**FITCH RATES MESQUITE ISD, TX'S $125.6 MILLION ULT BONDS 'AAA' PSF/'AA+' UNDERLYING; STABLE OUTLOOK**

Fitch Ratings-Austin-27 June 2018: Fitch Ratings has assigned an 'AAA' rating based on the Texas Permanent School Fund (PSF) and an 'AA+' underlying rating to the following Mesquite Independent School District, Texas unlimited tax bonds (the bonds or ULTs):

--$125.6 million unlimited tax school building bonds, series 2018.

In addition, Fitch has affirmed the following ratings for the district at 'AA+':

--Issuer Default Rating;

--$518.4 million unlimited bonds outstanding. The rating outlook is stable.

The bonds are scheduled to sale during the week of July 9, 2018. Proceeds from the sale will be used to construct and equip new facilities.

SECURITY

The bonds are payable from an unlimited property tax levy and are further backed by the PSF bond guaranty program. (For more information on the Texas Permanent School Fund, see 'Fitch Affirms Texas PSF Rating at 'AAA'; Outlook Stable', dated July 21, 2017).

ANALYTICAL CONCLUSION

The 'AA+' Issuer Default Rating (IDR) and unlimited tax (ULT) ratings reflect Fitch's expectations that district will maintain a high level of financial flexibility throughout the economic cycle due

to its solid expenditure flexibility and strong reserves. Although the district's revenue-raising flexibility is limited, Fitch expects the state funding formula to provide protection from potential shifts in the local economy. Long-term liabilities and fixed costs are expected to remain within Fitch's moderate range over the next several years.

Economic Resource Base

This mature, suburban district is located 35 miles east of downtown Dallas and serves an estimated population of roughly 180,000. The district, which ties into the Dallas-Fort Worth (DFW) metro area, encompasses portions of Mesquite, Balch Springs, Seagoville and Garland. While the district is largely built out, the area is experiencing residential tax base expansion. Over the past year, taxable assessed value (TAV) has increased by 12% to $7.8 billion. While the district's wealth

and income levels lag those of the larger DFW metro area, the district's inclusion in this broad and robust employment market, coupled with continued regional economic expansion in the region is favorable for the district. Student enrollment has hovered around 41,000 for several years, with current enrollment at 40,923. Management expects marginal-to-modest growth over the near term.

KEY RATING DRIVERS

Revenue Framework: 'a'

Revenue growth has been strong, averaging above GDP for the 10 years through 2017. Future revenue growth will likely track expected enrollment growth given the state funding framework,

the strength of which is offset by the district's statutorily limited independent legal ability to raise revenues.

Expenditure Framework: 'aaa'

District spending is stable and the district maintains strong expenditure flexibility in salaries and pay-as-you-go capital spending. Spending growth is expected to trend in line with slower than strong revenue growth. The low fixed-cost burden for debt service and retiree benefits reflects state support for long-term liabilities. There are no contractual obligations with employees.

Long-Term Liability Burden: 'aa'

The long-term liability burden is moderate. The series 2018 issuance is the first installment of the voter authorized $325 million from the May 2018 bond election. After this sale, the district will have $190 million in authorized, but unissued debt remaining. Fitch expects that the liability burden will remain moderate even with this new debt issuance.

Operating Performance: 'aaa'

The district's strong history of operating surpluses, its maintenance of robust reserve levels and solid expenditure flexibility leave it well positioned to address any cyclical downturns.

RATING SENSITIVITIES

Financial Flexibility: The ratings are sensitive to material changes in financial flexibility, including maintenance of superior gap-closing capacity and strong reserve levels through a typical economic cycle and material shifts in enrollment trend expectations.

CREDIT PROFILE

The district's proximity to Dallas and its location in the broader DFW metro area provides residents with easy access to a large and diverse labor market. The DFW metro area is home to numerous corporate headquarters and prominent economic sectors include transportation, financial services, wholesale trade, manufacturing, oil/gas and education and government. The tax base is primarily residential, which taxable assessed value (TAV) accounts for over 65% of total TAV. Over the past couple of years, the tax base has experienced exceptionally strong growth. Since fiscal 2016 TAV has increased by 23% to $7.3 billion in fiscal 2018.

Revenue Framework

Funding for public schools in Texas is provided by a combination of local (property tax), state and federal resources. The state budgets the majority of instructional activity through the Foundation School Program (FSP), which uses a statutory formula to allocate school aid taking into account each district's property taxes, projected enrollment, and amounts appropriated by the legislature

in the biennial budget process. The Tier 1 component of the FSP provides districts a certain level of operational funding, and the basis for most Tier 1 allotments is called the basic allotment.

The basic allotment is a per-pupil dollar amount that multiplied by average daily attendance, and adjusted for specific district student characteristics, produces a district's Tier 1 allotment. The vast majority of districts are funded using a target revenue approach, whereby the combination of local and state funding for operations meets a predetermined per pupil amount, which varies from district to district.

The district received 76% of fiscal 2017 operating revenues from state aid, followed by property taxes at 20%.

The compound annual growth rate (CAGR) of district revenues exceeded U.S. GDP over the 10 years through 2017. Over the near term, Fitch anticipates that relatively stable enrollment and residential tax base expansion will yield strong revenue growth, absent policy action.

The district's maintenance and operations tax rate of $1.04 per $100 taxable assessed value (TAV) is 13 cents below the legal limit of $1.17. The district would need voter authorization to raise the rate above $1.04 but there are no current plans to do so. The district levies a separate, unlimited debt service tax rate, which is currently 42 cents per $100 of TAV. The debt service rate will ramp up to 48 cents in fall 2019. Despite the recent uptick in tax base growth, the district has based

its debt repayment on modest TAV and enrollment growth assumptions. While the property tax pledge securing school district bonds is unlimited, state law requires districts to demonstrate the ability to service outstanding and any proposed debt with a debt service tax rate of no more than 50 cents per $100 of taxable value.

Expenditure Framework

The district's main expenditure category is instruction, which accounted for 63% of operating expenses in fiscal 2017. Fitch expects instruction costs to grow in line with or below revenues, along with the district's other operational costs. Historically, the district has funded some capital outlay from the general fund. While the district will likely continue to finance some capital needs through the general fund, Fitch does not expect this practice to negatively impact the expenditure framework assessment.

The pace of spending growth has somewhat trailed revenue growth due to underspending of budgeted expenditures. This trend is likely to continue, barring any changes in district policy. Moreover, in Fitch's view, the district's largely mature nature limits future growth-driven expenditure pressures.

The district's fixed cost burden is low, with carrying costs for debt, pensions and other post- employment benefits (OPEB) equaling 10% of 2017 governmental expenditures. Taking into account state support for debt service carrying costs decrease to a low 5.9% (Mesquite ISD received about 43% of the 2016-2017 annual debt service from state aid). While Fitch expects the fixed-cost burden to rise with the series 2018 bond issuance, and subsequent issuances from the May 2018 authorization, it will likely remain low to-moderate given the strong state debt service support. The district retains flexibility in staffing levels given the modest enrollment growth prospects and does not have any labor contracts or evident wage pressure.

Long-Term Liability Burden

The district's total debt and net pension liability represents about 15% of personal income, with the district's direct debt representing the bulk of the total liability. The district received a strong 72% voter support for its May 2018 bond program; this sale is the first installment of the program and will be used to construct secondary level facilities, in an effort to address capacity issues.

Fitch anticipates the district's debt burden will rise but remain a moderate burden on recourses throughout the issuance of the authorization.

The district participates in the Texas Teachers Retirement System (TRS), a cost-sharing multiple employer pension system. Under GASB 67 and 68, TRS's assets cover 78% of liabilities as of fiscal 2017, a ratio that falls to 62% using a more conservative 6% return assumption.

Like all Texas school districts, Mesquite ISD is vulnerable to future policy changes that shift more of the contributions and liabilities onto districts, as evidenced by a relatively modest 1.5% of salary contribution requirement that became effective in fiscal 2015. Mesquite ISD's

contributions are currently limited to the 1.5% of salaries and pension costs for salaries above the statutory maximum (total contribution totaled $3.3 million in fiscal 2017). The district's pension contributions are determined by state statute, rather than actuarially, and like other Texas school districts, have historically fallen short of the actuarial level. Recent state reforms have lowered benefits and increased statutory contributions to improve plan sustainability over time.

Operating Performance

Throughout the great recession, the district maintained a strong financial cushion despite the recessionary pressures and state funding cuts. Moreover, the district retains solid expenditure flexibility to manage well through economic downturns. Fiscal 2016 general fund reserves stood at a strong $119 million (35% of spending). While the fiscal 2018-adopted budget reflects a $13.9 million general fund deficit, management indicates that the bulk of this drawdown is due to one-

time capital needs, which are board approved. Given the district's conservative budgeting practices, by the close of the fiscal year, the drawdown is expected to be less than budgeted. Even if the

$13.9 million drawdown were fully realized, the unrestricted general fund balance would still account for 31% of operating expenditures, which remains commensurate with the 'aaa' financial resilience assessment. Given the district's history of conservative budgeting and maintenance of robust reserve levels, Fitch anticipates that the district will continue to maintain its ample financial cushion. The district has a commitment to maintaining a sizeable financial cushion, as its minimum fund balance target is 22% of operating expenses.

The operational impact of TAV declines is largely mitigated by the state's funding formulas, which backfill lost local revenues with additional state aid. This backstop serves to limit revenue volatility. The district benefits from an exceptionally strong gap-closing capacity. Fitch expects that the district will manage through economic downturns while maintaining ample reserves and a high level of fundamental financial flexibility.

The district has demonstrated a strong commitment to supporting financial flexibility. Budgeting is conservative and typically includes capital projects and management has been proactive in maintaining operational balance throughout economic cycles.

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In addition to the sources of information identified in Fitch's applicable criteria specified below, this action was informed by information from Lumesis and InvestorTools.

Applicable Criteria

U.S. Public Finance Tax-Supported Rating Criteria (pub. 03 Apr 2018) [https://www.fitchratings.com/site/re/10024656](http://www.fitchratings.com/site/re/10024656)

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