Indiana School Building Corporations – An Overview

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INVESTMENT COUNSELORS SPECIALIZING IN TAX-EXEMPT MUNICIPAL SECURITIES

Indiana school districts' (also referred to as School Building Corporations, or SBCs) debt represents an attractive, sometimes overlooked, investment opportunity in the municipal market. The strong and improving SBC credit quality has been driven by prudent financial management, a stable and expanding economy, and favorable demographic trends.

Prudent Financial Management

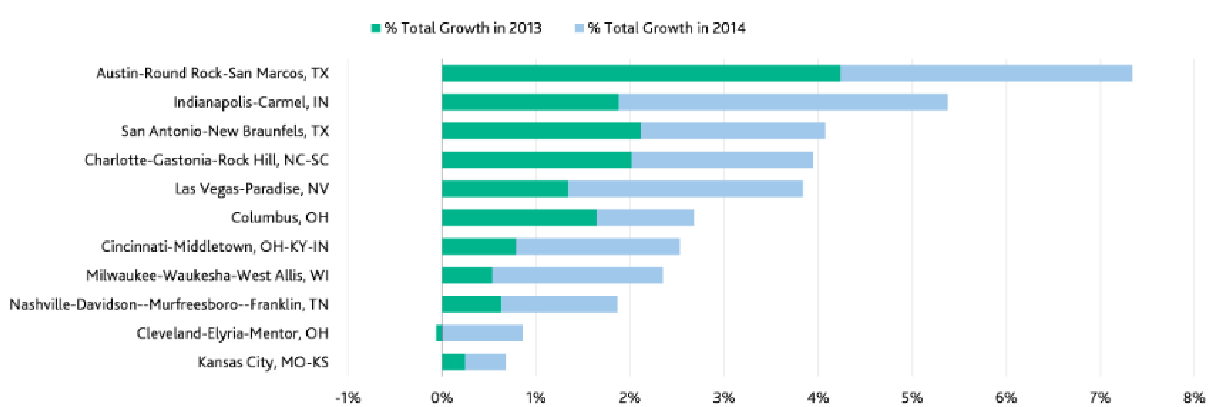
Local management of SBCs is strong, evidenced by generally balanced operations, healthy reserve levels, and prudent long-term planning. Though debt levels are slightly elevated relative to other school districts we analyze, this is often observed in rapidly expanding areas which require significant infrastructure development. Pension expense is modest. SBCs contribute to two state-run pension plans, which were ~80% and 90% funded, respectively, as of June 30, 2015. Funding for Indiana schools is comprised of a mix of state aid and local property tax revenues. Since SBC general operating funds are funded almost entirely by the state based on a per-pupil funding formula, student enrollment levels are key. Local property taxes fund several other initiatives such as capital projects, transportation needs, and debt service.

Recent revisions to the state's constitution placed tax caps on various property types, thereby restricting local governments' revenue-raising ability. State law, however, requires that debt service levies be levied to their full extent, a positive for bondholders, with any revenue losses distributed across other funds. To offset this revenue loss, districts can approach voters and request they pass an excess operating levy. Based on our observations, voters typically pass these levies by healthy margins.

Stable and Expanding Local Economy

Due to its role as state capital, central location, and extensive highway and rail access, Indianapolis is the primary driver for much of the state's economy. Many of the SBCs that we purchase at C.W. Henderson & Associates are situated in and around the Indianapolis metropolitan area. Job growth in recent years has outpaced other regional hubs, including San Antonio, Charlotte, and Las Vegas.

Indianapolis Region's Job Growth Ranks High Among Other Peer Regions



Source: US Department of Labor, Bureau of Labor Statistics

Not only is private-sector job growth burgeoning, but long-standing healthcare and higher education institutions, such as Eli Lilly and IU Health, are also expanding. Indianapolis has one of the world's busiest airports in terms of cargo traffic and is home to the second-largest Federal Express hub in the country.

Favorable Demographic Trends

As a result of an attractive job market, Marion County population has increased 9% from 2000 to 2015 and currently stands at ~939,000. As of March 2016, the county unemployment rate was 5.4%, on par with the state and slightly higher than 5% national rate. As families move into the Indianapolis area and surrounding suburbs, school districts' enrollment levels rise and the demand for new, more modern school facilities increases. Although income levels within the city of Indianapolis are suppressed by elevated poverty rates, the surrounding areas tend to demonstrate a much stronger socioeconomic profile.

Other Factors

All Indiana SBCs participate in the Indiana State Aid Intercept Program. Under this program, the state treasurer is required to withhold state aid if the school corporation is unable to pay GO debt service requirements and divert those funds to the paying agent. Districts receive an "A" or "AA+" enhanced rating based on whether or not state aid covers maximum annual debt service by 2x or not. It is important to remember that we always evaluate credits based on their underlying strengths and view this program only as an enhanced security feature.

The state of Indiana is rated AAA by the two major rating agencies and benefits from prudent fiscal management, strong reserve levels, a low debt burden, and an expanding, diverse economy. Employment is fairly equally distributed across numerous sectors, including trade/transportation, manufacturing, education and health, government, and leisure and hospitality. The relatively low cost of living and business-friendly legislation make the state an attractive target for firms looking to expand and relocate. Similar to Marion County, Indiana's population increased 8% from 2000 to 2015. Education funding has been stable in recent years and is budgeted to increase in the 2016-17 biennium.

Yield Enhancements

Despite the state tax exempt status of Indiana bonds for Indiana residents, SBC bonds typically yield 20-40 basis points more than comparably rated securities from other "specialty states". In today's low interest rate environment, SBCs often provide better "after state tax" returns for both specialty state and non-specialty state investors

Conclusion

C.W. Henderson views most Indiana SBCs as a strong investment opportunity. Expanding local and state economies and positive demographic trends provide a robust backdrop that supports local school district strength. We believe credit quality is likely to remain strong in the coming years.

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