North Carolina: State-Specific Credit Overview

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MARKET OVERVIEW

As we experience a volatile start to 2016, many of last year's themes remain at the forefront of the municipal space. Supply ended 2015 just below our $400 billion estimate, and we believe total issuance will end 2016 around the $400 billion mark. Supply will be driven again by refundings, the reason being twofold: 1) the universe of outstanding bonds eligible to be refunded is higher in 2016 vs. 2015 and 2) the increase in short-term rates (via Fed policy) will decrease the negative arbitrage associated with advance refunding escrows, assuming the long-end of the curve remains anchored by subdued global growth and lack of inflation. Net issuance should decrease for a 6th consecutive year, as new money issuance has historically declined in election years. On the credit front, many of the same names remain in the headlines. Puerto Rico officially defaulted on $37 million of Infrastructure Finance Authority debt, and negotiations continue around a complete restructuring of the island's debt, but ownership, for the most part, has shifted toward non-traditional buyers who participate in the distressed credit market. The City of Chicago continues to fight off insolvency with tax increases while Illinois and Pennsylvania battle budget gridlock at the state level. We view these distressed credits in isolation and do not consider a systemic credit event likely should one or more of these credits become insolvent or face further credit pressure. We also continue to monitor the impact subdued oil prices are having on oil dependent states such as Alaska, Wyoming, Texas, and North Dakota and what downstream pressure their local governments remain subject to.

STATE OF THE STATE

North Carolina continuously ranks as one of the most fiscally well-run states in the nation and has been rewarded with Aaa/AAA/AAA ratings. The State ended FY 2015 with another solid financial performance with the general fund balance up 63% over FY 2014 to $2.5 billion (Figure 1). The fund balance has grown steadily in post-recessionary years. Tax revenues decreased in FY 2014 due to revisions to the state income tax structure but came back stronger in FY 2015, leading to a sizable operating surplus. The state's economy is advancing at a solid pace and continues to transition away from the declining manufacturing sector toward professional and business services. Population growth is steadily increasing as net migration into the state continues. Residents have recently approved a $2 billion bond program, its first in fifteen years. Proceeds from the sale of the bonds will be used for improvements and new construction for education, water & sewer infrastructure, public safety and agriculture. The public investment should bolster the state's competitiveness and further economic expansion without negatively impacting its AAA rating as the state's debt burden is well below the national average. The State's unfunded pension liability is manageable and ranks in the top half of the country according to rankings of adjusted net pension liability in a Moody's report released January 15, 2016 (Moody's Investor Services, 2016). Further increasing credit worthiness of the State and its local governments is the Local Government Commission, which is an added layer of oversight that approves all debt sales for local governments within the State.

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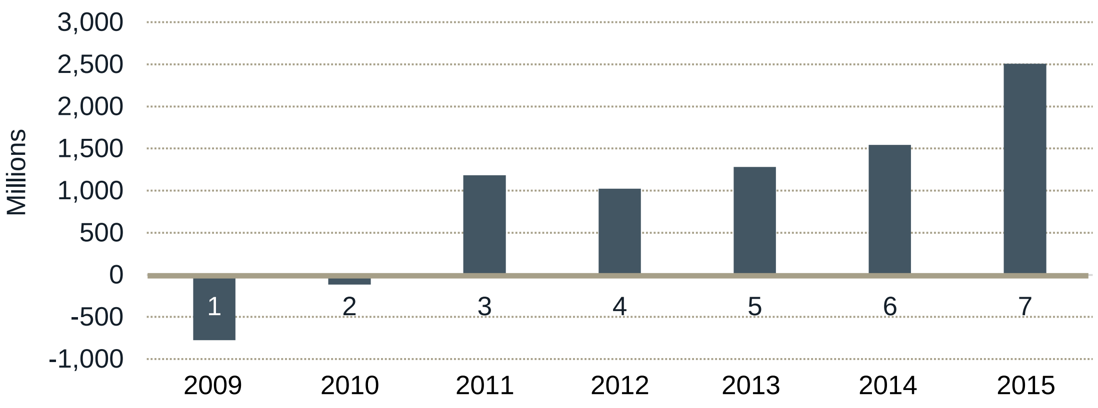
over FY 2014. As shown in the chart to the right, fund balance has grown steadily post-recessionary years."

FIGURE 1: NORTH CAROLINA GENERAL FUND BALANCE[1]



1. Bloomberg L.P. (2016). Graph for North Carolina Fund Balance 1/1/2009 to 12/31/2015. Retrieved April 25, 2016 from Bloomberg L.P.

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STATE OF THE STATE CONTINUED

Although statewide issuance has been on the rise, the majority has been for the purpose of refunding outstanding bonds (replacing one bond for another), not for new money projects (adding new bonds into the market). Further, when comparing issuance to population, North Carolina lags its Aaa-rated peers. In 2015, total issuance was approximately $5.7 billion, ranking the state 20th in terms of total issuance. However, when analyzing personal income data from the U.S. Bureau of Economic Analysis, the State is the 13th ranked wealthiest state in the nation. This presents a unique problem for municipal bond investors within the State as there are large pockets of wealth seeking in-state, tax-deductible income.

Overall low new money issuance, strong credit fundamentals, and conservative management and oversight create problems for investors in search of yield. With absolute yields still at historic lows, investors are drifting down the credit curve and/or buying longer-dated maturities to pick up additional yield. We caution against this approach because the longer maturities subject investors to a longer duration in what many perceive to be a potential rising interest rate environment. Many localities and issuers are still working through fiscal constraints caused by the recession; therefore, the perceived incremental yield priced into lower credits does not always correlate with the increase in credit risk. Below we highlight three sectors in North Carolina where we believe there is an opportunity to realize additional yield without extending duration or taking on unnecessary credit risk.

LIMITED OBLIGATION BONDS

CONSIDERATIONS: Unlike General Obligation (GO) Bonds, Limited Obligation Bonds (LOBs) are classified as Special Indebtedness under the North Carolina General Statutes and are subject to annual appropriations, rather than the full faith and credit of the issuing entity. LOBs are further secured by 1) a dedicated revenue stream from a project and/or 2) a mortgage or deed on a property or piece of property. Since LOBs are subject to appropriations, they are typically rated one to two notches below the issuing localities GO rating. Thus, they demand incremental yield above where a locality's GO credit would trade. Understanding the essentiality of the underlying project is key, as well as fully understanding what, if any, additional collateral is being pledged as security for the project.

CREDIT HIGHLIGHTS: The County of Brunswick, North Carolina (Aa2/AA+) issued $10.5 million Limited Obligation Bonds (Aa3/AA) in April 2015 to provide funds to construct an addition to North Brunswick High School and a gymnasium at Waccamaw School. The LOBs, subject to annual appropriation, were further secured by a mortgage on school property. As we analyzed the credit, the offering document revealed that the deed only included a mortgage on North Brunswick High School and did not include any security interest on Waccamaw School. We view a deed comprising a mortgage on school property as a credit positive. Schools are not only essential to communities but are also viewed as politically devastating for public officials who fail to appropriate funds toward school projects, thus potentially defaulting and losing ownership of a school. However to further uphold our view of the underlying security, we reviewed public property records and found that the total assessed value of North Brunswick High School alone is over $13 million, well above the $10 million of bonds issued against its value. When looking at secondary trading of the County's GO credit, we estimate that the LOBs sold with yields approximately 0.15% to 0.20% higher (in the one-to-ten year range) than where the county's GO was trading at the time of the LOB issuance. This is an excellent opportunity for investors to pick up additional yield from a highly-rated, well-run county issuing essential purpose LOBs with additional security in the form of a mortgage on the school – an essential project.

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CREDIT WARNINGS: In May of this year, the Town of Mooresville (Aa2/AA) issued $66.6 million Refunding Limited Obligation Bonds (AA-) to refund bonds that were used to acquire and make improvements to communications systems, including cable television, high-speed internet access and telephone. The bonds are also secured by a deed of trust granting a lien on a) real, and b) mortgaged property. At first glance the security appears straightforward. However, a deeper dive into the offering document reveals, first, that the real property mortgaged is valued at only $1.3 million. Second, the mortgaged property pledged consists only of property purchased with proceeds of the bonds, i.e. certain communications equipment for the system, which is secured by neither the communications system itself nor revenues derived from its operation.

LIMITED OBLIGATION BONDS CONTINUED

CREDIT WARNINGS CONTINUED: No representation is made as to the value of the mortgaged property in the event of default. One could only speculate as to the value of that used equipment in its current condition at the time of default. Further complicating bondholders' security interest, the offering document discloses that the Town also pledged a separate security interest in additional equipment associated with the same communications system as part of a 2008 bank loan. Should the town default on the bank loan, the bank could seize that collateral, which could negatively affect the operations of the communications system and the value of the bonds' mortgaged property. Also of note, if the sale of the mortgaged property is insufficient to pay all remaining obligations in full, the Town may not be held liable to bondholders for any deficiency. As you can see, bondholder security can be complex and burdensome to fully understand. Knowing what you own and understanding your security rights are paramount to assess relative risk.

HOSPITAL REVENUE BONDS

CONSIDERATIONS: Hospital System Revenue Bonds are typically viewed as a lower-rated / higher-yielding credit sector. However, looking past the sector headline risk, there is value in well-run hospital systems. Additional due diligence is required, and increased focus should be put on the primary service areas and any changing demographics within those service areas, along with financial metrics such as operating margins, leverage and liquidity. Particular attention should also be paid to current events like the impact of the Affordable Care Act on a system's profitability and operations. We recommend focusing on those systems that are well established and prepared to handle the aftermath of ACA implementation. Benefits to owning hospital system revenue bonds include additional yield, portfolio diversification, and increased continuing disclosure from issuers.

CREDIT HIGHLIGHTS: The Moses Cone Health System (MCHS) is an integrated health care delivery system based in Greensboro that serves the greater Greensboro area and surrounding counties through a system of hospitals, ambulatory care centers, physician offices and other related health care facilities. MCHS has been particularly proficient at finding synergies through strategic consolidation, for example it's consolidation with Carolina's Health System. These consolidations, although weakening the system initially, ultimately strengthened balance sheet performance and operating efficiency within a few years. A select view of MCHS's credit metrics (Figure 2) shows that it performs in-line with other AA-rated peers. MCHS's history of strategic, yet conservative, management and strong operating performance, along with positive financial metrics, makes it one of the finest systems in the State. Bonds issued by MCHS present an ideal opportunity for investors to gain the additional yield that accompanies the hospital system sector without taking on additional credit risk within the sector.

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FIGURE 2: THE MOSES CONE HEALTH SYSTEM[1]

	MOSES CONE (2015)	AA-RATED HOSPITAL MEDIANS (2014)
Coverage		
Debt Service Coverage	6.6x	6.2x
Leverage		
Debt to Revenues	1.7%	2.4%
Liquidity		
Days Cash on Hand	241	242

CREDIT WARNINGS: Hospitals are subject to an abundance of risk factors, both expected and unexpected, which can impact overall performance and credit quality. As previously mentioned, increased credit monitoring is needed to identify those risks before they impact operating and financial performance. For example, we identified that Wake Forest Baptist had been exhibiting deteriorating margins over several quarters and incurred a significant write-off of accounts receivables in FY 14 putting further stress on its financials.

1. AA-rated by S&P and/or Moody's as reported by Merritt Research Services

HOSPITAL REVENUE BONDS CONTINUED

CREDIT WARNINGS CONTINUED: The system was concurrently increasing leverage and was subsequently downgraded. We identified these issues prior to the downgrade and ceased adding exposure to the name. These financial trends are something a casual investor may miss if not carefully reviewing quarterly disclosures. Although financial performance has been improving, margins remain below historical levels, and we would like to see several quarters of improvement before considering investing in the hospital again. Considering that hospitals are still in the early stages of ACA implementation, it remains to be seen which systems are financially flexible enough to weather any near-term stress related to the application of the required rules and procedures.

EDUCATION BONDS

CONSIDERATIONS: Higher Education bonds continue to face negative headlines in 2016 as state governments continue to decrease education funding. Enrollment trends are down at many colleges and universities as individuals attempt to quantify the value of higher education given rising tuition and an evolving job market. Beyond the headlines, most North Carolina colleges remain financially sound and desirable for future students, both in and out of state, making bonds issued by these universities attractive investments. Typical of many states, North Carolina does not pledge robust support to their public universities, and future state support is expected to decline modestly. We find value in the larger, more established universities with diverse revenue streams, as these universities can weather future down-turns more efficiently and have the flexibility to change capital plans and limit expenses if needed. Further, we believe that federal research grants should increase in the near-term, boosting the bottom line of those universities with research-related criteria and curriculums already in place, as there will be strong competition for these federal grants.

CREDIT HIGHLIGHTS: North Carolina State University (Aa1/AA) is the largest four-year institution in the State, educating approximately 35,000 students. The university has done a tremendous job adapting to future students' interests and the changing job market. In FY 2013 the university spent $417 million on research activities, placing N.C. State among the most productive U.S. research universities. The school has reached research partnerships with organizations including the Gates Foundation, the National Nuclear Security Administration, and just last year the White House selected the school to lead a $70 million Power America National Innovation Institute program. The university has also increased funding for and promoted its engineering program and is currently the only university in the nation leading two active National Science Foundation Engineering Research Centers. Although projected undergraduate enrollment trends over the near term are expected to plateau, increased focus has been directed toward the growing doctoral enrollment, especially in STEM (Science, Technology, Engineering, Mathematics). Financially the university is stable; revenues were up approximately 6% in FY 2015, and total assets have been increasing, reaching $3 billion in 2015 (Figure 3). Universities with substantial assets, like NC State, are better positioned to weather periods of financial stress. Although state funding has decreased slightly over the past couple of years, the university was able to cover the shortfall through ample reserve funds. The university has not issued bonds since 2013, but recent secondary market trading activity suggests that bonds maturing in the seven-to- fifteen year range yielded 0.20% to 0.35% more than top-rated municipals with similar maturities. This strong higher education credit presents an opportunity to realize additional yield without accepting an abundance of credit risk.

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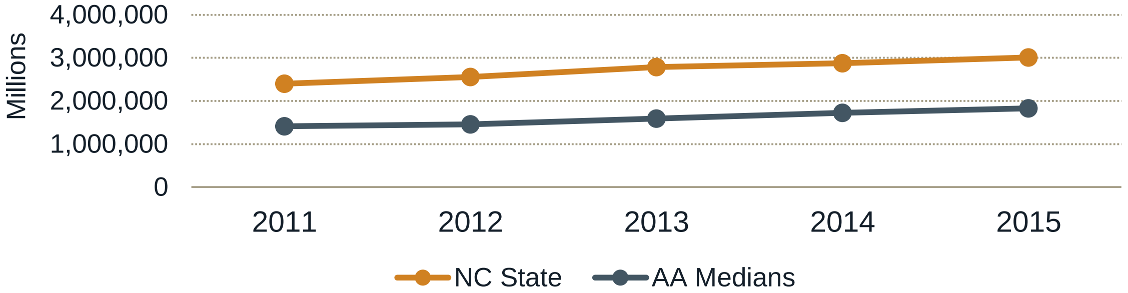
FIGURE 3: NC STATE NET ASSETS[1]



1. AA-rated by S&P and/or Moody's as reported by Merritt Research Services

EDUCATION BONDS CONTINUED

CREDIT WARNINGS: Winston-Salem State University has endured recent struggles due to declining enrollment and declining state appropriations, the largest source of revenue for the university. The university's operating performance has remained fragile as it adjusts to lower enrollment figures. The school is currently running negative operating margins, which results in less than 1.0 times debt service coverage. Additionally, liquidity is extremely thin at approximately 35 days cash on hand. The state could ultimately step in and provide additional support should the university continue to struggle, both operationally and financially, but it is certainly not required to do so. Investors who own education bonds should be cognizant of not only the underlying university's financial health but also should understand and accept the potential absence of state-level support. Regardless, investors should be aware of negative headlines surrounding troubled situations and understand how they may impact the value and liquidity of their bonds.

DISCLOSURE

Sources: Bloomberg, Moody's Investor Services, S&P, Fitch, Thomson Reuters, Caprin Internal Systems, EMMA, 2015 Clemson Comprehensive Annual Financial Report, Bond Buyer, Merritt Research Services.

Robust 2014 Investment Returns Provide Pause in Growth Adjusted Net Pension Liabilities. (2016, January 15). Retrieved February 26, 2016, from www.moodys.com