

CREDIT OPINION

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New Issue

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South Bend (City of), IN Water Enterprise

New Issue - Moody's Assigns Aa3 to South Bend, IN's Waterworks Ref. Rev. Bonds

Summary Rating Rationale

Moody's Investors Service has assigned an Aa3 rating to the City of South Bend Water Enterprise's \$3.4 million Waterworks Refunding Revenue Bonds of 2016. A portion of the system's outstanding revenue debt also has an existing Aa3 rating. Post-sale, the system will have \$18.3 million of outstanding revenue debt, \$10.6 million of which is rated by Moody's.

The Aa3 rating reflects the utility's large and stable service area; satisfactory financial operations and debt service coverage, despite limited rate setting authority; adequate legal provisions; and manageable debt levels.

Credit Strengths

- » Stable, diverse customer base
- » Satisfactory reserve levels

Credit Challenges

- » Dependence on Indiana Utility Regulatory Commission (IURC) approval for rate increases
- » Relatively low resident income indices

Rating Outlook

Outlooks are usually not assigned to local government credits with this amount of debt.

Factors that Could Lead to an Upgrade

- » Increased debt service coverage
- » Material increases in liquidity
- » Improved ability to achieve adequate and timely rate increases to support the financial obligations of the system

Factors that Could Lead to a Downgrade

- » Narrowed debt service coverage or liquidity
- » Increased system leverage
- » Inability to manage operational expenses and debt needs to maintain coverage in excess of the utility's rate covenant

Key Indicators

Exhibit 1

South Bend (City of), IN Water Enterprise					
System Characteristics					
Asset Condition (Net Fixed Assets / Annual Depreciation)	30 years				
System Size - O&M (in \$000s)	10,651				
Service Area Wealth: MFI % of US median	63.9%				
Legal Provisions					
Rate Covenant (x)	1.00				
Debt Service Reserve Requirement	DSRF funded at lesser of standard 3-prong test				
Financial Strength					
	2011	2012	2013	2014	2015
Operating Revenue (\$000)	14,116	15,468	15,130	14,512	14,282
O&M (\$000)	9,302	9,021	12,320	10,106	10,651
Long-Term Debt (\$000)	14,972	22,426	21,236	20,000	18,767
Annual Debt Service Coverage (x)	1.35	3.92	1.33	2.13	1.66
Cash on Hand	68 days	71 days	104 days	155 days	133 days
Debt to Operating Revenues (x)	1.1x	1.4x	1.4x	1.4x	1.3x

The above metrics do not include the current issuance.

Source: Moody's Investors Service, Audited Financial Statements, US Census data

Detailed Rating Considerations

Service Area and System Characteristics: Large, Stable Service Area With Weak Socioeconomic Profile

We expect the system's customer base to remain stable, reflecting in part the presence of several higher education institutions. Located approximately 140 miles north of [Indianapolis-Marion County](#) (Aaa negative) and 90 miles east of the [City of Chicago](#) (Ba1 negative), South Bend serves as a regional economic hub and the seat for [St. Joseph County](#) (Aa3). The city is home to several colleges and universities, including the [University of Notre Dame](#) (Aaa stable), which lends considerable stability to the regional economy. Resident income levels are weak, with median family income at just 64% of the US average. This is likely understated to a degree due to the city's large student population. As of August 2016, the city's unemployment rate of 5.7% was above both the state (4.6%) and national (5%) averages.

The utility serves the entire city of South Bend and portions of the surrounding unincorporated county, drawing water from 30 municipal wells and providing treatment and distribution services. The system operates five treatment facilities, with the capacity to handle up to 40 million gallons per day (MGD) and maintains five storage tanks with a storage capacity of 17.3 million gallons. Average daily water pumped in 2015 totaled 15 MGD, with a maximum of 26 MGD. The utility's 10 largest customers accounted for a modest 7% of fiscal 2015 billings, and the system has historically maintained a diverse mix of users, with residential customers comprising 62% of total consumption, followed by commercial (19%) and irrigation (9%) users.

Debt Service Coverage and Liquidity: Satisfactory Debt Service Coverage; Historically Infrequent Rate Increases

We expect the system will maintain satisfactory debt service coverage despite inconsistent rate increases. Rate increases are subject to approval by the Indiana Utility Regulatory Commission (IURC), which may sometimes cause delays in implementing needed rate increases, though the city has not had significant problems to date. The most recent adjustment to rates for the water system was a 22% increase in February of 2006. Management reports the city is currently seeking a 43% increase, effective fall 2017, though this proposed adjustment has not yet been approved by the City Council or IURC.

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on www.moody's.com for the most updated credit rating action information and rating history.

Despite the lack of consistent rate increases, the system's coverage ratios have remained satisfactory and are expected to improve following the anticipated rate increases. Debt service coverage levels have fluctuated in recent years, dropping from a high of 3.9 times in fiscal 2012, to 1.3 times in fiscal 2013, predominantly due to rising treatment and distribution costs. The system closed fiscal 2015 with coverage of 1.7 times, and fiscal 2016 revenues projections provide an estimated coverage of 1.5 times. Maximum annual debt service (MADS) is scheduled for 2017, with budget projections indicating MADS coverage of 2.7 times.

While current coverage and projections remain adequate, the regulatory environment may delay the implementation of sufficient rate increases. The system's ability to manage operational costs and manage necessary rate increases will be the focus of future credit reviews.

LIQUIDITY

The system closed fiscal 2015 with reserves of approximately \$3.9 million, or 36.5% of O&M, up from \$1.7 million, or 18.6% of O&M, in fiscal 2011. Additionally, the utility holds \$2.2 million in its operating reserve fund. Inclusive of these reserves, the system had a solid 210 days cash on hand at fiscal year-end 2015.

Debt and Legal Covenants: Adequate Legal Provisions

The utility's bonds, including the current issue, are secured by a senior lien on the net revenues of the system, defined as gross revenue after deduction only for the reasonable expenses of operation, repair and maintenance. Legal provisions call for a debt service reserve fund equal to the lesser of MADS, 125% of average annual debt service, or 10% of the stated principal amount. The rate covenant calls for net revenues to provide 1.0 times debt service coverage, which is relatively weak. The additional bonds test requires net revenues to provide 1.25 times debt service coverage.

DEBT STRUCTURE

All of the system's debt is fixed rate and amortizes over the long term.

DEBT-RELATED DERIVATIVES

The water system has no exposure to any debt-related derivatives.

PENSIONS AND OPEB

Most employees of the water enterprise system participate in the Indiana Public Employees' Retirement Fund (PERF), like other city employees. The PERF is a cost-sharing defined benefit pension plan governed by the Indiana Public Retirement System (INPRS) Board. INPRS administers the plan and set the contribution requirements. The PERF benefit consist of the pension provided by employer contributions plus an annuity provided by the participating member's annuity savings account.

Management and Governance: Rates Subject To IURC Approval

The City of South Bend owns and operates the municipal water utility. The water utility is regulated by the IURC, which has jurisdiction over the rates and charges of the system. Management maintains a five-year capital plan associated with its infrastructure needs and recently concluded a rate study for the water system. The city is currently in the process of getting a rate increase approved for fall 2017. The utility's formal fund balance policy requires reserves of at least two months of expenditures in the Waterworks O&M Reserve Fund and a minimum 5% of expenditures in the Waterworks Operating Fund. Both funds currently exceed these targets.

Legal Security

Debt service on the revenue bonds is secured by a senior lien on the net revenues of the water system.

Use of Proceeds

Proceeds will be used to currently refund the city's Waterworks Revenue Bonds of 2000 and Waterworks Revenues Bonds of 2006 for debt service savings.

Obligor Profile

The water utility is operated by the city of South Bend, providing services to approximately 43,500 users within the city and portions of surrounding unincorporated areas.

Methodology

The principal methodology used in this rating was US Municipal Utility Revenue Debt published in December 2014. Please see the Rating Methodologies page on www.moodys.com for a copy of this methodology.

Ratings

Exhibit 2

South Bend (City of) IN Wtr. Ent.

Issue	Rating
Waterworks Refunding Revenue Bonds of 2016	Aa3
Rating Type	Underlying LT
Sale Amount	\$3,355,000
Expected Sale Date	11/30/2016
Rating Description	Revenue: Government Enterprise

Source: Moody's Investors Service

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