

Easy Muni

Financing local projects just got tougher

by Chris Birk | March 2009

The municipal bond market started to rattle last summer, and the city of Lodi jumped before it came apart.

A financing deal linked to the city's six-year-old, \$47 million electric utility bond issue was set to expire in months. The interest rate on the short-term, variable-rate bonds started to skyrocket, triggered by the credit crunch and broader economic crisis.

Unsure of where the muni market was headed, city officials decided not to gamble. They refinanced in July using fixed-rate bonds, adding \$17 million in new debt in exchange for a guaranteed rate.

"The City Council decided to just bite the bullet and get out of it, and deal with the known rather than deal with the unknown at a future date," says city spokesman Jeff Hood. "It was a broken system; we felt we had to get out."

Lodi got out just in time.

By early fall, the municipal bond market was paralyzed by ballooning interest rates and an exodus of underwriters, institutional investors and top-tier bond insurers.

Now, at a time when they could use a tool to pump cash into the economy through bond-backed projects, governments face high costs, low demand and crimped conditions that make it more difficult and expensive to issue bonds.

The problems are, in some ways, worse in California, where the state budget is choking off funds that cities, counties, school districts and other government bodies could otherwise use to back bonds. Plans have been reworked, delayed or abandoned since the market tightened, from affordable housing in Stockton to the next wave of bonds for the terminal expansion at Sacramento International Airport. Some governments have constructed unusual financing strategies to keep key projects moving.

After a brutal close, 2008 went down as the worst year in a decade for domestic municipal bonds. States and cities issued about \$385 billion in long-term bonds in 2008, down almost 10 percent from 2007, according to Thomson Reuters.

At the same time, yields hit record highs last year compared to U.S. Treasury bonds, and fees that cities pay to sell bonds increased to their highest in two decades by mid-December.

The outlook for 2009 isn't much brighter, with the state budget and recession roiling municipal finances and companies that rely on public contracts. Cities from Vallejo to Manteca face grim fiscal outlooks, but ills could resonate through counties, school districts, water resource districts and a host of other public entities.

The fallout: Many governments will be forced to abandon projects that might have provided economic relief. Cities, counties and local agencies turn to bond sales to pay for capital projects, infrastructure improvements and large-scale equipment purchases.

Although there were signs of life in January in the municipal bond market, California municipalities have entered a new, stark chapter marked by painful decisions regarding services, infrastructure and budget cuts.

"It's going to be burdensome for the people of California by way of having to cut essential services [and] infrastructure projects that are absolutely critical in the time of a recession," says Jeffrey Small, managing director of Capitol Public Finance Group LLC, a consultant in Sacramento. "I think this is a short-term phenomenon. But, frankly, it is a disaster."

A booming bond market — it was set to crack the record \$450 billion mark set in 2007 — fell apart last year. U.S. municipalities issued about \$15 billion in fixed-rate bonds in September 2008, about \$8 billion less than in September 2007, according to Municipal Market Advisors, a bond market research group based in Massachusetts.

Until 2008, the average fee that municipalities paid to sell bonds had fallen every year except one since 1981, hitting a record-low of \$5.27 per \$1,000 bond in 2007, according to Bloomberg. It almost hit \$6 per issuance in November.

At the same time, California governments were sandwiched between the exodus of institutional investors, bond insurers and underwriters and an unprecedented rise in municipal bond yields. The combined effect is higher costs and a more difficult market.

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— Jeff Hood, spokesman, city of Lodi

With institutional buyers on the sidelines, sellers had to rely more on bond purchases by individuals. For example, California sold about \$5 billion in state bonds soon after the U.S. government bailed out besieged banks late last year. About 80 percent of the buyers were individuals; the usual figure is 30 percent. In January, Thomson Reuters data showed institutional investors still on the sidelines; while issue volume was up from January 2008, sales volume fell sharply, according to The Bond Buyer, an industry newspaper.

Meanwhile, bond insurance was pummeled. Rating downgrades swept the industry as Wall Street worried about losses tied to subprime mortgages. With questions about how safe the bonds were, investors demanded higher yields.

During the first three weeks of November, municipalities used bond insurance on only 9 percent of all issues, compared to 45 percent during the same period in 2007, according to Thomson Reuters.

"Unless you're an agency that has a sterling credit rating, bond insurance is going to be difficult to obtain," says Hood, the Lodi spokesman. Agencies will be able to issue debt, but interest rates may be punishing, he says.

All the while, the nation's largest bond underwriters were feeling the strains of the credit and subprime debacles. Five of the 12 biggest players left the bond game by year's end, shrinking the competition.

Nervous investors cashed out mutual funds in the bond market, forcing institutions to sell huge chunks of bonds, flooding the secondary market with paper. Yields spiked sharply: At one point, they hit 2.2 times the yield for Treasury notes, up from the historical average of 0.96, according to Municipal Market Advisors.

That higher yield would mean governments pay an additional \$2.93 million per year in interest for every \$100 million of debt sold.

"If you're a bond investor, it's a buyer's market," Small says. "It makes it very difficult for a municipality that needs cash to secure financing at a good price. They have to be very

careful.”

California’s budget only worsens the problem. This winter, officials halted about \$4 billion in public works projects, a move the state controller said would cost the California economy 200,000 private-sector jobs and \$16.2 billion.

“At the very time our economy needs stimulus, the markets that provide the lifeblood of public projects are frozen,” controller John Chiang wrote in a letter to Barack Obama’s transition team and the California congressional delegation.

Delayed projects throughout the state include a \$1.8 million plan for Lodi Unified School District improvements; \$7.2 million for low-income housing construction in Stockton; and \$3 million for Tracy Unified School District projects.

A delay in selling proposition 1C bonds, approved by voters in 2006 for housing and development, derailed the Stockton project, says Greg Sparks, a vice president with Mercy Housing California, the would-be developer on a 93-unit affordable apartment complex near Gleason Park. Contractor Broward Brothers Inc. hadn’t started work, though Mercy was set to pull the building permits.

“Without the state’s ability to sell bonds,” Sparks says, “and because we haven’t closed and started construction, they basically said, ‘Stop, we can’t guarantee when we’re going to be able to issue the bonds and move the money to you.’ We’re ready to rock and roll. We’re just standing back.”

On top of the state’s multibillion-dollar budget shortfall, the Legislature and Gov. Arnold Schwarzenegger have sought to take \$350 million from local redevelopment to help cover gaps in education funding. That’s money that could have gone to back bonds.

Cities and redevelopment agencies have decried the move, saying it will quell local improvements and even create deficits for some governments. The California Redevelopment Association and the city of Moreno Valley’s Redevelopment Agency sued in early December to block what they call a raid on the funds.

“When economic activity is at its lowest, the last thing you would do is cut the program which acts as an economic stimulus and provides dollars for more economic activity,” says John Shirey, CRA executive director. “But that’s exactly what the Legislature and the governor have done.”

Sacramento officials say the capital could feel the effects of the move. The legislative maneuver would stymie local governments in their efforts to pump needed investment dollars into communities, says Lisa Bates, deputy executive director for the Sacramento Housing and Redevelopment Agency.

“Would you buy our bonds if you thought we were going to lose two-thirds of our revenues?”

***— Satoshi Matsuda, financial strategies director,
Sacramento Housing and Redevelopment Agency***

The agency planned to use about \$3.2 million as leverage for a bond issue of about \$50 million, targeting capital projects and housing needs, says Satoshi Matsuda, SHRA financial strategies director. But the agency stands to lose about \$2 million to budget moves, which would limit the size of the bond issue.

"If you were a bondholder, would you buy our bonds if you thought we were going to lose two-thirds of our revenues?" Matsuda says. "We would not be able to sell the bonds with that hanging over our heads."

High-growth areas of the Capital Region and beyond are likely feeling the crunch the most, says Kenneth Dieker, an independent financial adviser and principal with Del Rio Advisors LLC in Modesto.

"Overall, borrowing costs have risen significantly, which puts pressure on municipal entities," Dieker says. "It's less likely an entity can go to the bond market because they don't have the budget to repay the [debt]."

Those areas that saw fast growth are especially vulnerable. Communities that exploded with population and tax revenue during the housing boom have been squeezed hard since the market tumbled.

Property tax revenue is significantly lower for scores of communities. County tax collectors have reduced assessed values on new construction back to 2001 levels, Dieker says. Another major source of sales tax revenue for communities — auto sales — has also dried up, further complicating the situation. The same goes for tourism-dependent communities that rely on hotel taxes.

Sales tax collections across the nation fell 2 percent from July through September, according to the Rockefeller Institute of Government in New York.

"Cities have gotten hit hard," Dieker says. "Capital projects are going to be put off."

Some municipal debt is still selling: Water, sewer and general obligation bonds are seen as safer than revenue bonds for purposes seen as less central to core municipal services.

Dieker helped the city of Brentwood issue a water revenue bond in late 2008, pulling in a couple of institutional investors toward the end of the order period. A few weeks later, as yields started to fluctuate, a lease-revenue bond for the Riverside County Palm Desert Financing Authority failed to attract a single institutional investor.

The \$72 million bond issue, with a 14-year maturity, was sold entirely to individual 'retail' investors.

Even if the initial signs of a thaw in the municipal bond market prove true, a huge backlog of bond issues is waiting at the gate. At the start of 2009, about \$20 billion worth of postponed bond deals were set to hit the market.

"We have to wait and see if the market is able to absorb all of that," Dieker says. "Access to the market is still available on a somewhat limited basis, and I hope that loosens up. Albeit, I don't know where those yields are going to go."

Still, the state budget mess looms over all.

"There's no reason for a school district, for example, to issue any bonds or fund any projects," Small says. "The state can't fund [its] share. The only debt issuance we'll see right now is just no-choice, desperate bond issues."

There have been success stories amid the collapse. A combination of good credit, pressing need and creativity may help some municipalities ride out the storm.

Officials in Lodi, for example, remain pleased with their decision to refinance.

Elected officials in Yuba County struck a similar chord after engineering a unique bond issue in

September to finance much-needed flood projects.

With the help of Capitol Public Finance, the Yuba Levee Financing Authority issued \$64 million in tax-exempt revenue bonds for a setback levee and other improvements along the Feather River. Then they went a step further, issuing \$14 million in taxable revenue bonds to cover interest costs on the tax-exempt bonds for about six years.

The maneuver will help the county avoid dipping into its pocket for debt service payments — and buy time for development and tax revenue to return to the region. The bond issue earned “Deal of the Year” honors for the Far West Region from The Bond Buyer.

“Because the county pressed hard and took the chance of doing a deal that was much more difficult but really insulated them,” Small says, “they did a deal that was in their best interests, as opposed to what would have been an easy deal for Wall Street.”

The future for other communities is still unclear. The city of Vallejo declared bankruptcy last spring, and some economic observers say a few other California cities may follow suit in 2009.

Dieker remains confident the gap between municipal and Treasury bond yields will narrow, a key cog in returning normalcy to the market.

“I think the market is slowly starting to open,” he says. “Ultimately, if investors begin to believe that this is attractive, I think you’ll start to see the market stabilize.”