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Lone Star College System, Texas; General Obligation

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US$20.0 mil ltd tax GO rfdg bnds ser 2020 due 08/15/2036		
Long Term Rating	AAA/Stable	New
Lone Star Coll Sys GO		
Long Term Rating	AAA/Stable	Affirmed
Lone Star Coll Sys GO		
Long Term Rating	AAA/Stable	Affirmed

Rating Action

S&P Global Ratings' assigned its 'AAA' long-term rating to Lone Star College System (district), Texas' $20 million series 2020 limited tax general obligation refunding bonds. At the same time, we affirmed our 'AAA' rating on the district's existing (GO) debt. The outlook is stable.

The rating reflects our view of the district's seasoned management team, healthy tax base, revenue and expenditure flexibility, and solid reserve levels coupled with its participation in the Texas economy. So far, based on our management discussions, there has been an immaterial impact on the district's finances and economic base due to the COVID-19 pandemic and the current recession.

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. We view the limited-tax GO debt pledge on par with the district's general creditworthiness, because there is no significant limitation on resource fungibility available to the district. The district'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 2020. Officials will use the bond proceeds to refund its series 2008 bonds for savings.

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 "Ratings Above The Sovereign: Corporate And Government Ratings—Methodology And Assumptions" criteria, published Nov. 19, 2013, 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.

We understand that due to the COVID-19 outbreak and given broader public safety concerns, the district closed its campus locations and transitioned lecture-based courses online for the remainder of the spring and summer 2020

semesters. Courses with lab and clinical instruction that do not transfer easily to an online format are anticipated to be opened on a limited basis on June 1, 2020 following an initial suspension. These developments are consistent with the district's in-state and national peers.

There is a lot of uncertainty about the duration and extent of the impact from the COVID-19 outbreak and the related effects on the performance of the entities we rate, including their ability to continue delivering programs virtually, and the potential of increased demands for the refunding of tuition, fees, and auxiliary revenues. Management reports the transition to online has been smooth and, so far, there are no meaningful unplanned expenses from COVID-19. The district expects to receive $28 million from the federal Coronavirus Aid, Relief and Economic Security (CARES) Act, of which 50% must be used on student-related emergency grants, with the remainder expected to support districtwide operations. We expect state funding to continue for the fiscal 2020 year. Pre-COVID-19 and recession, based on the governor's initial budget proposal, the district's fiscal 2021 state funding was expected to remain flat from fiscal 2020. At this time, the district is cautiously optimistic that this funding will not decline, and management is also contingency planning in the event there are any decreases.

We believe the pandemic and economic uncertainties could hamper the district's finances if state funding and enrollment decline meaningfully, student-generated charges (tuition, fees, and auxiliary revenues) drop due to a growing demand for refunds, or additional unexpected expenses are incurred related to virtual delivery. Management maintains good reserve levels. In our view, this partially mitigates near-term risks, although the full effect on state, federal funding, and emergency reimbursements are unknown at this point. We will closely monitor development from COVID-19 and the recession for potential credit impacts on the district and take appropriate actions.

Credit overview

The rating reflects our opinion of the district's history of balanced operational performance on a full-accrual basis, good revenue diversity, and tax-raising flexibility. Factors that support the rating include the district's solid and growing property tax base, significant tax-raising flexibility, diverse operating revenue streams, and increased state appropriations. While many Texas community colleges have seen recent enrollment declines, the district experienced moderate growth as a result of the solid demand from both its traditional transfer and workforce-development programs.

The district currently has $185 million of authorized, but unissued general obligation debt, and officials are discussing plans to issue a portion of this debt by the end of 2020. It does not have any plans to issue revenue or maintenance tax notes.

The 'AAA' rating further reflects the district's:

- 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 revenue diversity with most revenues tied to property taxes, tuition and fees, and state appropriations. Solid financial flexibility from substantial operating-tax-rate capacity, competitive tuition rates, and a healthy, growing tax base; and
- 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.

We believe these strengths are partially offset by the district's:

- Modest financial ratios indicative of the 'AAA' category, with adjusted unrestricted net assets (UNA) equal to 6.7% of operating expenses; and
- Historically lackluster and volatile full-accrual operating performance, but consistently positive on a cash basis coupled with modest improvement budgeted for fiscal 2020.

Generally our rating outlook timeframe is up to two years. Given the current uncertainty around the pandemic, our view of the district's credit risks revolve around the more immediate potential budget effects in fiscal 2021. 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.

As of May 2020, total GO-supported long-term debt is approximately $571 million, including maintenance tax notes.

Environmental, social, and governance factors

In our view the district is exposed to elevated social risk due to the uncertainty about the duration of the COVID-19 pandemic, and the unknown impact on fall 2020 enrollment levels and mode of instruction. We view the risks posed by COVID-19 to public health and safety as a social risk under our environmental, social, and governance (ESG) factors. Despite the elevated social risk, we believe the district's environmental and governance risk are in line with our view of the sector as a whole.

Stable Outlook

Downside scenario

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. Although we think that management has taken steps to address COVID-19 pandemic, we could consider a negative rating action during the outlook period should unforeseen pressures related to the pandemic materially affect the district's demand, finances, or trajectory.

Credit Opinion

Lone Star College System, with an estimated 2.3 million residents, spans more than 1,400 square miles principally in northern Harris County and southern Montgomery County. It includes six campuses, eight centers, and two university centers. The system's boundaries include 11 different school districts, with students coming from these and other districts not in the system's boundaries.

The district's service area is in one of the fastest-growing regions in the state, with healthy tax base expansion due largely to access to and participation in, the rapidly growing Houston MSA economy, which we consider to be broad

and diverse. This has allowed the college to post steady enrollment trends with full-time enrollment counts equal to 51,316 for fall 2019. Officials are projecting relatively flat growth in the near term of 1%-2% annually.

Furthermore, the system's already large property tax base continues to grow rapidly. Taxable AV has increased an aggregate 31% over the past four years, reaching $195 billion in fiscal 2019. With substantial development underway in the residential, commercial, and industrial sectors, officials indicate that AV growth will increase nearly 7% for fiscal 2020.

Finances

The system's financial performance remains satisfactory in fiscal 2019, in our view. The district has reported surpluses in each of the past four years. Fiscal 2018 and 2019 saw a significant increase in revenues mainly due to state support, and the rate of expense growth was minimal in these years, which contributed to higher surpluses as compared with previous years.

State appropriations increased $12.7 million in 2019, primarily due to Hurricane Harvey specific appropriated funding. State appropriations increased $7.1 million in 2018 as a result of additional growth funding received and an increase in state contributions for health insurance. Tax revenues increased $7.6 million in 2019 and $8.7 million in 2018 due to an increase in appraised values and the addition of new properties tied to continued healthy area economic expansion. Officials did approve a tuition increase for in-district students to $1,086 per 12 student credit hours, which still allowed them to maintain the 10th-lowest in-district tuition rates in the state, allowing continued financial flexibility, in our view.

For fiscal 2020, officials expect revenues for its three main sources--property taxes, tuition and fees, and state appropriations-- to come in as budgeted or better and result in at least breakeven operations. Officials conservatively project to use $7.8 million of the $14.0 million CARES Act funding for operations as well as realize $5.7 million in expenditure cuts tied to hiring freezes at fiscal year-end 2020. We also believe officials have budgetary flexibility given their conservative revenue and expenditures estimates, which are currently tracking better than budgeted. Officials have no plans to draw-down unrestricted cash in fiscal 2020 and are projecting to have $6.2 million in CARES funding available for operations in fiscal 2021, without including potential higher revenue realized from budgetary flexibility. While fiscal 2021 state appropriations remain unchanged since the most recent legislative session, we believe that it could adversely affect fiscal 2021 revenues, given the current economic climate. We will monitor operating results as information becomes available over the course of our routine credit surveillance.

The system has good revenue diversity, in our view, with approximately 40% of operating revenues derived from property taxes, about 20% from state appropriations, and roughly 20% from student charges (tuition, fees, and auxiliary revenues). Tuition and fees remain competitive with other Houston-area community college systems, in our view.

The system's adjusted UNA as of fiscal year-end 2019 were $33 million or what we consider a good 6.7% of operating expenses after pension and OPEB-related adjustments. We will monitor the system's adjusted UNA levels and would view any material decrease from current levels as a negative credit factor.

Management

We consider the system's financial management practices strong under our FMA 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, program, 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 as well as 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 it shares them 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 cash-reserve policy to maintain sufficient reserves for cash flow needs, in the event of emergencies or other unforeseen expenses. While not explicitly stated in the reserve policy, 16% is the board's unofficial reserve target.

Debt and pension liabilities

While the district has additional debt plans, it expects the overall debt profile to remain moderate. Following the series 2020 bond issuance, overall net debt, including overlapping entities, is, in our view, moderate at about $3,000 per capita, or 4.2% of market value. Amortization is rapid, with officials planning to retire 76% of principal during 10 years and 100% during 20 years.

We understand management will issue a portion of its remaining $185 million voter-authorized GO bonds during calendar year 2020, with no plans to issue revenue debt or maintenance tax notes. Despite the projected additional debt, we expect carrying charges will likely remain moderate, which management could easily absorb into the annual budget.

The district participates in the Texas Teachers' Retirement System, which was 75.2% funded at Aug. 31, 2019. The district's proportionate share of the collective net pension liability equals about $108 million. In fiscal 2019, the district paid its full required contribution of about $7.2 million toward its pension obligations, or less than 1% of expenditures.

Under a special-funding situation, the state contributes a sizable share of the employer's contribution and carries responsibility for the employer's proportionate share of the unfunded liability. Since the district makes statutory contributions typically lower than actuarially determined contributions (ADCs), fiscal 2019 contributions were materially below static funding and minimal-funding progress. Furthermore, the plan's 30-year, level-dollar, open-amortization schedule will result in slow-funding progress, even if actual contributions met ADCs, and the 6.9% discount rate leads to contribution volatility.

Despite that, we do not view pension and OPEB liabilities as an immediate credit pressure, because required contributions currently account for a small portion of the district's budget and we do not expect this to increase significantly during the next few fiscal years.

Ratings Detail (As Of May 5, 2020)		
Lone Star Coll Sys GO		
Unenhanced Rating	AAA(SPUR)/Stable	Affirmed
Lone Star Coll Sys GO		
Long Term Rating	AAA/Stable	Affirmed
Lone Star Coll Sys GO		
Long Term Rating	AAA/Stable	Affirmed

Many issues are enhanced by bond insurance.

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