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CREDIT OPINION
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Palomar Community College District, CA

Update following change in outlook to stable

Summary

Palomar Community College District, CA's (Aa2 stable) credit profile is supported by its extremely large and diverse northern San Diego County tax base, which will continue to see moderate growth in coming years driven by strong demand for housing. A strong resident wealth and income profile also supports the credit profile. The district's financial position is solid and reflects large surplus operations in fiscal 2021 and improved budgetary management following a 2019 report from the Fiscal Crisis and Management Team (FCMAT) which outlined weak governance practices. The district has taken significant steps to improve fiscal policies and procedures, though further action is needed fully achieve all of FCMAT's recommendations. A favorable current state funding environment along with hold harmless provisions in the state's Student Centered Funding Formula (SCFF) will continue to benefit the district as enrollment remains at depressed levels as a result of the coronavirus pandemic. The district has a moderate pension burden, and its debt burden is elevated but manageable. The district's OPEB liability remains above average when compared to peers.

On July 6 we affirmed the district's Aa2 general obligation unlimited tax ratings and revised the outlook to stable from negative.

Credit strengths

» Extremely large and diverse tax base

» Strong resident wealth and income levels

» Favorable current state funding environment

Credit challenges

» Declining enrollment trend

» Further progress to make in budgetary management and oversight

Rating outlook

The stable outlook reflects our expectation that financial reserves will remain healthy and long term liabilities will remain manageable, supported by improved fiscal policies and procedures and a favorable current state funding environment.

Factors that could lead to an upgrade

» Material and sustained improvement in financial reserves and liquidity

» Attainment of community funded (basic aid) status

Factors that could lead to a downgrade

» Continued enrollment declines

» Deterioration of reserves and liquidity

Key indicators

Exhibit 1
Palomar Community College District, CA

	2017	2018	2019	2020	2021
Economy/Tax Base					
Total Full Value ($000)	$109,746,198	$115,980,730	$122,534,373	$128,775,412	$134,997,891
Population	799,020	787,505	807,778	807,778	807,778
Full Value Per Capita	$137,351	$147,276	$151,693	$159,419	$167,213
Median Family Income (% of US Median)	121.4%	123.9%	125.7%	128.6%	128.6%
Finances					
Operating Revenue ($000)	$190,441	$189,048	$216,776	$218,429	$212,241
Fund Balance ($000)	$57,233	$48,730	$42,694	$41,449	$51,944
Cash Balance ($000)	$75,023	$70,169	$64,987	$52,523	$68,139
Fund Balance as a % of Revenues	30.1%	25.8%	19.7%	19.0%	24.5%
Cash Balance as a % of Revenues	39.4%	37.1%	30.0%	24.1%	32.1%
Debt/Pensions					
Net Direct Debt ($000)	$788,965	$784,968	$783,949	$784,427	$723,235
3-Year Average of Moody's ANPL ($000)	$314,411	$343,431	$363,633	$396,572	$478,706
Net Direct Debt / Full Value (%)	0.7%	0.7%	0.6%	0.6%	0.5%
Net Direct Debt / Operating Revenues (x)	4.1x	4.2x	3.6x	3.6x	3.4x
Moody's - ANPL (3-yr average) to Full Value (%)	0.3%	0.3%	0.3%	0.3%	0.4%
Moody's - ANPL (3-yr average) to Revenues (x)	1.7x	1.8x	1.7x	1.8x	2.3x

Sources: US Census Bureau, Palomar CCD's financial statements and Moody's Investors Service

Profile

The district is located in northern San Diego County (Aaa stable) and serves several communities including the cities of San Marcos, Vista, Escondido, Carlsbad, Oceanside and San Diego, and several non-incorporated areas of the county. The district is the largest community college district in the county with a service area of 2,555 square miles. The district operates its main campus in San Marcos, with additional education centers in Escondido, Rancho Bernardo and Fallbrook. Additional outreach sites serve Camp Pendleton, Ramona and Pauma Valley. The district reported full time equivalent students (FTES) of 14,993 in fiscal year 2021.

Detailed credit considerations

Economy and Tax base: large and diverse San Diego tax base remains strong

The district's local economy will remain strong as it benefits from the strength of the greater San Diego economy and strong residential and commercial demand. The district's tax base grew to an extremely large $139.9 billion in fiscal 2022, while growth has averaged a solid 5.0% annually over the last five years. The district has seen substantial residential and commercial development in recent years as it benefits from the availability of land and ample room for further growth in the Northern part of the county. Moderate growth is expected to continue, driven by further population growth and resulting housing demand. The tax base is highly diverse with top 10 taxpayers accounting for a low 1.8% of assessed valuation.

Resident incomes are strong with median family income equal to 128.6% of the national median, while full value per capita is also strong at $173,190, comparing favorably to Aa2 rated state peers. Countywide unemployment was 3.0% as of April 2022, modestly below the state and national rates of 3.8% and 3.3%, respectively.

Financial Operations and Reserves: improved financial position; reserves to remain stable

Financial reserves have significantly improved following a large surplus in 2021 and will remain healthy, supported by favorable state funding in fiscal 2023 and improved fiscal management.

The district's financial position has materially improved after being faced with an $11 million structural deficit in fiscal 2020, though improvements have largely been the result of one-time revenues and pandemic-related expenditure savings which will not continue. The district ended fiscal 2020 with essentially balanced operations, followed by a large $11.2 million surplus in fiscal 2021. The favorable 2020 and 2021 results are primarily driven by significant expenditure savings as a result of campus closures during the pandemic, in addition to the use of one-time COVID relief funds. The district has also achieved savings through prudent staffing decisions, however, which will continue to support stable operations in future years. Available general fund balance of $28.6 million at fiscal 2021 year end is equal to a solid 16.2% of revenue, while on an operating funds (general fund and debt service fund) basis, the district ended 2021 with fund balance approaching a stronger 24.5% of revenue.

The district's enrollment has declined significantly during the pandemic and represents a challenge to the credit profile. Full time equivalent students (FTES) fell to 14,993 in fiscal 2021, down considerably from 17,950 in fiscal 2019. The district reports further decline in fiscal 2022, to levels closer to 14,000 students. Significant enrollment decline has been seen at community colleges across the state, though Palomar notes that its enrollment losses were heightened by its early adoption of vaccine mandates for students, in addition to the mask mandates in place across the state. The vaccine and mask mandates have been rolled back in recent months and management notes that pre-enrollment levels for summer and fall are already showing material improvement. Rebuilding enrollment levels is a high priority for management and extensive outreach efforts are in place, in addition to reestablishing pipelines with high schools and 4-year universities.

Favorably, the state is holding community college districts harmless for enrollment losses through fiscal 2025. Though the district had FTES of 14,993 in 2021, they continue to be funded based upon FTES of 18,342, a support that has benefited the district greatly. State funding for community college districts is also highly favorable in 2023, with a sizable 6.56% cost-of-living adjustment (COLA) in addition to significant per-student funding increases and an additional COVID Recovery block grant. Of note, the district has continued its practice of pass-through COLAs for bargaining units, a practice which FCMAT has recommended should be improved upon.

The district currently projects a roughly $3.5 million increase to general fund balance at fiscal 2022 year end, while preliminary multiyear projections call for modest surplus operations annually through 2026. The district's current board policy calls for a 7% minimum fund balance policy, which the district has exceeded for many years, though the board is considering raising the policy to 16.7%, in line with state recommendations. Current estimates show that the district could achieve community funded (basic aid) status as early as 2027, which would insulate the district from changes in the state funding environment and provide the potential for stronger revenue growth than provided under the state funding formula.

Liquidity

The district’s general fund cash position as of fiscal 2021 is a solid 25.5% of general fund revenues and 32.1% of revenues on an operating funds basis. The district also has $8.9 million in available liquidity held outside of the general fund in its irrevocable OPEB trust fund that can be borrowed on an unrestricted basis.

Debt, pensions and OPEB: long-term liabilities elevated but manageable

The district's long-term liabilities will remain manageable given continued tax base and revenue growth, in addition to a lack of additional near-term debt issuance plans. The district had $661.5 million in net direct debt outstanding at fiscal 2022 year end, equal to a low 0.5% of full value but a somewhat elevated 3.1 times 2021 operating revenue. Debt service costs of roughly $33.5 million in 2021 were equivalent to a manageable 11.1% of operating revenue. The district does not have any unused general obligation debt authorization remaining and is currently evaluating capital needs, though it does not expect to approach voters for additional authorization before 2024 at the earliest.

Legal security

The general obligation bonds are secured by an unlimited property tax pledge of all taxable property within the district boundaries. The county rather than the district levies, collects and disburses the district's property taxes, including the portion constitutionally restricted to pay debt service on general obligation bonds. The bonds are covered by the county's teeter plan under which the district will receive its full property tax levy, including that for debt service, with the county covering any short falls due to delinquencies.

Debt structure

All of the district's debt is fixed rate and matures over the long-term. Principal repayment is slow with approximately 23% of principal retired over the next 10 years. Debt service is moderately ascending with final maturity in fiscal 2047.

Debt-related derivatives

The district does not have any debt-related derivatives.

Pensions and OPEB

Pension and OPEB costs will continue to pose an increasing expenditure pressure on the district, typical of other California Community College Districts. District employees participate in the California Public Employee Retirement System (CalPERS) and California State Teachers Retirement System (CalSTRS). In fiscal 2021, the district reported a net pension liability of $165.8 million, based on a 7.12% discount rate. Moody's adjusted net pension liability (ANPL) is significantly higher at $616.1 million, or 2.0 times operating revenue, based upon a 2.7% discount rate.

The district's pension contribution was $14.7 million in fiscal 2021, or 4.9% of operating revenue. The contribution was materially below Moody's calculated tread water level of $18.7 million, which represents the level of contribution that would prevent reported unfunded liabilities from growing under reported assumptions. This contribution gap is equal to approximately 1.3% of operating revenue and signals that the district's reported pension burden will continue to grow even if investment targets are achieved.

The district's net OPEB liability is high compared to peers, though it has moderated somewhat in recent years. The fiscal 2021 adjusted net liability of $111.1 million is equal to a somewhat elevated 0.37 times operating revenue, though represents an improvement from 2019 levels equal to 0.59 times operating revenue. The district has favorably established an irrevocable trust to help fund its other post employment benefits (OPEB) and the reported balance at fiscal 2021 year end was $8.9 million. This balance is expected to increase in the coming years as a $5 million loan to the general fund is repaid from fiscal 2022 through 2024.

Total fixed costs are moderate, accounting for roughly 18% of fiscal 2021 operating revenue.

ESG considerations

Environmental

Environmental risks do not currently present a material challenge to the district. The district’s location puts it at high risk exposure to water stress and wildfires, according to data from Moody's ESG Solutions, though these risks are not outsized compared to state peers. The district benefits from extensive planning and investment made by San Diego County with regards to wildfire prevention and response coordination.

Social

Social considerations do not currently pose material risks to the district's credit profile. Enrollment declines driven by the pandemic pose a significant challenge to the district, though enrollment is expected to largely recover over the next few years and the state is holding district's harmless for enrollment loss through fiscal 2025. Above average socioeconomic indicators in the district are a positive consideration, as is the low unemployment rate of 3.0% in San Diego County as of April 2022.

Governance

Governance considerations are material to the district's credit profile. Following the 2019 FCMAT report, which detailed shortcomings in budgetary oversight and planning, the district has made significant strides in improving policies and procedures and implementing FCMAT recommendations. The district has willingly worked with FCMAT and brought in an outside consultant to develop more comprehensive and integrated planning processes. A new management team has been put in place and is currently working toward developing an Educational Master Plan, which will outline facility plans and needs for the next 12 years. The district has also notably made significant progress in reducing the proportion of annual compensation costs to ongoing revenues, per FCMAT's recommendation. Though further work is necessary to fully align with all of FCMAT recommendations, including improving bargaining practices with constituent groups, the steps taken over the last few years demonstrate material tightening of governance practices and support the expectation of sound financial operations going forward.

California CCDs have an Institutional Framework score of "A", or moderate compared to the nation. California CCDs' major revenue sources are determined by the state government or, for the most part, can only be raised with voter approval. Ad valorem property tax rates cannot be increased above 1% except to meet GO bond payments, and assessed valuation growth is also generally limited to 2% annually unless a property changes ownership. Unpredictable revenue fluctuations tend to be moderate, or between 5-10% annually. Across the sector, fixed and mandated costs are generally less than 25% of expenditures. Unpredictable expenditure fluctuations tend to be moderate, between 5-10% annually.

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