Investor Caution Warranted When Considering Dedicated-Tax Bonds

Dedicated-tax bonds, which offer investors repayment from a specific dedication of revenues such as sales or income taxes, are imbedded with underappreciated investment risk. Some market participants have tended to favor such bonds, including paying price premiums, over related general obligation (GO) alternatives, but in our view caution is warranted:

- For any given pair of related obligors, an increase in financial distress typically corresponds to a ratings and price convergence between dedicated-tax bonds and their GO counterparts, underscoring the limited value of the former's structural enhancements
- Notable ratings downgrades question the belief that dedicated-tax bonds provide outsized stability and protection for bondholders
- Consequently, the fundamental creditworthiness of the associated government must factor heavily in any holistic assessment of relative value

At one point rated five notches above its associated GO bond, Puerto Rico's COFINA bonds, backed by sales tax revenue, have experienced severe credit deterioration into speculative-grade territory: as ratings descended, the bonds traded at increasingly wider spreads to the municipal benchmark index[1].

Table 1 lists other dedicated-tax bonds that have experienced a similar rating arc: where once they were buoyed by ostensible bond indenture enhancements, spruced-up structural mechanics, or legal opinions, they now face the reality that their fundamental creditworthiness is not too far anchored away from their GO brethren. For each of these names, rating agencies' downgrade rationales differ, but a common thread is a realization that prior dedicated-tax ratings were too high.

Table 1 Notable Multi-Notch Rating Downgrades

		Notable Downgrades (in notches)			Current Rating
Issuer	Pledged Dedicated Revenue	Moody's	S&P	Fitch	(Respectively)
Puerto Rico Sales Tax Financing Corporation (COFINA subordinate lien)	Sales taxes	Five	Five	Eight	Ca, CC, C
Illinois Metropolitan Pier and Exposition Authority	Appropriated sales taxes	—	Seven	—	BBB-
City of Chicago	Sales and use taxes	Two	—	Two	Ba1, BBB-
City of Chicago	Motor fuel taxes	Two	Six	—	Ba1, BBB-
Virgin Island Public Finance Authority	Excise tax matching funds	Two	Three	Three	B1,B, BB
Government of Guam	Business privilege taxes	—	—	Five	Withdrawn
Garden State Preservation Trust, NJ	Appropriated sales taxes	Two	Six	—	A2, BBB+

Sources: PNC Capital Advisors, Moody's, Standard and Poor's, Fitch

Our position has been to view buttressed dedicated-tax bonds with due circumspection. In our assessment process, we take note of all types of bond enhancements, which range from modest covenant modifications to large structured mechanics such as having a separate legal entity issue the bonds or by creating a carve-out of special tax revenues for bond repayment. Of late, we have seen this latter strategy be implemented by issuers exhibiting various degrees of credit stress. Most notably, the Chicago Board of Education offered a new dedicated-tax $500 million bond issue that garnered an A rating from Fitch, which is eight notches above the Board's GO rating level. Table 2 highlights additional rating discrepancies among pairs of related obligors.

1 74529JNX9 at issue in 2011 yielded 4.75% or 90 basis points (bps) above the MMD AAA yield curve; at March 8, 2017 IDC's evaluation service showed an 8.04% yield, which translates to a spread of approximately 500 bps above the MMD AAA yield curve.

Past performance is no guarantee of future results.

Table 2 Different Issuer Rating Discrepancies				
	Current Ratings (Moody's/S&P/Fitch)			Largest Rating Discrepancy between issuers (in notches)
Issuer	Fundamental	Alternative	Issuer	
Chicago Board of Education GO	B3/B/B+	NR/NR/A	Chicago Board of Education Capital Improvement Tax bonds	Eight
State of Connecticut GO	AA3/AA-/AA-	AA3/AA/AA-	Connecticut Special Tax Bonds	One
Detroit GO	B2/B/WD	Aa2/AA/NR	Michigan Finance Authority (senior lien)	Twelve
New York City GO	Aa2/AA/AA	Aa1/AAA/AAA	New York City Transitional Finance Authority	Two
Guam GO	NR/BB-/NR	NR/A/WD	Guam Business Privilege Tax bonds	Seven
Atlantic City GO	Caa3/CC/NR	Baa2/BBB+/BBB+	Atlantic City Luxury Tax Rev Bonds	Twelve
Erie County, NY GO	A2/AA-/A+	Aa1/NR/AAA	Erie County Fiscal Stability Authority	Four

**NR is Not Rated*

Sources:PNC Capital Advisors, Moody's, Standard and Poor's, Fitch

For many other dedicated-tax names, there exists another kind of ratings discrepancy, which involves one agency rating a bond issue one or more notches above a competitor (see Table 3).

Table 3 Same Issuer Ratings Discrepancies				
		Current Rating		Rating Discrepancy (Notches)
Issuer	Pledged Dedicated Revenue	Moody's	S&P	
New York City Transitional Finance Authority	Income and sales taxes	Aa1	AAA	One
City of Chicago	Sales taxes	Ba1	AA	Eight
Kansas Department of Transportation	Highway fund revenues	Aa2	AAA	Two
Illinois Retirement and Interest Fund	Sales taxes	Baa2	AAA	Eight
Maryland Department of Transportation (Baltimore pledge)	Highway user revenues	Aa2	AAA	Two
Pennsylvania Intergovernmental Cooperation Authority	Income taxes	Aa2	AAA	Two
San Diego County Regional Transportation Commission	Sales taxes	Aa2	AAA	Two
State of Arizona (Lottery Bonds)	State lottery revenues	A1	AA	Two
Utah Transit Authority	Sales taxes	Aa2	AAA	Two
Oregon Department of Administrative Services	State lottery revenues	Aa2	AAA	Two

Sources: PNC Capital Advisors, Moody's, Standard and Poor's, Fitch

Past performance is no guarantee of future results.

One sudden shift in rating approach or a wholesale methodology change could bring about a convergence between bonds, which would not only, by definition, impact the ratings, but also affect market price (see Table 4).[2]

Table 4 Credit Convergence Impact Example

	Chicago Board of Education GO 6.5s of December 1, 2046	Chicago Board of Education CITs 6.0s of April 1, 2046		Impact of Convergence
Ratings	B3/B/B+	NR/BBB+/A	Rating downgrades, respectively	Seven and eight notches
Reported Price	$95.75	$96.65		
Yield	7.36%	6.25%		
Adjusted Yield	N/A	7.36%		
Adjusted Price	N/A	$84.30	Theoretical capital loss	$11.45

**NR is Not Rated*

Source: Electronic Municipal Market Access

Given the choice, it would be prudent for investors to seek bonds that offer less risk and whose ratings more closely reflect the underlying credit fundamentals. When a government's general credit conditions seem likely to deteriorate, we believe investors are better off avoiding paired obligor dedicated-tax bonds that, sooner or later, may decline in tandem.

2 Capital loss calculation derived from the application of trade data on December 15, 2016: Chicago CIT's (cusip 167510AA) yield of 6.25% adjusted to Chicago Board of Education GO's (CUSIP: 167505RD0) higher yield of 7.36%, to account for differences in coupon and structure. The resulting price difference is highlighted in Table 4 above.

Past performance is no guarantee of future results.

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