Gurtin Municipal Bond Management

Municipal Credit Update

Chicago Public Schools: Déjà vu and Desperation

December 2015

Chicago Public Schools (CPS or the District) has again staggered its way into headlines with a fresh batch of negative rating actions (Standard & Poor's placed the District on CreditWatch with negative implications on November 20th), the looming potential for a teachers' strike and the recent resignation of its Chief Financial Officer. All of the recent news has arrived against the backdrop of the District banking on a $500 million life preserver from the State of Illinois – the same State of Illinois that is seemingly unable to make progress towards a budget for the 2015-2016 fiscal year that is now nearly halfcomplete.

When we reviewed the District in a July 2015 report titled, "Chicago Public Schools: Pension Payment is Merely the Tip of the Fiscal Iceberg" we noted that CPS is plagued by a confluence of unresolved issues that leave its fiscal future highly uncertain. In addition to budgetary and pension pressures, the District's relationship with the teachers union has become increasingly strained and only exacerbates the District's problems. In 2012, tenuous labor negotiations resulted in a prolonged teachers strike that attracted broad national attention. However, many of the union's concerns from 2012 remain focal points of discussion today as the District attempts to settle another round of labor negotiations. As of publication, these contracts remain unresolved and a practice strike vote yielded 97% approval in early November as the Chicago Teachers Union (CTU) prepares for an official vote anticipated to begin on December 9th.[1] Should the official vote yield such overwhelming support, the District may find itself in an entrenched battlewith a union that is demanding guaranteed levels of pension contributions and staffing levels that the District is not currently prepared or able to make as a result of its wait-and-see attitude toward potential state pension funding. Contract negotiations are just one of the District's many problems and they do not occur in isolation.

We believe CPS' future has only grown more clouded and that the District is extremely poorly positioned to repair the damage. Little has changed from our last review and the recent headlines are unsurprising as a sense of déjà vu settles in. CPS' desperation is growing as labor strife looms and it expects its pension problems to be resolved by a State that has seemingly made little progress on its own budget. As the District grapples with a new round of old issues we review why overreliance on struggling states necessitates more stringent credit thresholds for the underlying units of government.

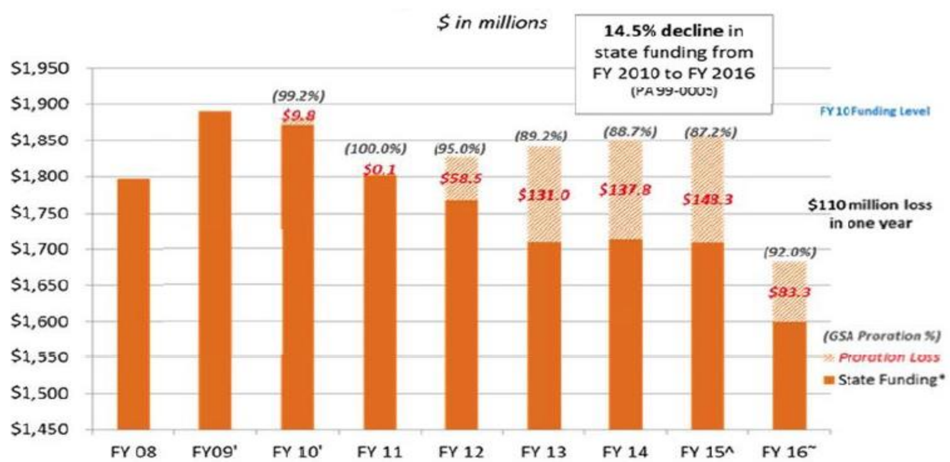
[1] FitzPatrick, Lauren. "Chicago Teachers Union Plans Strike Vote on Dec. 9: Report." Sun-Times. November 29, 2015. Retrieved from http://chicago.suntimes.com on December 1, 2015.

CPS Illustrates Why our Internal Credit Thresholds are Dynamic and Dependent on both the Fiscal Health of States and the Obligors They Support

The fiscal outlook for CPS may get significantly worse if a budgeted $500 million appropriation from the State does not materialize.[2] Overreliance on statutory support has resulted in revisions to our internal credit thresholds for local governments in the most troublesome states, such as Illinois and New Jersey. Through the economic downturn, many states attempted to balance their budgets on the backs of the underlying entities they support. As states' revenues plummeted and wide budget gaps emerged, many states implemented substantial reductions in aid to underlying obligors. State cuts ultimately heavily impacted K-12 funding, higher education support and social service aid to counties in most of the states.

Therefore, we believe it is crucial to analyze the share of operating revenues that are state-driven in conjunction with the fiscal health of the state to analyze how realistic an obligor's budgetary expectations are in light of the fiscal landscape. Should we believe state reductions are imminent, we assess how potential cost-cutting measures may impact the credit profile of the underlying obligors and whether those obligors have sufficient credit cushions to withstand the impact of state cuts.

Figure 1. State Aid to Chicago Public Schools Exhibits Negative



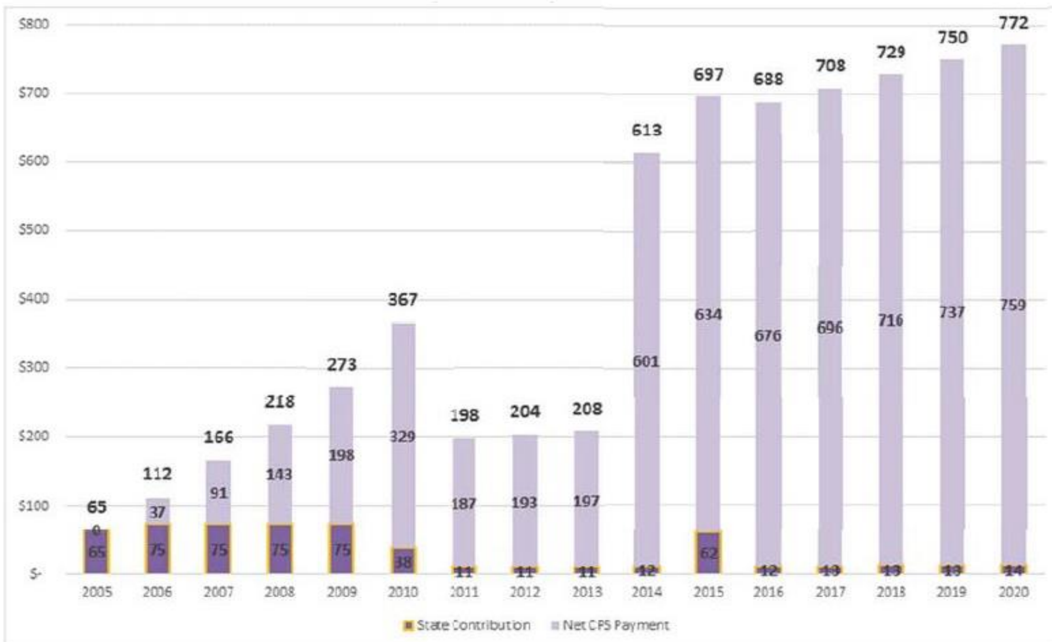
Source: Exhibit taken from Chicago Public Schools Fiscal 2016 budget. August 10, 2015. http://cps.edu/fy16budget/Pages/revenue.aspx

In the case of CPS, the financial troubles it has faced have been highly publicized following multiple years of budgetary imbalance resulting from state funding declines and escalating pension pressures. Recently, the District made headlines regarding its 2016 budget, which includes an expected new sizable contribution from the State towards its pension payment. Despite operating in a funding environment that has

[2] Gillers, Heather and Cynthia Dizikes. "Chicago Public Schools' Budgets Spend $500 Million District Doesn't Have." Chicago Tribune. July 13, 2015. Retrieved from http://chicagotribune.com on December 1, 2015.

experienced sustained reductions in state resources, as seen in Figure 1, CPS expects legislators in Illinois to appropriate an additional \$500 million toward its growing pension payment in the State's yet-to-be passed 2015-2016 budget.

Figure 2. CPS' Required Employer Contributions to CTPF Grows Dramatically



Source: Exhibit taken from Chicago Public Schools Fiscal 2016 budget. August 10, 2015. http://cps.edu/fy16budget/Pages/pensions.aspx

With the State confronting its own stubborn fiscal woes, placing bets on the budget including new money for the District's pensions is far from guaranteed. CPS has argued that the State does provide support to other school districts for pension funding. However, it is possible that the State may discontinue or reduce its contributions to teachers' pensions throughout the state altogether as a means of balancing its own budget, leaving all districts, including CPS, to deal with still another funding dilemma. Whether or not the State makes the contribution in the 2015-2016 fiscal year, the District's pension problem is far from over, as Figure 2 exemplifies, the need to find a long-term solution to a near-term problem has never been more evident.

If the State's budget does not ultimately provide CPS with the additional \$500 million in support, we believe CPS's fiscal future is bleak. This scenario illustrates why an overreliance on a distressed state for support demands careful and dynamic credit thresholds as opposed to blind faith that an enfeebled state will come to the rescue of underlying obligors that are stumbling towards distress.

Please feel free to contact us at research@gurtin.com
for additional information.

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Share the report:

Analysts:

Iliana Perez
Vice President
iperez@gurtin.com

Thomas Schuette
Partner, Co-Head of Credit Research, Co-Head of Portfolio Management
tschuette@gurtin.com

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