S&P Global Ratings

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Summary:

East Gull Lake, Minnesota; Non-School State Programs

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Credit Profile		
US$1.055 mil GO swr rev bnds ser 2024A dtd 01/25/2024 due 02/01/2039		
Long Term Rating	AAA/Stable	New
Underlying Rating for Credit Program	AA-/Stable	New

Credit Highlights

- S&P Global Ratings assigned its 'AAA' long-term rating and 'AA-' underlying rating for credit program to the City of East Gull Lake, Minn.'s anticipated $1.1 million series 2024A general obligation (GO) sewer revenue bonds.
- The outlook on all ratings is stable.

Security

The city's full faith and credit secures the series 2024A bonds; in addition, the city pledges revenues from its sewer utility. We rate to the GO pledge as the legal provisions are insufficient to rate to the utility pledge under our criteria. Bond proceeds will be used to finance wastewater projects.

Credit overview

The rating reflects East Gull Lake's large tax base relative to the size of its population, with very strong incomes, and operating budget supported predominately by property taxes. The city's tax base grew 68% in the past six years, with a pattern of residents moving out of city centers to lakeside properties, and highly valued secondary homes. Although East Gull Lake has limited operations, with a nominally small budget, the city maintains reserves above its informal policy of 50% operating expenses on hand. While the city's debt burden is high with elevated fixed costs, we do not expect it will crowd out operational spending due to the size of its growing tax base in conjunction with resident wealth levels, and statutory taxing flexibility to raise the levy as needed.

Overlapping debt is significant with $93.5 million attributable to Brainerd School District (compared with the city's $3.2 million in direct debt); debt service payments for both the district and City of East Gull Lake have been steady, and as we understand affordable for residents. The city has limited operations and assets, five full-time staff, public safety is contracted out to third parties, with low pension exposure and costs as a percent of budget. In addition to stable revenues consisting mostly from property taxes, the city has ample taxing flexibility as a Minnesota municipality with no levy limitations.

The 'AA-' underlying rating further reflects our assessment of the city's:

- Extremely strong market value per capita, reflecting the value of lake homes and the low-density population;
- Maintenance of very strong general fund reserves on a percentage basis and history of positive general fund

operations;

- Adequate management with standard financial-management policies and practices under our Financial Management Assessment (FMA) methodology and a strong institutional framework score; and
- Moderate direct debt burden but high overlapping debt when including neighboring municipalities of Brainerd Schools and Pillager Schools; Brainerd Independent School District issued about $209 million of voter-approved debt between 2018 and 2023 for new school buildings, $93 million is attributable to East Gull Lake. The school district's levy has been in place for five years and remains steady. We do not expect overlapping debt will change materially in the near term.

Environmental, social, and governance

We view the county's environmental, social, governance (ESG) risks as neutral within our credit rating analysis. Despite the city's proximity to lakes, management reports no financial or economic loss due to flooding or weather events.

Outlook

The stable outlook reflects our view that the city will likely maintain strong finances and at least stable economic metrics during the next two fiscal years. The stable outlook on the long-term rating reflects that of Minnesota.

Downside scenario

We could lower the rating if the city posts any material reduction in reserves.

Upside scenario

We would raise the rating if the city builds up reserves and maintains at nominal levels comparable with those of peers of a higher rating, along with debt service costs declining to a modest portion of the city's total government budget, couples with adoption of more-robust policies and practices. However, we do not anticipate this will occur in the two-year outlook horizon.

Credit Opinion

Small population, but growing tax base with recreational-based economy

East Gull Lake is 140 miles north of Minneapolis and 125 miles from Duluth. The city's population grew in the past decade and is expected to continue expanding by at least 10 new single-family homes per year and flexibility for individuals to relocate and work remotely. In preparation of additional residential growth from a new development with room for 137 single-family homes, the city has expanded operations of its southern wastewater facilities and will be decommissioning its northern wastewater plant for greater operational and cost efficiencies. Market values have increased dramatically with single-family new builds and renovations of smaller seasonal properties into permanent residences. The city anticipates more population growth with new developments in progress, citing 12 new homes built in 2023. East Gull Lake's top taxpayers and employers are lake resorts and golf courses. Incomes are above the national average, supporting the city's very strong economic profile. We view the city's robust incomes and market values as providing ample room to support capital needs, debt service, and to raise the levy without affecting affordability.

Positive general fund operations historically; budgeting to build reserves in fiscal 2024

The city's general fund has been stable, with annual surpluses due to positive variance, and available reserves have averaged 62% in the past three years, which we consider low on a nominal basis. We expect the county's financial flexibility and liquidity will be very strong, with available reserves to at least remains stable in 2023. The city has about $1 million in direct-debt placements outstanding, these placements do not contain acceleration provisions or nonstandard events of default, therefore we no do not consider these to be liquidity risks.

The fiscal 2023 general fund budget is structured with a deficit to reflect planned spending for various capital projects, resulting in a deficit of $8,000. The fiscal 2024 original budget also reflects large capital spending relative to the budget (negative $283,000), using built-up committed balances for trail and parks and a portion of available general fund reserves. However, with the 2024 approved levy increase, management excepts to end 2024 with a large surplus, restoring reserves to $460,000. In 2025 the city, is budgeting to continue to add to reserve levels. Property tax represented 68% of total general fund revenues in fiscal 2022, which we view as a stable revenue source supporting the city's finances.

The city is directing considerable spending toward capital projects in its general fund, and funds this through taxes and committed reserves for these projects in both the general fund and intergovernmental funds, which can result in some volatile total governmental performance. The wastewater system has posted deficits in past years, driven by maintenance, salary, and capital costs. Net operating revenues are expected to improve as the city commissions the northern plant, reducing operating costs, and with anticipated rate increases over the next few years.

Adequate FMA and a strong institutional framework score

Officials use at least five years historical look back and outside sources when developing the budget. Management provides the board with monthly budget-to-actual and investment reports. Capital planning is mainly at the departmental level, focused on roads and wastewater projects. The city has an informal fund balance policy requiring unassigned reserves to be 50% of expenditures, which the city historically has exceeded. The city does not have an investment or debt policy, nor does it produce a long-term financial forecast. Management has cyber-mitigation measures in place and has not had any issues with data breaches.

The institutional framework score of Minnesota cities with a population less than 2,500 people is strong.

Manageable fixed costs despite high debt burden

With this issuance, the city will have $3.5 million in net direct debt outstanding, but the city's overlapping debt is $98 million outstanding significantly inflating overall net debt. The city plans to issue $2.9 million in debt to finance wastewater projects to complete the transition to the southern wastewater treatment plant. Given the systems' already high overall net debt and elevated fixed debt service costs compared with the budget, the additional debt will not worsen the debt score.

Pension benefits are manageable and do not impair credit quality

The city participates in cost-sharing multiple-employer defined benefit pension plan administered by the Public Employes Retirement Association of Minnesota (PERA). The plan's contributions are a modest share of expenses, the associated liability is $348,000 (at year-end June 30, 2022); the city does not offer postemployment benefits. We believe the plans' costs are unlikely to accelerate meaningfully in the medium term, but pose some long-term risk of cost acceleration due to back-loaded contributions and an extended amortization period (For more information, see "Pension Spotlight: Minnesota," published Aug. 10, 2023, on RatingsDirect.)

Minnesota State Standing Appropriation Program

The 'AAA' long-term rating on the series 2024A bonds reflects our view of the city's eligibility for, and participation in, Minnesota's credit enhancement program for cities and counties, a state standing appropriation program administered by the Public Facilities Authority to prevent a default on the city's bond issues as authorized by Minnesota State Statutes, Section 446A.086. Under the program, the state will pay debt service on behalf of East Gull Lake from the state's general fund if the county fails to meet its debt service obligations for the qualified debt. Payments from the state represent a standing appropriation from Minnesota's general fund. We view this standing appropriation pledge as equivalent to a general fund pledge because it does not require adoption of a budget or any action of the legislature to make payment. Furthermore, the standing appropriation is not subject to executive unallotment authority. The credit enhancement program supports projects that are central to the state's operations and purpose. We see no unusual political, timing, or administrative risk related to the debt payment. The rating on obligations that have received enhancement under the program reflects that on the State of Minnesota and moves in tandem with the state rating.

East Gull Lake, Minn.--Key credit metrics

	Most recent	Historical information		
		2022	2021	2020
Strong economy				
Projected per capita EBI % of U.S.	131.3			
Market value per capita ($)	887,683			
Population		1,058	1,047	1,036
County unemployment rate(%)		4.2		
Market value ($000)	939,169	686,307	574,630	
Ten largest taxpayers % of taxable value	11.7			
Adequate budgetary performance				
Operating fund result % of expenditures		27.6	8.4	8.5
Total governmental fund result % of expenditures		-9.7	0.2	-1.6
Very strong budgetary flexibility				
Available reserves % of operating expenditures		65.0	61.2	60.0
Total available reserves ($000)		412	305	275
Very strong liquidity				
Total government cash % of governmental fund expenditures		98.6	108.6	93.4
Total government cash % of governmental fund debt service		324.4	315.5	256.6
Adequate management				
Financial Management Assessment	Standard			

East Gull Lake, Minn.--Key credit metrics (cont.)				
	Most recent	**Historical information**		
		2022	**2021**	**2020**
Very weak debt and long-term liabilities				
Debt service % of governmental fund expenditures		30.4	34.4	36.4
Net direct debt % of governmental fund revenue	310.9			
Overall net debt % of market value	10.7			
Direct debt 10-year amortization (%)	78.9			
Required pension contribution % of governmental fund expenditures		2.6		
OPEB actual contribution % of governmental fund expenditures		0		
Strong institutional framework				

Data points and ratios may reflect analytical adjustments. EBI--Effective buying income. OPEB--Other postemployment benefits.

Related Research

- Through The ESG Lens 3.0: The Intersection Of ESG Credit Factors And U.S. Public Finance Credit Factors, March 2, 2022
- 2022 Update Of Institutional Framework For U.S. Local Governments