May 26, 2015

California's Drought Heightens Scrutiny of Water Bonds

California's ongoing drought has begun to call into question the credit health of water revenue bonds across the state. Following Governor Jerry Brown's recommendation, the State Water Resources Control Board (SWRCB) approved new rules forcing municipal water systems and water districts to cut urban water usage by as much as 36% in some service areas. Recent articles in the *Wall Street Journal* and the *Los Angeles Times* highlight concerns that lower water usage will pressure revenues generated by municipal water utilities and the state's water districts, potentially threatening the ratings on bonds sold to finance water infrastructure projects.

Ascent has been closely following developments in California's water utility sector. We believe that some water bond issuers will face credit pressure as usage drops and the cost of purchasing water continues to climb for retail utilities. However, many issuers are well positioned to manage the pressures that water use restrictions may create. *Ascent does not take an all-or-none approach to the California water bond sector. We are opportunistic buyers of undervalued water revenue bonds that we believe exhibit solid credit characteristics. At the same time, however, we are actively reviewing all of our clients' holdings in the sector and will not hold positions in issuers we believe may be at risk for significant credit deterioration.* Our approach is driven by our careful fundamental analysis that examines the underlying characteristics of each issue and our significant experience investing in California water bonds.

California Feeling Parched

With the state enduring its fourth consecutive year of drought conditions, Governor Brown issued an executive order in early April mandating statewide water conservation efforts, including a 25% reduction in potable water use by water utilities and water districts. The SWRCB finalized rules on May 5th that implement the executive order and go some way in clarifying how the conservation efforts will be implemented. The finalized rules require local water departments to reduce water use as compared with 2013 levels, and are based on residential per capita water use.

Water systems with high levels of water use per capita and very little drop in usage since 2013 (Beverly Hills is a commonly cited example in the media) will face reduction targets of up to 36%. In contrast, systems with lower per capita water use that have made progress in reducing water usage, such as the San Francisco Public Utilities Commission and the Los Angeles Department of Water and Power, will face reduction targets in the range of 8% to 12%.

On the surface, it would appear that reductions in water usage would have direct negative impacts on water revenues and, consequently, hurt financial performance of local water utilities. While this simple analysis may be true in some circumstances, the effects of the conservation rules will be more nuanced for most issuers of water revenue bonds. Factors that are likely to affect the credit quality of water revenue bond issuers include:

- **The usage dynamics of the system** - As we mention above, the water use per capita and water reductions to date from the 2013 baseline mean different systems face very different conservation targets going forward.
- **The size of the system** - Small water systems often have less capability to deal with significant changes in cost structure or operations than larger systems.
- **The existing rate structure** - Systems typically charge water rates that have a fixed component as well as a variable component that changes based on consumption. The specific rate structure within a system will determine that system's vulnerability to usage volume reductions.
- **Sources of water supply** - Systems that purchase most or all of their water will experience declining operating expenses as they have to purchase less water to provide to customers. Systems that produce much of their water supply internally will not see the same reduction in purchased water expenses, but they are also more insulated from the impacts of rising per unit prices for wholesale water. The interplay between these factors is critical to the actual financial performance of a specific water system.
- **Leverage and liquidity** - Systems with higher leverage will experience greater pressure in trying to maintain financial metrics with a lower flow operating profile. Likewise, systems with higher liquidity will be better positioned to weather lower sales and maintain higher fixed cost coverage.

California's water utilities face a tough operating environment. As the cost of water increases, they will be challenged to meet conservation goals while maintaining solid financial margins and strong credit quality. Some water revenue bond issuers' ratings will come under increasing pressure over the next 12 to 24 months, and we believe that there will be selective downgrades. However, we also believe that there are many strong systems that are well positioned to handle these market challenges and maintain strong bond ratings.

Ascent's careful credit analysis allows us to find value for investors by looking for fundamentally sound bonds in market sectors that are out of favor. We believe the current market for California water revenue bonds represents such an opportunity.

Brian Tournier
Director of Research
Ascent Investment Partners

Disclosure: This newsletter is limited to the dissemination of general information pertaining to Ascent Investment Partners, LLC's ("Ascent Investment Partners") investment advisory services and general economic market conditions. This newsletter represents an assessment of the market environment at a specific point in time, is subject to change without notice, and should not be relied upon by the reader as research or investment advice. The information contained herein should not be construed as personalized investment advice, and should not be considered as a solicitation to buy or sell any security or engage in a particular investment strategy. There is no guarantee that the views and opinions expressed in this newsletter will come to pass. These views are subject to change at any time based on market and other conditions, and Ascent Investment Partners disclaims any responsibility to update such views.

Ascent Investment Partners is an SEC registered investment adviser with its principal place of business in the State of Missouri. Ascent Investment Partners and its representatives are in compliance with the current registration and notice filing requirements imposed upon registered investment advisers by those states in which such registration or notice filing is required. Ascent Investment Partners may only transact business in those states in which it is noticed filed, or qualifies for an exemption or exclusion from notice filing requirements. Any subsequent, direct communication by Ascent Investment Partners with a prospective client shall be conducted by a representative that is either registered or qualifies for an exemption or exclusion from registration in the state where the prospective client resides. For information pertaining to the registration status of Ascent Investment Partners, please contact Ascent Investment Partners or refer to the Investment Adviser Public Disclosure web site (www.adviserinfo.sec.gov). For additional information about Ascent Investment Partners, including fees and services, send for our Disclosure Brochure using the contact information herein.

Please note, past performance is not indicative of future results.