Municipal Market Comments

ASCENT Investment Partners

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Stockton's Bankruptcy Continues to Evolve

On April 1, a federal court ruled that Stockton, California is eligible for Chapter 9 bankruptcy. The Stockton ruling garnered a significant amount of coverage in the business press as the largest U.S. city (population 291,000) to ever file for bankruptcy protection. However, the ruling does not signal a resolution of the City's financial problems. Quite the opposite. Only now can Stockton begin to formulate a plan of reorganization. The City originally filed its bankruptcy petition on June 28, 2012, but the filing has been opposed by a group of creditors including holders of Stockton bonds and the insurers who enhanced those bonds. The City is now clear to begin to formulate a plan that the court will need to approve as treating all of the City's creditors equitably.

The City's bankruptcy case will likely be precedent setting for California municipalities, and may have broader national implications. Stockton's case raises the possibility of pitting retirees against bondholders in the reorganization process. Stockton has continued to make payments to Calpers for its retiree pension obligations even as it ceased payments to bondholders. Some of the key issues coming out of the Stockton case will be how the City proposes to treat these two groups of creditors and what plan the Court will ultimately approve as a fair settlement. We expect that Stockton will continue to be an occasional headline item over the summer and into the second half of 2013. Despite Stockton's issues, we view this situation as having limited application for the broader municipal market. The vast majority of municipalities continue to be characterized by high credit quality, solid financial position and effective management. While Stockton may provide a roadmap for future bankruptcy cases, we do not view Stockton as a preview of things to come for municipal investors in general.

Stockton was driven to insolvency by a combination of factors, including: a heavy debt load created by overly ambitious growth projections, the revenue shock of the recession, onerous retiree pension and health care obligations and the effects of the State dissolving local redevelopment agencies in 2012. Despite slashing expenditures and reducing service levels, Stockton recorded substantial budget shortfalls from 2009 through 2011 that consumed available reserves and left the City facing future budget gaps with no way to close them. After attempting 90 days of state-mandated mediation with creditors, the City decided that reorganizing its obligations was the only viable way to return to structural balance.

At the time it filed its bankruptcy petition, Stockton had approximately $355 million of bonds outstanding that were secured by the general government. None of Stockton's outstanding bonds are general obligation bonds secured by unlimited taxing power, and the City has ceased payments on most of this outstanding debt. Stockton's general governmental bonds are secured either with a promise to pay from available general fund revenues or with an appropriation pledge from general revenues. None of these issues were approved by voters or secured by a specific flow of dedicated funds. However, the City does continue to pay certain redevelopment bonds that are backed by pledges of tax revenues from specific redevelopment districts.

At the time of its filing, Stockton also had approximately $380 million of outstanding revenue bonds secured by water system, sewer system or parking revenues. The City's utility revenue bonds continue to make scheduled debt service payments from pledged revenues of the systems.

While Stockton's bankruptcy offers some useful lessons for municipal investors, we do not view its problems as being typical of municipalities, either in California or elsewhere. Stockton exhibits many of the common characteristics we have seen in municipal defaults over the past 20 years. What can we learn from Stockton?

- **Location matters.** California has one of the looser state laws governing municipal bankruptcy. It also has a track record of boom-and-bust economic cycles that create great stress on the state and its municipalities in recessions. California has also been the state most willing to inflict financial pressure on its localities in order to address its own state-level budget crises. States that have greater economic stability and stronger laws governing financial oversight and management of distressed municipalities inherently have less credit risk than states with looser financing environments.
- **Structure matters more.** In past bankruptcies and defaults both in California and elsewhere, tax-backed general obligation bonds have been paid. Lease revenue bonds, certificates of participation and other non-G.O. governmental obligations sometimes have not. It is vital that investors understand the structural protections incorporated within their specific bond issues and hold only those securities that provide adequate investment return for the true credit risk. There can be significant differences in credit quality even among issues from the same city or town.
- **Defaults are rare and unique.** While municipalities may share common characteristics, their financial and credit strength are a function of many specific factors that must each be considered. Many cities face pension and health care funding pressures. Many also have depressed tax base values as a result of the housing market downturn. Numerous municipalities have aggressive redevelopment plans that incorporate debt funding that leverages general governmental revenues. While such factors can suggest relative credit risks among the general population of issuers, they cannot be broadly applied to predict credit declines. The interplay of all of the credit factors on the individual issuer

determines the likelihood of timely repayment of debt. It is at that level of analysis that investors can determine relative risk and relative value opportunities.

- **Defaults develop over time.** Very rarely have we seen situations in which municipal bonds defaulted with little or no warning. More often, municipalities or projects experience a multi-year period of declining financial performance and deterioration of credit metrics. While such trends may not be reflected by rating changes, proper surveillance of municipal investments can most often bring problems to light, giving investors the opportunity to sell bonds before significant rating or market deterioration occurs.

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