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CREDIT OPINION
12 April 2023

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Duluth Independent School District 709, MN

Update to credit analysis following upgrade to A3

Summary

Duluth Independent School District No. 709's (A3) reserves have improved to solid levels from what had been a very narrow position following voter approval for a new operating levy as well as an influx of federal aid. The district will either need to raise revenue or reduce expenditures to maintain the financial momentum once federal aid is depleted. The district benefits from Duluth's role as a regional economic center and strong full value per capita. Credit challenges include a declining enrollment trend and elevated leverage.

On date, April 12 we upgraded the district's Issuer Rating to A3 from Baa2. We also upgraded the rating on the district's outstanding general obligation unlimited tax debt and the rating on the district's full-term certificates of participation (non-contingent lease backed by GOULT pledge) to A3 from Baa2, and the rating on the district's annual appropriation certificates of participation (lease: appropriation) to Baa1 from Baa3.

Credit strengths

» Economic base serves as regional hub supporting solid full value per capita

» Voter support for operating levy that is supporting recovery of finances

Credit challenges

» History of weak budgetary performance resulted in an extended period of narrow reserves

» Declining enrollment trend

Rating outlook

Moody's does not usually assign outlooks to local governments with this amount of debt.

Factors that could lead to an upgrade

» Further growth in reserves and liquidity

» Material reduction in leverage

Factors that could lead to a downgrade

» Decline in reserves and leverage

» Material increase in leverage and fixed costs

Key indicators

Exhibit 1
Duluth Independent School District 709, MN

	2019	2020	2021	2022	Baa Medians
Economy					
Resident income	97.0%	106.7%	100.0%	N/A	86.0%
Full value ($000)	$8,846,660	$8,832,730	$9,445,089	$10,394,088	$971,081
Population	93,687	93,667	94,589	N/A	12,995
Full value per capita	$94,428	$94,299	$99,854	N/A	$78,968
Enrollment	8,706	8,896	8,358	8,487	1,707
Enrollment trend	0.3%	1.3%	-1.9%	-0.8%	-1.5%
Financial performance					
Operating revenue ($000)	$132,056	$143,052	$141,077	$150,173	$25,791
Available fund balance ($000)	$5,649	$13,024	$20,501	$23,584	$2,637
Net cash ($000)	$26,677	$30,191	$41,473	$39,809	$3,224
Available fund balance ratio	4.3%	9.1%	14.5%	15.7%	10.6%
Net cash ratio	20.2%	21.1%	29.4%	26.5%	12.4%
Leverage					
Debt ($000)	$197,853	$196,601	$183,561	$208,814	$20,047
ANPL ($000)	$217,226	$263,598	$328,040	$278,278	$55,909
OPEB ($000)	$16,635	$15,593	$16,471	$16,170	$6,554
Long-term liabilities ratio	326.9%	332.6%	374.3%	335.1%	373.0%
Implied debt service ($000)	$21,703	$14,425	$14,079	$12,875	$1,426
Pension tread water ($000)	$5,795	$5,870	$6,667	N/A	$1,760
OPEB contributions ($000)	$1,301	$1,843	$211	$234	$240
Fixed-costs ratio	21.8%	15.5%	14.9%	13.2%	15.8%

For definitions of the metrics in the table above please refer to the US K-12 Public School Districts Methodology or see the Glossary in the Appendix below. Metrics represented as N/A indicate the data were not available at the time of publication. The medians come from our most recently published K12 Median Report.
Sources: US Census Bureau, Duluth Independent School District 709, MN's financial statements and Moody's Investors Service

Profile

Duluth ISD 709 is located along the Lake Superior shoreline about 150 miles north of the Twin City metropolitan area and has a resident population of just under 100,000. The district provides prekindergarten through twelfth grade education to residents of the City of Duluth as well as all or portions of five surrounding townships and has an enrollment of over 8,000.

Detailed credit considerations

Economy: regional economic center with declining enrollment

The district benefits from the City of Duluth's (Aa2 stable) role as a regional economic center. Key industries underpinning the economy include tourism, healthcare and mining driven by iron ore and the Port of Duluth on Lake Superior. The largest single employers in the district are Essentia Health and St. Luke's Hospital. Three institutions of higher education, including the second-largest campus of the University of Minnesota (Aa1 stable) serve as stabilizing anchors. Resident income is on par with the nation while full value per capita is very strong.

Before the pandemic, the district's enrollment had been trending downward because of a declining number of school aged children. A large drop of over 500 students, or 6% in fiscal 2021 was driven by pandemic related pressures including the loss of students to private schools, neighboring districts and online providers. The district recovered a couple of hundred students in school years 2022 and 2023. Officials project that enrollment will slowly grow going forward given positive momentum in early childhood education, but are conservatively budgeting for enrollment to remain flat.

Financial operations: rapidly recovering finances following voter approval of operating levy

The district's financial position will continue to strengthen for at least the next two years because of a voter-approved increase to the operating levy, improved budget management and federal aid. Although a budget will not be passed until the spring, officials preliminary planning indicates the district is poised for another strong year in fiscal 2024 (year-end June 30). The district has about $20 million remaining in federal aid from Elementary and Secondary School Emergency Relief Fund (ESSR) that will be split between fiscal 2023 and fiscal 2024. Funds are reimbursed to the district after spent. For fiscal 2023, officials are currently projecting that general fund revenue will exceed expenses by about $1 million inclusive of federal aid. In addition, the district recently sold another property for $7 million, which will accrue to general fund balance and be spent down over several years for technology.

The district will either need to raise revenue or reduce expenditures to maintain the financial momentum once federal aid is depleted. Officials are proactively planning budgeting for that moment. The district used the infusion of federal aid to hire staff such as counselors, psychologists, math and reading intervention specialists and staff to reduce class sizes. The district is reducing half of those positions for the next school year. The district is also considering approaching voters for a new operating levy. If the district does not receive additional revenue, officials plan to eliminate the remaining positions funded with federal aid. The other key variables in the district's future financial trajectory will be the pace of state aid increases and salary growth. Officials are striving to keep cost of living wage increases for employees under state aid increases given the district reports that wages are very competitive with neighboring districts. The state's biennium budget that extends through the end of fiscal 2023 increased per pupil funding relatively modestly at 2.45% in the first year and 2% in the second year.

The district's reserves more than tripled growing to nearly 16% of revenue in fiscal 2022 from under 5% of revenue in fiscal 2019 primarily because of increased revenue from a new operating levy, an infusion of federal aid, positive expenditure variances and a property sale that generated $3 million.

Liquidity

The district's cash balance is much higher than fund balance because the district defers spring tax collections to the next fiscal year. About half of the district's cash is held in the debt service fund. Most of reserves in the debt service fund is because of the timing between the levy and debt service payments, but a portion has been accumulated over time from levying more than was needed for debt service.

Leverage: limited borrowing plans

The district's leverage is unlikely to change materially for the next several years because most of its liabilities are related to unfunded pension liabilities and the district is unlikely to issue any debt for a few years. The district's fixed-cost ratio is moderate with expenses equal to about 13% of revenue. Actual fixed costs are higher at over 20% of revenue because the district is favorably amortizing debt more rapidly than the 20 years assumed under our implied debt service calculation. The district may have a small bond issuance in the next few years for technology. The district's two high schools had major remodels just a few years ago.

Legal security

The GOULT bonds are backed by the district's pledge to levy a dedicated property tax unlimited as to rate and amount. The GOULT bonds are additionally secured by statute and supported by the State of Minnesota's School District Credit Enhancement Program which provides for an unlimited advance from the state's general fund should the district be unable to meet debt service requirements.

The full-term COPs do not carry the district's full faith and credit pledge but are supported by a separate, dedicated levy. The obligation of the district to make rental payments is absolute and unconditional and it is not subject to annual appropriation. The Full-Term COPs are also additionally supported by the State of Minnesota's School District Credit Enhancement Program.

The annual appropriation COPs are supported by lease payments which are subject to annual appropriation. The pledged assets are school facilities, which we deem to be a more essential asset.

Debt structure

All of the district's debt is long-term and fixed rate. Amortization is rapid with most GO debt retired in 10 years.

Debt-related derivatives

The district is not a party to any debt-related derivatives.

Pensions and OPEB

The district participates in two multiple-employer cost-sharing plans, the General Employees Retirement Fund (GERF) and the Teachers Retirement Association of Minnesota (TRA). Most of its unfunded liabilities are attributable to the TRA. The State of Minnesota approved legislation in 2018 that modified benefits and modestly increased contributions to TRA. Because of the reform package, school districts are in the process of increasing their TRA employer contribution rate to 8.75% of payroll in 2024 from the previous rate of 7.5%. In aggregate, the total contributions to TRA from all participating school districts in 2021 were equal to about 74% of our tread water indicator, which reflects the issuer contribution that would be required to prevent the unfunded liability from growing assuming realization of all plan assumptions.

ESG considerations

Duluth Independent School District 709's ESG Credit Impact Score is moderately negative (CIS-3), reflecting moderately negative exposure to governance risks, and neutral-to-low exposure to environmental and social risks.

Environmental

Duluth Independent School District 709's E Issuer Profile Score is neutral-to-low (E-2), reflecting neutral-to-low exposure to environmental risks across all categories, including physical climate risk, carbon transition, water management, natural capital and waste and pollution.

Social

Duluth Independent School District 709's S Issuer Profile Score is neutral-to-low (S-2), reflecting relatively low exposure to social risks across all categories, including demographics, labor and income, education, housing, health and safety and access to basic services. The district's demographics, educational attainment and labor market are in line with the nation. Residents have access to basic services.

Governance

Duluth Independent School District 709's G Issuer Profile Score is moderately negative (G-3), reflecting a history of weakness in budget management and policy credibility and effectiveness. The district's previously stressed financial position was, in part, because of negative budgetary variances including budgeting for land sales that did not materialize. To reduce negative variances, management began budgeting more conservatively including assumptions of flat to declining enrollment and are now reacting much more quickly to bring amendments to the board. Transparency and disclosure practices are sound, including timely audit releases. A variance report on how revenue and expenditures are tracking compared with budget is included monthly in the school board meeting packets, but there is not a designated location to access all of the district's variance report reports on its website. Duluth ISD operates in an institutional structure where the state controls the bulk of district revenue, though districts can generate a moderate amount of locally determined revenue.

Rating methodology and scorecard factors

The US K-12 Public School Districts Methodology includes a scorecard, a tool providing a composite score of a school district's credit profile based on the weighted factors we consider most important, universal and measurable, as well as possible notching factors dependent on individual credit strengths and weaknesses. Its purpose is not to determine the final rating, but rather to provide a standard platform from which to analyze and compare school district credits.

The assigned rating differs from the scorecard-indicated outcome because of forward looking information and additional considerations including a management strategy that had historically led to difficulty adhering to budget leading a long period with narrow reserves and the imperative to make budget adjustments to maintain the financial momentum once federal aid is depleted.

Exhibit 2

Duluth Independent School District 709, MN

	Measure	Weight	Score
Economy			
Resident Income (MHI Adjusted for RPP / US MHI)	100.0%	10.0%	A
Full value per capita (full valuation of the tax base / population)	109,887	10.0%	Aa
Enrollment trend (three-year CAGR in enrollment)	-0.8%	10.0%	A
Financial performance			
Available fund balance ratio (available fund balance / operating revenue)	15.7%	20.0%	A
Net cash ratio (net cash / operating revenue)	26.5%	10.0%	Aaa
Institutional framework			
Institutional Framework	A	10.0%	A
Leverage			
Long-term liabilities ratio ((debt + ANPL + adjusted net OPEB) / operating revenue)	335.1%	20.0%	A
Fixed-costs ratio (adjusted fixed costs / operating revenue)	13.2%	10.0%	Aaa
Notching factors			
No notchings applied			
Scorecard-Indicated Outcome			A1
Assigned Rating			**A3**

Sources: US Census Bureau, Duluth Independent School District 709, MN's financial statements and Moody's Investors Service

Appendix

Exhibit 3

Key Indicators Glossary

	Definition	Typical Source*
Economy		
Resident income	Median Household Income (MHI), adjusted for Regional Price Parity (RPP), as a % of the US	MHI: American Community Survey (US Census Bureau) RPP: US Bureau of Economic Analysis
Full value ($000)	Estimated market value of taxable property accessible to the district	State repositories, district's audited financial reports, offering documents or continuing disclosure
Population	Population of school district	American Community Survey (US Census Bureau)
Full value per capita	Full value / population of school district	
Enrollment	Student enrollment of school district	State data publications
Enrollment trend	3-year Compound Annual Growth Rate (CAGR) of Enrollment	State data publications; Moody's Investors Service
Financial performance		
Operating revenue ($000)	Total annual operating revenue in what we consider to be the district's operating funds	Audited financial statements
Available fund balance ($000)	Committed, assigned and unassigned fund balances in what we consider to be the district's operating funds	Audited financial statements
Net cash ($000)	Net cash (cash and liquid investments minus short-term debt) in what we consider to be the district's operating funds	Audited financial statements
Available fund balance ratio	Available fund balance / Operating Revenue	Audited financial statements
Net cash ratio	Net Cash / Operating Revenue	Audited financial statements
Leverage		
Debt ($000)	District's direct gross debt outstanding	Audited financial statements; official statements
ANPL ($000)	District's pension liabilities adjusted by Moody's to standardize the discount rate used to compute the present value of accrued benefits	Audited financial statements; Moody's Investors Service
OPEB ($000)	District's net other post-employment benefit (OPEB) liabilities adjusted by Moody's to standardize the discount rate used to compute the present value of accrued benefits	Audited financial statements; Moody's Investors Service
Long-term liabilities ratio	Debt, ANPL and OPEB liabilities as % of operating revenue	Audited financial statements, official statements; Moody's Investors Service
Implied debt service ($000)	Annual cost to amortize district's long-term debt over 20 years with level payments	Audited financial statements; official statements; Moody's Investors Service
Pension tread water ($000)	Pension contribution necessary to prevent reported unfunded pension liabilities from growing, year over year, in nominal dollars, if all actuarial assumptions are met	Audited financial statements; Moody's Investors Service
OPEB contributions ($000s)	District's actual contribution in a given period, typically the fiscal year	Audited financial statements; official statements
Fixed-costs ratio	Implied debt service, pension tread water and OPEB contributions as % of operating revenue	Audited financial statements, official statements, pension system financial statements

*Note: If typical data source is not available then alternative sources or proxy data may be considered. For more detailed definitions of the metrics listed above please refer to the US K-12 Public School Districts Methodology.

Source: Moody's Investors Service

REPORT NUMBER 1359699

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