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Ratings

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Summary:

Lone Star College System, Texas; General Obligation

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Summary:

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Credit Profile		
US$132.17 mil ltd tax GO bnds ser 2017A due 08/31/2046		
Long Term Rating	AAA/Stable	New
Lone Star Coll Sys GO		
Long Term Rating	AAA/Stable	Affirmed

Rationale

S&P Global Ratings assigned its 'AAA' rating to Lone Star College System, Texas' series 2017A limited-tax general obligation (GO) bonds. At the same time, S&P Global Ratings affirmed its 'AAA' rating on the system's limited-tax-supported debt outstanding. The outlook is stable.

The bonds are payable from an ad valorem tax levied on all taxable property within the system's taxing boundaries. The system's tax rate is capped at 80 cents per $100 of assessed value (AV), with no more than 50 cents allowed for debt service and the remaining 30 cents for operations. Although the tax is limited, we do not consider this a credit constraint and view it as equal to a GO pledge due to the significant tax levy flexibility under the current state cap. The system's total tax rate is currently just 10.78 cents, with 8 cents allocated for maintenance and operations and 2.78 cents for debt service for fiscal 2017.

Lone Star College System's GO bonds are eligible to be rated above the sovereign because we believe the system can maintain better credit characteristics than the U.S. in a stress scenario. Under our criteria, titled "Ratings Above The Sovereign: Corporate And Government Ratings—Methodology And Assumptions," published Nov. 19, 2013, on RatingsDirect, U.S. local governments are considered to have moderate sensitivity to country risk. The system's GO pledge is the primary source of security on the debt; this severely limits the possibility of negative sovereign intervention in the payment of the debt or in the operations of the system. The institutional framework in the U.S. is predictable for local governments, allowing them significant autonomy, independent treasury management and no history of government intervention.

The college system intends to use the proceeds from the series 2017A issuance to finance the construction and equipment of school buildings in the system, as well as acquisition of necessary sites for the abovementioned purpose.

The rating reflects our opinion of the Lone Star College System, specifically its:

- Participation in the Houston-The Woodlands-Sugar Land metropolitan statistical area's (MSA) deep and diverse economy, resulting in strong income and wealth levels;
- Good financial position, with a diverse revenue mix of state funding, local property taxes, and student tuition;
- Significant amount of revenue-raising flexibility that offsets potential pressures from enrollment-driven capital

needs;

- Strong management with well-embedded and likely sustainable financial policies and practices under our Financial Management Assessment (FMA) methodology; and
- Low direct debt, albeit moderately high when factoring overlapping entities.

Economy

Lone Star College System, with an estimated 2.36 million residents, is the largest institution of higher education in the greater Houston MSA, encompassing more than 1,400 square miles in northern Harris County and southern Montgomery County. Reflecting the nature of employment opportunities available to residents locally and throughout the Houston-The Woodlands-Sugar Land MSA, resident median household effective buying income and per capita income levels are a strong 127% and 121% of the national level, respectively. Market value per capita, a wealth indicator, is also strong at $71,352.

The system's service area is in one of the fastest-growing regions in the state with healthy tax base expansion due largely to its access to, and participation in, the rapidly growing Houston MSA economy, which we consider broad and diverse. The property tax base is primarily residential with a substantial commercial and industrial tax base. Single- and multi-family residential properties constitute 59.3% of the service area's taxable base, followed by commercial and industrial properties, which account for 19% of assessed value (AV). While recent declines in oil prices have led to some uncertainty over near-term employment in the oil industry--a significant sector in the Houston MSA--we believe the economic base is broad and diversified enough to withstand a moderate oil industry slowdown. The tax base is diverse, in our view, with the 10 leading taxpayers accounting for 4.4% of fiscal 2016 AV.

Furthermore, the system's already-large property tax base continues to grow rapidly. Taxable AV has increased an aggregate 37% over the past three years, reaching $168.9 billion in fiscal 2016. With substantial development underway in the residential, commercial, and industrial sectors, officials indicate that AV growth will continue to rise at similar rates over the next several years.

Lone Star College System operates six main campuses, along with eight workforce centers and two university centers. Degree programs include an associate of arts, associate of sciences, and associate of applied science; in addition, it offers technical certificates, continuing education courses, and workforce development training.

The system's overall enrollment has continued to grow, with an unduplicated headcount of 72,363 credit students, a duplicated headcount of 85,661 credit students, and 98,661 credit and non-credit students for fall 2016. Management reports the training of the local workforce due to the strong local economy and the nationwide affordability of higher education is generating the enrollment growth. Management budgeted conservatively for a 3% increase in enrollment for fall 2016 (fiscal 2017) and estimates actual enrollment is likely to be approximately 4%. Although recent trends have indicated stronger annual enrollment growth, management conservatively projects 3% growth for fall 2017 (fiscal 2018).

Finances

The system's financial performance is strong, in our view, with a history of operating surpluses on a full-accrual basis. However, for fiscal year-end 2015, the change in net income before capital was slightly negative at $1.9 million, compared with $2.97 million at fiscal year-end 2014. Management reports that although it did not exceed its budget, revenues came in slightly lower and expenditures came in higher than anticipated.

For fiscal 2016, we understand management projected a $5.94 million deficit on a full-accrual basis. However, it estimates that the college system will finish fiscal year-ended Aug. 31, 2016 with a surplus due to rising AVs, coupled with new tax base growth, which contributed to an approximately $20.4 million increase to property tax revenue over fiscal 2015. In addition, annual state appropriations increased by $7 million. At the same time, student tuition and fee revenue remained flat from the previous year. On the expenditure side, management notes instruction, student services, institutional support, and plant operations expenses increased by $13.2 million, which is partially offset by a $12.1 million reduction in scholarship costs. According to the system's draft audited results for fiscal 2016, it projects a positive operating result of approximately $5.96 million.

Lone Star College System budgeted for positive $3.32 million operating result for fiscal year-ending Aug. 31, 2017. Based on its conservative budget estimates, management projects the system's total revenues will increase by approximate 2%, and total expenditures will rise by 1%. Based on actual performance, management reports key revenues are tracking above budget, while expenditures are on target with the budget. At fiscal year-end, management projects surplus operating results.

The system has good revenue diversity with 38% of operating revenues derived from property taxes, 21% from state appropriations, and 21% from student charges (tuition, fees, and auxiliary revenues). Tuition and fees remain competitive with other Houston-area community college systems, in our view. For the 2016 fall semester, the cost for 12 semester hours for an in-system student (constituting 84.3% of the system's students) is about $848. For the current fiscal 2016-2017 biennium, the system's total state appropriations are approximately $74 million per year, which is a 2% increase from the previous biennium.

The system's unrestricted net assets (UNA) as of fiscal year-end 2015 were a negative $28.2 million compared with $52.5 million at fiscal year-end 2014. For fiscal 2016, management indicates the system's UNA are expected to be a negative $44.45 million. This decrease primarily reflects the restatement to the beginning net position in 2015 of $54.6 million as required by the implementation of Governmental Accounting Standards Board (GASB) 68 as amended by GASB 71. Not including pension liabilities, adjusted UNA equated to $26.4 million, or a good 6.4% of operating expenditures for fiscal 2015. Based on unaudited results for fiscal 2016, adjusted UNA equated to $34 million, or a good 7.3% of operating expenditures Fiscal 2015 year-end cash and investments (net of unspent bond proceeds) equated to 24% of operating expenditures. The system's formal reserve policy is to maintain a minimum of 16% of operating expenditures.

At the same time, we believe management's budget management framework--which includes the adoption of conservative revenue and expenditure estimates, a centralized purchasing and expenditure system, and close monitoring of monthly budget activities--remains one of the key elements supporting the system's historically strong financial performance. Therefore, we do not anticipate Lone Star College System's financial position will deteriorate over the next two years.

Management

We consider the system's financial management practices strong under our Financial Management Assessment methodology, indicating practices are strong, well-embedded, and likely sustainable.

Key budgeting practices include management's use of three-to-five years of historical information to form its revenue and expenditure assumptions. In preparation of its annual budget, the system consults various outside sources, including appraisal districts to estimate AV growth and demographic information to calculate enrollment growth. The college system also reviews enrollment projections with local school districts, and it evaluates changes to student tuition and fees. In addition, Lone Star College System incorporates adjustments to annual debt service, new facility funding (included as buildings that are completed/opened), state benefit increases, and new faculty and benefit increases (including a 7% increase in health insurance each year). In addition, management meets with campus administrators to discuss capital and program needs and personnel needs, as well as performance goals and incentives.

During each fiscal year, officials monitor budgetary performance regularly, delivering monthly budget-to-actual reports to the board of trustees. On an as-needed basis, management recommends budget amendments to address expenditure reclassifications and supplemental appropriations, which the board must approve. In addition, the system has a written investment policy with strong internal controls and management provides a monthly summary to elected officials that details holdings and performance, and a more comprehensive quarterly performance report.

In addition, the system maintains a five-year long-term capital improvement plan (CIP), as well as a five-year financial model to provide insight into its operations related to new facilities and future conditions affecting the budget. The CIP identifies projects by department, costs and funding sources. Management updates both plans at least annually and management shares both the long-term financial forecasts with the board. The system's basic debt management policy provides written guidelines for various types of debt issuances allowed and maximum maturity and amortization of debt. It also prohibits the use of interest rate swaps and derivatives. The system also maintains a formal unrestricted cash reserve policy, which the board of trustees reviews and adopts annually. The board adopted a 16% cash reserve policy to maintain sufficient reserves for cash flow needs, in the event of emergencies or other unforeseen expenses.

Debt

The system issues both limited-tax and tuition revenue bonds. After this issuance, its limited-tax debt outstanding will total roughly $659.88 million while its tuition revenue debt is about $87.21 million. Direct tax-supported debt equates to approximately 0.44% of AV.

However, including all overlapping entities, the system's overall debt burden is what we consider a moderately high 8.6% of AV, or high at $6,134 per capita. This substantial variance between direct and overall debt is due to the numerous overlapping school systems and municipal utility systems within the college system's service area, and the significant amount of tax-supported debt they issue.

At the same time, amortization is average, with over 41% of tax-supported principal debt due to mature in 10 years, and all debt 2046. After this issuance, the system will have roughly $185 million of authorized but unissued bonds remaining from its 2014 bond authorization. Currently, officials are assessing the timeline for additional campus and systemwide needs through its capital planning process, but they expect the remaining balance could be issued over the next three-to-five years.

Pension and other postemployment benefit liabilities

The system contributes to the Teacher Retirement System of Texas (TRS), a cost-sharing, multiemployer, defined-benefit plan. In addition, employees can choose to participate in an optional retirement program (ORP) in lieu of participation in the TRS. Contribution requirements for both plans are not actuarially determined but are established and amended by the state legislature.

At fiscal year-end June 30, 2015, its proportionate share of TRS' net pension liability was approximately $48.59 million. Furthermore, the system contributed $4.95 million to TRS and $2.56 million to ORP, or 100% of its actuarially determined contribution, in fiscal 2015. As of Aug. 31, 2014, the most recent actuarial valuation, TRS' fiduciary net position as a percent of the total pension liability was 83.3%, which, in our view, is well funded. For fiscal 2016, the college system expects to contribute $5.321 million to TRS and $2.601 million to ORP.

The district also provides other postemployment benefits in the form of health care insurance through the state-administered state retiree health plan (SRHP). During fiscal 2015, it contributed $2.996 million to SRHP. Combined, TRS, ORP, and SRHP costs accounted for approximately 2.4% of total governmental expenditures in fiscal 2015, which, in our opinion, is low. For these reasons, we do not expect long-term liabilities to place significant downward budgetary pressure on the system's finances.

Outlook

The stable outlook reflects our expectation that the service area's strong economy, which centers on the rapidly growing and diverse Houston-The Woodlands-Sugar Land MSA, will continue to allow for ongoing tax revenue and enrollment growth. It also reflects our expectation that the system's strong financial management and good budgetary flexibility should allow it to at least maintain its strong financial profile. For these reasons, we do not expect the rating will change within our two-year outlook horizon.

While we do not expect it to occur, we could lower the rating should the system experience substantial economic or financial deterioration, leading to a significant or sustained decline in reserves or liquidity.

Ratings Detail (As Of December 14, 2016)		
Lone Star Coll Sys GO		
Long Term Rating	AAA/Stable	Affirmed
Lone Star Coll Sys GO		
Long Term Rating	AAA/Stable	Affirmed
Lone Star Coll Sys GO		
Unenhanced Rating	AAA(SPUR)/Stable	Affirmed
Lone Star Coll Sys GO		
Long Term Rating	AAA/Stable	Affirmed

Many issues are enhanced by bond insurance.

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com. All ratings affected by this rating action can be found on the S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.