S&P Global Ratings

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Summary:

Karnes City Independent School District, Texas; School State Program

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Credit Profile		
US$19.315 mil unltd tax sch bldg bnds ser 2021 dtd 10/01/2021 due 06/15/2031		
Long Term Rating	AAA/Stable	New
Underlying Rating for Credit Program	AA-/Stable	New
Karnes City Indpt Sch Dist PSF/CRS		
Long Term Rating	AAA/Stable	Current
Underlying Rating for Credit Program	AA-/Stable	Affirmed

Rating Action

S&P Global Ratings assigned its 'AAA' program rating and its 'AA-' underlying rating to Karnes City Independent School District (ISD), Texas' anticipated $19.315 million series 2021 unlimited-tax school building bonds. At the same time, we affirmed our 'AA-' underlying rating on the district's general obligation (GO) debt outstanding. The outlook is stable.

The 'AAA' long-term rating reflects our view of the district's eligibility for and participation in the Texas Permanent School Fund (PSF) bond guarantee program that provides the security of a permanent fund of assets, which the district can use to meet debt service on bonds guaranteed by the program. (For more information on the program rating, please see our report on the Texas PSF, published June 25, 2021, on RatingsDirect.)

Revenue from an unlimited ad valorem tax levied, without limit as to rate or amount, on all taxable property within the district secures the rated bonds, including the series 2021 bonds. We understand that the bond proceeds will be used to construct and renovate a new elementary school in addition to a new career and technical education facility. Voters authorized a $22 million issuance for school buildings in November 2020.

Credit overview

The district, located in the heart of the Eagle Ford shale approximately 55 miles southeast of San Antonio, has a history of extremely volatile assessed valuation (AV) largely due to the presence of mineral valuations and exploration activity that is subject to commodity price fluctuations. Given this volatility (and taxpayer concentration), the district maintains reserves of about a year's worth of operating expenditures to protect against revenue volatility, which we view as prudent. In addition, we believe that the district's sizable reserves position allows it to weather economic disruptions and any COVID-driven expense pressures through at least the next one to two years.

The rating further reflects our assessment of the district's:

- Good-to-adequate resident incomes and extremely strong per capita market value;

- Very strong available reserves;
- Rapid amortization, with all outstanding debt scheduled to amortize by 2024 and the series 2021 pro-forma debt service schedule reflecting a final maturity of fiscal year 2031; and
- High overall net debt per capita and a concentrated economic base in oil exploration and production, which has led to significant tax base volatility over the years.

Environmental, social, and governance factors

We believe that the local economy's heavy dependence on oil and gas production exposes the district to outsized environmental risks relative to its peer group, insofar as factors such as potential changes in federal regulations pertaining to carbon emissions and the steady, albeit slow, transition to various renewable energy sources may adversely affect the oil and gas industry, which could in turn pressure the local economy and revenue performance. That said, we believe that the district is mitigating its elevated environmental risks by maintaining very strong reserves and rapid repayment of debt from excess tax collections. We view governance and social factors as neutral within our credit rating analysis. Additionally, officials report that the ISD maintains sufficient protective measures that help protect it from cyber-attacks.

Stable Outlook

Downside scenario

A negative rating action or outlook is possible if the district's extremely strong reserve position (which serves to offset the economic concentration in our view) materially weakens for a sustained period.

Upside scenario

While unlikely, we could consider a higher rating if the local economy were to significantly diversify, leading to greater tax base and employment stability.

Credit Opinion

Core economy is stable with characteristic volatility tied to extraction industries

Karnes City ISD serves an estimated population of more than 5,000, most of which are residents of Karnes City. The district's 2021 market value of $5.3 billion or $1.1 million per capita, which we consider extremely strong. However, the economy is tied to oil and gas production creating characteristic volatility resulting in the district's tax base being subject to significant AV fluctuations beginning in fiscal 2012 when oil exploration and production activity started. Peaking at $6.4 billion in fiscal 2015 after measuring $271 million in fiscal 2011, values have seen continued swings that are tied to commodity prices. While fiscal 2020 values capped a three-year period of growth, values have since declined as expected to a five-year low of $3.5 billion in 2022, or a 42% overall decline from 2020. In addition, we note that roughly 55.4% of net taxable AV comes from the 10 largest taxpayers, representing a concentrated tax base, in our opinion. While we expect that AV will fluctuate given the link to commodity prices, the core economy will likely otherwise remain stable reflective of a relatively stable residential real estate market.

Finances reflect very strong available reserves, a key credit strength

District officials expect enrollment to be stable in the near term, remaining at more than 1,000 students, which we view as reasonable given historical trends. A wealth equalization formula, based on property values and average daily attendance (property wealth per student), determines state funding for all school districts. Therefore, increases or decreases in average daily attendance (enrollment) can lead to corresponding movements in the amount of state revenue a district receives. We understand that the temporary spike in enrollment to more than 1,500 students that occurred in fiscal 2021 was driven by the district's participation in the eSchools Inc. virtual instruction program. This strategic decision allowed the district to maintain sufficient enrollment to qualify for and receive pandemic funding to which it may have otherwise lost access. The district is not continuing its partnership with eSchools, Inc., due to the limited control it has over the virtual instruction program.

Given the district's sizable property valuations, the district's locally generated tax revenue typically exceeds its local entitlement, as outlined by Chapter 49 of the Texas Education Code, requiring it to remit the excess locally collected tax revenue to the state. These payments are directly linked to the district's AV, so increase or decreases will directly lead to changes in amounts remitted to the state which have fluctuated anywhere between $23 million and $51 million during the past several years.

The ISD typically produces general fund surplus that outperform balanced budgets, in part due to conservative estimates of property tax revenues and enrollment. District officials report that unaudited fiscal 2021 results reflect surplus general fund operations, compared to the breakeven budget. The fiscal 2022 general fund budget is balanced, without the use of reserves, and officials expect to again produce surplus results, which we view as reasonable given conservative budgeting practices and historical trends. We note that for fiscal 2020, the district adopted a new fiscal year end of June 30 so that the activity in the fiscal year 2020 audit reflects a short 10-month period. The district depends primarily on property taxes for general fund revenue (91.7%), with state aid accounting for about 6.2% of general fund revenue, based on the fiscal 2020 audit.

Further, the district has been awarded ESSER I, II, and III pandemic relief funds in the amounts of approximately $129,000, $932,000, and $1.4 million, respectively. We understand that approximately 70% of ESSER I funds were expended in fiscal 2021 with the remainder deferred to fiscal 2022. In addition, district officials expect approximately $275,000 of additional pandemic relief funds to be awarded next year. These funds are not included in the general fund budget but serve to support overall operations contributing to our expectation that surplus general fund results will likely continue in the near term.

Given several years of consecutive surplus general fund results, the district's unassigned fund balance grew to approximately $51.0 million (as of fiscal year end 2020), or roughly 86% of annual general fund expenditures. The fund balance excludes approximately $57 million of wealth recapture payments to the state and is not an operating expense of the district; revenue that the local tax base generates offsets the amount paid annually. The estimated recapture payment for fiscal 2021 is nearly $40 million according to preliminary bond documents. We understand that the district has no plans to significantly spend down these reserves and therefore expect the district to maintain the unassigned fund balance at a level we consider very strong.

Management maintains standard practices and adequate policies

We view the district's management practices and policies as standard under our financial management assessment methodology, indicating our view that the finance department maintains adequate policies in some but not all key areas.

Key practices include the use of historical data to perform trend analysis when making revenue and expenditure assumptions. The district updates the school board on budget performance monthly, making amendments as needed. The district also presents monthly updates to the board on investments, in accordance with its formal investment management policy. Long-term financial and capital planning is not performed or updated annually. Specifically, capital planning is largely tied to bond authorizations and is not a rolling plan. The financial forecast primarily reflects revenue (and recapture payments) but does not otherwise reflect operating expenses. The district maintains a formal reserve policy, targeting a minimum four months of operating expenses plus 10% of annual bond payments in assigned and unassigned general fund reserves, to cover potential emergencies or disruptions in revenue. The district has no debt management policy.

Pro-forma debt profile is stable

We believe the district's debt service carrying charges may increase on a pro-forma basis. However, we expect this ratio to remain low in the near term as the district has no plans for additional new debt following the series 2021 issuance.

On a pro-forma basis and following the issuance of the series 2021 bonds, the district will have approximately $27.8 million of debt scheduled to be fully retired by 2032 largely owing to the district's aggressive cash redemption strategy whereby the district uses excess debt service fund accumulations (during years of strong AV growth) to allow it to pay off debt ahead of schedule. We note that the district has one series of debt outstanding that has been privately placed, its series 2017 unlimited tax refunding bonds outstanding in the amount of $5.9 million, as of Sept. 1, 2021 according to preliminary bond documents. However, there are no nonstandard events of default or acceleration rights, so we do not view these series of bonds as carrying additional liquidity risk.

Pension and other postemployment benefit (OPEB) liabilities do not create immediate credit pressure

We do not view pension and OPEB liabilities as an immediate source of credit pressure for the district, as required contributions account for a small portion of total governmental expenditures and are not expected to materially increase during the next few years.

Under a special funding situation, the state contributes a sizable share of the employer contribution and carries responsibility for its proportionate share of the unfunded liability.

Karnes City ISD participated in the following plans as of June 30, 2020:

- Teacher Retirement System (TRS), 75.5% funded with a proportional share of the net pension liability equal to approximately $4.97 million.
- Texas Public School Retired Employees Group Insurance Program (TRS-Care), which provides health insurance coverage to members of the TRS pension plan. TRS-Care is 5.0% funded and the district has a proportionate share of the net OPEB liability of $6.03 million.

The district paid its full required contribution of approximately $294,000 or 0.4% of total governmental expenditures, toward its pension obligations in the fiscal year ended June 30, 2020. Also in fiscal 2020, the district contributed approximately $76,000, or 0.2% of total governmental expenditures, toward its OPEB obligations. Pension and OPEB carrying charges totaled 0.6% of total governmental fund expenditures.

Given that contributions are done on a statutory basis that is typically lower than the actuarially determined contribution, last year's TRS contributions were materially lower than both static funding and minimum funding progress. However, legislative changes increasing contribution rates will likely improve both funding metrics, though some assumptions remain a credit concern. For more information, see "Pension Spotlight: Texas," published Feb. 25, 2020, on RatingsDirect. Likewise, contributions to TRS-Care have not met actuarial recommendations and we believe that the liability and contributions will continue to grow. However, given the special funding situation, we believe that the district's postemployment benefit costs will remain manageable.

Karnes City Independent School District, Texas: Key Credit Metrics

	Characterization	Most recent	--Historical information--		
Economic indicators			**2020**	**2019**	**2018**
Population			5,136	4,951	4,973
Median household EBI % of U.S.	Adequate		90	84	92
Per capita EBI % of U.S.	Good		101	93	104
Market value ($000)		3,539,492	6,087,027	4,514,151	3,584,065
Market value per capita ($)	Extremely strong	689,153	1,185,169	911,766	720,705
Top 10 taxpayers % of taxable value	Concentrated	55.4	61.2	60.4	54.5
Financial indicators					
Total available reserves ($000)			50,958	46,078	41,148
Available reserves % of operating expenditures	Very strong		86.4	99.7	110.0
Total government cash % of governmental fund expenditures			47.9	17.6	20.6
Operating fund result % of expenditures			8.3	10.7	3.8
Financial Management Assessment	Standard				
Enrollment		1,047	1,078	1,096	1,112
Debt and long-term liabilities					
Overall net debt % of market value	Low	1.0	0.4	0.5	0.9
Overall net debt per capita ($)	High	6,902	4,257	4,683	6,162
Debt service % of governmental fund noncapital expenditures	Low		1.6	6.8	6.8
Direct debt 10-year amortization (%)	Rapid	100	100	100	100
Required pension contribution % of governmental fund expenditures			0.5	0.6	0.5
OPEB actual contribution % of governmental fund expenditures			0.1	0.2	0.3
Minimum funding progress, largest pension plan (%)		68.7	63.4	63.4	71.6

EBI--Effective buying income. OPEB--Other postemployment benefits.

Related Research

Through The ESG Lens 2.0: A Deeper Dive Into U.S. Public Finance Credit Factors, April 28, 2020