CREDIT OPINION
4 September 2019

San Jose - Evergreen Community College District, CA

Update to credit analysis

Summary
San Jose - Evergreen Community College District, CA's (Aa1 stable) credit profile is underpinned by a robust and growing tax base in the vibrant Silicon Valley economy with strong resident wealth measures. The district's credit strengths also include a stable financial profile supported by deep entrenchment in community funded or "basic aid" status and conservative fiscal management. While it has a fully funded other post employment benefits (OPEB) plan, the district's balance sheet leverage from long-term debt and pension obligations are more elevated than most peers.

Credit strengths
» Extremely large and growing Silicon Valley tax base
» Strong socioeconomic profile
» Stable financial position supported by deep entrenchment into basic aid, which reduces exposure to variations or reductions in state funding
» Conservative fiscal practices
Credit challenges
» Below-average general fund position for the rating
» Rising pension costs common across all Californian Community College Districts
» Above-average balance sheet leverage from debt and pension

Rating outlook
The stable outlook reflects our expectation that the district’s tax base will continue to grow, debt and pension burden will remain manageable, and that the district will maintain a solid financial position.

Factors that could lead to an upgrade
» Sustained growth in general fund reserves
» Successful management of pension cost increases

Factors that could lead to a downgrade
» Protracted decline in assessed value
» A material deterioration of financial position, including reserves and liquidity
» Inability to manage pension cost increases

Key indicators

<table>
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<th>Exhibit 2</th>
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<td>San Jose - Evergreen Community Coll. Dist., CA</td>
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<td>Economy/Tax Base</td>
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<td>Total Full Value ($000)</td>
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<td>Full Value Per Capita</td>
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<td>Cash Balance ($000)</td>
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<td>Fund Balance as a % of Revenues</td>
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<td>Cash Balance as a % of Revenues</td>
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<td>Debt/Pensions</td>
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<td>Net Direct Debt ($000)</td>
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<td>3-Year Average of Moody’s ANPL ($000)</td>
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<td>Net Direct Debt / Full Value (%)</td>
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<td>Net Direct Debt / Operating Revenues (x)</td>
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<td>Moody’s - adjusted Net Pension Liability (3-yr average) to Full Value (%)</td>
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<tr>
<td>Moody’s - adjusted Net Pension Liability (3-yr average) to Revenues (x)</td>
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</tbody>
</table>

Note: the large cash balances in fiscal 2014 and fiscal 2018 are driven by timing differences as bond proceeds are awaiting transfer to the district’s bond fund.

Source: San Jose - Evergreen CCD, CA, Moody’s Investors Service

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Profile
San Jose - Evergreen Community College District is located in Santa Clara County, CA and encompasses approximately 303 square miles in the heart of Silicon Valley, including a portion of the City of San Jose (Aa1 stable) and all of the City of Milpitas. The district operates San Jose City College and Evergreen Valley College, each of which is fully accredited by the Accrediting Commission for Community and Junior Colleges. The district is governed by a seven-member Board of Trustees. As of fiscal 2019, the district’s full time equivalent students was 12,231.

Detailed credit considerations
Economy and tax base: exceptionally large and diverse tax base poised for additional growth; strong resident wealth measures
San Jose - Evergreen Community College District has a robust and diverse tax base poised for continued growth under the vibrant Silicon Valley economy.

The district’s assessed value (AV) reached $150.9 billion in 2019 after growing at a strong average annual rate of 6.7% over the last five years. Santa Clara County’s preliminary estimate of the district’s 2020 AV is $162.4 billion, reflecting another 7.6% growth from 2019. During and after the last recession, the tax base also demonstrated resilience as it only contracted by 6.5% cumulatively. The size of the district’s tax base compares favorably with the median of similarly-rated CCDs in the nation ($76.5 billion).

The tax base is mainly residential (73.7% of secured AV) and is diverse, with the top ten taxpayers contributing to just 2.9% of 2019 secured AV combined. The largest property owners are mainly apartment complexes and office buildings of major technology companies such as Cisco Systems, Inc. (A1 stable), Apple Inc. (Aa1 stable) and Adobe Systems Inc. (A3 stable).

Going forward, we expect the district’s AV will continue to grow with the turnover of homes and with additional residential and commercial developments underway and anticipated, including office expansions of several large technology companies. Given the strong local economy, the area continues to absorb strong housing price appreciations; the current median sale price of a home in the area is around $1.0 million, more than double the district’s median AV of $477,511.

The district has above-average wealth measures – a per capita AV of approximately $180,000 and a median family income that is around 147.3% of the US. The City of San Jose’s unemployment rate has compared favorably with the state and the nation over the last decade, and was 2.8% as of June 2019, below that of the state (4.1%) and the nation (3.8%) for the same period.

Financial operations and reserves: sound reserve position supported by deep entrenchment into basic aid; moderate growth in enrollment in recent years
The district has a solid financial position, which we expect will remain stable given its deep entrenchment into basic aid and its conservative fiscal practices. As a community funded district, San Jose - Evergreen CCD receives more revenues from local sources than the level of funding it would receive under the state’s funding model. In fiscal 2019, the district’s local property tax revenues exceeded what it would otherwise receive under the state’s student center funding formula by around $39.5 million (53.0%). Having strong local revenues is beneficial for the district’s finances given the state’s history of education funding challenges during economic downturns. The major risks of a basic aid district include a material decline in AV and a large increase in enrollment. Positively, the district’s AV demonstrated resilience during the last recession, and its enrollment growth in recent years has been moderate.

As seen in Exhibit 3, the district has maintained a relatively stable general fund balance averaging $16.5 million (13.5% of revenues) over the last five years, albeit below average for the rating. The district has a formal policy to maintain unrestricted general fund at no less than 7% of annual expenditures, which it has consistently exceeded. In 2016, the district also created a financial stabilization fund that serves as a rainy day fund for the general fund. The district has a policy to transfer $250,000 - $500,000 of property tax revenues annually to this stabilization fund if property tax revenue growth exceeds 6% during a fiscal year. Management expects to have around $1.5 million (1% of general fund revenues) in this reserve after closing fiscal 2019 books.
The district ended fiscal 2018 with a small $0.5 million surplus and ended the fiscal year with $18.0 million (12.3% of revenues) in its general fund. Available operating fund balance, which for the purpose of our analysis includes available general fund and bond interest and redemption fund reserves, totaled a healthy $77.3 million (36.4% of revenues) as of fiscal end 2018. Management expects to close fiscal 2019 books with another surplus; its fiscal 2020 budget and multiyear financial projections also show continued additions to its general fund, although some of the surpluses projected may be offset by salary increases to be negotiated / not budgeted. The district has traditionally taken a conservative approach to financial planning, and has a history of outperforming budgets. For example, its revenue projections conservatively incorporates property value growth of 3.5% annually, compared to recent actual results that have consistently exceeded 6.5%, including 2020 (7.6%). The district is also exploring leasing out a vacant property that can generate additional lease revenues in the outer years.

After declining for consecutive years post the last recession, the district’s full time equivalent students (FTES) have increased moderately in 2018 and 2019 (see Exhibit 4) due to increased marketing efforts and dual-enrollment initiatives. Management expects continued modest growth in the district’s enrollment in upcoming years, which should be manageable given the district’s current facility and faculty capacity.
LIQUIDITY
The district's operating cash position was strong at $136.8 million or 64.3% of revenues as of fiscal 2018; around $43.7 million of the cash balance reflects bond proceeds awaiting transfer to the district's bond fund. Net of this adjustment, the district's cash position was still a healthy $93.0 million or 43.8% of revenues as of 2018. In addition, as of fiscal end 2018, the district also had around $4.2 million (2.9% of general fund revenues) in its capital projects fund, facility rental fund, and financial stabilization fund combined that can be borrowed by the general fund, if needed; of which, around $2.2 million (1.4% of general fund revenues) does not need to be repaid.

Debt and pensions: above-average debt and pension burden; fully funded OPEB liabilities
San Jose - Evergreen CCD's balance sheet leverage from long-term liabilities is somewhat elevated compared to peers in the state and the nation (see Exhibit 5), but still manageable.

The district has above-average balance sheet leverage from long-term liabilities

Exhibit 5

The district has above-average balance sheet leverage from long-term liabilities

The district has an above-average debt burden which we expect will remain manageable with additional issuances given the expected continued growth of the tax base. Post the issuance of the 2019 General Obligation (GO) Refunding Bonds, the district will have around $472.5 million of GO bonds, over $20 million in associated accreted interest, and $47.5 million of OPEB Bonds outstanding. Net direct debt represents a moderate 0.4% of AV. However, in relation to the district’s size of operations, the debt burden is above average at 2.4 times operating revenues compared to the national median of Moody’s-rated CCDs (1.0 times operating revenues). With overlapping debt, the district’s overall debt burden at 3.6% of AV is also higher than many peers.

The district has $663.0 million of unissued GO authorizations outstanding under its Measure X, with the next issuance anticipated in 2021.

DEBT STRUCTURE
The district’s GO bonds are long-term fixed rate obligations with a final maturity in 2043. General obligation bonds are secured by an unlimited property tax pledge of all taxable property within the district boundaries. Santa Clara County, rather than the district will levy, collect, and disburse the district’s property taxes, including the portion constitutionally restricted to pay debt service on general obligation bonds.

The district’s OPEB Bonds are privately-placed variable rate obligations with a final maturity in 2043 and subject to a mandatory tender on May 1, 2027. The bonds have an initial LIBOR index rate period ending on April 30, 2027, subsequent to which the district can elect various rate methods with a maximum rate of 12%. The variable rate bonds should not cause any undue stress to the district’s credit quality since they only represent 9.1% of the district’s total debt portfolio and are currently hedged with a fixed-payor swap. The OPEB Bonds are a general fund obligation and annual effective debt service currently represents a moderate 1.7% of general fund revenues.

DEBT-RELATED DERIVATIVES
The district’s variable rate OPEB bonds are swapped to fixed-rate through a swap agreement with Deutsche Bank AG (A3) that will expire on July 1, 2043. Under the swap, the district pays the counterparty a fixed payment of 4.239% and receives a variable payment based on the LIBOR index rate. The rating termination triggers for the swap are a function of the district’s and the swap provider’s ratings,
with the district’s option to terminate if the counterparty’s rating falls below Baa1 and the counterparty’s option to terminate if the district’s rating falls below Baa2.

**PENSIONS AND OPEB**

The district participates in CalPERS and CalSTRS multi-employer defined benefit pension plans. In fiscal 2018, the district reported net pension liability totaling $117.3 million using a weighted average discount rate of 7.12%. Moody's adjusted net pension liability (ANPL) for the district, using a discount rate of 3.87% under our methodology for adjusting reported pension data, was $329.3 million. The three-year average of ANPL represents a moderate 0.2% of AV or 1.4 times operating revenues.

California community college districts’ annual pension contribution rates have increased in recent years and will continue to grow. CalSTRS contribution rates are set by the state legislature; as statutory contribution rates have historically fallen short of actuarial requirements, the state implemented a funding reform in 2014, AB 1469, which increased state and school district contribution requirements to CalSTRS in an effort to address its heightened unfunded liability. CalPERS contribution rates are determined by state actuarial valuation and assumptions, and are also increasing because the state plan is gradually reducing its assumed investment return and has adopted a more aggressive repayment schedule to improved funding discipline.

The district's pension contributions represented 5.1% of its operating revenues in fiscal 2018, up from 2.0% of operating revenues in 2014. In fiscal 2018, the district’s pension contribution was nearly $3.1 million below Moody’s tread water level, or the level of contribution that would prevent reported unfunded liabilities from growing under reported assumptions. This contribution gap reflects approximately 1.5% of operating revenues, signaling that the district’s reported pension burden will continue to grow even if investment targets are achieved.

The district’s OPEB liability has been fully funded by proceeds of its OPEB bonds. As of fiscal end 2018, the district reported a total OPEB liability of $34.4 million, and had $45.0 million in an OPEB irrevocable trust. Moody’s adjusted OPEB liability for the district is $45.0 million, also sufficiently covered by assets in the OPEB irrevocable trust. Moody's adjusted NOL reflects the use of the same discount rate we apply to pensions to improve comparability between pension and OPEB liabilities and across rated issuers.

**Management and governance: moderate institutional framework; solid operating history**

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.

As a basic aid district, San Jose-Evergreen Community College District operates under a different funding model from the majority of CCDs within the state. As discussed above, it is primarily funded from local property taxes, at a level that is substantially above the state guaranteed minimum. Therefore, the district’s revenue predictability, especially during periods of state budgetary challenges, is somewhat higher than the typical district described by the Institutional Framework paragraph above. The district’s expenditure flexibility is also potentially higher than average, given the relatively high revenues per student.

The district’s five-year general fund operating ratio is 1.0 times, reflecting balanced operations.
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