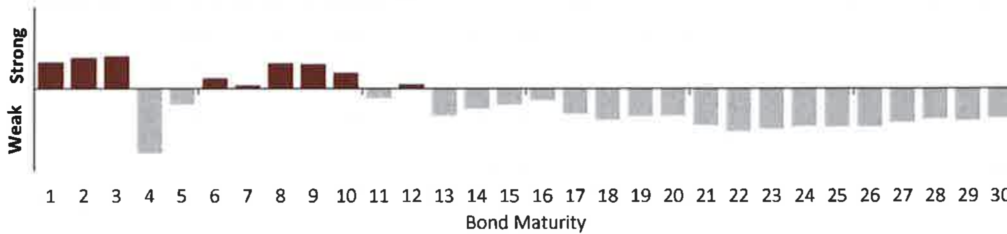
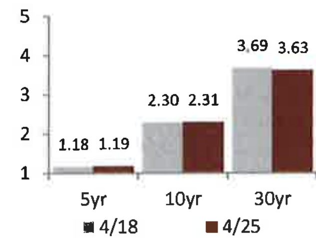
**MMA** The Power of Independence

APRIL 28, 2014

# MUNICIPAL ISSUER BRIEF




*Heading into this week, the market for bonds 11-years and longer continues to be in the "weak" column but not nearly as negative as it was in previous weeks. Remember, these maturities turned "weak" in response to the rally for longer bonds that indicated pricing power might be hitting its zenith there for the time being.*

## MARKET UPDATE

**MUNICIPALS ENDED STRONG LAST WEEK:** The market looked somewhat at risk mid-week but finished strong along with help from other bond markets and a few municipal-specific themes highlighted below.

**INVESTORS & ISSUERS**: Issuance this week takes a dip.

- Light issuance continues to be 2014's theme and this week is no different. The supply/demand dynamic again favors issuers. One reason why is detailed in today's **Topic of the Week** on **page 2**.
- The current context favors competitive bids, and this week larger high-grade competitive sales are scheduled from Pennsylvania, Ohio and a Virginia education issuer. **Mid-sized, high-grade competitive deals in April have taken advantage of dealers competing with each other for bonds given limited supply**.
- Triple-A Stanford should help set the tone for the market as high-grade benchmarks will follow this deal closely. All **issuers should pay attention to how it is priced as it may indirectly affect one's own transaction**. Of note, late last week a large money manager was buying Stanford bonds at strong levels—a positive dynamic.
- Also, **a few other large institutional money managers were actively and aggressively purchasing bonds maturing 15-years and out**. This especially helped the California GO sale and also is the reason why longer-dated New York issuers make our **Buyers Bites** list this week (long maturities & state specific).
- High-yield mutual funds continue to see investor interest and cash inflows. **Lower-rated issuers can take advantage of this.**
- **"Kicker structures," or short call options, also are a popular structure**, as witnessed last week with the Texas Public Finance Agency loan that featured short calls and experienced lower yields in the re-pricing.
- New Jersey bonds **began to decline** late last week after its sale, perhaps an indication the market is pricing in the recent downgrade.

**SEC SELF-REPORTING:** During a webinar hosted by the CA Debt and Investment Advisory Commission today, SEC Assistant Regional Director, Division of Enforcement, Peter Chan explained the SEC's new Municipal Continuing Disclosure Compliance Initiative. Chan stressed the importance for issuers and underwriters to self report if they believe offering documents have misrepresented past continuing disclosure compliance by the issuer. Chan said issuers will be able to avoid financial sanctions and enter into a more favorable agreement than if they do not self report by September 9.

### BUYERS BITES:

**WHAT IS TRENDING HOT:**

**1) Longer-dated New York issuers**
**2) California GO**
**3) Short-call structures**

**CURRENTLY HARDER SELLS:**

**1) New Jersey appropriation backed bonds**

**WHO IS REPORTEDLY BUYING:**

**Pension funds, life insurance companies, high-yield mutual funds, SMAs**

***Figure 1:** The Variable-Rate Demand Obligation (VRDO) market has been in a swift decline after the fallout from the financial crisis as bank credit quality was cut. Filling this void and providing municipal issuers with a brand new source of capital have been bank direct purchases. Last year alone these transactions totaled $40 billion to $50 billion, and 2014 looks for the segment to grow further. Understanding the pros and cons of direct purchases is important for issuers weighing options to manage budgets or finance new projects. **MMA** discussed this part of the industry on **page 2 in** the **Topic of the Week**.*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## TOPIC OF THE WEEK: DIRECT LENDING TO MUNICIPAL GOVERNMENTS

**BANK DIRECT PURCHASES GROW:** **MMA** expects the continued growth of direct bank lending to municipalities until strong commercial and industrial loan generation emerges. A direct purchase (DP) is where an issuer takes a loan straight from a bank for a financial need that could have been traditionally financed through municipal bonds. For the most part, DPs have been used to replace outstanding VRDOs, which have declined by nearly 50% since 2009, as bank credit quality deteriorated (see **Figure 1** on **page 1**). By industry estimates, banks' direct purchases of municipal loans totaled $40 billion to $50 billion in 2013, and projections show at least repeat volume in 2014. DP now represents a major new source of capital for infrastructure needs and cash flow for issuers. This activity is in addition to banks purchasing municipal bonds, which cumulatively hold $420 billion muni bonds (See this MIB for more). DPs have a long history with state and local governments, however the modern, larger loans have represented a major industry trend only since the financial crisis. **Structures of DPs include**: 3-year renewable notes with a floating-rate interest; fixed-rate loans of short and longer maturities with customized optionality; commercial paper program that functions like a line of credit; a bond anticipation note to drawn down as needed ahead of permanent financing, or DP's can be used to refund bonds that are not advanced refundable (see this MIB to review), among other structures.

**WHAT IT MEANS FOR YOU**: DPs are an option that some issuers may consider when looking at different financing options. A broad review of the positive of DPs:

1) These are issuer-friendly instruments, meaning that new loans can be concluded quickly and easily without the need for public documentations, ratings, bond counsel, advisory or underwriting (this is also a drawback as outlined below).
2) DPs avoid many regulatory obligations by intermediaries that are apt to increase costs of traditional issuance.
3) DPs do not rely on a bank letter of credit or another form of liquidity. Traditional VRDO issuance relies on a credit provider, which ties the issuer to the bank rating. This exacerbated problems for municipal issuers during the financial crisis when banks were downgraded.

There are some drawbacks to consider:

1) The lack of disclosure in DPs remains the most serious problem accruing from the spread of these transactions. Investors in a particular issuer's bonds may not know the credit and/or acceleration terms of a new DP borrowing by the issuer or that the DP has happened at all. This could force investors to be more cautious in allocating capital to that issuer. If you are going to engage in a DP, **MMA** strongly encourages issuer to disclose all details of the transaction (suggested best practices are **below**).
2) While DPs represent a move away from reliance on banks as a credit provider, it does magnify a growing theme in the industry as a whole: issuer reliance on bank capital. If a bank chose not to (or could not) rollover existing loans now being written, it could force issuers to term out the loan or access more alternative sources of capital.
3) As DPs proliferate, traditional bond issuance declines. This has been a major theme in 2014 and has helped issuers of traditional bonds attain lower yields. Still, shrinking issuance could accelerate the industry contraction as securities firms' revenues fall below budgetary levels. Fewer market participants could coincide with higher costs of traditional issuance in the future.

## INDUSTRY SUPPORTED BEST PRACTICES

**BEST PRACTICES FOR BANK LOANS:** In September 2011, the Municipal Securities Rulemaking Board (MSRB) released an Advisory on the *Potential Applicability of MSRB Rules to Certain Bank Loans*. The MSRB guidance discusses the nature of the transactions and when they could possibly be considered a primary offering, thus triggering numerous obligations for the professionals governments hired to execute the bank loan. Additionally, in 2012 the MSRB released a Notice on how bank loan information can be voluntary posted on EMMA.

In May of last year, the National Federation of Municipal Analysts (NFMA) led a group of industry leaders to develop a white paper, Considerations Regarding Voluntary Secondary Market Disclosure About Bank Loans. It discussed the questions issuers should consider with bond counsel when determining if a government's bank loan is material to outstanding and prospective bondholders. While the SEC doesn't require such disclosures, the paper encourages issuers to voluntary disclose information when appropriate. Key reasons to disclose include: 1) The bank loan may increase the issuer's debt outstanding; 2) The covenants and events of default for the bank loan may be different than those for the bonds, potentially allowing the bank to assert remedies before the outstanding bondholders; 3) Certain assets previously available to secure bonds may be pledged to the bank as security for the bank loan; and 4) The bank loan may be structured with a balloon payment at the end of its term and create refinancing risks that may impact the issuer's ability to pay outstanding bonds.

Also last year, the Government Finance Officers Association (GFOA), finalized a Best Practice on Understanding Bank Loans. It outlines the questions governments should ask when looking into these types of financial products, and recommends that issuers have a thorough understanding of their risks and rewards. The BP also supports the disclosure of bank loans especially if: 1) it is secured by any or all of the same revenues as an outstanding bond; 2) the bank loan is large enough to be material to the creditworthiness of the government, and 3) if there are numerous bank loans executed by the government that would thus be material to the creditworthiness of the entity.

## REGIONAL BOND ISSUES (Moody's/S&P/Fitch)

### NORTHEAST

On April 24th, **Bank of America Merrill Lynch** priced $19 million of revenue bonds for the **Maine Municipal Bond Bank**; Aa2/AA+/NR; callable in 11/1/2024:

| Maturity | Coupon | Yield | +/- AAA 5% |
|---|---|---|---|
| 2019 | 4.00 | 1.49 | +30 |
| 2024 | 5.00 | 2.63 | +30 |
| 2044 | 4.00 | 4.10 | +43 |

**Notes: Bond banks offer increased liquidity for smaller issuers**

### MID-ATLANTIC

On April 24th, the **Virginia Public School Authority** sold $225 million of school financing bonds to **Bank of America Merrill Lynch**; Aa1/NR/AA+; callable in 8/1/2024:

| Maturity | Coupon | Yield | +/- AAA 5% |
|---|---|---|---|
| 2019 | 5.00 | 1.27 | +8 |
| 2024 | 5.00 | 2.48 | +16 |
| 2026 | 3.00 | 2.90 | +30 |

**Notes: High-grade competitive deals continue to benefit in market**

### MIDWEST

On April 24th, **Wells Fargo Securities** priced $750 million of general obligation bonds for **Illinois**; A3/A-/A-; bonds in 2026, 2030, 2034 & 2039 were insured by Assured Guaranty; callable at par in 5/1/2024:

| Maturity | Coupon | Yield | +/- AAA 5% |
|---|---|---|---|
| 2019 | 5.00 | 1.97 | +78 |
| 2024 | 5.00 | 3.38 | +106 |
| 2039 | 5.00 | 4.54 | +96 |

**Notes: The perception of pension issues being resolved helped**

### SOUTHEAST

On April 23rd, **Raymond James & Associates** priced $124 million of non-AMT residential finance program bonds for the **Tennessee Housing Development Agency**; Aa1/AA+/NR; callable at par in 1/1/2024:

| Maturity | Coupon | Yield | +/- AAA 5% |
|---|---|---|---|
| 2019 | 1.60 | 1.60 | +41 |
| 2024 | 3.10 | 3.10 | +77 |
| 2034 | 4.05 | 4.05 | +65 |

**Notes: This infrequent issuer saw ample demand**

### SOUTHWEST

On April 23rd, **Stifel Nicolaus & Co. Inc.** priced $17 million of revenue bonds for the **Maricopa County IDA, Arizona**; NR/A-/NR; callable in 1/1/2024:

| Maturity | Coupon | Yield | +/- AAA 5% |
|---|---|---|---|
| 2019 | 4.00 | 2.28 | +109 |
| 2024 | 4.00 | 3.65 | +132 |
| 2044 | 5.25 | 4.87 | +120 |

**Notes: Sub 5% yield in 30-yrs locked in a favorable rate given rating**

### FARWEST

On April 22nd, **California** sold $575 million of general obligation bonds to **Wells Fargo Securities**; A1/A/A; callable at par in 5/1/2024:

| Maturity | Coupon | Yield | +/- AAA 5% |
|---|---|---|---|
| 2022 | 5.00 | 2.15 | +15 |
| 2024 | 5.00 | 2.55 | +24 |
| 2044 | 5.00 | 3.90 | +22 |

**Notes: Spreads were incredibly close to triple-A yields in this sale**