Viewing Municipal Finances through the Lens of a Pandemic

With the advent of the coronavirus pandemic, many municipal bond investors have had to reassess how to evaluate the credit risk associated with current and new investments. The following information is intended to provide a framework for you to consider as you address your own portfolio.

Finances

Issuer financial statements were published prior to the COVID-19 outbreak, so the financial review should focus on issuer strength entering into the crisis and the likely impact on revenue during and after the crisis. Since it is not generally practical to review all client holdings in detail, consider prioritizing your efforts first on issuers that were previously known to have financial issues, issuers with low investment ratings, and issuers with narrow revenue sources. The information noted below are all attainable from EMMA and MuniPoints via the Vining Sparks customer website using the “municipals” link in the “portfolio” section.

The analysis of an issuer’s finances should be focused on evaluating the issuer’s/obligor’s financial resources and flexibility to support its obligations over the near and long terms. One should look at the general fund and any other tax-supported funds in which the use of revenues is flexible and could be allocated to general government purposes.

Revenue Analysis

Revenue sources should be viewed for volatility and diversity. In general, a diverse revenue system with a foundation of broad-based taxes, such as property, sales, and income taxes, is more stable and better able to capture the issuer’s economic wealth and activity, resulting in a stronger financial profile. Reliance on more narrowly-focused, economically-sensitive revenues such as real estate transactions, hotel occupancy, or gaming taxes may expose the issuer to financial volatility and lead to a credit concern.

An issuer’s ability to control its own revenue sources, including the power to adjust tax rates without voter approval and flexibility in the use of revenues, is an important credit positive. Since property tax revenues form the foundation of most local issuers’ revenue structures, one should view the ability to adjust property tax rates to fund operations and/or debt service to be an important credit positive while recognizing that such increases can be politically or practically difficult. Restrictive property tax -raising environments are generally viewed with concern, although limits on taxable assessed value growth that can mitigate volatility in property tax revenues offset this concern to at least some extent. Low property tax collection rates or collections that fall short of budgeted levels are viewed with concern.

For entities that rely heavily on state funding, such as school districts, one should evaluate the consistency of the funding and how potential adjustments would affect the entity, recognizing as a risk states’ view of the ability to adjust funding to local governments as an element of their own financial flexibility.

For special tax bonds, the revenue analysis focuses on historical performance of the pledged revenue stream, including its average rate of growth and year-to-year volatility. Also important is the degree of an issuer’s level of control over the tax base and rate. An issuer’s ability to increase either is uncommon, but where it exists is viewed positively. One should also look at distribution formulas, many of which have a population-based component, and whether such events as annexations or incorporations might affect the level of pledged revenue available to bondholders. Such taxes are often subject to statewide legislative changes, such as alterations in the base covered by the tax or changes to the distribution formula. In instances in which reductions to the rate are permissible, a rating should take into account the issuer’s lack of control over the revenue source. However, if state legislation includes non-impairment clauses, changes that clearly threaten a local entity’s ability to repay debt likely would be subject to challenge and such viewed as unlikely. For the review of a special tax bond the authorization must extend at least to the final bond maturity date unless the issuer agrees to put sufficient funds in an irrevocable trustee-held escrow prior to the bond closing to cover debt service after the tax expiration date.

Expenditure Analysis

Here one should look at trends in expenditure growth, the issuer's ability to make adjustments in spending both as part of the annual budget process and during the course of the fiscal year, and the expected stability in each major spending item. The ability to implement timely spending cuts to maintain balance is a credit strength. For example, an issuer with a high fixed-cost burden or a highly unionized work force will generally have less ability to make meaningful spending cuts than one with a low fixed-cost burden or a more flexible labor situation. The analysis also considers potential funding pressures, including outstanding litigation or unfunded mandates from higher levels of government.

For special tax bonds, the expenditure analysis focuses on the planned use of and dependance on pledged revenues remaining after payment of debt service. The ability to reduce such planned spending in the event of weakness in the pledged revenue source is a positive rating factor. An issuer with moderate and flexible operating needs, such as a park and recreation district, presents less credit concern than an issuer with the same pledged revenue stream but a more demanding operating environment, such as a transit or hospital district.

Operating Margin Trends

One should evaluate recurring revenues as compared to recurring expenditures. Concerns arise when operating expenditures consistently exceed operating revenues, as the use of nonrecurring revenue is unsustainable and can lead to depletion of reserves and deeper financial imbalances. Assuming reserve levels are satisfactory, the use excess recurring revenue for one-time purposes such as pay-as-you-go capital funding is viewed as positive.

Fund Balance/Reserve Levels

A satisfactory fund balance should be viewed as an important cushion against potential revenue and expenditure volatility. The amount that one should consider satisfactory varies based on such factors as economic or tax base concentration, revenue and/or expenditure volatility, and flexibility to adjust revenues and spending. Established reserves that benefit from automatic funding mechanisms and clear restrictions on use are the strongest credit features, but fund balances that have been maintained consistently over time also are viewed positively. Segregated funds that are available, or could be made available for general expenditures, are considered additional financial flexibility.

Liquidity

One should analyze an issuer's liquidity position, including tax collection schedules, the timing of disbursements, and the quality and timing of receivables and payables. Generally one should also review the trend in fiscal year-end cash levels, recognizing differences among issuers based on property tax collection cycles. Those in the strongest position do not depend on external cash flow borrowing. For those that have a trend of borrowed amounts increasing faster than budget growth, one should take note since this could be an indication of possible financial strain.

Please contact your sales rep or this author if you would like to discuss how to approach your portfolio or if you have specific bonds that you would like to discuss.

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