Bond Case Briefs

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Blackrock 3Q Muni Credit Highlights: Know What You Own.

Highlights

- The familiar names continue to make headlines, but overall creditworthiness in the municipal market is the strongest it has been in over five years.
- The approval of a bankruptcy-like process for public companies in Puerto Rico
- gave the rating agencies and investors reason for pause.
- We are watching the tobacco sector, as recent trends in cigarette consumption
- could harken trouble for future payments to tobacco bondholders.

Overview

On balance, the core of the municipal market remains on solid footing. State revenues have grown in each quarter of the past four years, according to the Rockefeller Institute of Government, though the pace of gain declined significantly in the third and fourth quarters of 2013. Weaker growth is projected for the first quarter of 2014 as well. Some of the softening in data may be due to the fact that many taxpayers accelerated their income from calendar year 2013 to calendar year 2012 to avoid the increase in federal taxes. The inconsistency in the recent data could make budgeting more difficult for states going forward.

On the expenditures side of the ledger, spending generally has remained muted. States are exhibiting a reluctance to borrow, in part due to political factors in a midterm election year. With 28 incumbent governors up for reelection in 36 states this November, few politicians want to risk rankling voters. This often results in inaction on important decisions. Onerous required pension payments are also limiting states' ability to invest. Fixed costs associated with pensions and other post-employment benefits (OPEBs) will continue to drag on state and local finances.

Meanwhile, an improving housing market (and stronger property tax collections) is providing important stability for local budgets. The public sector should continue to add jobs, providing a small boost to U.S. employment.

PERFORMANCE REVIEW (TOTAL RETURNS)

	Q2 2014	YTD 2014
By Rating Category		
A	2.71	6.73
BBB	3.54	8.70
High Yield/Non-Investment Grade	2.37	8.54
Non-Rated	3.72	8.87
By State/Territory		
California	2.85	7.04
New Jersey	2.07	6.00

New York	2.48	5.62
Puerto Rico	-1.38	5.93
By Sector		
Corporate Backed	3.39	7.91
Education	2.91	6.81
Hospitals	3.49	8.08
Housing	2.37	5.87
Land Backed	4.18	8.57
Lifecare	4.06	9.78
Tobacco	2.66	11.52
Transportation	2.97	7.21
Utilities	2.03	5.67

Source: S&P Indexes.

Places to Watch

Puerto Rico: The quick passage of legislation that would allow public corporations to restructure debt in a local process akin to bankruptcy is being received as credit negative. While general obligation (GO) and sales tax (COFINA) bonds are excluded for now, the current or any future administration could feasibly propose legislation to restructure these securities as well. In the short run, the new law may signal Puerto Rico's willingness to allow its corporations to selectively default to protect its GO security, but we believe the long-term implication is that the Commonwealth is broadly willing to accept default as an option. Moody's multi-notch downgrade to several public corporations, as well as its three-notch cut to the GO rating and five-notch demotion of COFINA bonds, underscores the significant shift from a strong inclination to pay bondholders to a willingness to dilute them. Overall, Puerto Rico's economy remains troubled, and we remain doubtful of any sustainable economic or fiscal developments in the near future.

Illinois: Efforts to address burdensome pension liabilities hit an obstacle when the Illinois Supreme Court ruled that subsidized health care premiums for retired state employees are protected under the state constitution. The decision centers on a 2012 law that allowed the state to charge retired workers for health care insurance premiums, which many had not had to pay (depending on length of service). Retired workers sued, arguing the changes violated a provision in the state constitution that declares pension benefits "shall not be diminished or impaired." Attorneys for the state argued the constitution did not specifically protect health care benefits. The justices, however, found "nothing in the text of the Constitution that warrants such a limitation" and ruled to protect the benefits. This ruling could signal trouble for another pension overhaul plan being challenged in court. The upshot could be potential ratings pressure and price underperformance, but we are not worried about a long-term default scenario.

New Jersey: All three rating agencies downgraded the state citing persistent and growing budget gaps and limited flexibility in resolving them. New Jersey faces reduced reserves, high overall leverage and large unfunded pension liabilities. The volatile budget season ultimately closed on time after Gov. Christie cut a planned $1.57 billion pension contribution. A Superior Court judge previously ruled that the governor's order to withhold $884 million in pension payments in FY 2014 was justified by the state's serious fiscal situation and limited time to amend the budget, but she withheld judgment on the FY 2015 payment cut.

California: Moody's upgraded California from A1 to Aa3, its highest rating in over a decade. The upgrade was based on improving debt metrics, strong liquidity, robust employment growth and recent governance changes. We are watching the pending expiration of temporary tax hikes (sales tax in 2016 and personal income tax in 2018) to discern the potential impact on credit and bond valuations.

Sector Watch

Utilities: Severe drought conditions in places such as California and Texas have led to increased conservation efforts and, in some areas, mandatory cutbacks in water consumption. While drought conditions, and decreased demand may lead to some financial underperformance for water utilities in the near term, we believe most are well prepared to manage through these conditions, having navigated similar circumstances in the past. Additionally, many utilities have invested significant capital to expand storage capacity, acquire additional water rights and supplement existing supplies through technology, including water reuse and desalinization. These investments should prove beneficial, as little drought relief is expected in these areas through the normally dry summer months.

Health Care: In response to concerns regarding wait times experienced by veterans seeking health care through the Department of Veterans Affairs (VA), Congress passed with overwhelming support the Veterans Access to Care Act. The upshot is that health care providers outside the official VA system may start seeing more veteran patients to alleviate delays in care. Any services provided by a facility not under an existing VA contract would be reimbursed at rates set by the VA, Tricare or Medicare, whichever is greatest. Private providers in the respective service areas will reap the most benefit. An example is in the Phoenix outpatient market, where Banner Health and Dignity Health could see an uptick in utilization.

Trend Watch

Employment: The public sector, especially local governments, has continued to add (net) jobs, providing a small boost to overall employment. Local jobs saw an increase of roughly 22,000 in May, with the bulk of the gains in education. This bounce is not unexpected, as school districts have begun to fully benefit from both the continued restoration of state aid and an improvement in property taxes as recent gains in property values are recognized in assessed valuations.

Bond Protections: Lower-rated issuers are taking advantage of investors' increased risk appetite and a lack of muni bond supply. For example, a marginally investment-grade Illinois health system offered bonds with virtually no legal protection for the construction of a hospital. The deal did not have a debt service reserve fund or a mortgage lien, protections investors typically require. With muni issuance down 50%, the acceptance of such "covenant-lite" deals is little surprise and a trend worth watching.

Quarterly Spotlight: Tobacco

With a return of 11.52%, tobacco was the best-performing sector in the S&P municipal indexes in the first half of the year, providing a return nearly double that of main index's 6.08%. What is driving this outperformance and is it sustainable?

Drivers of Performance

With yields still near historic lows and the Fed in no particular hurry to raise interest rates, investors are hungry for income. Tobacco bonds offer yield in a low-rate environment, attracting crossover buyers and improving liquidity.

While the tobacco sector represents only 1% of the municipal bond market, it is one of the more liquid sectors due to its deal size. To date, 19 states and territories have issued bonds backed by their payments under the tobacco Master Settlement Agreement (MSA).* The average deal size of $1.5 billion is large enough to allow institutional investors and broker/dealers to invest with some price transparency. With bellwether names offering yields roughly 4% greater than AAA -rated munis, some investors feel they are being compensated for the risk. We are not so sure.

Declining Consumption Presents a Risk

Larger-than-expected declines in tobacco use could be bad news for tobacco bondholders, as their payments are based on cigarette consumption and currently assume annual declines below 3%. But the rate of decline in cigarette shipments has been accelerating. Since the MSA was signed in 1998, the rate of decline has averaged 2.55%. In the past 10 years, however, the rate of decline was 3.16%. It was 4.55% over the past five years and 4.8% in 2013. Earlier bond deals were structured under the assumption that the rate of decline would average 1.8%; deals originated in 2007 used 2.9%. This has caused early bond deal cash flows to fall short of expectations, prompting draws on some reserve funds and defaults as early as 2023.

Investors are aware that consumption and, therefore, tobacco bond cash flows are declining. What makes tobacco-backed bonds unique is that the states will continue to receive payments, so even defaulted bonds will continue to receive a cash flow for years after their maturity date. Some investors model these cash flows and use an internal rate of return calculation to determine a discount rate and price level they are willing to accept for the presumably perpetual annual payment. But is it safe to assume that payments, while declining, will continue in perpetuity? Perhaps not, particularly given the headwinds to consumption.

Many factors negatively impact consumption, including price hikes, increases in state and federal excise taxes, less disposable income, smoking bans, packaging and marketing restrictions, and graphic warning labels, to name a few. But an even more substantial threat lies in the increasing popularity of electronic cigarettes (e-cigs).

The Significance of E-Cigs

Sales of e-cigs have grown from a few hundred million in 2010 to $2.2 billion in 2013. While scientific research into the safety of e-cigs is limited, the majority of the findings so far indicate they are significantly less harmful than combustible cigarettes. The FDA, in fact, has acknowledged e-cigs’ potential as a less harmful alternative to smoking.

The big-three tobacco manufacturers have entered the e-cig market and are widely expected to dominate the category. Meanwhile, consumer acceptance of the product is also on the rise given both health and cost advantages. Disposable e-cigs cost 40% less than an equivalent number of combustible cigarettes, and vaporizers cost 90% less. Estimates around the timing vary, but most expect e-cigs could eventually replace combustible cigarettes.

E-cigs are not considered tobacco products under the MSA, so no payment is required to the states. Every cigarette replaced by an e-cig reduces the payments made to states under the MSA. As such, it would not be surprising if the cash flows under the MSA do not experience a steady decline (continuing in perpetuity), but rather, drop dramatically as e-cigarettes completely replace cigarettes.

What’s an Investor to Do?

Tobacco bonds vary in credit quality, with ratings ranging from AAA to CCC. At BlackRock, we use a sophisticated model to run a series of cash flow scenarios, recognizing that each deal, and more specifically, each maturity within a deal, will perform differently under various stress levels. We believe this type of analysis is critical and, for that reason, we recommend investors relegate the work of navigating the tobacco sector to a professional money manager.

Strategy and Outlook

On balance, we favor states over locals and higher-yielding revenue sectors with strong credit fundamentals over GO bonds. In terms of quality preferences, we are biased toward the A-rated part of the credit spectrum and are using market strength to migrate up in quality.

High yield municipals have continued to capture a large share of investor assets this year and have outperformed the broader market. This reflects an investor reach for yield in a low-rate world and we would advise investors to be discerning in their choice of credits. We remain cautious toward those sectors that still face significant challenges, such as tobacco, lifecare and land-secured bonds.

Finally, overall market performance in 2014 has exceeded expectations, and that realization comes with an ounce of caution. The pace of gain is unlikely to continue unabated. This points to the importance of knowing what you own, and knowing what to avoid in the current investment climate.

Q3 MUNICIPAL CREDIT PREFERENCES

Places We Like…	**Based on…**	**Places for Pause…**	**Based on…**
• Intermountain West • Gulf Coast	Faster economic growth driven by lower costs, better business climates, favorable population trends	• Rust Belt	Urban municipalities with high legacy costs and deteriorating tax base
• Great Plains	Strong global demand for commodities	• Sun Belt	Exurbs exposed to boom/bust housing cycles
• Southeast • Midwest	Select areas benefiting from a resurgence in U.S. manufacturing	• Puerto Rico	Severe economic recession, high debt, population declines

Revenue Bonds	**Look for**	**Avoid**
Utilities	Providers that enjoy monopolistic status and rate-setting autonomy	Providers beset with aging infrastructure and regulatory pressures
Airports	Large-market hub locations with international exposure	Regional airports exposed to airline route realignment
Toll Roads	Established roadways with higher toll rates	Managed-lane models struggling to gain acceptance
Hospitals	National systems and regional providers operating in growing service areas with balance sheets able to handle potential changes in reimbursements under the ACA	Stand-alone providers located in markets with weak demographic characteristics and lacking financial flexibility

Education	Large public universities; private institutions with strong demand and significant endowments	Niche institutions overly reliant on tuition discounting to maintain demand

Aug 4, 2014

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