplus realized in 2015 is attributed to delayed receipt of federal impact aid; the district had not received payments from fiscal 2011, fiscal 2012 and fiscal 2013. The district has earmarked $3 million of that one-time payout for debt service on revenue bonds issued for teacher housing.

In fiscal 2015, a majority of General Fund revenues were derived from state (63.8%) and federal (29.4%) sources. Given that the district does not rely on property taxes for operations, if the base were to contract due to pressure in the energy sector, the district would remain largely unaffected from a revenue standpoint. However, if the contraction were to result in job loss and subsequent enrollment declines, state and federal funding could be adversely impacted. Future reviews will focus on the district's ability to balance recurring expenditures and revenues.

The fiscal 2016 budget projects use of $6.6 million in cash reserves, which is a typical budgeting practice of New Mexico school districts. The district has benefitted from increased state aid and federal apportionments, and conservatively expects to balance the budget with a nominal use of fund balance.

The district is in early stages of fiscal 2017 budget preparation.

#### LIQUIDITY

The district's fiscal 2015 General Fund cash position is favorable, with $19.6 million, or 19.2% of revenues, held in reserve. This is a marked increase from prior year's $9.5 million, or 10.2% of revenues. Operating net cash, including both the General Fund and Debt Service Fund, is $33.4 million, or 30.5% of operating revenues. Moody's notes that a majority of monies in the Debt Service Fund are expended in August of the following fiscal year for debt payments.

### Debt and Pensions: Manageable Debt Burden with Rapid Principal Payout; Elevated Pension Burden

We expect the district's debt burden to remain manageable over the long-term given rapid principal amortization. At 2.7% of fiscal 2016 full value, the district's debt burden is above average compared to state and national A1 medians of 1.5% and 1.6%, respectively. Included in the burden is $19.6 million of revenue bonds issued through the New Mexico Finance Authority (NMFA) for teacher housing. Post-sale, the district will not have any authorized unissued debt remaining. Given ongoing capital needs, officials anticipate approaching voters in February 2017 for a $25 million authorization. If approved, the district will issue in installments over the following three to four years.

Voters approved extension of the district's two mill capital levy in February 2016 for another six years. The levy generates approximately $1.4 million per year for various capital improvements.

#### DEBT STRUCTURE

Inclusive of the new issuance, the district has $49.3 million in GOULT bonds outstanding. All debt is retired by 2028. The NMFA revenue bonds retire by 2026. Ten year principal amortization is rapid at 90.2%.

#### DEBT-RELATED DERIVATIVES

The district is not party to any interest rate swaps and does not have any variable rate debt.

#### PENSIONS AND OPEB

The district has an above-average employee pension burden, based on unfunded liabilities for its share of the Educational Retirement Board (ERB), a cost sharing plan administered by the state. Moody's fiscal 2015 adjusted net pension liability (ANPL) for the district, under our methodology for adjusting reported pension data, is $334.9 million, or an elevated 3.06 times operating revenues. The three-year average of the district's ANPL to operating revenues is 3.10 times, while the three-year average of ANPL to equalized value is very elevated at 13.69%. 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.

The New Mexico pension plan funding structure experienced several changes with the signing of SB 115 in 2013, including the reduction of a cost-of-living adjustment (COLA) and increases in employee contributions. The legislation will maintain the funding changes until the plan has reached 100% funding, which is estimated to be achieved in 2043. We believe the funding changes adopted in SB 115 will limit budgetary pressure on the district related to future pension costs.

For more information on Moody's insights on employee pensions and the related credit impact on companies, government, and other entities across the globe, please visit Moody's at www.moodys.com/pensions.

### Management and Governance

New Mexico school districts have an institutional framework score of “A,” or moderate. Districts have a low ability to raise revenues because state aid provides over 95% of funding, and property taxes are subject to a small 0.5 mill cap. State aid is moderately predictable given a recent trend of increased funding and a history of funding cuts over the past decade. Expenditures, which are primarily comprised of personnel and facility costs, are moderately predicable given flat student enrollment levels. Districts have a moderate ability to reduce expenditures given above average fixed costs.

The district does not have a formal fund balance policy.

## Legal Security

The bonds are secured by ad valorem taxes that are levied against all taxable property within the district without limitation as to the rate or amount.

## Use of Proceeds

Proceeds will be used for various capital projects, specifically completion of Lincoln and Thoreau elementary schools.

## Obligor Profile

The district is located in McKinley County in western New Mexico (Aaa stable), and encompasses 4,957 square miles, the largest school boundary in the state. Current enrollment is approximately 11,000 students.

## Methodology

The principal methodology used in the underlying rating was US Local Government General Obligation Debt published in January 2014. The principal methodology used in the enhanced rating was State Aid Intercept Programs and Financings: Pre and Post Default published in July 2013. Please see the Ratings Methodologies page on www.moodys.com for a copy of these methodologies.

## Ratings

Exhibit 2

### GALLUP-MCKINLEY COUNTY SCHOOL DISTRICT 1, NM

| Issue | Rating |
|---|---|
| General Obligation School Building Bonds, Series 2016 | A1 |
| Rating Type | Underlying LT |
| Sale Amount | $7,750,000 |
| Expected Sale Date | 03/07/2016 |
| Rating Description | General Obligation |
| General Obligation School Building Bonds, Series 2016 | Aa1 |
| Rating Type | Enhanced LT |
| Sale Amount | $7,750,000 |
| Expected Sale Date | 03/07/2016 |
| Rating Description | General Obligation |

*Source: Moody's Investors Service*

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