

# RatingsDirect®

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## Summary:

# Mishawaka, Indiana; Water/Sewer

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## Table Of Contents

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Rationale

Outlook

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### Credit Profile

US\$12.55 mil Swg Wks Rev Bnds ser 2018 dtd 10/03/2018 due 09/01/2038

<i>Long Term Rating</i>	A/Stable	New
Mishawaka swg <i>Unenhanced Rating</i>	A(SPUR)/Stable	Affirmed
Mishawaka swg (BAM) <i>Unenhanced Rating</i>	A(SPUR)/Stable	Affirmed

Many issues are enhanced by bond insurance.

## Rationale

S&P Global Ratings assigned its 'A' long-term rating and stable outlook to Mishawaka, Ind.'s series 2018 sewage works revenue bonds and affirmed its 'A' underlying rating (SPUR), with a stable outlook, on the city's existing sewage works revenue debt.

The rating reflects our opinion of the combination of strong enterprise- and financial-risk profiles.

The enterprise-risk profile reflects our opinion of the system's:

- Service-area participation in the limited South Bend-Mishawaka metropolitan statistical area economy,
- Very low industry risk as a monopolistic service provider of an essential public utility,
- Currently affordable rates measured against the city's median household effective buying income and St. Joseph County's poverty rate, and
- Good operational management practices and policies under our Operational Management Assessment (OMA).

The financial-risk profile reflects our opinion of the system's:

- Improving all-in debt service coverage (DSC), when including tax-increment-fund (TIF) revenue and payments in lieu of taxes (PILOTs);
- Declining, yet still very strong, liquidity relative to the system's size with more than \$4.5 million in available funds, or more than 200 days' cash on hand;
- Moderate debt with approximately \$88 million in sewage works revenue bonds outstanding following the issuance of the 2018 bonds and a debt-to-capitalization ratio of 53%; and
- Good financial management practices and policies under our Financial Management Assessment (FMA) methodology.

Officials intend to use series 2018 bond proceeds to finance capital-sewage-works improvements related to the

long-term control plan (LTCP).

In our opinion, all bond provisions are adequate. Net sewer system revenue, which also includes TIF revenue of \$3.36 million annually, secures debt-service payments. However, the system must maintain rates such that net revenue, including TIF revenue, provides sufficient, at least 1x, DSC of operations, maintenance, and debt service. An additional bonds test stipulates that prior-year net revenue, which the city has adjusted to account for rate increases, must be, at least, 1.25x existing and proposed maximum annual debt service (MADS) for the system to issue new bonds. The city will also finance a debt-service-reserve fund at MADS.

If the system were to eliminate TIF revenue from its revenue stream, there would be an equal corresponding reduction in the TIF credit to ratepayers, resulting in a net-neutral effect on system revenue.

Mishawaka's sewage works serves more than 15,800 customers in the city, along with a limited customer base outside city limits. The diverse customer base has been relatively stable recently, increasing by 2% from 2015-2018. The 10 leading customers accounted for roughly 9% of total fiscal 2017 revenue. The system's 2017 usage, measured in million gallons per day (mgd), was about 50% of average-design capacity. The plant's average capacity is 20 mgd, and its peak-design-flow capacity is 42 mgd. Management reports the treatment plant can sustainably treat peak flows of up to 60 mgd without violating discharge permits.

Mishawaka is east of, and adjacent to, South Bend. Notre Dame University, with a student population estimate of more than 12,000, anchors the area's economy. Mishawaka's population estimate was more than 50,000 in 2017. City median household effective buying income was, in our opinion, below average at 82% and 75% of state and national levels, respectively, in 2017. City unemployment averaged 3.2% in July 2018, lower than the state's 3.5% and nation's 4.1%.

The current sewer rate is \$62.08 for 800 cubic feet consumed. We understand city customers receive a TIF credit on their monthly sewer bill. After the TIF credits, the monthly sewer rate is \$50.22 for 800 cubic feet consumed, or 1.7% of median household effective buying income. Mishawaka last raised rates by 3% on Jan. 1, 2018. The city council also passed an 11% rate increase, effective Jan. 1, 2019, and a 9% increase, effective Jan. 1, 2020.

Mishawaka typically reviews rates at least annually, and it expects the current rate increases to support existing and 2018 debt and an additional \$25 million in new-money debt planned for 2020. The city bills water, sewer, and electricity services monthly; it reports collections are high. Management has established a record of raising rates incrementally over multiple years. Mishawaka uses various websites, social media, and press outlets to reach customers regarding utility strategies and long-term needs.

Based on our OMA, we view the utility's operational management as good. The city's sewer utility wastewater treatment plant has an average-design capacity of 20 mgd with a peak design capacity of 42 mgd. Average flows typically account for 50% of average-flow capacity.

The utility is under a U.S. Environmental Protection Agency (EPA) consent decree to address combined-sewer-overflow (CSO) issues, and it is operating under an LTCP. To date, the city has invested more than \$250 million in the system. Mishawaka has reduced annual CSO volume discharge by 97.8% since 1990; we recognize

it can operate with 15 or less overflows. However, the current EPA CSO consent decree calls for the elimination of all CSO discharges.

Management is preparing to renegotiate its consent decree with the EPA and Indiana Department of Environmental Management. If there are no amendments to the zero-overflow requirement, management expects it would need to spend an additional \$160 million. Management is attempting to renegotiate down to 15 overflows (the current state); nine overflows, costing an additional \$20.5 million; or eight overflows, costing approximately \$24.4 million, including the 2018 bonds.

Consistent with the article titled "Methodology: Industry Risk," published Nov. 19, 2013, on RatingsDirect, we consider industry risk for the system very low, the most favorable assessment possible on a six-point scale, with '1' being the best and '6' the worst.

Liquidity remains, what we consider, very strong when including operating and improvement funds; however, cash declined recently due to capital spending. Unrestricted days' cash on hand was still very strong, in our opinion, at \$4.7 million, or 208 days', at fiscal year-end Dec. 31, 2017, down from \$10.5 million, or 447 days', in fiscal 2016. City-provided fiscal 2018 projections show a another decline to \$3.7 in fiscal 2018 to fund capital projects before improving due to stronger operating margins from rate increases.

Annual DSC has improved following the significant 16% rate increase adopted in 2017. When including pledged TIF revenue and subordinated PILOTs in the general fund, all-in DSC was 1x and 1.1x in fiscal years 2015 and 2016, respectively. Following the rate increase, DSC improved to 1.6x for fiscal 2017. City-provided projections show all-in DSC for fiscal years 2018-2020 improving to more than 1.5x when adjusting for revenue from rate increases.

We understand the city will most likely issue new debt to address LTCP needs, but the amount and timing of additional capital for the consent decree remains uncertain as the city enters renegotiations. The city's debt-to-capitalization ratio is moderate, in our opinion; its fiscal 2017 ratio was more than 50% with more than \$75 million of debt outstanding, including the series 2018 bonds.

Due to the city's expectation of additional debt sometime during the next few years, we expect its debt-to-plant ratio to rise. We also expect Mishawaka to adjust rates accordingly to maintain, at least, good DSC and liquidity. Management expects to issue an additional \$25 million in sewage works revenue debt in fiscal 2020, and additional issuances could be necessary pending consent-decree renegotiations.

Based on our FMA, we view financial management as good, indicating that financial practices exist in most areas but that governance officials might not formalize or regularly monitor all of them.

Highlights include management's:

- Use of historical trends for budget and operational performance analysis;
- Monthly reports on budget-to-actual results and investments to the city council, financial advisor, mayor, and board of works; and
- Five-year capital improvement plan, which it updates annually and includes the LTCP.

Mishawaka does not have a debt-management policy. The utility is required to maintain, at least, two months' operating reserves; management's target is to maintain the improvement fund at \$6 million, which it has not done recently because it used cash to help fund capital projects. Management reports audits according to generally accepted accounting principles.

## **Outlook**

The stable outlook reflects S&P Global Ratings' opinion of the system's expected improvement in financial performance and S&P Global Ratings' expectation management will likely take appropriate measures, including additional rate increases, to maintain finances as the utility addresses capital needs, especially with its consent decree. The outlook further reflects our view of the city's recognized role as a regional economy despite its adequate income, providing rating stability during the two-year outlook period.

### **Downside scenario**

Due to cyclical fluctuations of all-in DSC and liquidity, we could lower the rating if financial metrics do not rebound or if the local area economy were to deteriorate, specifically an increased county poverty rate or decreased median household effective buying income that leads to stress on rate affordability, particularly during necessary and implemented rate increases to support the LTCP.

### **Upside scenario**

If Mishawaka were to renegotiate its consent decree successfully and curb LTCP costs while smoothing out financial performance and establishing very strong DSC and liquidity, we could raise the rating.

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