The “Illinois Effect” on Local Municipal Bonds

Yield Penalties & Investment Opportunities

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GENERALIZED CREDIT RISK – SPECIFIC OPPORTUNITIES

The State of Illinois' fiscal problems are well known. The State receives widespread media coverage from having the lowest bond rating of any state in the country. Does this imply that all bonds issued by local governments within Illinois are poor credits? Not necessarily so, in our view.

Illinois is made up of thousands of local governments with varying economic and financial characteristics. Thorough credit analysis helps uncover solid quality bonds within the diverse universe of municipal credits. Oftentimes, these issues offer attractive yields relative to the actual credit risk. This paper focuses on the idea that applying blanket statements of credit risk across Illinois can lead to overlooked investment opportunities. We discuss Bernardi's Three Pillars approach to municipal bond credit research by comparing the creditworthiness of one Illinois local government bond issuer to a similar credit issued in another state.

RECENT STANDARD & POOR'S RATING ACTIONS

Standard & Poor's Rating Services (S&P) downgraded its rating on the State's general obligation (G.O.) debt to "A-" from "A" on January 25, 2013. As a result, Illinois became the lowest-rated U.S. state. According to the rating report released by S&P, the downgrade reflected the State's large unfunded pension liabilities, its large general fund balance deficit and overall structural budget challenges.

In December of 2013, S&P affirmed its "A-" rating on the State's G.O. bonds, but modified the State's outlook from "negative" to "developing" after Governor Pat Quinn signed legislation that promises to reduce Illinois' significantly underfunded pension system. "The change reflects the consensus reached on pension reform, which we believe could contribute to a sustainable path to fiscal stability," said Standard & Poor's credit analyst Robin Prunty. "Although we view the consensus achieved by Illinois on this difficult issue as positive from a credit standpoint, the developing outlook reflects the implementation risk — legal and budgetary — associated with various provisions of the pension reform, as well as the overall structural budget challenges facing the State," added Ms. Prunty.

MUNICIPAL BOND INVESTORS DEMAND MORE YIELD

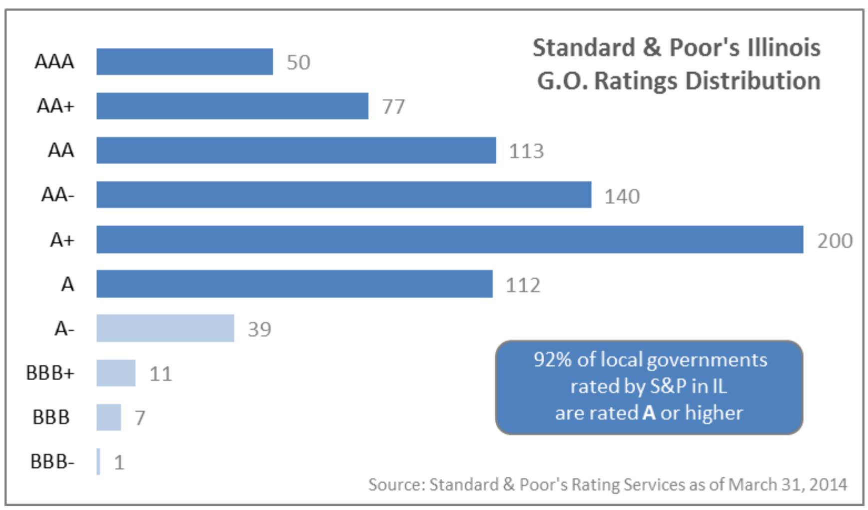
Until the State's bond rating moves up the credit ladder, the State will continue to pay higher yields on its bonds because of the perceived risk associated with low credit ratings. In addition to the higher yields associated with its low credit rating, some observers believe Illinois pays additional yield beyond the traditional credit factors such as economic and financial characteristics. For example, Professors Luby and Moldogaziev argue that a portion of the higher yield that Illinois pays on its bonds is related to its fiscal reputation.[i]

The State's fiscal reputation also affects local governments in Illinois. Market participants have observed an "Illinois effect": local governments with solid credit characteristics pay additional yield or premium on their bonds just because they are located in Illinois. It is not uncommon for a local government in Illinois issuing bonds to pay higher yields compared to similar local governments in other states. Local governments with good credit metrics that are not overly dependent on the State for funding, often, pay higher yields on their bonds.

READING BEYOND THE HEADLINES

Illinois is made up of thousands of local governments. These local governments have different socioeconomic, financial and management profiles. We regularly find local governments in Illinois with solid credit fundamentals. The depth and breadth of our municipal bond credit research process helps us identify these good credits.

The chart to the right is a distribution of S&P's General Obligation (G.O.) bond ratings for Illinois local governments as of March 31, 2014. S&P maintains many high-grade ratings on local governments in Illinois. <u>In fact, 50% of the local governments in Illinois rated by S&P are rated AA- or higher and 92% are rated A or higher.</u>



It's important to remember that S&P's ratings are not static, will change over time and that S&P does not rate every bond issued. This snapshot of S&P's rating distribution indicates to us that others also believe there are good credits within Illinois despite the negative headlines about the State's finances.

YIELD COMPARISON: ILLINOIS VS. NON-ILLINOIS

The following table illustrates the "Illinois effect" by comparing the pricing of Houston County, Alabama ("Houston") to Peoria County Community School District No. 323, Illinois ("Peoria"). Both bond issues received the same rating by Moody's Investor Services and both were priced on the same day. The table shows Peoria priced at wider spreads to the Municipal Market Data index than Houston for every maturity. For example, the 10-year bond for Peoria priced at a spread of 35 basis points to the Municipal Market Data top-rated index whereas the 10-year Houston maturity priced at a spread of 20 basis points. Peoria's 10-year maturity pays an additional 15 basis points over Houston.

Bond Year	AAA MMD (3/3/14)	Houston County, AL G.O. ULT Rating: Aa2/AA- Sale Date: 3/3/14 Yield (due: 4/1)	SPREAD to MMD Benchmark	Peoria Cnty CUSD # 323, IL G.O. ULT Rating: Aa2 Sale Date: 3/3/14 Yield (due: 4/1)	SPREAD to MMD Benchmark
2023	2.27%	2.450%	0.180%	2.600%	0.330%
2024	2.40%	2.600%	0.200%	2.750%	0.350%
2025	2.54%	2.750%	0.210%	2.875%	0.335%
2026	2.67%	2.870%	0.200%	3.125%	0.455%
2027	2.80%	3.000%	0.200%	3.200%	0.400%
2028	2.91%	3.120%	0.210%	3.300%	0.390%
2029	3.02%	3.250%	0.230%	3.450%	0.430%
2030	3.12%	3.400%	0.280%	3.550%	0.430%

Source: Bloomberg

Are the higher yields on the Illinois bond justified? To help answer this question we apply *Bernardi's Three Pillars* approach to municipal bond credit research and analysis. At Bernardi Securities, we rely on this well-developed and time-tested process. Our credit research process is the cornerstone of Bernardi's portfolio management process. It helps us identify good bonds with solid credit quality. Often, these bonds are undervalued, in our view.

THE THREE PILLARS

I. Issue Purpose

Houston County, Alabama, with a population of 101,547, is located in the southeast corner of the state of Alabama. The County issued General Obligation **Warrants** 2014-A to finance road and bridge improvements and certain energy conservation improvements to public buildings and facilities within the county.

Peoria County Community Unit School District No. 323 is located in Peoria County, Illinois, approximately 160 miles southwest of Chicago and 62 miles north of Springfield, Illinois. The District includes the northwest side of the City of Peoria and the Village of Dunlap. The District issued General Obligation Refunding School **Bonds**, Series 2014A to refund its outstanding Taxable General Obligation School Building Bonds, Series 2010B bonds. The Series 2010B bonds were issued to finance the construction of a new elementary school.

Both Houston and Peoria issued debt for essential public purpose projects. Generally, we assume debt issued for non-essential projects are associated with a diminished willingness to repay bond investors. Local governments are responsible for financing essential public purpose infrastructure. We believe project essentiality is often an indicator of an issuer's willingness to repay bond holders.

II. Issue Structure

It is difficult to make an informed assessment on a particular municipal bond, without an understanding of the security structure underpinning the issuer's source of repayment. One way to arrive at an understanding of the security pledge and the strength of that pledge is to thoroughly read the Official Statement and the Bond Resolution.

The security language in the Official Statement for Houston reads, "The Series 2014-A Warrants will be general obligations of the County, for the payment of which the full faith and credit of the County will be irrevocably pledged." However, in the following paragraph, we find that none of such legally available revenues of the County are specifically pledged for payment of debt service on the Series 2014-A Warrants. This means that the Warrants are payable from all legally available funds in the County's general fund, but there is **no specific lien on any particular revenue**.

The security language in the Official Statement for Peoria states that the Bonds are secured by any funds of the District legally available, and all taxable property in the District is subject to the levy of taxes to pay the Bonds without limitation as to rate or amount. The Bond Resolution provides for **a specific levy of ad valorem taxes, unlimited as to rate or amount**, to be levied upon all taxable property within the District in amounts sufficient to pay all principal of and interest on the Bonds when due. The Official Statement further states, "The Bond Resolution will be filed with the County Clerk of Peoria County, Illinois, and will serve as authorization to the County Clerk to extend and collect the property taxes to pay the Bonds."

We believe the security pledge of Peoria's bonds is stronger than the pledge to repay Houston's warrants. Recent events in Detroit tell us that general fund creditors of a distressed municipality are more vulnerable to repayment delays than secured creditors. Our December 2013 Market Update discusses the difference between unlimited tax general obligation bonds (UTGO) vs. limited tax general obligation bonds (LTGO) in light of the City of Detroit's bankruptcy petition. Additionally, Alabama is one state that authorizes municipalities to file for Chapter 9 bankruptcy and offers no statutory lien for general obligation bonds.[ii]

III. Issue Underlying Credit Quality

A review and comparison of the current audited financial statements of each issuer provides key credit metrics to assist us in assessing the issuers' creditworthiness. Below is a snapshot summary of our research. The table shows Peoria has stronger budget flexibility with general fund reserves at 97% of general fund expenditures. An analysis of the District's financial statements over the past five years reveals that the District is not significantly dependent on the State of Illinois for operating revenues. State sources of revenues for the District have averaged approximately 8% annually over the last five years. Strong budget flexibility indicates that the District can weather reduction in state funding levels. Houston's general fund reserves were at 19% of general fund expenditures, indicating less budget flexibility. Peoria has stronger liquidity as indicated by its total governmental cash available at 79% of total governmental fund expenditures compared to Houston which recorded total cash available at 31% of total governmental fund expenditures. Houston has lower debt per capita numbers; however, Peoria has a more rapid amortization schedule for its debt. Peoria reports per capita income of 141% of the State of Illinois compared to 104% of the State of Alabama for Houston.

	Peoria Cnty CUSD No. 323, IL Rating: Aa2	Houston County, AL Rating: Aa2/AA-
Liquidity		
Cash as % of Governmental Revenues	79%	19%
GF balance as % of GF Expenditures	97%	31%
Debt Burden		
Debt as % of Mkt. Value	2.80%	1.90%
Debt per Capita	$ 3,288	$ 270
% of Debt Retired in 10 yrs.	53%	63%
Wealth & Income Levels		
Population	20,345	102,369
Per Capita Income	$ 41,570	$ 37,391
As % of State	141%	104%

Source: Audited financial statemetns for fiscal year ending September 30, 2012 for Houston County, Alabama. Audited financial statemetns for fiscal year ending June 30, 2013 for Peoria County CUSD No. 323

It is important to note that the median household income in 2012 for Illinois was $56,853 or 131% of Alabama's $43,160 median household income.

Peoria and Houston both have locally funded pensions systems, the Illinois Municipal Retirement System (IMRF) and the Employees' Retirement System (ERS), respectively. Each contributed 100% of the required annual pension cost for fiscal year 2012 and in recent years both have fully funded their required annual pension cost. The IMRF covers non-teacher personnel at Peoria and the ERS covers county personnel at Houston. As of the most recent actuarial valuation, the locally funded pension system for Peoria and Houston had a funded ratio of 70.16% and 67.20%, respectively.

In addition to IMRF, Peoria also participates in the Teachers' Retirement System of the State of Illinois (TRS) that covers teacher personnel. Under current law, the State of Illinois maintains primary responsibility for funding TRS. The State makes contributions directly to TRS on behalf of Peoria's TRS-covered employees. As of June 30, 2013, the funded ratio for TRS was 40.60%. The goal of the State's recent pension reform law is to stabilize the finances of TRS; however, lawsuits challenging the law could delay implementation of the law's provisions until a final ruling is made.

We conclude that Peoria and Houston have historically contributed 100% of their required annual pension cost to their locally funded pension retirement systems and both have similar funded ratios. The State of Illinois's liability for TRS-covered employees appears to penalize Peoria. This penalty is reflected by the additional yield Peoria pays on its bonds.

SUMMARY

We reviewed the purpose of each issue and found that both Peoria and Houston were issuing bonds to finance essential public purpose projects. We reviewed the structure of each issue and concluded the security pledged on Peoria's bonds is stronger for bondholders than the security pledge for Houston's warrants. We believe a specific and separate revenue stream to cover debt service is a stronger security pledge than a full faith and credit pledged with no specific revenue pledge. Lastly, we reviewed the underlying credit quality and found that Peoria has stronger budget flexibility and liquidity than Houston. Despite having a stronger security pledge and underlying credit quality, the 10-year maturity for the Peoria bond pays an additional 15 basis points over Houston's warrants.

We conclude from our analysis the yield penalty paid by this particular Illinois local government due to the "Illinois effect" is unjustified. The perception of heightened credit risk appears to penalize Peoria. After sifting through the details we conclude the yield penalty is not commensurate with credit risk. Our comparison highlights the importance of thorough municipal bond credit research to help identify underpriced bonds. There are many local Illinois issues with good credit fundamentals that provide attractive investment opportunities because of the "Illinois effect".

IMPORTANCE OF CREDIT RESEARCH

Municipal bond credit research is at the core of our portfolio management process. Our in-house credit research team analyzes issue credit strength in order to determine its ability and willingness to pay debt service. Our credit research process has been developed and honed over several decades. As state and local governments continue to face fiscal challenges, credit research is more important than ever. Our research team often will speak with local officials and occasionally make site visits to get the complete picture. In today's complex municipal bond market, we believe our municipal bond credit research process is critical for finding value in the municipal bond market.

Please call your investment specialist if you have specific questions about certain credits or if you would like us to review your municipal bond portfolio.

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[i] Luby, Martin J., Moldogaziev, Tima, (2014). The Scarlet Letter in the Municipal Bond Market, A Cost of Illinois' Poor Fiscal Reputation

[ii] Sigo, Shelly, (2012). Alabama Raises a Question: When Is a GO Not a GO? Bond Buyer, 112 Retrieved from http://www.bondbuyer.com/issues/121_100/jefferson-county-alabama-bankruptcy-general-obligation-bonds-1040055-1.html?CMP=OTC-RSS

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