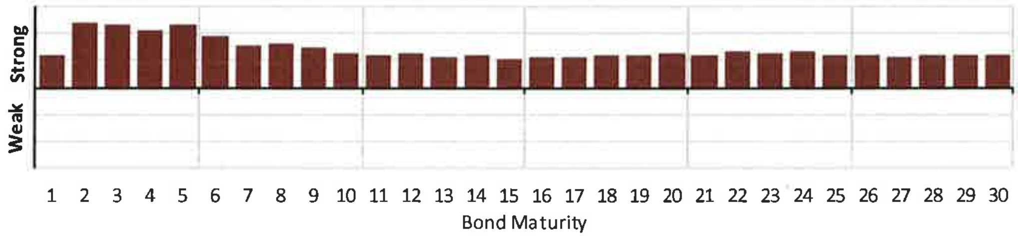
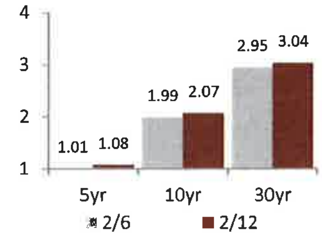
MMA Independent & Data Driven

FEBRUARY 17, 2015

MUNICIPAL ISSUER BRIEF





Heading into this week, there is some slight indication of stability. The last two weeks saw a large increase in yields, and investors began to show some interest in municipal bonds at adjusted levels. This may bode well for issuers this week, though broader fundamental themes are still most influential, i.e. Treasuries.

MARKET UPDATE

MARKET UNDERGOES ANOTHER CHALLENGING WEEK: As governmental bond markets worldwide rose in yield last week, municipal bonds also lost ground making for a second straight week of challenging conditions for underwriters and therefore issuers.

INVESTORS & ISSUERS: Investor resistance to yields continued

- February continued to be a challenging month, as yields moved higher **and many deals struggled during pricing.**
- Many underwriters continued to be **unable to sell many of the recently issued bonds of 2015**, and as a result, opted to take a loss and sell balances at cheaper levels.
- When institutional investors see this type of activity it gives them an upper hand when bidding the market. The consequence is a **re-pricing of the broader market to significantly cheaper levels.**
- Adding momentum to the losses was **general retail resistance to still historically low nominal levels.** Many retail brokerages noted that last week was one of the slowest in months.
- As for new issues, Trinity Healthcare (that postponed its sale two weeks ago) priced last week and yields on some maturities **were as much as 40 basis points cheaper** than where they planned to sell the previous week (see **page 3** for more details).
- One silver lining was that municipal bond mutual funds continued to experience investor inflows. **MMA notes that many of the funds are buying in the primary market.**
- Additionally, the week ended with some positive themes as the U.S. Treasury market stabilized and a few larger institutional investors were **cautiously buying bonds at stronger prices in longer-dated, liquid names, such as California and New York City.**
- This week's holiday has limited the scheduled new-issue volume, so **the market may be poised to stabilize**, especially if the recent increase in secondary selling by institutions abates.

DISCLOSURE: The National Federation of Municipal Analyst's (NFMA) new board President, Jennifer Johnson, stated her goal to continue NFMA's educational work on disclosure issues, and to ensure collaboration with other market participants last month. The NFMA has produced numerous best practices on disclosure, from an investor's perspective, and has worked with the Government Finance Officers Association (GFOA), the National Association of State Auditors, Comptrollers and Treasurers (NASACT) and other issuer and industry groups on these papers, including bank loan disclosures. The NFMA's goals dovetail with **MMA**'s belief that disclosure will drive the regulatory dialogue in the coming year. (See **page 2** for more on regulations.)

BUYERS BITES:

WHAT IS TRENDING HOT:

1) Longer CA GO, NYC GO, NYC water rev outperformed

CURRENTLY HARDER SELLS:

1) Competitive deals demonstrate dealer hesitancy
2) IG Healthcare
3) Tobacco, Puerto Rico GO

WHO IS REPORTEDLY BUYING:

Mutual funds, large domestic banks, SMAs

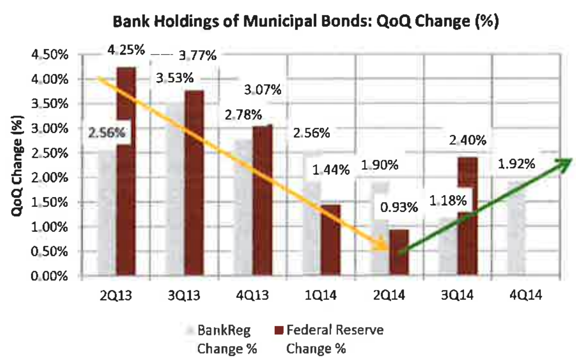


***Figure 1**: A key demand element since the sub-prime crisis has been bank investment portfolios. Banks are the 3rd largest holders of municipal bonds, surpassing property and casualty companies during the last 5 years when overall municipal bond ownership grew significantly. However, banks ownership of municipal bonds began to decrease over 5 quarters (yellow arrow in chart **above**). The latest data though shows that over the last two quarters a slight recovery of bond investments has begun (green arrow in chart **above**). The continued presence of bank buying is important to both smaller issuers and to regional dealer firms who serve them. Additionally, large underwriters need the bank demand to assist with the distribution of underwritings that pose a risk to banks who cannot adequately hedge rate risk during volatile periods.*

TOPIC OF THE WEEK: LOCAL BACKSTOPS

LOCAL BACKSTOP PLEDGES: The latest turn in Harrisburg, Pennsylvania's financial troubles has implications for local government issuers agreeing to make up debt-service shortfalls for projects and/or borrowers. To review, in 1998, the Harrisburg Redevelopment Authority issued about $7 million zero-coupon bonds to purchase an office building secured by lease revenues. To help the deal get done, the city "unconditionally guaranteed the full and prompt payment of principal," according to the official statement. In essence, the city provided its support to raise funds to purchase a private office building in the name of economic development. Fast forward to 2015: the office building's main tenant, Verizon, is not extending its lease and the city now has had to sign an agreement to restructure the payment scheduled on the debt, as it cannot afford to pay the debt service that will only begin to grow as the zero-coupon bonds mature. The restructuring agreement is the most recent indictment of local government backup support for economic development projects.

WHAT THIS MEANS FOR YOU: Often the extension of support by a local government to a project is for a specific purpose—to achieve a bond rating or to qualify for bond insurance—and lawyers involved in the transaction go to great lengths in structuring the support to demonstrate it is equal to other local obligations (as was the case with Harrisburg). MMA told our institutional investor clients last week that "guarantees and other structures in which local governments lend their rating to a bond financing for a non-essential project should be viewed as substantially weaker than a similar pledge on directly issued debt." Further—investors should assume that in times of fiscal distress issuers may well look to avoid paying on back-up pledges for underperforming projects (office buildings, golf courses, convention centers, sports facilities) to free up cash to support more vital services. In sum, while the official statement vows the support of the city or county to backstop the security, MMA expects investors will increasingly judge these structures as weaker than similarly secured direct obligations of the local government. Issuers involved in these types of transactions should be mindful of the contingent obligation they are agreeing to and the effect on their finances if called upon to provide funds. Paying on the contingent liability—if material—can impair finances and failure to pay can negatively impact investors' views on creditworthiness and credit ratings.

IMPORTANT SEC DEVELOPMENT

TOWER AMENDMENT: Last Friday, Securities and Exchange Commission (SEC) Commissioner **Luis Aguilar** provided a public statement (read it here) calling for greater transparency in the municipal market that most notably called for the repeal of the Tower Amendment and offered several ideas on how to improve issuer disclosure practices. While Aguilar in the past has stated support for the SEC to be more aggressive in the municipal sector, he has also throughout his tenure recognized the challenges many issuers face in terms of disclosure. This new statement, however, makes clear—under his own name rather than commenting on other initiatives—that he supports many of the initiatives in the SEC's Municipal Securities report from 2012, and ideas discussed throughout the field hearings process done prior to the report. In the statement he stated 6 reforms that are needed for the market, including repeal of the Tower Amendment (which, aside from fraud, prohibits the SEC and Municipal Securities Rulemaking Board (MSRB) from directly regulating issuers) and changing SEC Rule 15c2-12 to enact specific disclosure requirements on issuers. Aguilar also mentions increasing available pre- and post-trade information.

Previously MMA has discussed the new aggressive tact that the SEC is taking toward the public finance industry and this recent statement accelerates this. From the broader perspective, the SEC action since Dodd-Frank also has implications for the tax-exemption of municipal interest as many of the suggested reforms do not appear compatible with the current mechanisms of raising capital for infrastructure projects. MMA sees this as a broader and longer-term Federal effort that could lead to the repeal of the exemption altogether.

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

Three large deals that moved the market last week and why (highlighted below):

- **Trinity Healthcare** made the decision to re-enter the market last week after postponing the sale. The result was the issuer priced bonds as much as 40 basis points cheaper than the prior week—crystalizing the losses experienced in the broader market and demonstrating how the healthcare sector has underperformed the rest of the market during the recent sell-off.
- **The Maryland Department of Transportation**—a name with implications for triple-A benchmarks—did not see very aggressive bidding in its competitive issue on Wednesday, which acted to solidify traders' belief that dealers were on an aggregate, long the market, meaning they had more bonds on their balance sheets than usual and were unable to find sufficient buyers.
- **Santee Cooper,** a utility system in South Carolina was forced to cheapen levels by more than 10 basis points during re-pricings. As the week's largest sale in the investment grade category, the cuts were widely noted by market observers.

NORTHEAST

2/11: **RBC Capital Markets Inc.** priced $11.2 million general obligation bonds for the **Kinnelon Board of Education, NJ**; NR/AA/NR; School Board Reserve Fund; callable at par in 2/1/2025:

Maturity	Coupon	Yield	+/- AAA 5%
2020	2.00	1.26	+20
2025	5.00	2.29	+23
2033	4.75	3.01	+34

Notes: Enhanced SD bonds amid negative headlines out of NJ

MID-ATLANTIC

2/11: The **Maryland Department of Transportation** sold $280 million consolidated transportation revenue bonds to **Citigroup Global Markets, Inc.**; Aa1/AAA/AA+; callable at par in 2/1/2023:

Maturity	Coupon	Yield	+/- AAA 5%
2020	5.00	1.10	+4
2025	5.00	2.10	+4
2030	4.00	2.87	+41

Notes: A +4bps to the AAA Benchmark was not aggressive

MIDWEST

2/11: **Bank of America Merrill Lynch** priced $895 million composite issue bonds in 3 series for **Trinity Health Credit Group**; Aa3/AA-/AA; callable at par in 6/1/2025, except in '30-'35, '38 which are C22:

Maturity	Coupon	Yield	+/- AAA 5%
2020	5.00	1.66	+60
2025	5,00	2.77	+71
2038	5.00	3.44	+56

Notes: This deal was had been postponed from the prior week

SOUTHEAST

2/11: **Barclays Capital** priced $957 million Santee Cooper revenue obligations for the **South Carolina Public Service Authority**; A1/AA-/A+; callable at par in 6/1/2025:

Maturity	Coupon	Yield	+/- AAA 5%
2020	4.00	1.56	+50
2025	5.00	2.60	+54
2045	5.00	3.59	+57

Notes: The long bond was cut 12 bps from retail to prelim pricing

SOUTHWEST

2/11: The **Red Lick Independent School District, TX** sold $4.9 million general obligation bonds to **FTN Financial Capital Markets**; NR/A+/NR (PSF: NR/AAA/AAA); callable at par in 2/15/2025:

Maturity	Coupon	Yield	+/- AAA 5%
2020	4.00	1.15	+9
2025	4.00	2.00	-6
2035	3.50	2.95	+15

Notes: BQ designation helped produce 3.5% coupon payments

FARWEST

2/12: The **Sequoia Union HSD, CA** sold $52.1 million general obligation bonds to **Morgan Stanley & Co.**; Aa1/AA/NR; callable at par in 7/1/2024:

Maturity	Coupon	Yield	+/- AAA 5%
2021	5.00	1.38	+2
2025	5.00	2.11	+4
2029	3.00	3.00	+60

Notes: Fairly aggressive pricing 10-years and shorter