

The municipal bond roadmap

A look at investment opportunities for today's market



Recession's effect on municipal bonds

The National Bureau of Economic Research, a private nonprofit research group that is considered the official arbiter of economic contractions and expansion, recently determined that the Great Recession ended in June of 2009. Despite the good news, however, state finances are likely to feel significant negative pressure for at least two more years.

One reason for this is pretty straightforward: Municipal credit quality usually lags after a recession. The consequences of high unemployment, low productivity and depressed wages seep into and depress traditional state-government revenue streams well after a recession has technically ended. For state governments, the declines in personal income taxes, sales taxes and corporate income-tax collections have led to multi-billion-dollar budget gaps across the country. To address the gaps, states and local governments have had to raise revenue, cut spending, and in some cases, employ accounting gimmicks to deliver a balanced budget.

Municipal sector overview

Despite the record declines in state and local revenue streams and the likelihood that state and local credit quality will continue to be challenged for another two years, we still consider state and local investment-grade general obligation (GO) debt to offer inherent credit strengths. In fact, state and local government issuers offer a security package that is difficult to replicate in other investment products—specifically, the legal authority to impose and collect taxes and fees. In terms of security—or in a worst-case scenario, ultimate recovery—investment-grade GO bonds are hard to rival.

Investment-grade GO debt from states and local governments is not the only conservative investment in the municipal market. For conservative investors, we also point to the inherent strengths of essential-service revenue debt, and in certain circumstances, special-revenue-secured investment-grade debt. Essential services, often run as enterprise funds, offer inherent credit quality almost on par with GO bonds. Since municipalities often have monopolistic control over an essential service such as water and sewer or other utilities, the inherent strengths of the essential service contract are difficult to upend. While a state or local GO issuer can raise taxes to cover debt service, an essential service

State and local government, essential-service and special revenue issues may represent lower risk within the municipal sector

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provider can raise rates to do the same, carrying the threat of disconnect for nonpayment. With its service-area-monopoly and vital-service components, the essential service revenue credit can be a staple investment for the conservative investor.

Rounding out the conservative core municipal investment products is the special-revenue-secured transaction, in which the special revenue is a well-defined traditional tax or fee, such as a general sales tax or tax on fuel, vehicle registration or other essential activity. With this type of security, the tax stream is pledged to bondholders and bound by restrictive covenants and can offer inherent credit quality. Additionally, special revenue deals are usually bankruptcy remote should the associated municipality ever enter into an approved bankruptcy filing. Special revenues, to the extent they are protected by statute, cannot be commingled with other municipal funds in a bankruptcy, allowing special-revenue-secured deals to continue to perform even if the related municipal issuer has been granted protection under a chapter 9 bankruptcy.

GO bonds: Still a worthy investment class

GO bonds offer a feature that is not available with most other investments. With GO bonds, an issuer pledges its full faith and credit to repay the financial obligation, a pledge that comes with the legal authority to raise and collect taxes. In the case of state GO bonds, the full faith and credit pledge requires a state to raise fees and/or any other revenues to whatever level is necessary to pay debt service. In the case of local issuers for whom the ad valorem pledge (a tax on the assessed value of real estate) is the traditional credit pledge, the issuer is obligated to raise property taxes to whatever level is necessary to cover debt service.

Among investment-grade-rated issuers, defaults have been rare, especially in the top three rating categories (triple, double, and single A) in which bonds have historically defaulted at rates of less than one tenth of one percent as measured by Moody's Investors Service 2009 default study, "U.S. Municipal Bond Defaults and Recoveries, 1970-2009," dated February 2010. For traditional GO tax-backed municipal bonds, we believe that bond credit ratings have been a good indicator of relative credit risk within the larger municipal market. Nevertheless, we suggest that an investor examine how an issuer measures up in the following areas before buying GO bonds:

- **Tax and economic base:** Is the issuer overly exposed to a specific industry? Do only a few taxpayers represent a large percentage of the tax rolls? Capacity (i.e., debt capacity and untapped taxing capacity) is a key indicator of credit strength. In general, an issuer with a wealthy population, a diverse set of employers and industries, stable assessed valuation levels and low relative levels of taxation has more capacity to bear additional levies and will generally carry higher ratings.
- **Financial indicators:** Has the city spent down budgetary reserves? What is the trend in tax receipts? How well does the issuer's actual performance meet its budget projections? Effective budgeting and flexible policies to address declining revenues are all characteristics of a highly rated issuer. Are budgets well monitored and adaptive? Does the city or state track tax metrics that are material to them, and can you, as an investor, easily track them, too?

- **Debt and long-term liabilities:** Highly rated, stable GO issuers tend to have low debt loads relative to wealth, income and asset valuation, and these issuers generally amortize debt – pay it off quickly – as well. Issuers that have contingent liabilities can present credit challenges, with the financial impact limited only by the size of the liability relative to the budget. If the contingent liability—for example, an agreement to backstop a related issuer’s debt—is of significant size relative to the issuer’s budget and tax base, the issuer might be overexposed to contingent risk and could face financial stress if called upon to honor the contingent commitment.
- **Pension and other post-employment benefits (OPEB) liabilities:** Pension and OPEB funding are long-term problems issuers have been dealing with for decades. While funding the plans can and has been deferred in many places, the resultant large gaps will have to be filled eventually, representing a future demand on budget resources, potentially constraining flexibility. We believe that while the problem of underfunded pensions is significant, issuers still have considerable time and a palette of options for addressing long-term gaps before they find themselves at risk of depleting the pension funds. Nevertheless, all other things being equal, an issuer with a smaller (or no) pension funding gap does represent a greater level of financial flexibility compared to an issuer with a large and growing funding gap.
- **Management factors:** While the ability to pay is a hallmark of a highly-rated issuer, the willingness to pay is also critical. How an issuer’s governmental structure allows it to function to address changing economic dynamics (passing a new tax package, for example) is a credit consideration. Good management encompasses everything from effective processes for handling bill assessment and collections to setting sound financial and operational procedures. Highly-rated issuers will generally boast seasoned management teams, efficient governmental processes and clear statutory language defining most governmental processes.

GO bond summary

GO bonds, whether secured with an ad valorem pledge at the local level or the full faith and credit pledge of a state, offer significant security advantages over many other investments. While excessive debt, falling valuations, declining personal income-tax collections and any number of other circumstances can erode credit quality in the GO sector, investment-grade GO bonds have historically exhibited a low rate of default and have a high recovery rate in regard to the few issuers that do default. Most importantly, GO issuers pledge to raise taxes and/or fees to whatever level is necessary to cover debt-service requirements as part of their contract with bondholders.

Essential-service revenue bonds

From a default standpoint, essential-service revenue bonds issued by monopolistic, government-controlled enterprises fare just as well as GO bonds on rating-agency-default and transition studies. While their legal protections might be marginally less robust on water and sewer utilities, for example, the necessity of the services being financed and generating the revenues underlies the issue's credit quality. In general, essential-service revenue bonds offer a coverage covenant requiring an issuer to raise rates if certain thresholds of debt-service coverage are not met. At its most basic level, an essential-service revenue bond is an entirely straightforward issue. For the most part, proven technologies, durable demand and years of successful operations have proofed the sector. Essential-service revenue bonds issued for water and sewer purposes represent one of the traditional, core responsibilities of municipal government. Some key determinants when evaluating credit strength in the essential-service sector include:

- **Economic base:** Would the economic base be able to support an increase in rates if the issuer needed to generate additional funds? Is the customer base sufficiently diverse? Even as an essential service, a municipal utility generally performs best in an area with a stable to growing user base and where there is not a disproportionate reliance on one or two companies or industries for customers.
- **Structural protections:** Well-structured essential-service secured revenue bonds offer a few key protections, namely, a debt-service coverage covenant and an additional bonds test. Rate covenants protect bondholders by requiring the issuer to raise rates to whatever level is necessary to cover debt service. While the sufficiency of the coverage level can vary depending on the breadth of the utility's customer base, typical and sound coverage covenants will often require a level above the debt-service expense of current revenues. Furthermore, highly-rated issuers will feature protection against overleveraging, as afforded through a restrictive additional bonds test that measures current revenues against both current and expected additional debt service from any new issue.
- **Reserves:** Revenue issuers typically carry a debt-service reserve to provide liquidity against unforeseen events. If an issuer does not have a reserve, the issuer should have a significant level of internal liquidity—cash on hand, in other words—to provide the same basic protective function.
- **Financial and operational metrics:** Even though the day-to-day functioning of a traditional municipal enterprise is fairly straightforward – with limited new or untested technologies or procedures to complicate operations – municipal enterprises can experience fiscal stress. Highly-rated essential-service providers will show durable debt-service coverage ratios over time, solid internal liquidity, regular expenditures for upkeep and a history of positive operating results. While higher coverage levels may be more comforting, many publicly financed municipal utilities are operated intentionally at thresholds closer to break-even, both to limit customer rates and to make sure the system is being leveraged sufficiently to deliver service. Thinner coverage is not necessarily a sign of financial stress or limited flexibility.

- **Autonomy:** The most flexible issuers will have significant rate-setting authority. We also look into their control over factors such as availability of water (or power in the case of an electric utility), and the ability to set capital plans.

Essential service bond summary

Revenue bonds can offer a simple type of financing that is easy for investors to understand. A municipal utility has to meet operational expenses and cover debt service, but the number of expense items a utility revenue stream has to cover is relatively small compared to the obligations of a general fund. How well an issuer covers its debt-service obligation out of current rates and what capacity might exist among the rate base to pay higher rates are both determinates of credit quality. An issuer with the authority to raise rates at its own discretion and with a rate base broad and deep enough to accommodate rate increases is well situated in terms of credit quality. If, in addition, an issuer has several months of cash on hand, a well maintained physical plant and a seasoned management team, it will likely be rated even higher.

Special revenue bonds

Special revenue bonds could conceivably cover a range of potential bond issues, but for our purposes, we're looking at only tax-backed special revenue bonds. More specifically, we consider the special-revenue-secured category of transactions to include sales-tax-secured deals, deals secured by motor-vehicle-fee revenue or transactions secured by fees charged on utility bills, to name a few types. While broader than the GO sector thanks to the range of activities that can be taxed to secure bonds, special revenue bonds fit the classic municipal risk profile since taxes are their source of repayment and security. To mirror the inherent quality of GO or essential-service revenue bonds, the revenue source pledged on a tax-backed bond should come from a stable and broad-based economic activity or from a tax or fee on an almost universal type of asset, such as a vehicle. Some key features to look for when considering special revenue or tax-backed bonds include:

- **Durability of the pledged revenue source:** Several standard types of tax-backed revenue streams are commonly pledged as security for special revenue bonds. Chief among them are sales taxes and other taxes imposed on traditional economic activity. When looking at a special revenue deal, always consider the history of the pledged revenue source to determine its durability. Sales taxes, motor-vehicle fees and taxes imposed on essential-service economic activities should show a history of stable performance, and transactions should be structured to account for whatever volatility might exist in the pledged revenue stream.
- **Enforceability and control:** To offer meaningful security, an issuer should ideally have the ability to raise the rate on the tax to maintain credit quality if the economic activity the tax is attached to starts to decline. The closer the issuer is to the statutory control of the rate, the better the protections for bondholders.

- **Other uses:** To the extent that the tax is also available for other uses, make sure that the tax is pledged first to the bond issue, with excess designated for other uses only after all debt-service-associated obligations are met.
- **Covenants:** Like any revenue-secured transaction, special tax-backed revenue bonds should offer solid debt-service coverage and additional bonds tests covenants. In general, the more robust and broad-based the revenue stream, the lower the coverage requirement can comfortably be. Similar to essential-service revenue bonds, special tax-backed bonds should show a stable debt-service coverage history and feature an additional bonds test that does not allow for significant dilution of the revenue stream through additional leverage.

Special tax-backed bond summary

Special revenue or tax-backed deals can represent a solid alternative to GO and essential-service secured debt, depending on the durability and source of the pledged taxes or fees. Taxes levied on utility bills, motor vehicles or other services or activities that are reasonably standard help impart credit quality to a special tax-secured transaction. While plenty of other tax-based revenue sources can also be attached to secure bonds – such as hotel taxes, rental-car taxes and the like – an investor should evaluate the pledged revenue source on the basis of the economic activity it leverages. Hotel taxes and car-rental taxes may be traditional sources of security for some areas, but these revenue streams may be less durable in an economic downturn, potentially leaving investors with reduced debt-service coverage on top of an underperforming revenue source with declining public support. For that reason, we suggest that conservative buyers of special tax-secured municipal bonds seek out the most stable types of special taxes as security for bonds – tax streams that have a history of performance even in an economic downturn and special tax bonds that are used for standard municipal purposes, such as infrastructure finance or schools.

A closer look at municipal bond risk factors

As discussed earlier, we see far less risk from essential-service revenue issuers and GO-secured borrowers than we see in certain other sectors. We believe the reasons are fairly obvious, when the credit characteristics of essential-service and GO bonds are contrasted with the credit characteristics of certain other types of issues that rely more directly on a specific economic activity or narrow consumption pattern or that fund's nonessential enterprises. Specifically – and in line with historical default studies compiled by the major rating agencies – we see more risk from the sectors within the municipal spectrum that are discussed below. While our list is not all-inclusive, and while there are certainly issuers within those sectors that are creditworthy on their own merits, our intention is to highlight the types of issuers that are more susceptible to credit problems, competitive pressures and limitations on raising revenues.

1. Economically-sensitive revenue streams

We consider GO-secured issues, in particular, to offer a high level of credit quality due to the legal package (obligation to raise taxes if necessary) included in those types of transactions. If a general obligation bond issuer is falling short of the revenue required to meet debt service, the issuer is typically legally obligated to raise taxes or fees to cover the debt. Many issuers in the municipal market, though, have found ways to issue debt

secured by revenue sources that are narrower (a hotel occupancy tax, for example) or that do not require any increase in the rate or collection should the revenue source experience a downturn.

The Harris County-Houston Sports Authority, which was recently downgraded by Moody's and Standard and Poor's, is an instructive example of not just an issuer that secured its bonds with economically sensitive taxes (a hotel occupancy tax and a motor-vehicle rental tax) but also of an issuer that was put together to issue debt for nonessential project financings (a number of venues catering to national sports franchises). While this issuer is dealing with an acceleration of some of its debt, which created an unexpected increase in the issuer's debt service, the issuer also saw a sustained and consequential decline in its revenue sources over the past year and a half as lower revenues were collected from the hospitality- and tourism-based revenue streams. We highlight this issuer as an example of a bond deal that was issued for a nonessential project (a sporting venue) and backed by narrow, hospitality-based revenue streams that have been significantly affected by the economic downturn.

2. Competition and demand

Other types of municipal financings that can represent a riskier credit profile come from issuers that are subject to competitive pressures, like hospitals, private education providers and nursing homes, to name a just few. While these types of issuers can represent solid individual credits when looked at on their own merits, we nevertheless caution investors in this sector since revenue raising flexibility can be inhibited by the need to remain competitive with other entities in the sector. While a GO-secured issuer has the legal authority to raise taxes to cover declining debt-service coverage, a hospital, nursing home or private education provider usually does not have the option of raising taxes and can be constrained in raising its own revenues if raising fees or tuition makes its services less affordable or desirable than the alternatives.

Nursing-home project financings are particularly susceptible in the current environment for several reasons: First, many nursing-home-revenue-secured deals are issued for new projects or project expansions that involve construction costs and rent variables. In addition, many nursing homes rely on a homeowner being able to sell a home to raise the entry fee for living in the nursing home. Uncertainties over the direction and rollout of health care reform also hamper the ability to predict how certain hospitals might fare under a new health care system.

3. Uncertain growth prospects

Another area of concern is municipal issuers that rely on expectations of future growth to cover an increasing debt-service schedule. Tax-increment financings fit this description and are one of the most problematic areas in municipal finance today. Whether referred to as TIFs, tax allocation bonds or community development districts, these transactions often rely on absorption of newly developed properties to create a growing tax base. Of course, not all developer-driven plans work out as expected or receive the kind of demand a developer anticipates, which can leave a taxing district with underdeveloped or even undeveloped property.

If property is not developed or sold on schedule, a bondholder secured by the incremental growth in an area's tax base could see its revenues fall short of what is needed to service debt. Florida, in particular, is experiencing financing shortfalls as developers who anticipated significant demand for new homes experience limited or even non-existent purchases of developed property. And in a slightly different way, California's recent experience with its economic-recovery bond restructuring – while not an example of a developer-driven transaction falling short – shows how expectations of continued growth in a revenue stream can cause a problem for any issuer. California recently had to restructure its economic recovery bonds, which are backed first by a sales tax, because the original transaction assumed a steadily growing collection from the pledged sales tax and because the issue had been structured with a steadily increasing debt-service schedule. When California sales taxes decreased in the recent recession rather than increased as the original projections had assumed, the transaction revenues fell short, causing the state to resort to its backup pledge to cover debt service. Restructured debt was then issued with level debt service and an expectation that sales taxes would stay flat at 2008 collection levels throughout the life of the new bonds.

Conclusion

As all of the recent default and transition reports published by Moody's, Standard and Poor's and Fitch have statistically identified, default risk is negligible for investment-grade GO bonds, essential tax-backed and essential-service providers. According to a recent Moody's study, only 54 Moody's-rated municipal issuers defaulted on their debts during the period between 1970 and 2009; of those defaults, the majority – 42 – were in the housing and health care sectors, which do not enjoy the kinds of legal remedies for adjusting revenues to combat a downturn that come with GOs, essential-service and special tax-revenue deals. For the most part, credit problems have usually been limited to the non-tax-backed sectors such as hospitals, nursing homes, project financings, development deals and multi-family housing, which all bear some level of competitive and economic risk.

While studies of default and credit risk can help inform investors about historical default patterns, statistical default rates are, by definition, historical and broad and do not indicate the creditworthiness of a particular bond or issuer. Within asset classes, rating categories and market sectors, it remains critical that investors understand the characteristics of a particular bond issue and evaluate its suitability accordingly. For GO bondholders, untapped taxing capacity and financial flexibility are key determinants of credit quality. For essential-service bonds, stable debt-service coverage, strong covenants and the necessity of the underlying services are significant indicators of credit quality. And for tax-backed special revenue-secured deals, the durability of the revenue stream, the essentiality of the activity being taxed and the issuer's control over setting rates are all keys to higher credit quality.

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