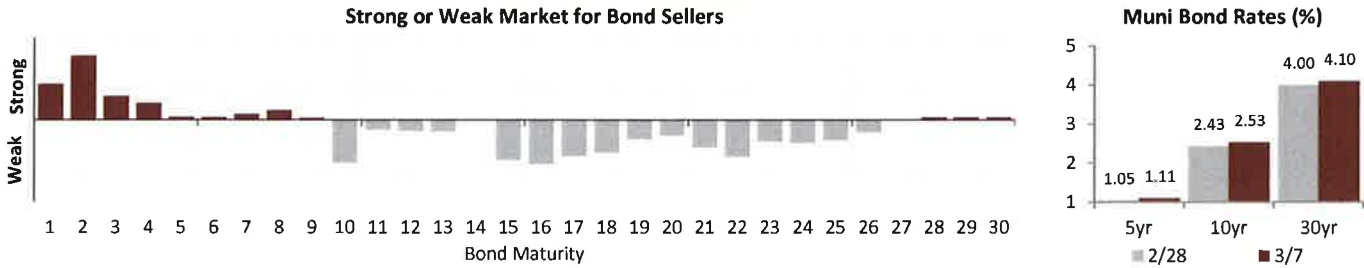
MMA The Power of Independence

MARCH 10, 2014

MUNICIPAL ISSUER BRIEF



Heading into this week, the extremely favorable market conditions for issuers has been mitigated to a certain extent. The market lost upward price momentum last week and as a result, there is apt to be less aggressive pricing from the 10-year maturity and longer.

MARKET UPDATE

MARKET HAD WORST WEEK SINCE LAST NOVEMBER: Several factors lined up against the municipal market last week that could stress (i.e. slow) new-issue distribution to investors over the next 5 days. The tentative demand may result in higher yields.

INVESTORS & ISSUERS: This is the biggest week of the year thus far.

- **Issuance will surge north of $10 billion this week**, which only happened twice last year and a single time in 2012 and 2011.
- Last week **municipals moved cheaper with other bond markets** as economic data came in better than expected.
- The recent weakness along with the large new-issue calendar **could pressure borrowing rates to increase** although because the increased issuance is coming after more than a month of very light issuance, it could be well received.
- **There are several billion (or near billion) dollar deals out of frequent issuers like California, New York and Houston, Texas.** Of note, during last week's move to higher yields, longer-dated California and New York credits performed the worst (**see chart on page 3 for more on California**).
- **Moody's Investors Service's downgrade of Chicago induced selling of the city's debt by many retail accounts.** This may present challenges ahead of the city's deal this week.
- **Puerto Rico** is slated to issue roughly $3 billion of general obligation bonds, a deal it needs to be able to remain solvent. **This will probably be the most observed municipal bond deal of the year** and how it fares will generate headlines that will affect the entire market. It has continued to trade to higher prices of late.
- **Longer-maturing bonds saw the worst performance last week** with yields moving the fastest to higher levels. Issuers of longer-dated bonds this week should take note.

OBAMA RELEASES HIS BUDGET: Last week, the Obama Administration released its Fiscal 2015 Budget Proposal, which includes a 28% cap on tax-exempt municipal interest and another round of "new" direct-pay BABs-like bonds and increased incentives for private capital in public infrastructure. The $3.9 trillion proposal also includes a national infrastructure bank and full funding for the highway trust fund. This follows the House Ways & Means Chairman's tax reform proposal, which would also tax municipals, as discussed in last week's MIB. A look at both proposals and how they would (often negatively) affect the municipal industry can be found here.

BUYER BITES:

WHAT IS TRENDING HOT:

1) **Shorter call options in the 2019-2021 range**
2) **Puerto Rico credits**
3) **Healthcare, retirement homes**

CURRENTLY HARDER SELLS:

1) **Maturities of 20-years or more**
2) **Chicago GO**

WHO IS REPORTEDLY BUYING:

Property & casualty insurance companies, direct retail, SMAs

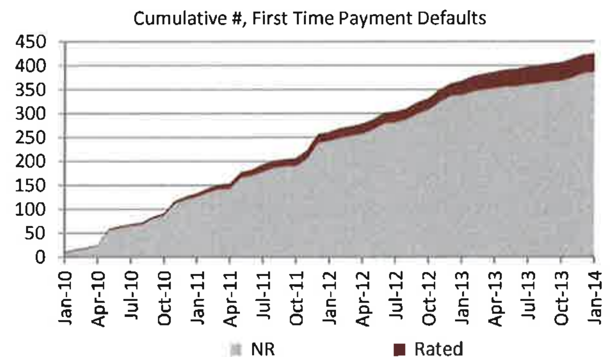


Figure 1: *The chart above looks at the number of first-time payment defaults by municipal bond issuers since January 2010. Many of these additions are related to the real estate boom of the mid-2000s that fell apart during the financial crisis and not considered safe-sector or public purpose projects, such as a GO issuance from a state or city. Note that the overwhelming amount of defaulters were not rated when issued. This highlights the general soundness of municipal credit as the majority of municipal bond issuers get ratings. The jump in rated issuance starting in 2011 are the result of Harrisburg, Jefferson County and Detroit—all unique situations.* ***Read more about municipal credit trends on page 2.***

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TOPIC OF THE WEEK: A NEW TOOL FOR ISSUERS

DIRECT LOAN WITH A TWIST: In January, the state of Wisconsin made the decision to take a direct loan from a bank rather than waiting until 2015 to undergo a current refunding of callable bonds in the traditional municipal market. The highly rated and frequent issuer elected to lock in capital for $278 million through a delayed draw term loan, a relatively new financial tool for municipal issuers. In doing so, the state was able to benefit from current rate conditions to generate savings of $19 million, or 7%, and also were able to comply with refunding/tax rules to keep it an exempt transaction. In essence, the bank has committed to lend the money to the state now, the state filed with EMMA that it intended to call the bonds next year and use the proceeds to make lenders whole at that time. By doing so, the state avoids the possibility of higher interest rates next year in the traditional market. With borrowing rates expected to increase in the next 1- to 4-year horizon, this could be a tool that more issuers take advantage of to "lock in" today's rates. Municipal market criticism of direct loans has been targeted at the uneven and often lacking disclosure by issuers regarding the use of this financing technique. However, Wisconsin and other large, very creditworthy issuers—to whom this product seems to be targeted—typically provide ample disclosure on their websites and through EMMA, which minimizes the risk that these transactions and their terms will be unknown to existing bondholders.

WHAT THIS MEANS FOR YOU: This is a tool that issuers could leverage to their benefit. However, larger, frequent issuers may be more likely to find this type of transaction advantageous. Issuers need to disclose direct loans to the market. Last month, Standard & Poor's released a special report warning issuers that failure **to disclose alternative financing structures in a timely manner could have a negative effect on the management component of the issuer's rating.** The report noted a frequent absence of timely information regarding the existence of such loans among its rated issuers, the agency cited concerns about the inability to assess the credit impact of these arrangements on outstanding rated debt. The growth of municipal direct lending over the past several years, the addition of financial management features such as the delayed draw to these types of facilities and willingness of banks to make sizable loans reasonably constrains municipal issuance projections for the coming year. These augment the other existing constraints on issuance for 2014 including a more cautious approach among municipal borrowers toward taking on new capital projects (and incurring debt) in the aftermath of the financial crisis and reduced refunding opportunities. As more issuers elect to utilize direct loans, it means traditional municipal issuance could remain subdued as it has thus far in 2014. This will likely result in demand outstripping supply which favors issuers, particularly against the backstop of a higher rate environment.

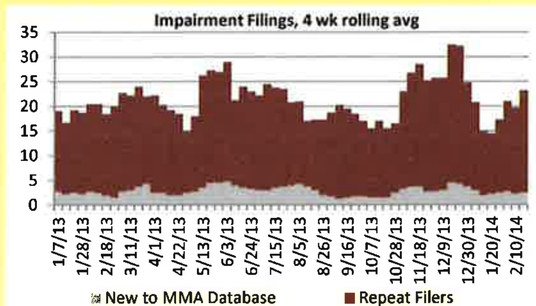
MUNICIPAL CREDIT TRENDS

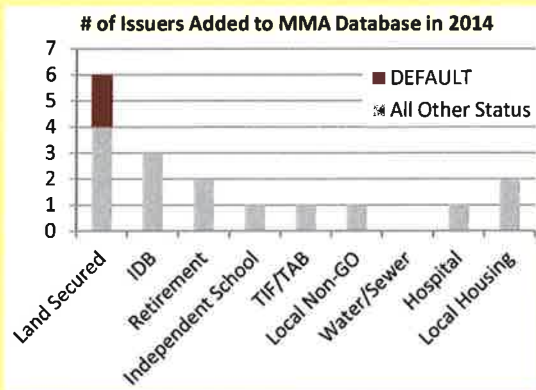
Municipal default and impairment trends remain constructive

- **MMA**'s default database collects both payment defaults and other credit events, such as impairment notices. The database shows that year-to-date, **MMA** has catalogued 147 unique impairment notices (such as a draw on a reserve fund or some other type of support but not necessarily default). This is up from the 127 through the same point last year (**chart, right**). Note that a vast majority are repeat offenders.
- There were 17 new issuers added to the **MMA** database thus far in 2014, of which only 3 were first-time payment defaults and none occurred in February. This is a steep drop from last year's pace of 15 through the same time period (**chart, below right**).

What does it mean?

- There are fewer issuers with ongoing impairments that are falling into default, which may be because many of the most vulnerable bond funded projects have already defaulted (such as those associated with the real estate boom in 2006). This means that the outstanding municipal bond universe is stronger—a fact that can be portrayed to investors to help put the municipalities in a favorable light.
- Current economic challenges are appearing somewhat less severe than in prior years. In particular: real estate developers, retirement homes and multifamily housing projects.
- Capital markets solutions, such as debt restructuring and fresh lines of credit, have become more available, helping troubled borrowers avert payment default.





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

NORTHEAST

On March 5th, **Roosevelt & Cross, Inc.** priced $96 million of general obligation bonds for **Rockland County, New York**; Baa3/BBB-/NR; not callable:

Maturity	Coupon	Yield	+/- AAA 5%
2016	5.00	0.85	+55
2019	5.00	1.90	+87
2024	5.00	3.45	+105

Notes: Assured Guaranty insured made for lower yields in re-pricing

MID-ATLANTIC

On March 6th, **Maryland** sold $237 million of general obligation state and local facilities loan bonds to **JPMorgan Securities LLC;** Aaa/AAA/AAA; callable at par in 3/1/2022:

Maturity	Coupon	Yield	+/- AAA 5%
2014	3.00	0.09	NA
2019	5.00	1.05	+2
2021	5.00	1.80	+6

Notes: The short maturity structure saw good demand

MIDWEST

On March 6th, **Mesirow Financial Inc.** priced $8.8 million of unlimited tax general obligation bonds for the **Peoria County CUSD #323, IL**; Aa2/NR/NR; callable in 4/1/2024:

Maturity	Coupon	Yield	+/- AAA 5%
2024	5.00	2.75	+28
2029	4.50	3.45	+22
2030	4.50	3.55	+21

Notes: Bank-qualified bonds have outperformed the market in 2014

SOUTHEAST

On March 6th, **RBC Capital Markets** priced $200 million of BJC Health System revenue bonds for the **Health and Educational Facilities of the State of Missouri**; Aa2/AA/NR; callable in 7/1/2023:

Maturity	Coupon	Yield	+/- AAA 5%
2019	5.00	1.19	+12
2024	5.00	2.94	+47
2044	5.00	4.40	+35

Notes: Healthcare has been very well received of late

SOUTHWEST

On March 6th, **Bosc, Inc.** priced $74 million of unlimited tax refunding bonds for the **Northside Independent School District, Texas**; Aa1/NR/AA+; callable in 6/15/2023:

Maturity	Coupon	Yield	+/- AAA 5%
2019	2.50	1.09	+6
2024	5.00	2.61	+20
2029	5.00	3.17	-2

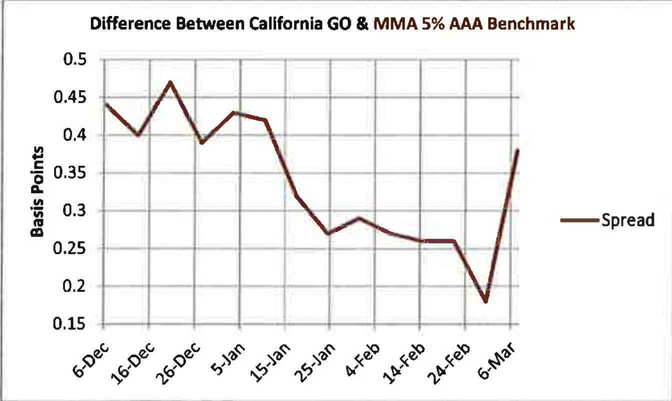
Notes: The PSF remains a pristine credit enhancement for TX issuers

FARWEST

On March 6th, **De La Rosa & Co.** priced $60 million of revenue bonds for the **Silicon Valley, California**; Aa3/AA/NR; callable 2/1/2024:

Maturity	Coupon	Yield	+/- AAA 5%
2019	4.00	0.99	-6
2024	5.00	2.60	+13
2029	5.00	3.38	+15

Notes: Fetching +15 basis points for this credit is strong in 2029



*The "spread" in the chart to the left marks the basis point difference between **California** GOs maturing in 2043 taken from **IDC** evaluations and the **MMA 5% AAA Benchmark.** The state has seen a continuing spread tightening over the last 4 months as investors were increasingly willing to pay more to own the bonds. Last week's market weakness saw a dramatic spread widening of the bond, which may have implications for this week's deal. While the spread did widen most recently, by larger historical standards, the state's GO continue to trade at low yields, which is a positive for the pending deal and the associated debt service.*