US Public Finance

Weekly Credit Outlook

MARCH 27, 2014

FEATURE ARTICLES

RESEARCH HIGHLIGHTS

RATING CHANGE HIGHLIGHTS

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New Jersey's Reduced Pension Contribution Reflects Persistent Budget Pressure

On March 21, New Jersey Treasurer Andrew Sidamon-Eristoff released a list of $694 million of spending cuts to close a mid-year fiscal 2014 budget gap. The measures include a recalculation and reduction of the fiscal 2014 pension contribution by $94 million. The state's fiscal 2014 budget-balancing actions reflect the credit negative strain of New Jersey's (Aa3 negative) persistent budget gaps and indicate that the state has already exhausted some of the easiest spending reductions.

The pension contribution reduction is based on revised actuarial assumptions that will use current employee contribution requirements, enacted in a 2011 pension reform, instead of lower, pre-reform contribution levels. The lower state contributions are consistent with minimum legislative requirements. However, the need to retroactively recalculate the amounts indicates that the state's financial position is weaker than expected and that more typical budget balancing solutions have already been exhausted. Additionally, while the changes provide budgetary relief through fiscal 2018, pension costs will be higher in later years than they would have been without the adjustment.

While the budget gap is only 2.3% of the revised fiscal 2014 budget, this is the third consecutive year that revenue shortfalls have required mid-year budget balancing. Through December 2013, the state's revenues had grown 5.7% year-over-year but were $331.7 million below the budget forecast. The state's recurring mid-year revenue shortfalls reflect both the one-year lag in the economic recovery and optimistic revenue projections.

As a result of recurring budget gaps and increasingly limited options, the state continues to use one-time fixes that indicate above-average financial weakness. Non-recurring budget solutions include debt restructurings for debt service savings, and in fiscal 2013, a one-time shift in Homestead Benefit payments that crossed fiscal years. Earlier this month, the state provided an enhancement to tobacco securitization bonds, committing additional Master Settlement Agreement receipts to a 2041 maturity in return for an upfront payment of approximately $92 million. The payment provided both budgetary relief and helped shore up the state's narrow liquidity position.

The state's current estimate for its fiscal 2014 ending fund balance remains consistent with its original projections at $300.6 million, a narrow 0.9% of revenues. These fund balances provide minimal liquidity and protection against contingencies, and are much lower than the $873 million (or 3% of revenues) fiscal 2011 fund balance and a current 50-state median fund balance of approximately 5%.

Several other states, including Indiana, Oklahoma, Tennessee and West Virginia, are also addressing mid-year revenue shortfalls. However, the budget balancing proposals in these states are limited to more typical measures, including across-the-board budget holdbacks, deferring capital expenditures, and using reserves and surpluses outside the General Fund.

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New Jersey Shore Tourism Withstands Sandy Damage

On March 20, the State of New Jersey (Aa3 negative) released new data showing that 2013 tourism-related economic activity in five coastal counties increased in aggregate over the prior year.[1] Although two counties had modest declines, the overall uptick is credit positive for local governments along the New Jersey coastline which had braced for a deep plunge in tourism activity in the wake of Superstorm Sandy. Monmouth County (Aaa stable) and Cape May County (Aa1) had the largest increases in tourism economic activity among coastal counties, increasing by 4.9% and 2.3%, respectively. Ocean County (Aaa negative) and Atlantic County (Aa2 stable) had modest declines of 2.3% and 3.2% respectively.

Local governments of the New Jersey coastline spent much of 2013 recovering from the storm, which heavily damaged popular tourist destinations like Seaside Heights Borough (A3). The governor's office estimated total storm damages of $36.9 billion.[2] Although state and local legislators were concerned that storm damage would keep tourists away, the newly released revenues are an encouraging sign of the region's successful rebound (see Exhibit). Statewide, the tourism industry generated $38.4 billion in direct sales and accounted for 6.9% of GDP.

Coastal Counties Experience Overall Growth

	Rating	Tourism Revenues[3]	% Change
Monmouth County	Aaa stable	$2.2 billion	+4.9%
Middlesex County	Aa2 stable	$2.1 billion	+4.6%
Cape May County	Aa1	$5.5 billion	+2.3%
Ocean County	Aaa negative	$4.2 billion	-2.3%
Atlantic County	Aa2 stable	$7.3 billion	-3.2%

Source: State of New Jersey, Division of Travel and Tourism

Economic activity related to tourism in Monmouth County grew by 4.9% after tourists returned to popular beach towns with proximity to New York City. Asbury Park City (Baa1) total tourism related revenues, including parking, beach badges, beach lockers and hotel occupancy taxes, increased 5% in 2013 over 2012. These sources account for 7.8% of the city's operating revenues.

Tourism-related economic activity in Atlantic County, which includes Atlantic City (Baa2 negative), fell by 3.2% to $7.3 billion. The tourism report attributed the decline to second home losses – approximately 10% of seasonal homes were affected by the storm. None of the casinos suffered storm damage, but flooding caused the city to close for five days following Sandy, hurting casino revenues in late 2012.

Ocean County, home to Seaside Heights Borough and Point Pleasant Beach (A1), experienced a tourism economic activity decline of 2.3% to $4.2 billion. The historic Seaside Heights boardwalk and pier were nearly destroyed by the storm. Although Seaside Heights Borough's boardwalk reopened in time for the summer season, a fire damaged much of the renovated boardwalk later in the year. Seaside Heights Borough projects a 26% decline in beach fee and parking meter revenue from 2012 to 2013. Although these revenues were down, borough management budgeted for the drop in revenues, so the net credit impact is minimal.

1 "The Economic Impact of Tourism in New Jersey" http://www.visitnj.org/sites/visitnj.org/files/2013-nj-economic-impact.pdf
2 http://www.state.nj.us/governor/news/news/552012/approved/20121128e.html
3 Tourism revenues include economic activity related to lodging, transport, recreation, and food and drink purchases.

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Proposed GSE Reforms Include Provisions for Housing Finance Agencies, a Credit Positive

On March 17, US Senate Banking Committee Chairman Tim Johnson (D-South Dakota) and the committee's ranking member Mike Crapo (R-Idaho) released the text of their proposed legislation to reform the housing finance system. If enacted, the proposed legislation would wind down Fannie Mae and Freddie Mac (the government-sponsored enterprises, or GSEs), replace them with a new mortgage origination platform and provide a federal guarantee for home mortgages meeting the bill's criteria.

Although passage anytime soon is uncertain, the draft is a significant milestone in defining the congressional approach to a new mortgage system if Fannie and Freddie are discontinued. Sections of the proposal are credit positive for housing finance agencies (HFAs) because they make qualified HFA mortgages eligible for the federal guarantee, allow HFAs to participate in the new mortgage platform and preserve the GSEs' multifamily lending activities. The bill provides a basis for HFAs to continue their lending program, which is their primary source of revenue for future operations and management of existing obligations.

GSEs have been important partners for state HFAs, whose primary business is financing home mortgages for low- and moderate-income buyers. Since the 2008 financial crisis, HFAs have relied increasingly on direct loan sales to GSEs and sales in the "to be announced" (TBA) market to finance single family mortgages.

If the GSEs are wound down, they would be replaced by a new federal agency, the Federal Mortgage Insurance Corporation (FMIC), which would provide an express federal guarantee for single-family mortgage losses only after private sector investors absorb at least the first 10% of the loss. The bill provides that HFA loans may be eligible for the guarantee, and it requires that other loan criteria conform as closely as possible to qualified mortgage rules recently enacted by the US Consumer Finance Protection Bureau and which favor HFA loans by exempting them from key restrictions on mortgage suitability.

The Johnson-Crapo legislation provides continued backing for existing GSE obligations during and after a wind-down, which is credit positive because it assures that existing GSE securities held by HFAs continue to have protection. The legislation provides for securitization of eligible home mortgages through a new member-owned securitization platform and includes provisions to ensure access for smaller lenders. HFAs are eligible to participate and thus can continue to securitize loans. The platform is designed to assure continued access to the TBA market. The securitization platform may adopt a tiered usage fee structure for HFAs to encourage affordable housing.

HFAs, like all lenders, would face a considerable challenge in creating new financing structures to provide for the top-loss private capital and meet the requirements of the new system, which will increase financing costs and risks posing barriers to serving moderate-income buyers. The provisions in the draft legislation that expressly recognize the role of HFAs provide a framework for their continued role as providers of affordable housing finance in a post-GSE world.

For multifamily financing, the draft provides greater continuity by directing that the GSEs' multifamily business be transferred to new entities and continued, subject to specific affordability targets. This will preserve a smaller but also significant part of HFA business because GSEs provide guarantees for affordable multifamily mortgage loans meeting their underwriting criteria. Sustained multifamily business also is positive for maintaining or growing revenues.

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Lawsuits Challenge College Sports' Amateur Model, a Credit Negative for the NCAA and Colleges

On March 26, the Chicago office of the National Labor Relations Board ruled in favor of Northwestern University football players' right to unionize, the latest credit-negative challenge to the prevailing business model of uncompensated athletes in college sports.

The ruling follows the March 17 filing of sports attorney Jeffrey Kessler's lawsuit against the National Collegiate Athletic Association (NCAA, Aa2 negative) and major athletic conferences. The suit seeks removal of the NCAA's limit on student-athletes' benefits. The litigation in federal court in New Jersey adds to mounting legal challenges against the NCAA and many member institutions.

The NCAA's challenges arise from the potential for negative financial pressure from legal judgments, settlements, regulatory change or self-imposed policies. Universities could face increased labor costs for players who are currently considered to be student-athletes.

Other credit negative developments in recent months include:

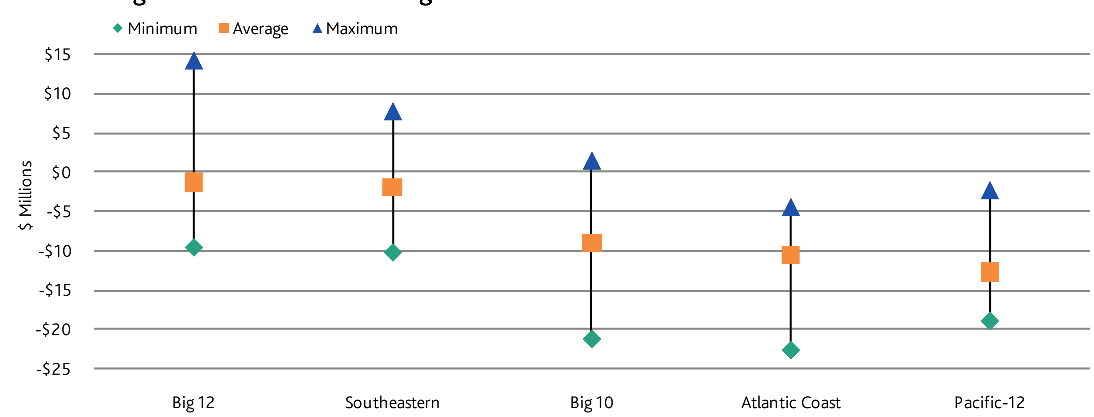
» The judge in the Ed O'Bannon class-action antitrust lawsuit against the NCAA signaled that the trial would begin in June.

» The same judge deemed that the case of Shawne Alston, a former West Virginia University football player, is closely related to the O'Bannon matter and can proceed.

Although each of these developments has unique aspects, they all pose a threat to the model of amateurism in college sports. The Kessler complaint names the NCAA along with five athletic conferences: the Atlantic Coast, Big Ten, Big 12, Pacific-12 and Southeastern.

The potential expense increase would put additional pressure on universities, which are already dealing with a challenging operating environment. Most athletic departments involved in the Kessler suit require a subsidy from their universities (see exhibit). For the public universities within those five conferences, the median subsidy requirement is around $7 million. In the absence of amateurism, players would likely gain additional compensation, greatly increasing the need for subsidization. In a market regime with no limits on player benefits, we would expect wide variation in both the ability and willingness of universities to compete for top players.

Athletic Program Net Income of Colleges in Conferences Named in Kessler Suit



Notes: Fiscal 2012 data reflect public universities only; net income excludes university subsidy and mandatory student fees
Source: Indiana University School of Journalism in conjunction with USA Today

We believe most universities would manage the challenge of the potential new expenses while avoiding deficit operations and maintaining operating equilibrium. In the case of a hypothetical university with $500 million in total university expenses and $20 million of annual revenue from athletic media contracts, a decision to share 50% of the media payments with players would total $10 million per year, or an increase 2% of campus-wide expenses.

The challenges to amateurism could evolve in numerous ways. If faced with abrupt change, we believe some universities or conferences might choose to compete under a new set of rules, in which some different form of amateurism would be retained. The prospects for self-regulated and gradual change within the NCAA have been hampered by the divergent interests of the various member institutions. One failed member proposal focused on allowing a stipend to student-athletes, but was voted down by less commercially successful members because of the financial burden it would have imposed.

A change in the compensation model for athletes would ultimately precipitate a major retooling of college sports programs, which are often critical to the identity of universities and help with student recruitment and donor support. For more information about the credit effect of college sports, see our October 2013 Special Comment, Eye on the Ball: Big-Time Sports Pose Growing Risks for Universities.

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Central Falls, Rhode Island, Recovery Plan Results in a Surplus

On March 20, less than two years after emerging from bankruptcy, Central Falls, Rhode Island (B1 positive), reported a $1.6 million surplus, before capital transfers, for the fiscal year ended 30 June 2013. These credit positive results provide evidence that the city's six-year recovery plan, developed as part of the bankruptcy process, is on track to stabilize the city's financial operations. Central Falls has achieved structural balance of its operations and fixed costs, allowing it to begin addressing deferred capital needs. Its steady recovery contrasts with Vallejo, California (unrated), which emerged from bankruptcy in 2011, but remains in structural imbalance and projects a deficit in 2014.

Central Falls' recovery plan includes a combination of annual property tax increases, ongoing spending controls and savings in pension and healthcare-related costs. The city transferred $1.79 million to its capital reserve fund during fiscal 2013 to fund some of the more than $125 million in deferred maintenance, a requirement of the recovery plan. Because of the transfer, total general fund reserves dropped to $1.2 million (6.7% of revenue) from $1.37 million the previous year. The surplus resulted from favorable variance to budget on current year property tax revenue ($759,494), non-tax fee revenue ($147,367) and medical insurance/unemployment compensation ($168,985).

General Fund Reserves as a Percent of Revenue Remain Healthy After Large Transfer to Capital Fund

Source: Central Falls, Rhode Island, audited financial statements

The city adopted the six-year financial plan (2012 through 2017) as a condition of its exit from bankruptcy. In addition to the requirement that any surplus in excess of $50,000 be used for deferred capital spending, the plan also requires the adoption of balanced budgets using annual levy increases (within the state's 4% levy cap), full payment of actuarially required pension costs and significant staffing and benefit expenditure cuts in 2011 and 2012. The city is well ahead of its original projection that it would end fiscal 2013 with a $46,000 surplus after transfers and that it would bring total general fund reserves to $197,000.

The city's recovery from bankruptcy included a 45% cut in retiree pension benefits and significant relief from accounts payable to general contractors and equipment leases. The city also increased its property tax levy by 19.5% in 2011. Just before the bankruptcy filing, the city's state-appointed receiver issued a report projecting sizable annual operating deficits from 2011 through 2015 if the city continued on its course without action.

Unlike Central Falls, Vallejo's plan did not include adjustments to employee pension benefits, which require escalating contributions that will only further the structural imbalance. Vallejo's financial position is challenged as pension costs escalate. The city's budget for the fiscal year ending June 30 2014 originally projected a $5.2 million structural imbalance, or 6% of its general fund revenues, and expects to narrow the gap to approximately $2-$3 million, partly through a reduction in retiree health benefits. However, without some adjustment to pension benefits, we expect rising costs to continue to negatively pressure Vallejo's finances.

RESEARCH HIGHLIGHTS

US Toll Roads: Federal TIFIA Loans Provide Low-Cost Capital, but Not Without Risks

US public toll road operators can access lower cost capital for projects through federal loans available under the expanded Transportation Infrastructure Finance and Innovation Act (TIFIA) program. However, the TIFIA backed financings usually add some credit risks not usually found in typical bond transactions. For example, the federal loan program's legal covenants are weaker than those typically seen in a municipal bond financing for toll roads. As TIFIA funding expands and loans grow larger, TIFIA and public toll road operators have been employing new modifications to these financings.

RATING CHANGE HIGHLIGHTS

Suffolk County (NY) Downgraded to A3; Outlook Stable

Mar. 26 – We downgraded Suffolk County's (NY)$1.4 billion of general obligation debt to A3 from A2. We also downgraded to Baa3 from Baa2 $70 million in lease revenue bonds issued by the Suffolk County Judicial Facilities Agency. The outlook on all of the county's debt is stable. The rating reflects the county's continued use of significant one-time revenues, reliance on significant cash flow borrowing and amortization of annual pension contributions. The stable outlook reflects our expectation that the county will reduce its reliance on one-time revenues to balance the budget and return to structural balance.

University of North Carolina Hospitals' Outlook Revised to Negative

Mar. 21 – We revised the outlook to negative for the Aa3 and Aa3/VMIG 1 ratings on the University of North Carolina Hospitals' bonds, affecting $274 million. The outlook change reflects increased transfers to the UNC Health Care System to support strategic investments. It also reflects our view that, with the implementation of a new information technology system, the University of North Carolina Hospitals is entering a period of cash flow weakness that will prevent balance sheet growth or may reduce liquidity over the near-term.

South Jersey Transportation Authority's (NJ) System Revenue Bonds' Outlook Revised to Negative

Mar. 20 – We revised the outlook to negative for the Baa1 rating on South Jersey Transportation Authority's outstanding Transportation System Revenue Bonds, affecting $455 million. The outlook change reflects our expectation that the authority will experience pressure with lower-than-forecasted traffic transactions, given its leisure-oriented traffic with elastic demand. The outlook change also recognizes the lack of any planned rate increases for the near-term future because of declining traffic.

UC Health (OH) Upgraded to A3; Outlook Stable

Mar. 21 – We upgraded to A3 from Baa1 UC Health's outstanding debt and issuer ratings, affecting $267 million. The upgrade reflects a rebound in operating margins in fiscal year 2014 to historical levels, as well as strong volume and market share growth. The upgrade also reflects UC Health's large project involving the expansion of West Chester Hospital and our expectation that capital spending will be below operating cash flow levels, thus preserving current balance sheet strength.

Health First (FL) Bonds' Outlook Revised to Stable

Mar. 18 – We revised the outlook to stable from negative for the A3 rating on Health First's bonds, affecting $326 million. The outlook change reflects Health First's favorable financial performance in fiscal year 2013 despite its acquisition of a large independent physician group in February 2013. It also reflects our expectation that Health First will continue to operate with 10% operating cash flow margins or higher, and that it will maintain or grow its liquidity from the current level.

Lehigh Valley Health Network's (PA) Outlook Revised to Stable

Mar. 21 – We revised the outlook to stable from positive for the A1 rating on Lehigh Valley Health Network's outstanding bonds, affecting $412.2 million. The outlook change reflects recent moderation of operating performance, which is below budgeted and historical levels, and our expectation that operational headwinds will continue.

Rex Healthcare's (NC) Bonds' Outlook Revised to Negative

Mar. 21 – We revised the outlook to negative for the A1 rating on Rex Healthcare's bonds, affecting $115 million. The outlook change reflects increased transfers to the UNC Health Care System. It also reflects our view that, with the implementation of a new information technology system, Rex is entering a period of cash flow weakness that will prevent balance sheet growth or reduce liquidity over the near-term.

Community Hospitals of Central California Upgraded to Baa1; Outlook Stable

Mar. 19 – We upgraded the ratings on Community Hospitals of Central California's revenue bonds to Baa1 from Baa2, affecting $494 million. We also revised the outlook to stable from positive. The upgrade reflects our expectation for further improved liquidity, the successful completion and operation of the new facility in Clovis, and the maintenance of adequate performance measures despite operational headwinds.

Regional Health's (SD) Revenue Bonds' Outlook Revised to Stable

Mar. 20 – We revised the outlook to stable from positive on Regional Health's (SD) A1 revenue bond rating, affecting $161 million. The outlook change reflects declines in Regional Health's operating performance measures and our expectation that operational headwinds will continue. Regional Health's operating performance has declined for a third consecutive year.

Butler County, OH's GOLT Downgraded to Aa2

Mar. 20 – We downgraded to Aa2 from Aa1 the rating on the outstanding general obligation limited tax debt of Butler County, OH, affecting $107 million. The downgrade reflects the credit challenges associated with the county's narrow General Fund position relative to other Aa-rated entities and its exposure to underfunded defined benefit retirement systems. The rating incorporates credit strengths tied to the county's sizeable tax base located between Dayton (Aa2 stable) and Cincinnati (Aa2 negative), sound demographic profile and moderate debt burden.

Greater Baltimore Medical Center's (MD) Outlook Revised to Stable

Mar. 21 – We revised the outlook to stable on the A2 and A2/VMIG 1 ratings assigned to Greater Baltimore Medical Center's outstanding debt, affecting $107.5 million. The outlook change reflects growth in liquidity, which provide for more solid debt cushion and strengthened financial performance over the last two fiscal years. The favorable improvement is based on successful cost initiatives implemented to meet the changing dynamics and incentives under Maryland's rate regulation.

Cuyahoga Community College District's (OH) Outlook Revised to Negative

Mar. 24 – We revised the outlook to negative on Cuyahoga Community College District, OH's Aa1 issuer rating and Aa2 revenue bond ratings, affecting $125 million. The outlook change reflects our expectation that the district will continue to generate narrow cash flow and debt service coverage in the near-term given pressure to grow revenues. It incorporates the college's declining state appropriation support and stable but weak economic profile of the county.

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