S&P Global
Ratings

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Summary:

Mishawaka, Indiana; Water/Sewer

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Credit Profile		
US$40.525 mil swg wks rev and rfdg rev bnds ser 2017 dtd 12/12/2017 due 09/01/2034		
Long Term Rating	A/Stable	New
Mishawaka swg		
Long Term Rating	A/Stable	Downgraded
Mishawaka swg		
Unenhanced Rating	A(SPUR)/Stable	Downgraded

Many issues are enhanced by bond insurance.

Rationale

S&P Global Ratings lowered its long-term rating and underlying rating (SPUR) on Mishawaka, Ind.'s sewage works revenue debt one notch to 'A' from 'A+'. The outlook is stable.

The rating action reflects our opinion of the utility producing net revenue covering debt service over the past three fiscal years at levels we consider just adequate and not commensurate with its 'A+' rated peers. An uncertainty of the utility's future capital needs related to a combined-sewer-overflow (CSO) consent decree, particularly as management begins renegotiations with state and federal agencies concerning CSOs, also influenced the rating decision.

In addition, S&P Global Ratings assigned its 'A' long-term rating and stable outlook to Mishawaka's series 2017 sewage works revenue and refunding revenue bonds.

The rating also 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 when 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:

- Adequate all-in debt service coverage (DSC), when including tax-increment fund (TIF) revenue and payments in lieu of taxes (PILOTs);
- Very strong liquidity with more than $10 million in available funds, translating to more than 400 days' cash on hand;
- Adequate debt; and
- Good financial management practices and policies under our Financial Management Assessment (FMA) methodology.

The city is issuing its series 2017 bonds to refund a portion of its series 2010B sewage works revenue bonds and finance capital sewage works improvements.

In our opinion, all bond provisions are adequate. Net system revenue of the city's sewage fund, 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 plus proposed maximum annual debt service (MADS) for the system to issue new bonds. The city will also fund 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 15,700 customers in the city, along with a limited customer base outside city limits. The diverse customer base has been relatively stable recently, increasing by 1.8% from 2014-2017. The 10 leading customers accounted for 10.5% of total fiscal 2016 revenue. The system's 2016 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.

Mishawaka is east of, and adjacent to, South Bend. Notre Dame University, with a student population of more than 12,000, anchors the area's economy. Mishawaka's population estimate was more than 49,700 in 2016. City median household effective buying income was, in our opinion, adequate but below average at 78% and 71% of state and national levels, respectively, in 2016. City unemployment averaged 3.4% in September 2017, lower than the state's 3.6% and the nation's 4.1%.

The city's current sewer rate is $60.28 for 800 cubic feet of usage. We understand city customers receive a TIF credit applied toward their monthly sewer bill. After the TIF credit, the monthly sewer rate is $50.28 for 1,000 cubic feet of usage, or 2% of median household effective buying income. Mishawaka last raised rates by 16% in March 2016. The city council also passed a 3% rate increase, effective Jan. 1, 2018, and an 11% increase, effective Jan. 1, 2019. The city typically reviews rates at least annually, and it expects the current rate increases to support existing and 2017 debt and an additional $30 million in new-money debt. The city bills water, sewer, and electricity services monthly; it reports collections are high.

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 CSO issues, and it is operating under a long-term control plan (LTCP). To date, the utility has reduced annual CSO volume discharge by 98.6%; it can operate with 15 or less overflows.

However, the current CSO consent decree is 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 consent decree--a zero overflow requirement--the city expects it would need to spend an additional $160 million. The city is attempting to renegotiate the consent decree to more-favorable levels: four overflows (costing approximately $61 million), eight overflows (costing approximately $50 million), or 15 overflows (the current state, costing approximately $53 million).

Management reviews rates annually, and it has established a record of raising rates incrementally over multiple years. The city uses various websites, social media, and press outlets to reach customers regarding utility strategies and long-term needs.

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.

The utility's liquidity remains, what we consider, very strong when including its operating and improvement funds; liquidity, however, has declined recently. Unrestricted days' cash on hand was very strong, in our opinion, at $10.5 million, or 447 days', at fiscal year-end Dec. 31, 2016, down from $12.9 million, or 612 days', in fiscal 2014. Fiscal 2017 projections, provided by the city's financial advisor, show a slight increase to $11.1 million before declining to $8.7 million, or 340 days' cash on hand, in fiscal 2018 for the spending down of capital.

Annual DSC is adequate when including pledged TIF revenue and subordinated PILOTs to the general fund. All-in DSC was 1x and 1.12x in fiscal years 2015 and 2016, respectively. Projections from the city's financial advisor show all-in DSC for fiscal 2017 improving to 1.3x following the rate increase and more than 1.4x in fiscal years 2018 and 2019.

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. The city's debt-to-capitalization ratio is moderate, in our opinion; its fiscal 2016 ratio was 50% with more than $73 million of debt outstanding, including the $13 million in new-money debt associated with the series 2017 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 $11 million in sewage works revenue debt in mid-fiscal 2018, and additional issuances could be necessary pending consent-decree renegotiations.

Based on our FMA, we view the utility's 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.

Management highlights include its:

- Use of historical trends for budget and operational performance analysis;
- Monthly budget-to-actual and investment reports 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.

The city does not have a debt-management policy. The utility is required to maintain at least two months' operating reserves, and management's target is to maintain the improvement fund at $6 million. 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 that 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.

Upside scenario

We could raise the rating to 'A+' if the utility were to develop a consistent trend of meeting and exceeding all-in DSC projected in fiscal years 2018 and 2019 while maintaining very strong cash. We could also raise the rating if the utility were to expand and diversify the service-area economy, leading to improved income.

Downside scenario

We could lower the rating if current financial performance were to deteriorate or if the utility were to fail to renegotiate the consent decree to more-favorable terms, which would, in our opinion, significantly pressure finances and long-term rate affordability.