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Municipal Bonds Can't Easily Dismiss Doomsayers This Time.

When going out in public has changed radically, public finance might have to as well.

For decades, the $3.9 trillion municipal-bond market has been seemingly immune to hyperbole about its demise.

There was banking analyst Meredith Whitney, who in December 2010 warned of "hundreds of billions of dollars" of defaults in the coming year. Berkshire Hathaway Inc. Chief Executive Officer Warren Buffett said in 2014 that public pension plans were a "gigantic financial tapeworm" for state and local governments. Each high-profile bankruptcy was supposed to be the "big one": Alabama's Jefferson County in 2011, then Detroit in 2013, then Puerto Rico almost three years ago to the day. And yet, each time, the critical U.S. market that funds roads, bridges and schools chugged along unabated. It was, in its own quirky way, almost too idiosyncratic to collapse.

The coronavirus pandemic will test that resilience like never before. It's growing more likely by the day that public finance might never be quite the same — precisely because being out in public has radically shifted across America, all at the same time. "It's an interesting philosophical point: If there are all of these idiosyncratic risks, but they're all very similar, when does it become more of a systemic risk?" Matt Daly, head of the corporate and muni teams at Conning, said last week in an interview.

Having started my career at Bloomberg covering munis, I'd be one of the last people to recklessly speculate about the market's impending demise. I fully expect it to survive — but not without taking more punishing blows than ever before.

One of the advantages of writing about tax-exempt bonds for years is you get to know precisely what kind of borrowers access this market for capital. Yes, there are state and local governments, which are clearly strained because of the Covid-19 outbreak, as illustrated by last week's jobs report, which showed they cut payrolls by almost 1 million in April. But in the end they're still quasi-sovereign entities with taxing power. They may have to raid rainy-day funds, which were at record highs, but they'll be standing once the Great Lockdown is over.

There's far more to the muni market than just them, however. To name some other issuers: Mass transit systems, airports, toll roads, universities and colleges, hospitals and health-care institutions, nursing homes, museums, convention centers and sports stadiums. These are not one-off projects. Together, they account for hundreds of billions of dollars of debt. These borrowers won't all default suddenly, but they could be scarred in lasting and not-yet-fully-understood ways.

"It doesn't take a lot of imagination to appreciate how the impact of what we're doing here is going to affect all those sectors differently — the muni market has potentially more credit uncertainty to it now than the corporate market," Guy Benstead, a portfolio manager at Shelton Capital Management, told me last month.

“The component that’s really different from last time around is there’s a lack of clarity around how the economic impacts of the stay-at-home, social-distancing policies are going to impact your standard, run-of-the-mill municipal-bond issuer,” he said. “If you run a mass transit system, and zero people ride the system, what happens?”

New York’s Metropolitan Transportation Authority found out the answer firsthand last week. Downgraded by the three biggest credit-rating companies this year, it managed to increase the size of its bond offering to $1.1 billion but had to offer yield spreads that were four times as large as its previous deal in January. That’s only natural considering the agency faces a potential $8.5 billion deficit this year, and it’s very much an open question of when — or if — subway ridership returns to pre-pandemic levels.

New Yorkers might have previously taken a train to the Museum of Modern Art, which is less than a year removed from the opening of a $450 million expansion and renovation. Guess what helped finance that project? Some $281 million of muni bonds issued in 2016. Now, MoMA has taken a “chain saw” to its staff, budget and exhibitions. It was on track to have about 3 million visitors this year but now expects less than 1.5 million.

MoMA’s debt is holding up fine. Credit-rating agencies haven’t been in any rush to downgrade bonds tied to museums, with S&P Global Ratings recently affirming its grade on debt issued for the Morgan Library & Museum, just a mile south of MoMA. “While we recognize that these are unprecedented times, we acknowledge that management has taken prudent measures to address the situation and is planning proactively for what the coming months may bring,” S&P analysts wrote. Museums beyond these Manhattan mainstays might not have such wherewithal, however. S&P downgraded the Philadelphia Museum of Art last week, citing “material operating pressure.”

Convention centers and sports stadiums are in the same predicament as museums. What happens if large gatherings are put off until 2021, or even 2022 or 2023? How do stadium bonds fare if there are no fans paying for tickets, parking or concessions? Some of these securities are backed by a government’s “moral obligation” to make up revenue shortfalls, but that structure has proved to be less than ironclad when money gets tight.

In one example, Moody’s Investors Service says the Las Vegas Convention and Visitors Authority should have solid debt-service coverage well into the fiscal year that starts July 1. A more severe-than-expected scenario, analysts note, “could put stress on the credit to the extent that its liquidity is drained.” Also working in its favor: “Long-term contracts with many of the largest conferences and conventions will likely ensure that business will resume at some point.”

That’s fine, but what about $45 million of bonds issued to fund a new ballroom at Sacramento’s convention center, where construction is delayed? There, debt-service coverage is “very likely to drop below 1.0 times in the near term,” Moody’s said in a report revising its credit outlook to negative. The Lombard Conference Center & Hotel in Illinois has already tapped reserves to pay its debt. Las Vegas may have some margin for error; other places don’t.

The pandemic shocked airport bonds, too. As Bloomberg News’s Danielle Moran reported, the 11% loss on those securities in just two weeks probably went too far, given that the largest airports aren’t going to close suddenly. But like public transit agencies, it’s suddenly unclear whether demand will rebound to pre-coronavirus levels.

Then there’s higher education. Some bonds are backed solely by student housing fees. While Bloomberg Intelligence’s Eric Kazatsky said “making a broad statement that the whole sector is in peril would be unfair,” he noted that two-thirds of the projects are backed by an entity unrelated to the associated university. If students don't show up in the fall, it will be fair to say those securities are very much at risk. As for small colleges themselves, I wrote last month that they won't all outlast the coronavirus.

If your imagination isn't exhausted yet, consider hospitals, health-care systems and nursing homes. The Mayo Clinic announced last month that 30,000 of its employees would face reduced hours or furloughs "as part of our financial stabilization efforts related to the Covid-19 pandemic." Some of its debt recently traded at the lowest level in more than six years. The Becker's Hospital Review is keeping a running tally of nationwide furloughs due to sharp declines in revenue; it's up to 243 hospitals as of May 7.

"Part of the point of sheltering in place is to take the strain off of the health-care system, and we've decimated them," Patrick Leary, chief market strategist at Incapital, said in an interview. "That's a really big unintended consequence."

Senior-living facilities, a $30 billion slice of the muni market, are the most tragic case of all. Here's one example from Bloomberg News's Martin Z. Braun: The Henry Ford Village, a 1,038-bed continuing care retirement community in Dearborn, Michigan, will need to draw on reserves to make its May 15 debt payment. What's worse, 25 of its 900 residents had tested positive for the virus through April 21 and nine had died. Fifteen employees also tested positive. A Washington Post analysis found that nursing home residents may ultimately account for half of all U.S. coronavirus deaths.

From the onset of this crisis, senior homes were clearly in trouble. I wrote on March 16 that a handful of the facilities played a role in crushing the largest muni high-yield exchange-traded fund. My Bloomberg Opinion colleague Stephen Mihm recently suggested the coronavirus might put an end to the idea of assisted-living facilities. At the very least, it should slow the movement toward age segregation, which means the elder-care business is in for a reckoning.

Many opinions about how the world will change because of the pandemic will inevitably be wrong. It's possible, perhaps even likely, that some segments of the muni market will bounce back faster than expected. The biggest wild card is any sort of relief package from the federal government, which would go a long way toward staving off a worst-case scenario.

But it won't all go back to the way it was before. This sort of shock, bringing activity to a halt from coast to coast and reshaping the way Americans interact with their local communities, is something that denizens of the muni market won't soon forget. It might not be as flashy as Whitney's call for widespread defaults, but maybe munis' relative yields will have to be permanently higher than in previous decades. Idiosyncratic or not, the market's risks are real.

Bloomberg Opinion

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May 11, 2020, 3:00 AM PDT