

Municipal Credit Note



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from  Montage Investments

Beaumont Independent School District, TX

On April 2, Moody's lowered the Beaumont Independent School District's GO rating to Baa1 from A1 and maintained a negative outlook on the rating. This follows Fitch's downgrade of the district on March 3rd to A from AA, with its rating maintained on Rating Watch-Negative. S&P still maintains its AA- rating, but hasn't published a rating update on the credit since 2011. We do expect that S&P will act in the coming weeks and place the district's rating on CreditWatch negative or downgrade the rating.

Over the past few months, a number of items have come out:

- The former finance director and comptroller are under FBI indictment for embezzling somewhere between \$2.5 million and \$4 million.
- This may have been done in part by inflating enrollment numbers. As a result, the Texas Education Agency (TEA) has placed the district's accreditation status under review and there is the possibility that the District would have to reimburse the state for overstated per-student state aid from past years.
- TEA has recommended that the school district be placed under the control of a state management board due to its unwillingness to cooperate with the TEA investigation and also because of the internal control problems in the district.
- The financial statements will have to be restated at least back to FY2012, and no FY2013 audit will be available for some time.

This district has a large tax base and has historically shown solid financial performance with sound reserves, even after accounting for the loss of as much as \$4 million. The enrollment trend in the district has been solidly positive over the past seven years (enrollment being the most significant driver of revenue growth for school districts via per-pupil state aid). While the enrollment figures are being scrutinized and may be revised downward, the credit fundamentals point to a district with a solid economic and tax bases and favorable demographic characteristics. We believe there are enough solid credit fundamentals for the district's finances to be stabilized and the credit ratings to eventually be strengthened.

The district could significantly benefit from the appointment of a state oversight board. In situations such as this, we believe reestablishing sound and trustworthy financial management is the key. Decisive action to remove the Board and clean up the district would likely have a calming effect on residents, rating agencies and the bond market. We cannot envision a scenario in which the state allows the district to drift into financial decline or that the credit situation deteriorates so much that these bonds drop below investment-grade credit quality.

The district has issued multiple bond issues over past 10 years, some backed by the Texas Permanent School Fund (rated Aaa/AAA/AAA) and the rest insured by Assured Guaranty Municipal (rated A2/AA). We believe the bonds our clients hold benefit from this credit enhancement (as it ensures that there will be no payment interruption in the near term), however, we believe that the district's solid financial position provides sufficient credit strength on a stand-alone basis. Over the intermediate- to long-term, we expect the district's credit ratings to stabilize in the single-A range.

In summary, we believe the district will weather this situation, maintaining solid credit quality throughout. Consequently, we will hold existing positions if market bids reflect depressed prices based on the headlines and not the ultimate strength of the district's underlying credit fundamentals.



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