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University of California Sells Into Falling Market: Muni Credit

(Bloomberg) — The biggest risk to the University of California's sale of $2.8 billion of bonds this week, the most it's offered at once, isn't a battle over tuition increases and taxpayer subsidies. It's the stumbling municipal market.

The 10-campus system, which educates 242,000 students, wants to use $2.3 billion of the proceeds for refunding as rising interest rates threaten the finances behind such deals.

Economic strength and accelerating sales of munis have the $3.5 trillion market on pace for its first back-to-back losses since 2013. Benchmark 10-year munis yield 2.17 percent, the highest since December, after Labor Department data last week showed the U.S. jobless rate fell to an almost seven-year low of 5.5 percent.

"Depending on what rate it takes them to issue the debt, to entice enough buyers to buy the debt, the refunding may not work for them," said John Bonnell, who oversees about $3.8 billion as assistant vice president of mutual funds at USAA Investment Management Co. in San Antonio. "They may choose not to refund as much if that happens."

Tuition Clash

Governor Jerry Brown and University President Janet Napolitano, the former U.S. Secretary of Homeland Security, are clashing over Napolitano's plan to raise tuition as much as 28 percent if Brown won't boost state funding. The Board of Regents voted in November to raise tuition 5 percent annually for five years. Brown, a board member, opposed the increase and is engaged in talks with Napolitano to end the impasse.

Yields have risen from close to five-decade lows since the start of February. Helping fuel the increase, localities offered a combined $62 billion of debt in January and February, almost double the 2014 pace, data compiled by Bloomberg show. About 68 percent of deals this year have been for refinancing, Bank of America Merrill Lynch data show.

"The Regents' upcoming revenue-bond transactions are looking to take advantage of historically low interest rates in order to refinance existing debt and lock in low interest rates for new money needs," Dianne Klein, spokeswoman for the university's Office of the President, said in a statement.

Tuesday's Business

The system leads governments issuing at least $5.9 billion of refinancing bonds this week, out of a $12.2 billion long-term sales slate, the most since December.

It's set to begin offering $1.14 billion of general-revenue bonds Tuesday and $1.66 billion of limited-project revenue debt Wednesday. The combined amount is the most it's sold at one time, according to data from the state treasurer's website dating to 1996. About $1 billion of the refunding is to convert general-revenue bonds into limited-project revenue debt.

When the University of California regents borrowed in April 2014, they priced 10-year bonds to yield 2.74 percent, or about 0.17 percentage point above top-rated debt, Bloomberg data show. Standard & Poor's rates the general-revenue debt AA, the third-highest level.

Those bonds are repaid from student fees and tuition, state subsidies, as well as grants, contracts and income from university-owned enterprises. The limited-project revenue bonds are paid from funds generated by infrastructure they finance, such as parking garages, athletic fields and student and faculty housing.
Nathan Brostrom, the system's chief financial officer, declined to answer questions about the financing.

Funding Need

The university system also operates five medical schools and medical centers and four law schools. It's involved in running nuclear-weapons laboratories and research facilities for the Energy Department. Its faculty and researchers have won 62 Nobel Prizes, more than any other U.S. public university system.

"The tuition controversy is short-term in nature," said Michael Ginestro, director of muni research at Bel Air Investment Advisors, which manages $2.7 billion of munis. "If you look at the revenue, the endowment fund, the number of campuses they have and the product they deliver, it overwhelms any concerns."

Napolitano has said additional funding is needed to stabilize revenue for a system that's an incubator of leaders for government, industry and Silicon Valley in California's economy, the world's seventh-largest.
Brown, 76, who graduated from the flagship campus in Berkeley, says the system needs to rely less on taxpayer subsidies.

Tax Increases

In 2012, the Democrat won voter approval for higher sales-and income-taxes. He pledged to use the increased revenue to add more than $500 million to university funding over four years if the regents froze tuition. Lawmakers paid the first $125 million installment last fiscal year.

The tax increases he championed have spurred demand for the tax-exempt debt of California issuers. The state's own borrowing costs have shrunk to the lowest since 2007.

"Any time the Regents issues debt it's well-received," Bonnell said. "I don't think this one will be any different."

Beginning in 2013, the state shifted some debt service for bonds it issued for the university from its books onto the system's accounts.

Brown's budget for the fiscal year beginning in July would boost spending for the system by 4 percent to $3.05 billion, including $200 million for debt service. The move is intended to force the university system to factor debt costs into its fiscal outlook.

Napolitano said March 3 that unless Brown boosts aid, she'd freeze enrollment of California students while admitting more out-of-state students because they pay higher tuition and fees.

Even after climbing for weeks, yields are hovering above generational lows, so issuers can still reap savings from refinancing. A Bond Buyer index of 20-year general obligations yields about 3.7 percent, compared with the 5.8 percent average since 1961.

"Even if rates start to back up a little bit, you as an issuer are still going to get pricing that is at your advantage," said Ginestro at Bel Air.

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