ENTERPRISE RISK IN THE MUNICIPAL MARKET

INTRODUCTION

More than five years after the end of the most recent recession, a number of local governments are still struggling to align stagnating revenues with increasing expenditures. In an attempt to bolster economic activity, some local governments have taken on projects that do not provide typical governmental services in an effort to produce a boost in revenues. These projects often times include arenas, stadiums, ballparks, manufacturing plants, and hotels, among others. This is certainly not a new trend in the municipal market, local governments have been funding these enterprises for a number of years, well before the most recent recession. In strong economic periods these projects operated well, bringing in adequate revenues to be self-sufficient. However, the recent recession exposed a number of these nonessential projects, as sputtering operations failed to provide sufficient revenues. The financial underperformance of these projects also highlights the actual exposure some governments have to noncore services. Often, the risks inherent in these projects may not always be clear and the local government's connection or obligation to the projects is not always understood.

Ultimately, the concern with financing noncore projects, or "enterprise risk", is that the underlying government may be required to provide financial support to an underperforming project. Shouldering the financial burden of a project could cause severe stress, especially if the local government has already experienced a weakened tax base, growing pension and benefit costs, and depleted reserves.

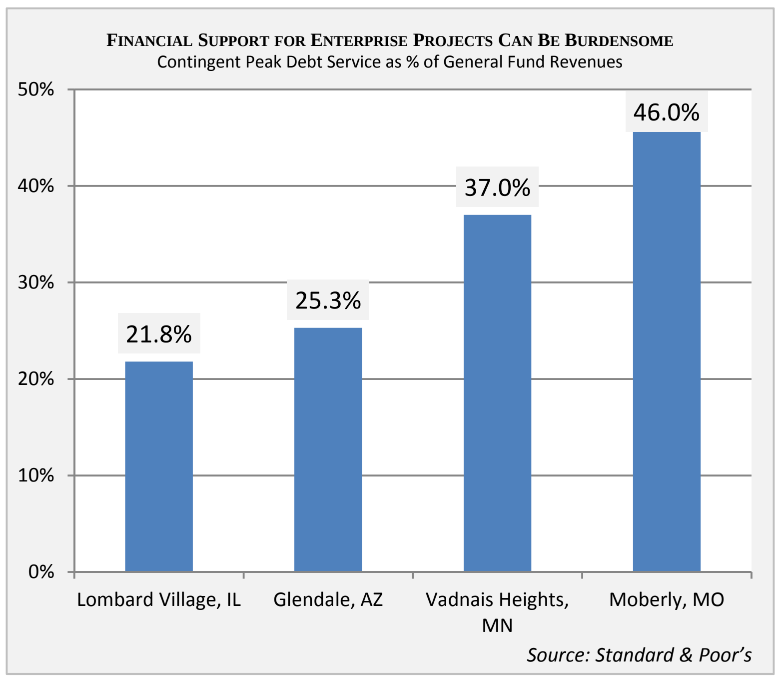
In this publication, we will aim to define what enterprise risk is, highlight what may happen when projects don't meet expectations, and discuss how investors might minimize exposure to enterprise risk when investing in municipal bonds.

WHAT IS ENTERPRISE RISK?

Within the Municipal market, enterprise risk is defined as the undertaking of a project that involves a purpose or use that is non-essential and not associated with typical governmental services. As discussed above, examples could include sports stadiums, golf courses, office buildings, or hotels, but are certainly not limited to these.

The financing of these projects can take a number of forms. For instance a sponsoring government could provide a backup pledge in the event net revenues from the project were insufficient to cover debt service. This pledge typically takes the form of a broad promise to appropriate funds from the government's general fund. Other times, the sponsoring government could directly provide a general obligation pledge, with the idea that operating revenues from the project or indirect economic revenues (e.g. sales taxes or incremental property taxes) will help offset the cost of debt service. From an investment standpoint, the security provisions of the financing can have a significant impact on that specific bond's rating, yield, and price performance. However, from a broader credit analysis standpoint, we view the undertaking of non-essential projects, no matter what the financing structure is, as a form of enterprise risk as long as the sponsoring government has clear and direct financial exposure. It's important to point out that small towns and cities are not the only ones subject to enterprise risk. We continue to see media attention given to the financing of sports stadiums by states and large cities. However, the risk to smaller governments is typically magnified, as the financial burden to support the project represents a greater share of total government resources. The chart above illustrates the potential burden enterprise projects can have on the sponsoring government.

The Cost to Support Poorly Performing Projects can Overwhelm Local Government Budgets



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EXAMPLES OF ENTERPRISE RISK IN THE MUNICIPAL MARKET

The following examples demonstrate the adverse impact a project can have not only on the debt that financed the project, but on the underlying sponsoring government. We note that these examples highlight the negative consequences of non-essential projects, but there are instances of projects that spur economic activity and have been a boon to the sponsoring government. We will discuss at the end of the publication why we believe the downside risk typically outweighs the potential benefits.

MOBERLY, MO

In 2010 the City of Moberly, MO's Industrial Development Authority issued $39 million in debt to build a sucralose (artificial sweetener) manufacturing facility to be operated by Mamtek, US Inc, a subsidiary of a larger Chinese firm. The City pledged to appropriate from its general fund to cover debt service but fully expected receipts from the plant to cover the expense. Unfortunately, Mamtek turned out to be a fraud and the company failed to make its first lease payment, walking away from the facility mid-construction. Citing the significant financial burden the debt service payment would have required, Moberly officials chose to default on the city's obligation. Moberly saw its bond rating drop as the market penalized the city for a lack of willingness to honor its obligations. At the time of the financing in June 2010, S&P rated Moberly "A" with a stable outlook. In the most recent review in December 2013, Moberly's rating had dropped nine notches to "B", deep within sub-investment grade territory.

In this case, fraud was the driving force behind the city's problems, but it is a good example of what can happen when a smaller local government shoulders the financial burden of a failed enterprise project.

GLENDALE, AZ

Financing and supporting sporting facilities has long been an underlying economic development theme of Glendale, AZ. City-financed projects include the Gila River Arena (formerly Jobing.com Arena), home to the National Hockey League's Arizona Coyotes, and Camelback Ranch, spring training home for two Major League Baseball teams. Unfortunately, those projects have come at a net cost to the City, as large amounts of debt and underperforming operations have required significant financial support.

Glendale spent $220 million to construct the Gila River Arena, pledging a portion of the city's excise tax to secure the bonds. Poor attendance and financial mismanagement led to a bankruptcy filing by the hockey team, hefty operating subsidies were paid by the City to the NHL to keep the team afloat, and additional financial concessions were assumed by Glendale in an effort to convince team owners to remain in Glendale. The net annual cost to Glendale is approximately $12.9 million, even when including excise tax revenues and revenue-sharing agreements with the team. In a separate transaction, Glendale spent $200 million in 2009 to build the Camelback Ranch facility to host spring training for the Los Angeles Dodgers and Chicago White Sox. Operating revenues of the facility are negligible and the city pays approximately $13 million a year in debt service, taking significant dollars away from essential government services.

Glendale is a good example of how a relatively large city can succumb to the risks of supporting non-essential projects. While the city's decline is not as drastic as Moberly's, the effects are still significant. S&P rated the City of Glendale as high as "AA" in May of 2010. Today, Glendale's general obligation rating is "BBB+", a decline of five notches.

Rating Consequences of Enterprise Risk

Some Issuers Who Have Experienced Credit Deterioration Due to Enterprise Risk	S&P GO or Equivalent Rating 2010	2014
Glendale, AZ	AA	BBB+
Lombard Village, IL	AA+	B
Moberly, MO	A	B
Vadnais Heights, MN	AA	B
Wenatchee, WA	A	BBB

Source: Standard & Poor's

CONCLUDING THOUGHTS

As the national economic recovery continues to grind along, there are regions and areas within the country that have not benefited from a return to growth. Government officials in those specific geographic areas are contending with stagnating revenues and ever-growing expenditures. As that gap between reoccurring revenues and expenditures grows wider, some officials are willing to take a leap of faith that a hockey arena, a hotel and convention center, or a water park will be the key to sparking economic development and increased revenues. A few may succeed, but others will fail, leaving both the municipality and its constituents, such as citizens and businesses, saddled with the unpaid bills. We acknowledge that not all enterprise projects are negative and that it may be impossible to completely avoid enterprise risk altogether. In fact, many of the largest and most prolific issuers in the municipal market have financed non-essential projects to some degree. However, large municipalities can typically afford to take modest risk with the comfort that a broad and diverse economic base, healthy financial reserves, and diverse revenue sources can offset the potential burden of a failed project.

We think the most significant risk lies in smaller local governments that are overly reliant on the success of one or a few projects for economic development. While the highest degree of risk lies in project-specific debt, it is also important for investors to appreciate the indirect risks that a project can have on the underlying municipality. According to Moody's, of the twelve rated local government defaults since 1970, one-third were sparked by enterprise risk. In the case of small local governments, it is not sufficient enough to hold the general obligation debt while avoiding the project-specific bonds. In the worst case scenario, that city may be required to provide financial support, forcing management into a difficult decision between risking default and financing typical governmental services. We believe these risks, which are often hidden, highlight the need for independent and in-depth credit analysis. Proper vetting and prudent ongoing surveillance are necessary for identifying and avoiding undue exposure to enterprise risk. In addition, maintaining a disciplined preference for large, well-established local governments that benefit from a broad economy and diverse sources of revenue largely insulates investors from the potential adverse effects of a failed project.

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Nate Harris
Assistant Vice President