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Golden State Not All Bad

Despite the Crisis, Some Local Note Issuers Do Well

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By Rich Saskal

SAN FRANCISCO — It is the worst of times in California — with the controller warning of the impending "meltdown" of state government, and the possibility that efforts to raise cash through short-term borrowing may fail completely.

But there are better times for some other issuers in California, those with credit profiles allowing them access to the short-term debt markets, where they have been able to issue one-year revenue management notes at rates under half a percent.

The budget crisis has been building to a crescendo for months, with Controller John Chiang adding more bad news Wednesday: May revenues were $827 million below projections made just weeks earlier.

The projected cash crunch has also ballooned, with Chiang foreseeing a negative cash balance of almost $3 billion by the end of July without legislative action on the budget. Two weeks ago, his office projected a $1 billion gap.

John Chiang

By April, without corrective action, cash balance will fall to a negative $25.3 billion, Chiang said Wednesday, calling on lawmakers to take immediate action to balance the budget.

"Without immediate solutions from the governor and Legislature, we are less than 50 days away from a meltdown of state government," he said in a letter to legislative leaders and Gov. Arnold Schwarzenegger. "This presents a terrible threat to California's economy and to the state's delivery of basic public services. A truly balanced budget is the only responsible way out of the worst cash crisis since the Great depression."

While lawmakers on both sides acknowledge the severity of the crisis, agreement on how to respond is more difficult.

Schwarzenegger has proposed $24 billion in cuts, including the wholesale elimination of social service programs like welfare for families and health insurance for low-income children, and cuts to

in-home services for all but the most severely disabled. Schools would also take a big hit.

Leaders in the Democratic majority have been reluctant to sign on to the full extent of the social service cuts.

There is almost no prospect of a tax hike, which would require two-thirds votes in each house, and therefore support from some minority Republicans, who view drastic social service cuts as a policy goal rather than something to be averted.

Chiang has a team in place to sell revenue anticipation warrants, a short-term borrowing instrument that can be issued to bridge different fiscal years. The state can also issue revenue anticipation notes through the treasurer's office, assuming a budget is in place showing investors a plan for repayment by the fiscal year-end.

The primary reason California would issue Raws as opposed to Rans is the increased flexibility it gives the state to set a maturity date, according to the state Legislative Analyst's Office.

"The ability to have a later maturity date means the state can borrow for cash-flow purposes even if the state's cash outlook is challenging in the near term," the report said. "Because of this longer maturity schedule and the fact that Raws typically are issued when the state faces challenging budget times, they generally are more costly — with higher interest and other issuance costs — than Rans."

In Chiang's letter, he said he is prepared to launch marketing outreach for Raws within two weeks.

The team includes Goldman, Sachs & Co. and Merrill Lynch & Co. as structuring agents, Magis Advisors as financial adviser, and Orrick, Herrington & Sutcliffe LLP as bond counsel, said Hallye Jordan, Chiang's spokeswoman.

"If necessary, Goldman and Merrill would be leading what we expect to be a series of negotiated offerings," Jordan said. "They would lead a syndicate for offerings of Raws in public sales."

Chiang warned in his letter that there is no guarantee of success.

"Without credible and durable budget solutions that produce positive results in the state's cash position and demonstrate the state's ability to repay at time of maturity, any form of cash-flow borrowing — whether a revenue anticipation warrant or revenue anticipation note — will be met with heavy skepticism by investors," he wrote. "At best, this will result in a borrowing of limited size and at significant expense. At worst, it could result in a failed sale."

Schwarzenegger, for his part, told the Los Angeles Times editorial board Wednesday he'd rather let the government grind to a halt than approve a loan at high interest rates the state would have to pay without a solid repayment plan budgeted.

State officials this year unsuccessfully lobbied the Obama administration to provide a backstop for cash-flow borrowings, saying such support would not only help California, but other issuers as well.

Despite the crisis, other issuers in the state have been able to access the short-term note markets at a very low cost.

California issuers typically have a "note season," in which they issue tax and revenue anticipation notes — or Trans — in the month or so before and after the July 1 start of the fiscal year, as a cash-management tool to adjust for the uneven arrival of tax revenues during the year.

Like swallows returning to Capistrano, the note season usually kicks off with a Tran sale by the Santa Clara Unified School District. This year, the district priced $12 million of Trans in a competitive sale May 27, drawing seven bidders, with Jefferies & Co. winning the deal with a true interest cost of .44%.

"I think it's worth it to be aggressive and out in front of anybody else," said Jeffrey Small, managing director of Capitol Public Finance Group LLC, the district's financial adviser.

The district benefits from attributes not shared with many other school districts or agencies in California — its property tax base is so substantial that it provides most of its operating budget, and therefore the district isn't as reliant on state funding as most. Standard & Poor's gave the notes its tip-top SP-1-plus rating.

It wasn't the only jurisdiction to find success in the market. Last week Ventura County priced $145 million of Trans with a 2.5 coupon and a 0.37% yield. Merrill Lynch was the manager.

The yield curve appears to favor note issuers who can get to market. Tax-free money funds, which depend on notes and variable-rate demand obligations, have fewer VRDOs to choose from these days.

Variable-rate issuance this year, through Tuesday, was just over $14 billion — less than a quarter the volume of a year ago.

At the same time The Bond Buyer one-year note index has hit record lows of late. As of Wednesday it was 0.65%. There probably isn't much room for rates to get lower than Santa Clara's, Small said.

"Money fund buyers have expenses, too," he said. "I think you do have a floor somewhere." It won't be that easy — or cheap — for everyone, said Small, who works extensively with school districts.

"There's going to be disparity among the SP-1-pluses," he said. "There's going to be disparity between SP-1-plus and SP-1s. And there'll be a huge disparity between SP-1s and the SP-2s."

The big problem for most districts is their heavy reliance on money from the state general fund to support operations. That's the same budget that Chiang said faces imminent meltdown.

"The districts that are going to be more problematic are the ones with a very thin [cash] balance coming in," Small said.

Earlier cash-flow solutions adopted at the state level have imposed deferrals on scheduled payments to school districts, moving them from the current fiscal year that ends June 30 into July and August.

But will deferrals turn into cuts? That's the big question, Small said: "If they are really deferrals, presumably we'll be able to [borrow against] them today. If they're really cuts, we can't finance them."

Small said he's had to rethink cash-flow strategies for his client districts on an almost month-by-month basis as circumstances evolve. One development that is good for many districts: money from the federal stimulus package.

"Even with these state deferrals, the fact that the districts are getting federal stimulus money that is actually backfilling and negating the effect of those deferrals," Small said. "That part of the American Recovery and Reinvestment Act is working well."