Voters Approve Houston ISD's Proposition 1, a Credit Positive

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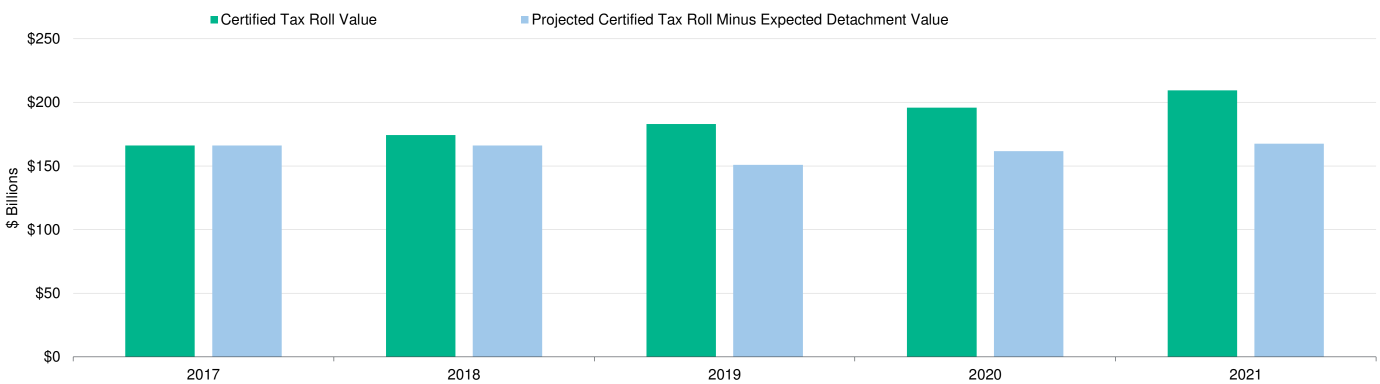
On May 6, local voters approved Proposition 1 for Houston Independent School District (Aaa stable), which is credit positive because the proposition stops the state from reassigning portions of the district's tax base to poorer school districts. Maintaining the property preserves the district's tax base, which allows bondholders to maintain a larger base for the repayment of debt. Nevertheless, the school district remains a property wealthy school district, which will require annual recapture payments to the state.

Absent Proposition 1, the Texas Education Commission was expected to detach and reassign $8 billion of property in fiscal 2018, which was a manageable 4.8% of the district's fiscal 2017 property tax roll value. The state would likely have had to annually detach and reassign property to other school districts through fiscal 2021, based on anticipated growth in Houston ISD's tax base. For example, the district estimated that the state would have detached up to $22.4 billion (14.9%) of the district's projected tax roll value in fiscal 2019 (see Exhibit 1). Any reduction in tax base valuation would have constrained the district's future ability to generate sufficient revenues to pay debt service.

Exhibit 1

Detachment Would Have Significantly Reduced Houston ISD's Tax Base Gains Between Fiscal 2018-21



Assumptions for certified tax roll value and projected certified tax roll minus expected detachment value include increases of 5% in fiscal 2018 and 2019, and 7% in fiscal 2020 and 2021, which could vary from actual results. Assumptions for the detachment value were obtained directly from the district. Data as of April 2017.
Sources: Houston Independent School District, Texas Treasurer's Office Projections

A property wealthy school district, or a Chapter 41 district under Texas' finance system for school districts, means that the district's taxable value per weighted average daily attendance exceeds an amount set by the state. The designation requires that the district share its local tax revenues with other, less wealthy school districts. There are five ways to reduce a district's property wealthy status but school districts typically choose to make a payment to the state in the form of an annual recapture payment to the state, which requires voter approval. If voters reject the recapture option, the state is required to annually remove sufficient property to reduce the wealth above the designated threshold and assign the detached property to a property poor school district; the state has never had to detach property.

With the property tax base intact, Houston ISD's recapture payment is still scheduled to grow under the state's funding formula. As of May 11, 2017, the Texas Education Agency's preliminary estimates indicate the district faces a recapture payment of $228.9 million in fiscal 2018, an increase of 195.4%, compared to $77.5 million in fiscal 2017. The district projects the recapture payment could grow to over $500 million by fiscal 2021. Currently, the fiscal 2018 recapture payment accounts for a manageable 11.4% of the estimated appropriations, including the local optional homestead exemption credit. Recapture payments could become a budgetary challenge in the future. However, the district has a demonstrated history of prudent fiscal management reflected in ample reserves, which should continue to support the district's credit quality.

Houston's (Aa3 negative) local economy is robust and benefits from stabilizing oil prices, as well as continued commercial and residential investments, which should result in tax base gains over the next three to five years.

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