S&P Global
Ratings

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Summary:

East Lansing, Michigan; General Obligation

Primary Credit Analyst:
Benjamin D Gallovic, Chicago + 1 (312) 233 7070; benjamin.gallovic@spglobal.com

Secondary Contact:
Jennifer Boyd, Chicago + 1 (312) 233 7040; jennifer.boyd@spglobal.com

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Credit Profile		
US$5.665 mil ltd tax GO rfdg bnds ser 2021 dtd 05/04/2021 due 04/01/2032		
Long Term Rating	AA+/Stable	New
East Lansing GO		
Long Term Rating	AA+/Stable	Affirmed
East Lansing GO		
Long Term Rating	AA+/Stable	Affirmed

Rating Action

S&P Global Ratings assigned its 'AA+' long-term rating to East Lansing, Mich.'s series 2021 limited-tax general obligation (GO) refunding bonds. At the same time, S&P Global Ratings affirmed its 'AA+' long-term rating on the city's previously issued debt. The outlook is stable.

The city's limited-tax GO debt is secured by the city's full faith and credit, payable from ad valorem taxes levied on all taxable property, subject to statutory limitations. We rate the limited-tax GO debt at the same level as our view of the city's general creditworthiness given that the ad valorem taxes are collected from the city's entire tax base and given a lack of limitations on the fungibility of resources available for debt service.

Officials will use series 2021 bond proceeds to refund portions of the city's series 2011A and 2012 GO bonds for interest cost savings.

Credit overview

In our view, East Lansing's credit quality benefits from the stabilizing influence of Michigan State University (MSU), very strong financial management policies, and a low direct debt burden. The city also has a long history of maintaining structurally balanced operations through various economic cycles and keeping reserves close to 15% of expenditures. To address the city's underfunded pension plan, the city recently gained voter approval for an income tax that will allow it to overfund its annually required pension contributions and help improve the funded ratio. Income tax revenue has declined as a result of the pandemic, but so far this has not affected the city's ability to make these supplemental pension payments. Furthermore, although the city has experienced other revenue losses as a result of the pandemic, management has offset these losses with various expenditure reductions and federal stimulus funding. Overall, we anticipate that the city will weather effects from the pandemic, while maintaining structural balance and very strong reserves as well as continuing to improve its pension funded ratio. That said, if the city fails to make significant progress in improving its pension funded ratio, as a result of lower-than projected income tax revenue or other market factors, we could consider a lower rating.

The rating reflects our view of the city's:

- Adequate economy, with access to a broad and diverse metropolitan statistical area and a local stabilizing institutional influence;
- Very strong management, with strong financial policies and practices under our financial management assessment methodology;
- Adequate budgetary performance, with a history of surplus operating results tempered by pandemic-related risks;
- Very strong budgetary flexibility, with an available fund balance that we expect will improve in the near term from its fiscal 2020 level of 13.2% of operating expenditures;
- Very strong liquidity, with total government available cash at 94.1% of total governmental fund expenditures and 52.3x governmental debt service, and access to external liquidity we consider strong;
- Adequate debt and contingent liability position, with debt service carrying charges at 1.8% of expenditures and net direct debt that is 44.1% of total governmental fund revenue, but a large pension and other postemployment benefit (OPEB) obligation; and
- Strong institutional framework score.

Environmental, social, and governance factors

We consider the city's social risks consistent with those of peers. Although the pandemic has spurred an increase in remote working, which could threaten the financial viability of cities that rely on income taxes from commuters, we believe that East Lansing is somewhat insulated from this risk given our belief that most MSU employees will return to campus as the pandemic subsides. In the short term, the city's general fund is also somewhat insulated from pandemic-related income tax declines given that a large portion of income tax revenue funds nonrecurring expenses (such as supplemental pension payments). We will monitor trends and reassess our ratings as necessary. We believe that the city's environmental and governance factors are in line with those of the sector. The city's location does not leave it overexposed to extreme weather events or long-term changes in climate trends.

Stable Outlook

Downside scenario

We could lower the rating over the next two years if the city does not make progress toward improving its pension funded ratio to levels in line with those of higher-rated peers, if it is unable to maintain structural balance, or if it fails to maintain reserves near its target of 15% of expenditures.

Upside scenario

All else equal, we could raise the rating if the city's wealth and income levels improve, reserves increase and are sustained at levels commensurate with those of higher-rated peers, and if its pension and OPEB liability significantly moderates.

Credit Opinion

Adequate economy

We consider East Lansing's economy adequate. The city, with an estimated population of 49,901, is located in Clinton and Ingham counties in the Lansing-East Lansing metropolitan statistical area, which we consider broad and diverse. The city also benefits, in our view, from a stabilizing institutional influence. The city has a projected per capita effective buying income of 66% of the national level and per capita market value of $55,169. Overall, the city's market value grew by 8.4% over the past year to $2.8 billion in 2021. The weight-averaged unemployment rate of the counties was 3.5% in 2019. Preliminarily, the weighted average unemployment rate increased to 7.3% in 2020.

East Lansing is the home of MSU, which employs approximately 10,200 and has an enrollment of approximately 50,000. We consider the university a long-term stabilizing presence to the tax base and economy. That said, because of the COVID-19 pandemic, a majority of university classes are being held virtually. Although many students are still living in off-campus apartments, economic activity in the city has been diminished, hurting small businesses throughout the city. We understand that the university plans to resume most in-person classes during the fall 2021 semester, and we would expect an uptick in economic activity as a result. We see some risk that the pandemic may have a lagging negative effect on property values, particularly in the commercial sector, though management notes that the city's housing market has been performing well, which may offset declines in the commercial sector.

S&P Global Ratings believes that economic recovery from the COVID-19 pandemic and associated recession will begin to accelerate, but with unemployment remaining precrisis levels until 2023. (See S&P Global Economics' reports "Economic Outlook U.S. Q2 2021: Let The Good Times Roll," published March 24, 2021, on RatingsDirect, and "Within Reach: How Stimulus Proposals Lift U.S. GDP to Pre-Pandemic Levels," published Feb. 1, 2021.)

Very strong management

We view the city's management as very strong, with strong financial policies and practices under our financial management assessment methodology, indicating our view that financial practices are strong, well embedded, and likely sustainable.

The city maintains formal debt, investment, and reserve policies. It has a six-year rolling capital improvement plan in addition to a five-year rolling financial forecast, both of which are updated at least once a year. The capital improvement plan identifies sources of revenue and costs for related items, and the long-term financial forecast includes explanations of assumptions. During the year, investment performance and holdings and budget-to-actual progress reports are reported to the council quarterly. Last, the city uses well founded revenue and expenditures assumptions when preparing the budget.

Adequate budgetary performance

East Lansing's budgetary performance is adequate, in our opinion. Although we believe the city has demonstrated strong budgetary performance historically, event risk associated with the pandemic and lagging effects from the recession weakens our view.

Historically, property taxes have been the city's main revenue source. However, given revenue constraints from the large amount of tax-exempt property at MSU, as well as the need for a new revenue source to fund the city's underfunded pension plan, the city gained voter approval for an income tax in 2018. The tax was approved for a 12-year period, effective Jan. 1, 2019, and in conjunction with a five-mill reduction in the city's property tax levy. The city levies a 1.0% income tax on residents and businesses and a 0.5% tax on nonresidents who work in the city. Management estimates that about 50% of income tax collections come from nonresidents. The income tax is used first to offset the property tax reduction in the general fund, which is about $5.5 million annually. Any income tax collected in excess of this amount is then allocated 60% to supplemental pension payments, and 20% each to public safety costs and infrastructure projects. The city had originally estimated that the income tax would generate about $10 million annually, but collections in the first year brought in about $13.5 million.

On a budget basis, the city collects the income tax in a separate fund, and then transfers the portion for property tax replacement, pensions, and public safety to the general fund. On an audited basis, the income tax fund is considered part of the general fund. In fiscal 2020 (ended June 30), the general fund balance increased by $3.5 million, reflecting the first full year of income tax collections. The surplus income tax revenue was classified as restricted fund balance in the audit, and then expensed in fiscal 2021. Netting out the restricted income tax revenue, the general fund would have shown about a $1 million deficit in 2020, though this was the result of an additional $500,000 supplemental pension payment, $500,000 in discretionary transfers for capital projects, and $200,000 in one-time pandemic-related costs (which were reimbursed by Coronavirus Aid, Recovery, and Economic Security, or CARES, funding in fiscal 2021). After accounting for these one-time costs, the general fund was structurally balanced in 2020. The city reported a surplus of 5.7% across all governmental funds.

The city's original fiscal 2021 budget was balanced, though didn't account for any effects from the pandemic. As revenue effects from the pandemic materialized, the city made corresponding expenditure reductions. The city estimates that income tax revenue will fall by 25% to $10.4 million in fiscal 2021 largely as a result of nonresidents' working remotely during the pandemic. However, this will not affect general fund operations given that only the first $5.5 million of the income tax funds recurring general fund expenses. Outside of income tax revenue, the most significant revenue losses have been in parks and recreation fees, parking revenue, parking tickets, and ordinance fines. To counter these losses, the city temporarily laid off about 100 employees and deferred certain capital projects, among other miscellaneous cost cutting measures. The net effect of revenue losses and expenditure reductions is a small operating deficit in the general fund. However, the city is receiving about $1.4 million in CARES funding in 2021, which will offset the deficit and increase the general fund balance by about $825,000. The city also expects to receive roughly $12.5 million in funding from the American Rescue Plan but has not factored this into its budget yet.

A class-action lawsuit has been filed against the city regarding the city's collection of electric utility franchise fees. The lawsuit contends that the fee is functionally a tax that was not voter-approved, and therefore unconstitutional. The city's general fund collects about $1.5 million in franchise fees annually (about 3.2% of general fund revenue). Although timing on the resolution of the lawsuit is uncertain, management believes that the city could absorb the potential loss of this revenue by reducing its supplemental pension payment from the general fund. Overall, we anticipate that the city will make budget adjustments as it deems necessary to maintain structural balance in future years. The city plans to adopt a balanced budget for fiscal 2022.

Very strong budgetary flexibility

East Lansing's budgetary flexibility is very strong, in our view, with an available fund balance that we expect could improve in the near term from its fiscal 2020 level of 13.2% of operating expenditures, or $5.5 million.

The city's reserve policy calls for maintaining the unassigned general fund balance at 8% to 15% of expenditures. In practice, the city aims to keep reserves at or slightly above 15%. The unassigned portion dipped below 15% in fiscal 2020 as a result of timing issues with the recording of the CARES funding. Management expects to end fiscal 2021 with an unassigned fund balance of 15.5%, and we believe that it will maintain reserves above this level in future years. The city generally assigns reserves above the 15% level to specific uses, such as paying down its pension and retiree health care liability or for specific road projects. The assigned portion of reserves is commonly spent down, but is then replenished through operating surpluses. We anticipate that the total available reserve position will remain very strong.

Very strong liquidity

In our opinion, East Lansing's liquidity is very strong, with total government available cash at 94.1% of total governmental fund expenditures and 52.3x governmental debt service in 2020. In our view, the city has strong access to external liquidity if necessary, as demonstrated by a long history of issuing debt. It has $4.7 million of existing limited-tax GO debt that is variable rate and with a mandatory tender provision, but with 180 days' notice. We do not consider this obligation a source of pressure on liquidity.

Adequate debt and contingent liability profile

In our view, East Lansing's debt and contingent liability profile is adequate. Total governmental fund debt service is 1.8% of total governmental fund expenditures, and net direct debt is 44.1% of total governmental fund revenue.

Our net direct debt ratio does not include enterprise-revenue-secured debt or debt that is paid through enterprise-type revenue. Amortization of all direct debt is 57% in 10 years. The city has no additional plans to issue tax-supported debt, but does plan to issue about $35 million in revenue debt for work at its water treatment plant. Thus, we anticipate that the initial debt indicators will remain consistent.

Pension and OPEB liabilities

- In our opinion, a credit weakness is East Lansing's large pension and OPEB obligation given elevated pension and OPEB carrying charges and an underfunded pension plan.
- We believe weaker pension actuarial assumptions, such as a high discount rate, increase the risk of cost volatility.
- Despite the low funded ratio and weaker assumptions, we believe the city's new income tax should help improve the funded ratio over the long term.

East Lansing participates in the following plans:

- Municipal Employees Retirement System (MERS) of Michigan: 52.1% funded with a proportionate share of the net pension liability of $93.5 million
- A single-employer, defined benefit health care plan: 37.9% funded with a total net OPEB liability of $27.9 million in 2020

The city's required pension and actual OPEB contributions totaled 19.5% of total governmental fund expenditures in 2020, with 14.4% representing required contributions to pension obligations and 5.1% representing OPEB payments. The city contributed 170% of its annual required pension contribution.

The city participates in an agent multiple-employer, defined benefit pension plan administered by the Municipal

Employees' Retirement System of Michigan (MERS), which covers eligible city employees. MERS is an agent multiple-employer plan, meaning its assets are jointly managed. The plan has a 7.6% discount rate, which we believe could lead to contribution volatility. Furthermore, some of the amortization methods, including its open period and level percent of pay assuming 3% growth, are likely to lead to increasing actuarially determined contributions. There is also a hybrid defined contribution and defined benefit plan administered by MERS, and a small number of employees participate in a separate defined contribution plan administered by MERS.

With the new income tax, the city aims to overfund the pension ARC by $5 million every year. Under this scenario, the city projects that the funded ratio could improve to 66% by 2024. So far, the city has exceeded its goal, contributing supplemental pension payments of $5.6 million in 2020, and $6.7 million in 2021. Although the decrease in income tax revenue spurred by the pandemic will reduce the size of the city's supplemental pension payment in fiscal 2022, management still expects to collect sufficient income tax revenue to meet the $5 million target. The city expects annually required contributions to level off before beginning to decrease as the funded ratio improves.

For OPEBs, the city generally funds costs on a pay-as-you-go basis, but occasionally makes one-time contributions to the trust above this amount. The city ceased providing OPEBs for nonpublic safety employees in 1993, so it currently provides benefits only for public safety employees and nonpublic safety employees hired before 1993.

Strong institutional framework

The institutional framework score for Michigan municipalities with a population of 4,000 to 600,000 is strong.

Related Research

- S&P Public Finance Local GO Criteria: How We Adjust Data For Analytic Consistency, Sept. 12, 2013
- Alternative Financing: Disclosure Is Critical To Credit Analysis In Public Finance, Feb. 18, 2014
- Criteria Guidance: Assessing U.S. Public Finance Pension And Other Postemployment Obligations For GO Debt, Local Government GO Ratings, And State Ratings, Oct. 7, 2019
- Through The ESG Lens 2.0: A Deeper Dive Into U.S. Public Finance Credit Factors, April 28, 2020
- 2020 Update Of Institutional Framework For U.S. Local Governments