Appleton Partners, Inc.

2024 Appleton Partners Municipal Sector Outlook

APPLETON PARTNERS
2024 MUNICIPAL SECTOR OUTLOOK

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APPLETON PARTNERS, INC.

SECTOR OUTLOOK

STATE GOVERNMENTS

Outlook: **Stable (maintain)**

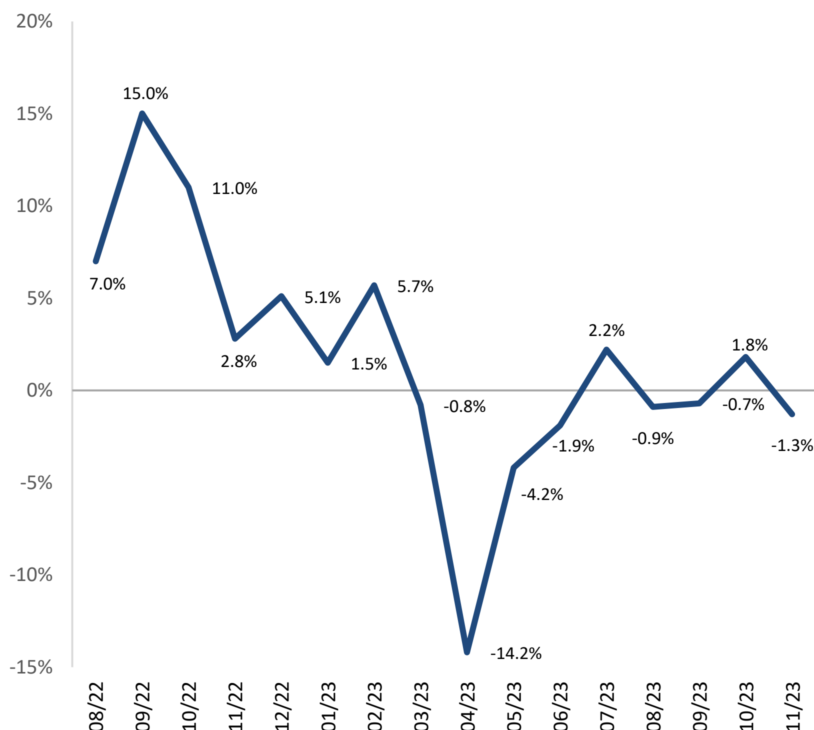
Sector Overview & Outlook:
We are maintaining our "stable" outlook for the State sector, acknowledging that an expectation for weaker economic activity will be manageable for most states given large reserve balances, conservative spending plans, and ample budgetary flexibility.

Our expectation for a softer tax collection environment in 2023 proved correct, although it was still adequate for most states. The softening witnessed in late 2022 carried through this past year with collections flat to slightly down for most states, with some notable exceptions in April as those states relying on capital gains materially misjudged 2022 investment market performance.

State budget officers entered the current fiscal year (ends 6/30/24 for most) with a cloudy vision of what the economy would look like. Prudently, most incorporated that uncertain view into their spending plans, with proposed expenses up a limited 2.5% from FY 2023 according to the National Association of State Budget Officers (NASBO). Even if budget forecasts turn out to be overly rosy, states continue to maintain significant reserves that can offset disappointing revenue collections. According to the NASBO Spring 2023 Survey, median rainy day fund balances at the end of 2023 covered 12.0% of annual expenses, substantially higher than the 6.8% average over the previous 10 years. Multiple years of strong tax collections have also allowed states to reduce balance sheet liabilities, utilizing excess revenues to pay down debt and make supplemental pension plan contributions.

We expect most states to maintain relatively solid credit profiles in 2024. Robust reserves, budget flexibility and reduced fixed costs provide strong offsets to a potentially weaker economy. For those states already facing budgetary pressure, implementing structurally sound measures while largely avoiding one-time gimmicks will be key to credit stability. A shimmer of hope came through surprisingly positive 2023 equity market returns, which may bode well for states with an above average reliance on capital gains taxes. As an example, California's steep revenue underperformance in 2023 and large projected out-year deficits may be partially mitigated by strong income tax receipts in April 2024.

We are also focused on those states that over-relied on federal pandemic aid to cover recurring costs. As this aid nears depletion, will it unearth structural deficits that need to be reined in? Diligent, issuer-specific budget analysis will help to identify challenged states and will be incorporated into our investment actions.



APPLETON PARTNERS, INC.

SECTOR OUTLOOK

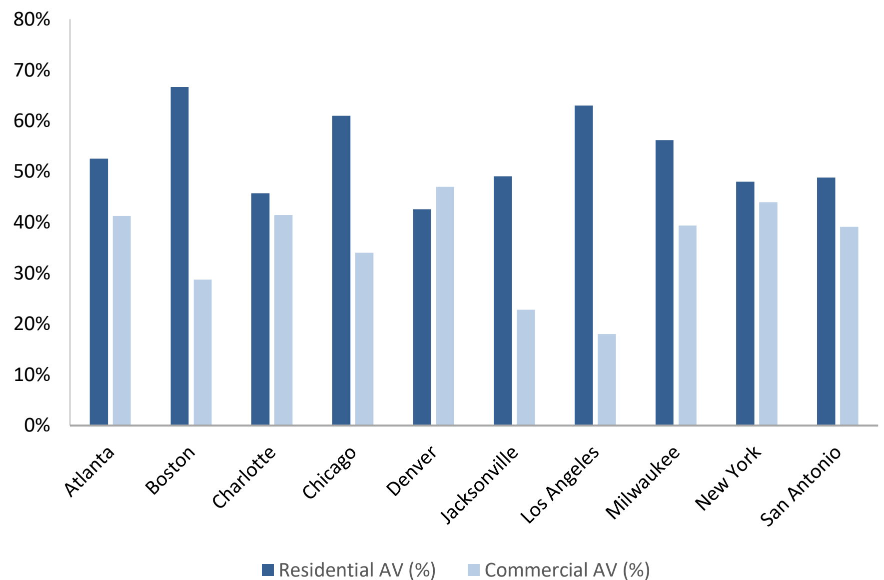
LOCAL GOVERNMENTS

Outlook: **Stable (maintain)**

Sector Overview & Outlook:
A key to Local Government credit stability lies in the extent to which there is reliance on property taxes to support budget spending. Although revenue mix varies, property taxes are often a local municipality's primary revenue driver, and this is a source of revenue that tends to be relatively stable throughout economic cycles. Commercial real estate is a risk factor that has garnered our attention, most notably in the office market. A difficult cycle is not over, and conditions could weaken in 2024 as asset owners and lenders capitulate. Economic vibrancy, demographic trends, balance sheet resources, and prudent budgeting are all factors we carefully evaluate when assessing a local issuer's credit stability.

Property tax revenues tend to exhibit less volatility than income or sales taxes, an attribute that should benefit local governments if economic activity continues to soften. There is also a 1 to 2-year lag between market value changes and property assessments, providing budget officers ample time to adjust. While office real estate remains a challenge (see below), residential housing remains strong, supported by structural demand/supply imbalances and low available inventory. As a result, we expect local government revenue performance in 2024 to be relatively stable.

Hybrid work schedules appear to be here to stay, resulting in elevated office vacancies and weaker foot traffic in Central Business Districts. However, this is not a new phenomenon and cities have largely accepted the reality that downtowns have changed, requiring a rethinking of property utilization. In the meantime, office property values continue to decline, a dynamic that will have a negative impact on property taxes. The actual impact will vary by city, and we note that residential is typically a larger percentage of a city's assessed value. For those cities with above average commercial exposure, revenue diversity away from property taxes provides a strong offset. Declining office valuations and a rethinking of downtown districts will be a multi-year development and a trend that cities will adjust to over time. We do not believe it is a revenue cliff, despite some alarmist media headlines to the contrary.



Source: Issuer Financial Disclosures

Other risks we are monitoring include potential state budget cuts, federal pandemic aid depletion, demographic trends, and costs to shelter migrants. Given uncertain economic trends that have the potential for further softening, we favor Local Governments that serve vibrant economies, continue to attract businesses and residents, generate locally sourced revenues that reduce reliance on state aid, and have proactively managed long-term liabilities such as debt and pensions.

Appleton Partners, Inc.

Sector Outlook

Healthcare

Outlook: **Cautious (maintain)**

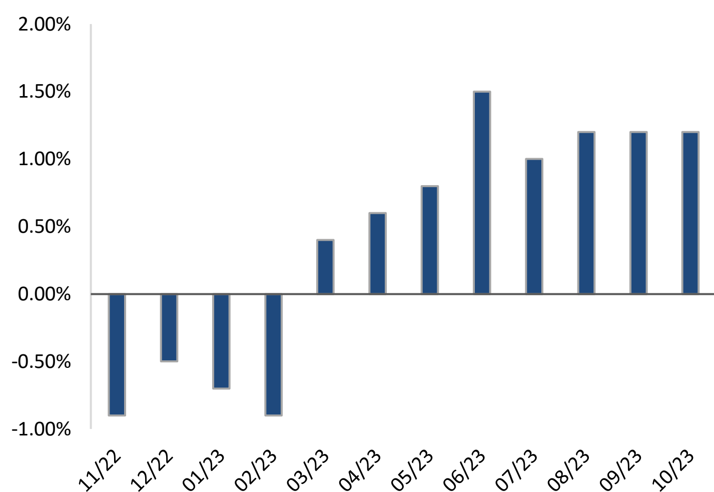
Sector Overview & Outlook:

The healthcare sector has been challenged by ongoing staffing shortages, supplies inflation, and wage growth since the onset of the pandemic. These challenges have remained significantly more persistent than many healthcare systems had anticipated, producing modest margin growth as FY 2023 margins are reported. While expenses remain burdensome, inflation and wage growth are expected to grow at more manageable levels and the sector has made headway in revenue improvement, thereby contributing to our expectation of marginal profitability improvement. While we feel healthcare systems will be able to achieve sustainable margins over the long-term, margins should remain compressed in 2024, driving our cautious outlook.

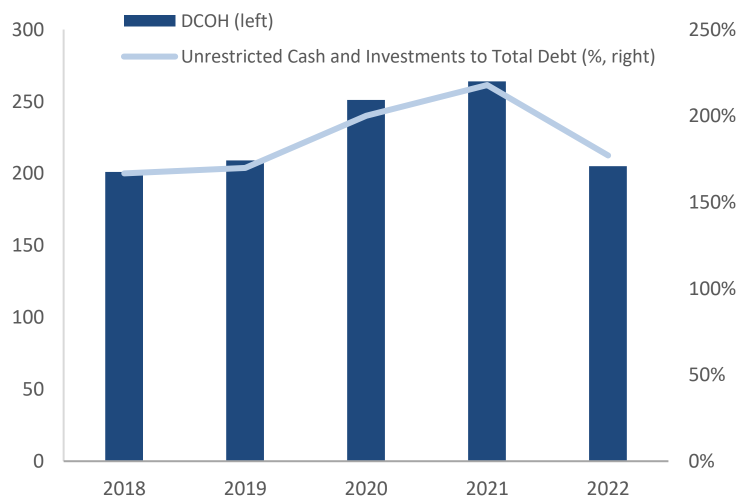
Persistent inflation remains a key concern for healthcare credits moving into the New Year. Contrary to prior years, many systems are starting to see their expense control efforts come to fruition, with many focusing on improving efficiencies across hospitals and utilizing advancements in technology to improve productivity across a myriad of departments. Many hospitals have also been able to mitigate contract labor and improve employee turnover which has helped alleviate wage pressure. Nonetheless, increased union activity across the nation may make labor negotiations more contentious, thereby increasing the likelihood of wage pressures.

On the revenue side, many systems have been able to negotiate higher insurance reimbursement rates. Large systems have been able to expand high margin outpatient facilities to attract patients and improve profitability. Volume recovery has also been positively impacted by stabilizing staff turnover, as well as through a focus on freeing up inpatient capacity by reducing the average length of stay. These factors should lead to operational improvement, although we expect margins to remain below levels that would be supportive of needed capital investments and balance sheet growth.

We believe opportunities remain in large multistate systems that have significant resources to combat the persistent short-term challenges. Large healthcare systems also typically have seasoned management teams that are much better equipped to make critical operational decisions and sustain the performance needed to excel in a unique environment.



Source: Kaufman Hall



Source: Moody's Investor Services

SECTOR OUTLOOK

HIGHER EDUCATION

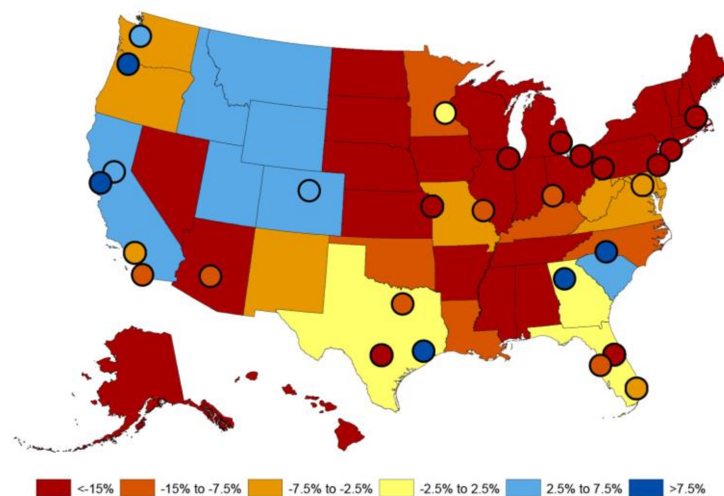
Outlook: Stable (maintain)

Sector Overview & Outlook:

We are maintaining a stable outlook on the Higher Education sector but note that that we do see weakening credit fundamentals among issuers further down the credit spectrum. Our research team prefers large, flagship state universities, as well as well known, highly selective private colleges. We expect that credit conditions among issuers in this space, while certainly facing headwinds, will remain stable in the coming year, aided by strong management teams, healthy financial reserves, and strong demand profiles.

Shifts in both demographics and sentiment towards the value of a college degree continue to pressure the overall sector. While the US birth rate is declining, certain regions are particularly challenged. Colleges and universities are preparing to face what some are calling a longer term “enrollment cliff,” essentially a sharp drop in the college-aged population that is expected to arrive in 2025 due to a declining US birth rate. This demographic trend will produce a decreasing pool of students, which in turn leads to increased competition from an enrollment perspective. As potential investments, we seek out colleges and universities with stable to improving enrollment trends (enrollment count, acceptance rate, matriculation rate). Of note, enrollment has yet to return to pre-pandemic levels at many colleges and universities.

Forecast Change in % of College-Aged Population Attending Higher Education(2012-2029)



Source: Nathan D. Grawe, Carleton College.pdf

Favorably, endowment returns in FY 2023 averaged +8.7%, vs. an average loss of 10.2% the prior year. Volatility in the capital markets is impacting bottom line performance across US colleges and universities, as they not only rely upon investment performance for annual endowment spending but also annually report realized and unrealized investment gains in their audited financial statements. Our research team looks to colleges and universities with diverse revenue streams and formal endowment spending policies to help mitigate investment performance.

The higher education space has recently incurred widespread expense pressures driven by high inflation and increased labor costs. This is particularly true at institutions with large healthcare components, as staffing shortages and labor strikes continue to push salaries upward. The higher education space is particularly vulnerable to wage pressures given that roughly two-thirds of their expenses are personnel related. Tuition increases are one of the primary cost recovery tools utilized by higher education institutions. Median tuition increases for S&P rated public and private universities were +2.5% and +3.0%, respectively in FY 2022, vs. a +3.2% rate of inflation.

In June 2023, a US Supreme Court ruling restricted the use of affirmative action in the college admissions process. This decision is expected to modestly increase expenses as institutions seek new ways to foster diversity, such as modifying existing admissions processes, hiring new staff to implement new strategies, and restructuring financial aid practices.

Finally, reliance on state aid in the public education space is a historical trend we are actively monitoring given the potential for an economic slowdown, as states often cut appropriations for higher education during weaker cycles. Positively, we currently view state credit as stable and see this as more of a longer-term credit concern.

Sector Outlook

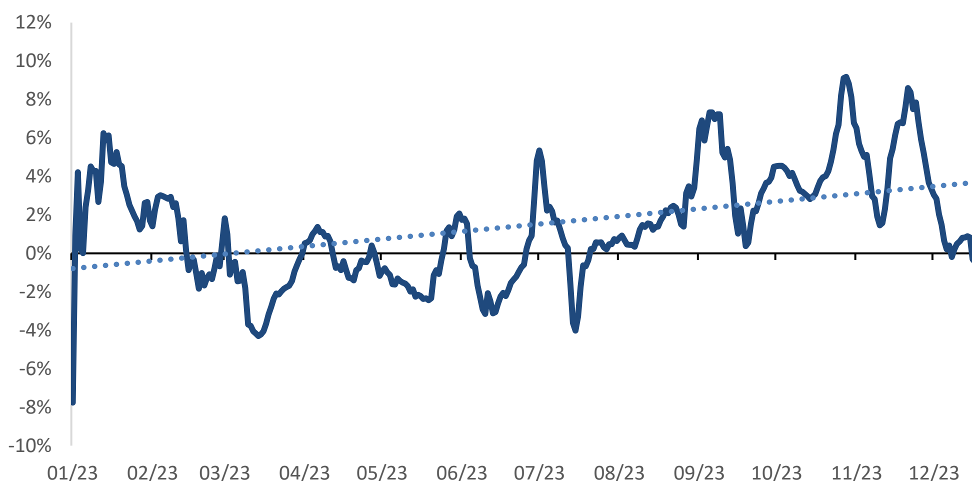
Airports

Outlook: Stable (maintain)

Sector Overview & Outlook:

Passenger activity continued to improve in 2023, with TSA passenger volumes up 12.2% YoY. Importantly, activity surpassed pre-pandemic levels in mid-August, with YTD activity through 12/17 up 1.3% vs. 2019. That said, as seen below, the pace of growth began to slow toward year-end, with December activity essentially in-line with 2019 levels.

This trend of slower, uneven growth is very likely to persist throughout 2024, largely due to the expected weakening of the consumer and related reduction in discretionary spending. This should lead to lower demand for leisure air travel, with activity projected to increase by just 2% in 2024. This slower growth will have an outsized impact on smaller airports that relied on lower-cost carriers and leisure travel to recover over the past 2+ years.



Source: Transportation Security Administration

In addition to an expected decline in demand, the sector will be challenged by increased issuance to fund substantial capital plans. Moody's estimates that the largest airports in their rated universe will issue $60B through 2029, up from an estimated $50B earlier this year. This increase is due to a combination of higher costs due to inflation and an increase in scope given the rapid recovery in activity.

Importantly, airports enter this period in a very strong financial position, with substantial reserves and strong leverage profiles. Management teams may also be able to moderate spending plans should demand for air travel begin to decline, reducing the need for additional debt in the near term. Additionally, even with this expected increase in leverage, projected slower growth in 2024 will still allow most issuers in the sector to maintain a leverage profile in line with historical averages.

Given a more challenging operating environment in 2024, we prefer large hub airports as well as select smaller regional airports that benefit from a dominant market position with a consistent passenger demand profile. Strong management teams will again prove important as airport systems manage increasing capital needs and a volatile demand profile. Those able to adapt quickly will be better able to maintain strong credit profiles.

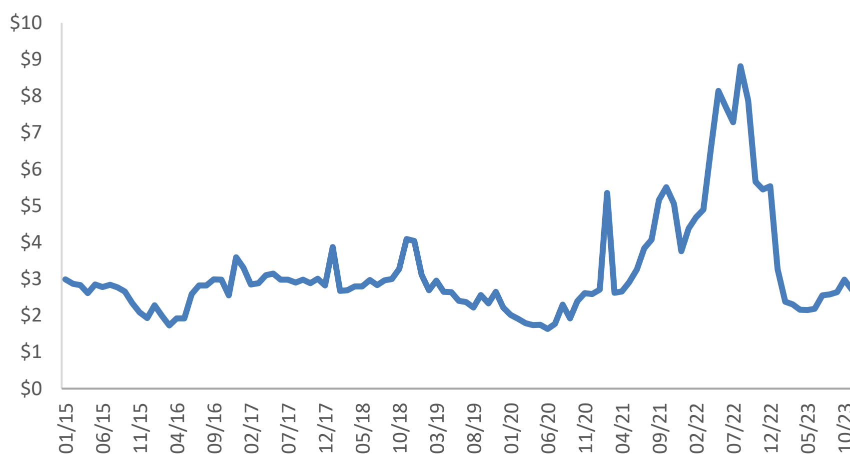
Sector Outlook

Public Power

Outlook: **Stable (maintain)**

Sector Overview & Outlook:

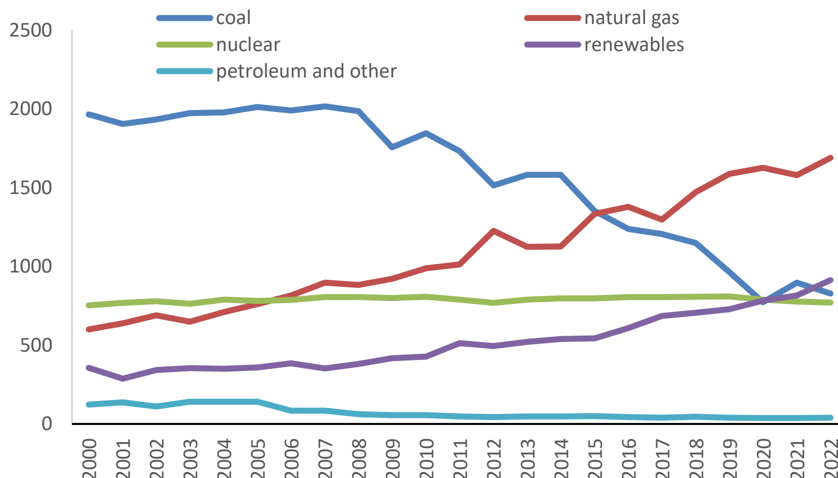
We are maintaining a stable outlook on the Public Power sector. The last year was not without challenges in the sector as extreme weather events and volatility in natural gas prices resulted in increased costs for many public power issuers. Natural gas remains a growing portion of public power supply portfolios. Price volatility during FY 2022 resulted in higher-than-average expenses for issuers reporting financials during calendar year 2023. Favorably, public power entities benefit from the ability to pass on increased expenses to consumers through largely unregulated rate increases. These can be addressed by management during intra-year adjustments, or in some cases are part of automatic pass-throughs built into the rate structure.



Source: Thomson Reuters

Rate fatigue may be an issue in 2024, particularly in the event of an economic downturn. As such, we are very selective in this space and invest in issuers with the strong liquidity needed to mitigate potential cost pressures.

Longer-term, the public power sector could be challenged by the need to invest in renewable resources to meet regulations under the US Inflation Reduction Act, as well as at the local level pursuant to state legislated emissions targets. Large scale projects could prove to be particularly costly given the current labor and supply market. Favorably, the US Inflation Reduction Act includes tax incentives and credits that will defray the costs of such investment, though how these will be implemented remains to be seen. We are seeking investment opportunities with issuers that have strong management teams and well-planned capital improvement programs that factor in the need to invest in renewables.



Source: US Energy Information Administration, Monthly Energy Review and Electric Power Monthly, February 2023; preliminary data for 2022

Overall, our investment thesis remains largely unchanged from last year. We still prefer Public Power issuers with strong, reliable service bases, consistent debt service coverage levels, and ample liquidity and financial resources. Given the defensive nature of the sector, we believe that ongoing cost pressures will be largely mitigated by issuers' ability to pass along expenses through rate adjustments. Liquidity and debt levels will remain a focus moving forward as we enter what is likely to be a large capital investment cycle.

SECTOR OUTLOOK

TOLL ROADS

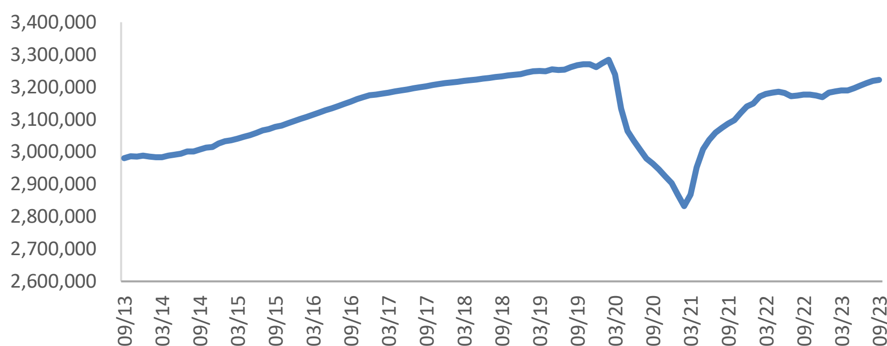
Outlook: Stable (maintain)

Sector Overview & Outlook:

Toll Roads saw sustained traffic growth through the year, with total vehicle miles traveled increasing +2.2% YoY though September, now trailing 2019's prior high by only 1%.

Total Vehicle Miles Traveled (9-Months Ended):	
9.30.23	2,430,206
9.30.22	2,377,645
9.30.21	2,340,750
9.30.20	2,157,274
9.30.19	2,455,727

Moving 12-Month Total Vehicle Miles Traveled



Source: Federal Reserve Economic Data, Federal Reserve Bank of St. Louis

Toll revenue has already surpassed the prior high given largely CPI-linked toll increases over the past two years, despite some systems choosing to raise tolls less than policy allowed given affordability concerns. This growth in revenue has allowed sector debt service coverage to return to about 2x and enabled average liquidity to remain above 1,000 days cash on hand. In aggregate, the sector enters 2024 with a very strong credit profile.

Nonetheless, there are some headwinds that should put a damper on growth and likely weaken liquidity metrics in 2024:

- A potential economic slowdown would lead to lower consumer spending and a reduction in commercial traffic. We are already seeing what had been a sharp increase in commercial traffic during the post-pandemic recovery period returning to historical levels. This could have an outsized effect on revenues given the materially higher tolls commercial vehicles pay.
- Toll systems remain committed to funding the large capital plans that were put on hold during the pandemic, with higher borrowing costs likely leading management teams to spend down their substantial liquidity to help maintain a stable leverage profile.
- The significant increase in tolls seen over the last few years is expected to moderate given a decline in inflation, removing one of the main contributors to the sector's credit strength over the last few years.

Despite these challenges, we anticipate the Toll Road sector will sustain its growth, albeit at a slowing rate. Traffic is expected to meet or exceed the prior high and toll rates should increase by about 2% YoY, both developments that point to growth in revenue. This growth will allow the leverage profile of sector issuers to remain sound even as debt is brought to market to fund the large capital programs. Liquidity will likely weaken from the 1,000+ days cash on hand over the last few years but should remain very strong and supportive of the sector's stable credit profile.

While our stable outlook remains, we prefer large toll systems that cover a broad, economically vibrant service area providing an essential travel route to growing populations. We also look for systems supported by strong, seasoned management teams that demonstrate a track record of maintaining strong liquidity and leverage profiles as this points to an ability to manage a more challenging operating environment in the coming year.

SECTOR OUTLOOK

WATER & SEWER

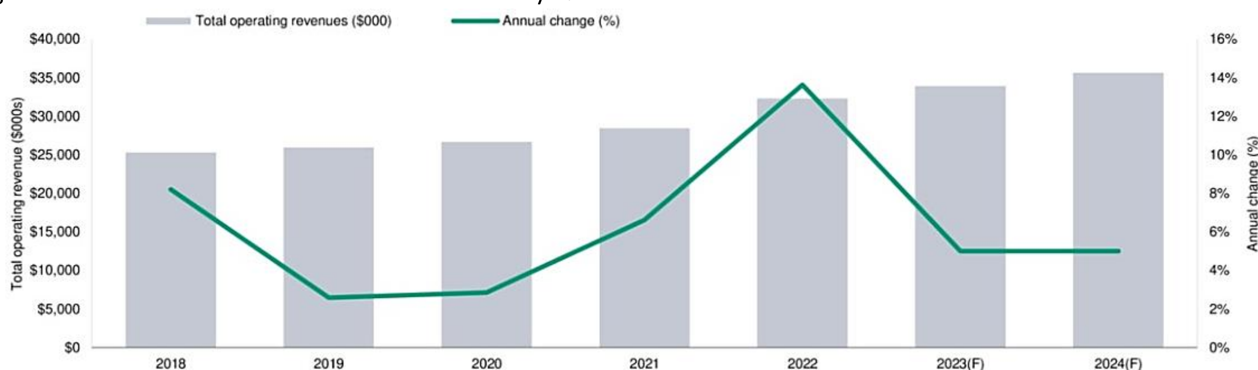
Outlook: **Stable (maintain)**

Sector Overview & Outlook:

Water & Sewer issuers benefit from being essential service providers with rate setting autonomy. We are maintaining our "stable" outlook on the sector, supported by expectations of sustained revenue growth driven by rate increases, strong liquidity, solid debt service coverage, and overall demand inelasticity.

Many utility providers in fiscal years 2020 and 2021 provided rate relief during the height of the COVID-19 pandemic in the form of smaller than normal rate increases, by pausing rate increases, or through payment relief. However, this practice has largely stopped as the peak of the pandemic has passed, and many water and sewers issuers returned to rate hikes for fiscal years 2022 and 2023. Per Moody's, rate increases are expected to climb in the coming year, and overall operating revenues are projected to increase by 5% in 2024. While still below the prior five-year average of almost +7%, this should outpace anticipated expenditure growth of 4%. We foresee surplus operations supporting ongoing liquidity growth, while also producing solid debt service coverage metrics.

Operating Revenue for Water & Sewer Utilities Will Grow by 5% in 2024



Source: Moody's Investors Service

However, the Water and Sewer sector is not without challenges. The need for capital investment continues to pressure bond issuers. Capital investments include a need to expand systems to meet growing populations, as well as funding projects that address evolving environmental standards. For example, over the last decade many sewer issuers signed consent decrees with the EPA concerning combined sewer overflows. While these projects are typically large in scale and expense, they are often undertaken over multi-year time periods and are eligible to be subsidized by the Federal government through lower interest rate loans.

Looking ahead, Water issuers may face a similar test with proposed federal legislation related to per-and-polyfluoroalkyl substances (PFAS). While many states already have parameters in place for acceptable levels of PFAS in drinking water, the Congress in 2023 introduced legislation that will mandate lower levels of PFAS in water, at a total cost of up to $3B across the sector (as per S&P). When coupled with aging infrastructure, these regulatory pressures are expected to present ongoing challenges. Many Water and Sewer issuers are likely to defer regular capital maintenance to the extent possible due to higher construction costs and elevated borrowing costs.

Drought conditions continue to plague sizeable areas of the country, particularly Texas and other areas of the Southwest. We expect drought conditions and an overall increase in extreme weather events to remain an issue due to the impact of climate change. Per the National Oceanic and Atmospheric Association (NOAA), by August the US had experienced 23 separate, billion-dollar weather and climate disasters in 2023, the highest on record. Our bond selection in this sector remains focused on utilities with access to sustainable water resources, those that demonstrate a viable long-term supply plan, and have the liquidity needed in the event an extreme storm disrupts operations.

SECTOR OUTLOOK

MASS TRANSIT

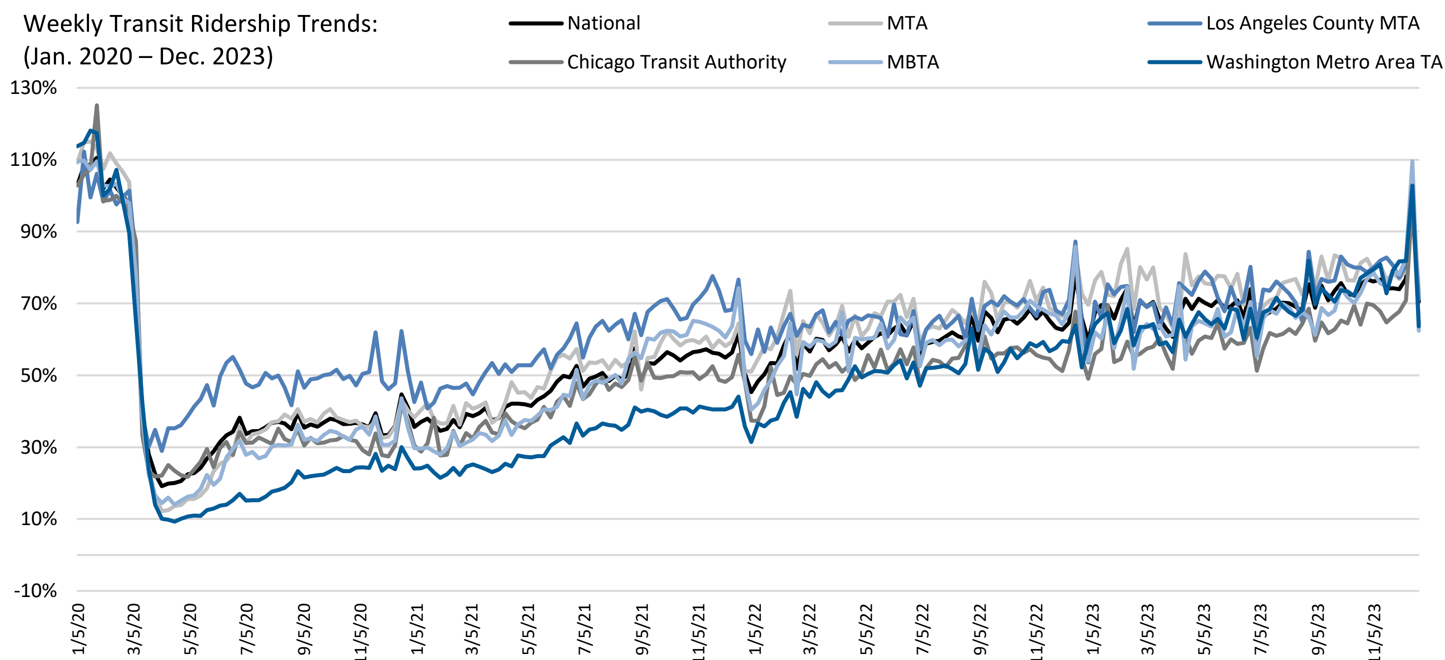
Outlook: Cautious (maintain)

Sector Overview & Outlook:
The Mass Transit sector has faced significant ridership challenges since the onset of the pandemic. Many systems are now confronting stagnating volume recovery and are being forced to adjust to what appear to be long-term lower ridership levels. These challenges could cause financial difficulties for many transit systems if assertive actions are not taken to combat revenue loss. Federal aid had been used to temporarily bridge the gap, although with stimulus funds drying up as soon as 2024, transit systems will have to find new revenue streams.

Most systems already rely heavily on tax revenues derived from the economies they serve and, although these revenue sources are typically relatively stable, slowing economic growth and consumer spending in 2024 could be a drag on system revenue. Transit providers will need to cautiously budget and adjust expenses and capital spending accordingly.

Revenue reliance on state aid is also likely to become increasingly necessary, a concern somewhat offset by the critical role transit systems play in local and regional economies. While we value this essentiality and recognize the importance of state and federal aid, this revenue source can be volatile given the need for annual appropriation and the ability of states to reduce funding during weak economic periods. These revenues are also vulnerable to fluctuations resulting from service reductions or operational adjustments aimed at reducing the costs of underutilized service lines. Overall, sustaining financial flexibility and operational excellence has become increasingly challenging for most mass transit systems in an age of new ridership norms.

Our Credit Research team favors mass transit systems that are economically essential, enjoy strong voter support, have debt secured by dedicated tax revenues, and benefit from healthy local economic conditions. Appleton has historically been inclined to invest in issuers characterized by relative revenue stability, ample debt coverage, and those that segregate revenue to fund debt service before operations.



Source: American Public Transportation Association, https://transitapp.com/apta

Appleton Partners, Inc.

Sector Outlook

Ports

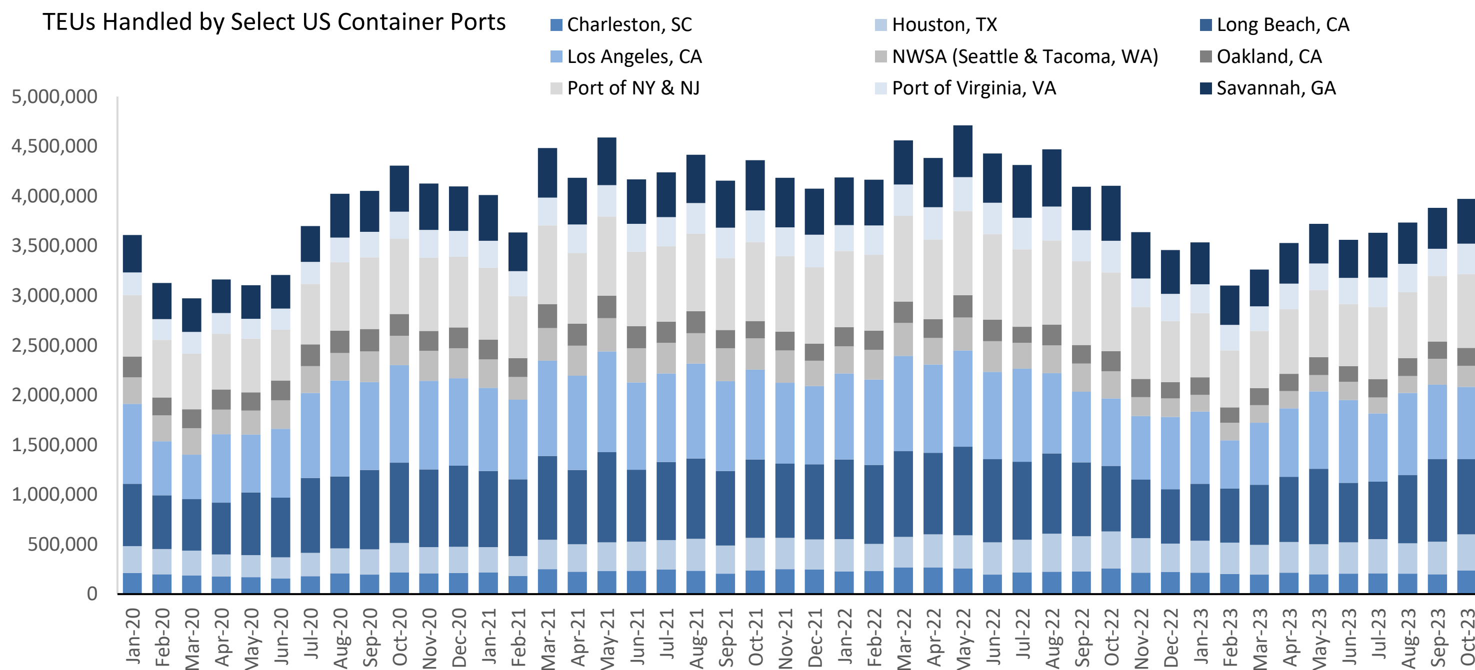
Outlook: **Stable (maintain)**

Sector Overview & Outlook:

Cargo volume is expected to increase at a modest 2% rate in 2024, a result of tepid GDP growth, modest consumer spending, and leaner inventories. This follows a significant contraction in 2023, a year in which cargo volumes are expected to fall more than 10%, the largest decrease since the 2008 global financial crisis. Despite 2023's weakness, absolute levels of cargo volume remain above pre-pandemic levels due to growth that occurred between 2020 and 2022. We expect to see greater stability than has been the case in recent years, and anticipate steady, moderate growth off current base levels.

Our outlook also reflects productive labor negotiations at West Coast ports, as a new contract will offer predictability through 2028. West Coast ports impacted by this deal handle 45% of all US container cargo. On the contrary, a new set of labor talks for East Coast and Gulf Coast dock workers begin in 2024, a process that could produce disruptions. Drought conditions and low water levels in the Panama Canal have also constrained shipping activity. If restrictions are prolonged or increase in 2024, cargo volume in Gulf Coast and East Coast ports could be affected. Cargo volume growth on the East Coast has outpaced West Coast ports in recent years as shippers have sought to avoid extreme congestion on the West Coast, however volume may shift back out west if disruptions materialize.

Ports benefit from their essentiality to the US economy, as the transport and delivery of goods throughout the nation is critical to commerce. Most issuers also possess strong reserves accumulated through robust operations during the pandemic. Our credit process seeks port issuers based in economically strong areas that boast dominant market positions, advanced infrastructure, and stable financial profiles. We also favor "landlord" ports that derive a large portion of revenue from long-term leases, as this facilitates stable financial operations.



Source: Bureau of Transportation Statistics and Respective Ports

SECTOR OUTLOOK

HOUSING

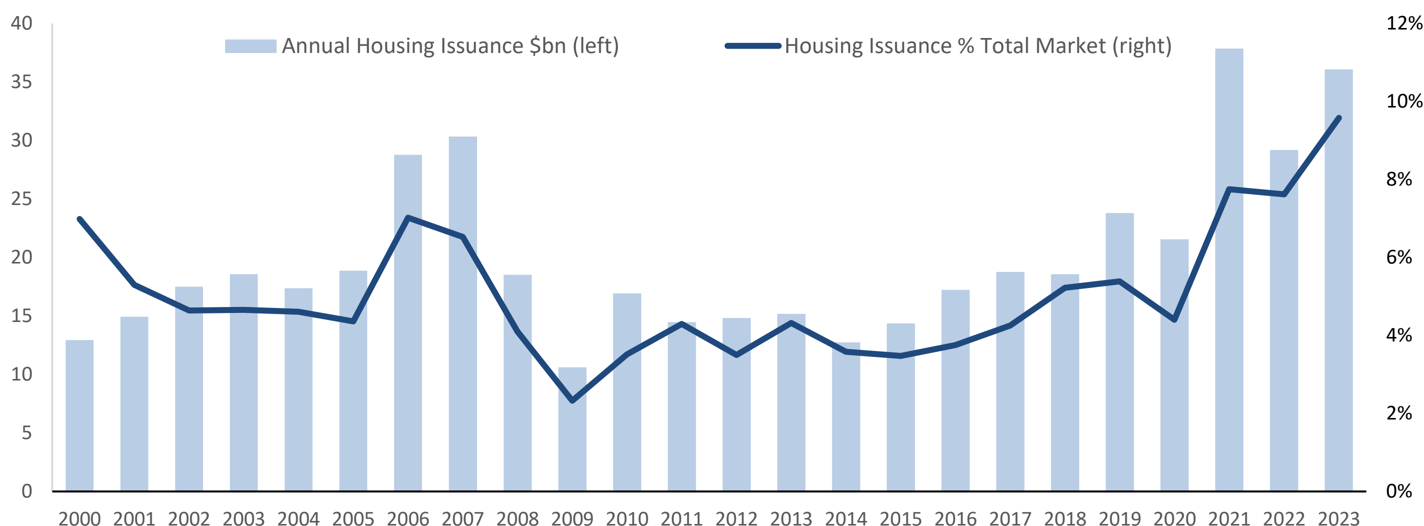
Outlook: Positive (changing from Stable)

Sector Overview & Outlook:
We have a "positive" outlook for the Housing sector as strong demand and improved attractiveness of Housing Finance Agency offerings relative to commercial products should lead to rising loan origination and increased revenue. Underwriting prudency will be important, although access to federal enhancement programs as well as historically conservative lending practices lead us to expect that loan portfolio performance will be positive. As a caveat to our newly "positive" outlook on the Housing sector, Appleton's investment opportunities in this area of the tax-exempt market will be limited due to what we see as unfavorable structural elements of many Housing bonds, namely prepayment risk, small maturity sizes, and low coupons.

Last year we noted that higher borrowing rates increase the attractiveness of municipal housing agency mortgages relative to commercial offerings, a dynamic that drives increased mortgage origination. This proved to be the case, as reflected in rising Housing Agency bond issuance to finance mortgage production. Should existing home sales pick-up in 2024 as rates moderate or even begin to recede, we would expect increased issuance and more opportunities for municipal investors to purchase Housing bonds, potentially at wider spreads that account for higher inventory of new offerings.

Softening economic activity is a risk that presents the potential for increased mortgage delinquencies and defaults. As noted last year, Housing Agencies are better prepared for a downcycle, having learned valuable lessons from the 2008-2009 housing crisis, although we expect nothing of that nature. Loan portfolios have also been fortified, in part through greater exposure to government enhanced loans either through insurance programs or agency collateralizations.

At Appleton, our Housing exposure is concentrated with state housing agencies, given their large and seasoned portfolios, conservative underwriting standards, access to ample reserves, and support provided at the state level. We continue to avoid local housing agencies focused on narrow geographic regions and single-project financings given their lack of revenue diversity and often speculative business position.



Source: Bloomberg

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