APPLETON PARTNERS, INC.

SPECIAL TAX BONDS: SCRUTINIZE PARENTS, NOT JUST THEIR OFFSPRING

IT'S WORTH TAKING A CLOSER LOOK

Sometimes it's prudent to dig more deeply, whether evaluating the risk of a child's credit application, or a special purpose bond offering.

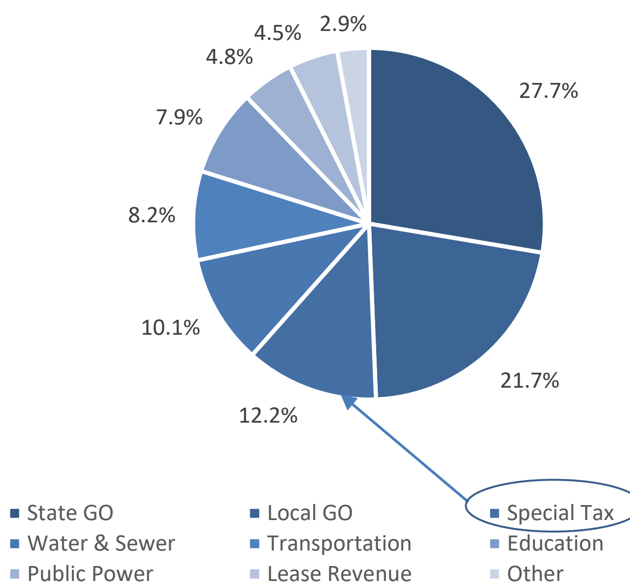
In a recent public release, S&P Global Ratings published revised criteria for special tax bonds titled "Priority-Lien Tax Revenue Debt" on October 22, 2018. Eight days later the agency lowered its rating on Build Illinois senior and junior lien sales tax bonds five notches to "BBB" from "AA-." In what many have called a "super downgrade", the rating change called attention to an ongoing debate in the municipal market concerning whether a Special Tax Bond should have a materially stronger credit profile than its sponsoring government entity, or "parent".

WHAT IS A SPECIAL TAX BOND?

In creating the Build Illinois Bonds, the State of Illinois enlisted a common municipal financing strategy whereby a dedicated revenue stream is carved out of the sponsoring government's overall operations to back a special tax bond offering. By segregating a distinct revenue stream, the issuing entity aims to create a financing vehicle that benefits from a stronger credit profile, thereby potentially leading to a higher rating and lower borrowing costs. In this case, the State dedicated a portion of its sales taxes to the Build Illinois program and pledged these revenues to the entity's bonds.

Special Tax Bond proceeds can serve beneficial purposes such as funding valuable projects or infrastructure, thereby helping issuers more cost effectively address social and economic development needs. At Appleton, we regularly evaluate and periodically invest in Special Tax Bonds, often taking a degree of comfort in the dedicated revenue streams and associated debt service coverage.

Municipal Managed Money Short/Intermediate Index: Sector Composition (as of 10/31/18)



Source: Bloomberg Index Services Limited

CREDIT OBSERVATIONS AND IMPLICATIONS

Nonetheless, we strongly believe that analysis of Special Tax Bonds ought to also emphasize the health of the sponsoring issuer, or "parent." This reflects inherent overlapping economic attributes, as well as the potential risk that a deteriorating fiscal situation at the issuing government level could test the legal structure of the associated Special Tax Bond program. Lending to the "child" without scrutiny of the "parent" is imprudent in our view. It should be noted that we do not own Illinois GOs or Build Illinois bonds in any client accounts. S&P's multi-notch downgrade of the Build Illinois Bonds reinforces the importance of extending due diligence analysis beyond the specific security in question.

S&P's criteria change establishes a greater emphasis on the ultimate obligor, limiting the rating of a Special Tax Bond to no more than four notches above the issuing government's credit rating. We concur with S&P's decision, as credit deterioration at the government level often raises material liquidity and budget management concerns, particularly among higher risk entities. These scenarios heighten the risk that revenues previously thought to be "ring-fenced" could be put "in play" in a worse-case scenario. S&P indicated that of their approximately 1,300 special tax ratings, 15%-25% would not change, 40%-50% would rise or fall one notch, 15%-25% would change two notches, and 10%-20% would change three or more notches.

We welcome S&P's guidance, as it reaffirms a core element of our longstanding research process and will not alter our credit analysis or security selection. Although we rely upon 3rd party credit ratings for relative value analysis purposes, our approval of bond issuers has always been based on proprietary credit analysis and an internal credit scoring system.

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PORTFOLIO IMPACT WILL LIKELY BE LIMITED

The impact of these developments on our client portfolios should be very limited. In some cases, we may already rate bonds likely to be downgraded by S&P as higher risks than others looking more narrowly at an issue's dedicated revenue streams. Furthermore, certain names likely to be downgraded by S&P have traditionally traded with excess spread premium relative to their S&P rating. Such situations may reflect bond market credit concerns, and/or lower ratings assigned by other rating agencies.

More broadly, although we will opportunistically monitor the market's reaction to any rating changes, we do not expect widespread credit spread movement at the individual or special tax sector level. Nonetheless, the multi-notch downgrade of the Illinois Sales Tax Bonds by S&P is a meaningful credit development, as it highlights the importance of thorough, independent research. Not only is analysis of the specific bond essential, linkage and overlapping fundamentals of the sponsoring issuer and associated obligors can be revealing. Credit deterioration at a higher level may have follow-through effects on other obligors, requiring timely and proactive action by investment advisors.

Simply put, there's no substitute for a broader perspective.

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