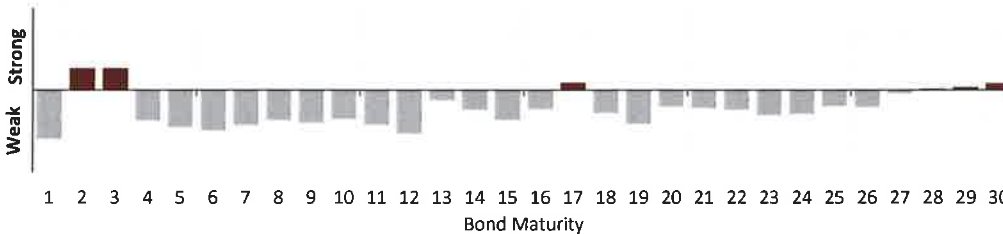
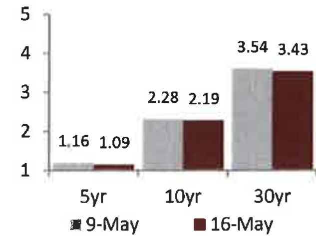
MMA The Power of Independence

MAY 19, 2014

MUNICIPAL ISSUER BRIEF





Heading into this week, the market rally over the last month has many buyers skeptical of the longevity of currently low interest rates (although reasons below lay out why this continues to be a strong market for issuers). Still, the columns in the "weak" dynamic are improved from last week—a positive development.

MARKET UPDATE

MUNICIPAL RATES STILL PINNED DOWN: Despite expectations of a rising-rate and generally more difficult marketplace for municipalities this year, the exact opposite has occurred and last week's action only magnified the issuer-friendly trends.

INVESTORS & ISSUERS: A confluence of events favor issuers.

- Many of last week's deals **priced early in the week to favorable results** with oversubscriptions and re-pricings to lower yields.
- As the week progressed, a rally in other bond markets **triggered heavy secondary trading of municipals to much lower rates.**
- On Wednesday and Thursday a few large money managers in particular **got the ball rolling by actively making aggressive markets** in many of the more commonly traded issuers, such as California GOs, New York City Municipal Water, New Jersey Transportation Trust and Pennsylvania Turnpike, among others.
- **The weeks new issues also traded to lower levels**, led by New Jersey Turnpike Authority and a deal financing the new Dulles Toll Road in Virginia.
- Once again this week the scheduled issuance is below historical averages, as it has been for most of 2014, **meaning issuers continue to have the upper hand as investors outweigh issuance.**
- Mutual funds that buy municipals bonds again saw more investments with the latest data showing interest in all types of funds as opposed to the prior focus on funds that specialize in lower-rated municipal securities.
- We continue to see more issuance via competitive bidding this year, **which in general has been positive for issuers that take advantage of dealer competition** (see **Figure 1** for more).
- One area that didn't do as well was bonds from Illinois, **which hit a wall when the state's pension reform efforts stalled.**

GFOA ACTION: The Government Finance Officers Association's Debt Committee met in Minneapolis and began work on updating a best practice on bond proceeds investments to include information about how the SEC Municipal Advisor Rule affects how issuers can seek advice for transactions. The GFOA also released a new alert for its members on the SEC MA rule with suggested language for when issuers seek to use one of the rule's exemptions that allows professionals such as underwriters to provide advice to issuers. The GFOA is also working on new best practices on understanding primary disclosure responsibilities and credit rating relationships. **See next week's MIB for more on these developments.**

BUYERS BITES:

WHAT IS TRENDING HOT:

1) California, New York & New Jersey
2) Longer maturities
3) Short-call options
4) Healthcare, higher education, transportation

CURRENTLY HARDER SELLS:

1) Illinois
2) Puerto Rico

WHO IS REPORTEDLY BUYING:

Large and regional banks, pension funds, mutual funds & separately managed accounts

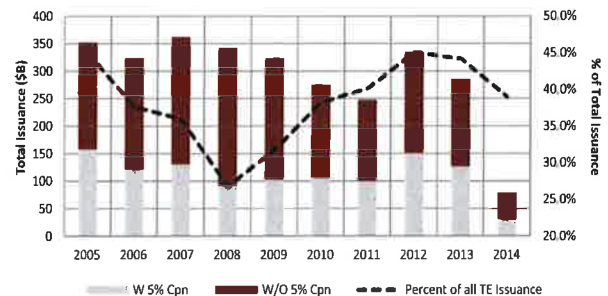


***Figure 1:** Use of the 5% coupon in tax-exempt municipal bond deals rose dramatically as the market recovered from the 2008 financial crisis. Usage peaked in 2012 and has since begun to decline. This is the result of issuers being able to successfully use lower coupons and also as insurance companies have increased their interest in tax-exempt bonds. These investors prefer par-coupon bonds in the 15- to 25-year maturity area and is something issuers that offer bonds in that part of the curve can take advantage of. This year the continued declined of 5% coupons is also the result of more competitive bond issues being made in which dealers offer lower coupons to reduce the true interest cost of a deal to help them win the business.*

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TOPIC OF THE WEEK: SEC SELF DISCLOSURE

NEW DISCLOSURE PROGRAM: Despite the warm spring weather, industry concerns over the SEC's Municipal Continuing Disclosure Cooperative Initiative (MCDC) have begun to snowball. MCDC is a program by which the SEC is encouraging issuers and underwriters to self-report—by September 10th—instances when official statements for bonds sold since 2009 misrepresented issuers' compliance with continuing disclosure agreements of material events. In exchange, the SEC will recommend favorable settlements when violations are found. For issuers, "favorable" means no financial penalties but a public agreement to cease and desist from bad practices. For underwriters, there will be dollar penalties up to a cap of $500,000. The SEC makes a compelling case for compliance given the "ton of bricks" penalties reportedly waiting for violators not coming clean. The principal near-term concerns are workflow (there have been more than 80,000 bond series produced since 2009, many of which may warrant review), cost of compliance (banking firms are hiring temporary workers and issuers will likely choose to consult counsel) and reputation (for issuers not wanting to be publicly portrayed as having provided poor disclosure). On the last point, MCDC creates a potential conflict between issuers—who have paid for bond counsel opinions on what is and is not disclose-able—and their underwriters—who will reasonably seek to report as many deals as possible under the $500,000 penalty by applying a more simplistic test of compliance.

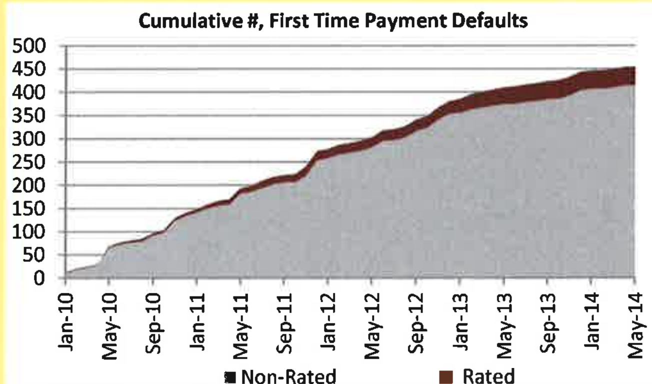
WHAT IT MEANS FOR YOU: If an issuer sold bonds during or after 2009 they are affected and should contact their underwriter immediately. Issuers should also commence their own processes to verify whether their disclosures were accurate at the time of bond sale. Tests likely should look to disclosures connected to mass rating changes via **Moody's Investors Service** rating recalibration in 2010 and the dozens of bond insurer downgrades between 2009 and 2011. If these events changed a rating, it should have been disclosed. Similarly, filing late by only a few days—in particular when the issuing government's credit quality was in flux—should be viewed critically. We expect most bond buyers and the rating agencies will take minor revelations of lapses in stride—in particular if current, very tight market conditions persist—but more meaningful discoveries may have repercussions to both. Making things more challenging, we expect the media to compile lists of the best and worst performers with the output of the program.

Apart from the one-time hits to industry budgets and issuer reputations, there are more meaningful implications from MCDC:

1. By failing to exactly define which events are material enough to have warranted prior notice, MCDC militates against the traditional, lawyerly approach issuers have used to determine what should or shouldn't be disclosed. In its place, a brighter-line, kitchen sink approach (as favored by risk managers, regulators, and credit analysts) may arise with, we expect, favorable consequences for borrowing costs but a bigger burden for public market borrowers.
2. We expect the program's implications for underwriters will be more acutely felt for competitive deals—where dealers may simply choose not to bid for lack of time or financial incentive to conduct a full disclosure review ahead of a deal award—and for smaller bond issues. As a result, we expect somewhat higher yields for issuers that fall into these categories.
3. Direct lending, an already growing field in the industry (more in MIB 4/28 edition) stands to see more use as issuers avoid new disclosure requirements.
4. Further, the SEC's safe harbor does not apply to FINRA or private parties: major new disclosures now could incite new lawsuits from both—and individual government managers found to have intentionally committed fraud could face SEC charges.
5. In concert with the imminent implementation of the SEC's Municipal Advisor rule, MCDC continues to re-shape the issuer/banker relationship from advisory and planning to one primarily focused on execution and compliance. This is not necessarily a negative for the industry or the state of infrastructure finance, but it is a clear one for current investment bankers.

CREDIT TRENDS

DEFAULT & IMPAIRMENT UPDATE: There were a larger number of default filings for the two weeks ending May 2, but the rolling trend in first-time defaulters remains intact. Consistent with seasonal expectations, notices of municipal defaults and impairments spiked in those last two weeks as certain problem issuers faced May 1 payments. There was also a jump in new credits being filed for their first impairment notices, resulting in 12 additions to the **MMA** database. Finally, there were two more first-time defaulters, which brings the year-to-date total to 11, affecting $320 million of outstanding bonds. Note that the number of first-time defaulters remains strongly skewed toward non-rated issuers (see **chart to the right**). Differentiating rated versus non-rated issuers like this helps to accurately portray the generally strong state of municipal credit.



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

NORTHEAST

On May 13th, **Goldman, Sachs & Co.** priced $1 billion of turnpike revenue bonds for the **New Jersey Turnpike Authority**; A3/A+/A; callable in 7/1/2024:

Maturity	Coupon	Yield	+/- AAA 5%
2029	5.00	3.34	+43
2034	5.00	3.65	+35
2035	4.00	4.00	+66

Notes: This deal benefited from long-end market strength last week

MID-ATLANTIC

On May 13th, **Loudon County, Virginia** sold $69 million of general obligation public improvement bonds to **Bank of America Merrill Lynch**; Aaa/AAA/AAA; callable in 12/1/2023:

Maturity	Coupon	Yield	+/- AAA 5%
2019	5.00	1.40	+21
2024	3.00	2.32	+4
2033	3.25	3.36	+13

Notes: Most of the maturities were sold in pre-sale

MIDWEST

On May 13th, **Morgan Stanley & Co.** priced $290 million of System facilities revenue bonds for the **Curators of the University of Missouri**; Aa1/AA+/NR; callable in 11/1/2024:

Maturity	Coupon	Yield	+/- AAA 5%
2019	5.00	1.45	+29
2024	5.00	2.42	+14
2034	4.00	3.52	+22

Notes: This deal was bumped 5 to 7 bps in a re-pricing

SOUTHEAST

On May 14th, **Bank of America Merrill Lynch** priced $89 million of St. Johns River Power Park System revenue bonds for **JEA, Florida**; Aa2/AA-/AA; callable at par in 10/1/2019:

Maturity	Coupon	Yield	+/- AAA 5%
2019	5.00	1.55	+40
2024	3.00	2.94	+68
2029	3.375	3.51	+62

Notes: Par-ish couponing 10-years and out did surprisingly well

SOUTHWEST

On May 14th, **Raymond James & Associates** priced $11 million of utility system revenue refunding bonds for the **City of Georgetown, Texas**; NR/AA/NR; callable in 8/15/2024:

Maturity	Coupon	Yield	+/- AAA 5%
2019	3.00	1.46	+31
2024	4.00	2.66	+40
2027	3.00	3.15	+48

Notes: Despite no state income tax the bonds found strong demand

FARWEST

On May 14th, **North Thurston Public Schools, Washington** sold $90 million of general obligation bonds to **Citigroup Global Markets Inc.**; Aa2/AA-/NR; callable at par in 6/1/2024:

Maturity	Coupon	Yield	+/- AAA 5%
2019	5.00	1.47	+32
2024	5.00	2.43	+17
2029	3.50	3.06	+17

Notes: The deal was insured with a state credit program (Aa1/AA+)