South Carolina: State-Specific Credit Overview

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knowledge preserves wealth

Caprin Asset Management, LLC 1802 Bayberry Court, Suite 202, Richmond, Virginia 23226 Phone: 804]648-3333 Website: www.caprinbonds.com

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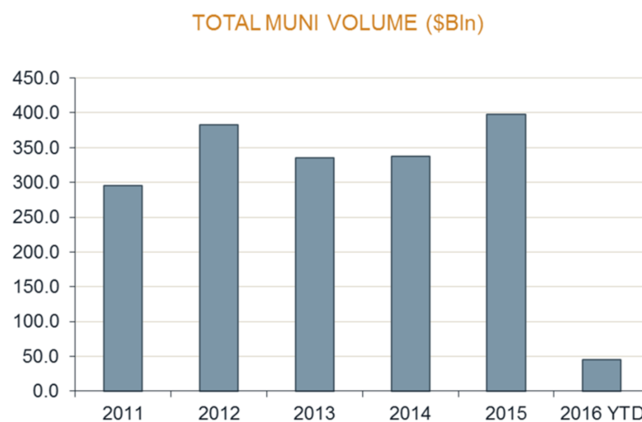
MARKET OVERVIEW:

GENERAL MARKET: 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.



*Bloomberg L.P. (2016) Graph for Total Municipal Issuance 1/1/2011 to 2/29/2016. Retrieved Feb. 29, 2016 from Bloomberg L.P.

STATE OF THE STATE: South Carolina is considered one of the most fiscally well-run states in the nation and has been rewarded with Aaa/AA+/AAA ratings. The State has a diverse economy and has implemented efforts to shift its economy away from declining non-durable goods manufacturing to high quality added durable goods. Its business-friendly policies (low unionization rates & willingness to provide economic incentives) are key contributors to the expansion of durable goods producers within the state, especially those in the auto manufacturing and aerospace industries. Volvo's announcement last summer that it will build its first U.S. factory in Berkeley County was followed by BMW (Spartanburg), Daimler (Charleston), and Boeing's (North Charleston) plans to expand operations within the state. In addition, the State Ports Authority has taken steps (including issuing bonds) to upgrade its port operations, making it one of only a handful of east coast ports able to accommodate the large, post-panamax cargo ships, strategically positioning itself to siphon trade away from heavily unionized west coast ports once the Panama Canal is opened. Governor Haley's proposed gas tax increase (to be offset by a decrease in state income tax) is estimated to produce $49 million in revenue alone in FY 2017 to pay for transportation improvements throughout the state. Fiscally, South Carolina has been steadily strengthening its financial position from recessionary years.

Founded in 1997, Caprin is an asset management firm that applies the substantial experience and expertise of its professionals to the creation and management of forward-looking investment solutions for those seeking wealth preservation and income generation.

South Carolina: State Specific Credit Overview

MARKET OVERVIEW: CONTINUED

STATE OF THE STATE CONTINUED: The general fund balance has increased every year since 2009, and liquidity remains strong as constitutionally required reserve funds (General Reserve Fund and Capital Reserve Fund) remain fully funded. Challenges facing the state are higher than average poverty levels, especially in its rural areas, and a large unfunded pension liability. South Carolina had the 23rd largest adjusted net pension liability (ANPL) at over $13 billion across its 5 plans as of FY 2014 (Moody's Investor Services, 2016). To put that amount in perspective, Nebraska had the lowest ANPL at $726 million while Illinois had the largest at $195 billion; the median is $11 billion.

Although issuance was up 49% in 2015, total issuance within the state represented only 1.4% of the $400 billion issued nationally. 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). This presents a sizable challenge for municipal bond investors within the State, as there are large pockets of wealth seeking in-state, tax-deductible income. Below we highlight three sectors in South Carolina where we believe opportunity exists to realize additional yield without extending duration or taking on unnecessary credit risk.

SCHOOL DISTRICT BONDS

CONSIDERATIONS: South Carolina School Districts, similar to all local governments, are subject to an annual debt limit of 8% of total assessed value within the District without voter approval. Years ago, many smaller school districts facing costly upgrades to deteriorating schools were presented a choice: they could seek voter approval for increased debt issuance or issue installment purchase agreements through a newly created conduit issuer. The South Carolina Association of Governmental Organizations (SCAGO) was formed in 2002 to act as conduit issuer for school districts. Issuing bonds through SCAGO allowed school districts to circumvent voter approved bond referendums and stay below their GO debt limit. Under this financing option, a district would issue long-term installment purchase revenue bonds that are secured by "appropriations" from the general fund, not a general obligation pledge. The district would then issue short-term bonds annually, or every few years, to cover current debt service on the installment purchase bonds. This structure, typically used by smaller and lower-rated districts, opens the issuers up to market access risk and appropriation risk, among others. After several lawsuits were filed by citizens of counties issuing these bonds, the South Carolina legislature agreed with the risks and signed a law in 2006 limiting the use of these bonds to refund prior installment purchase revenue bonds. We prefer the more traditional unlimited general obligation school district bonds issued by larger more mature school districts and tend to stay away from the risks posed by installment purchase revenue refunding transactions. Most traditional school district bonds are secured by a general obligation pledge and are additionally enhanced by a state-aid withholding mechanism.

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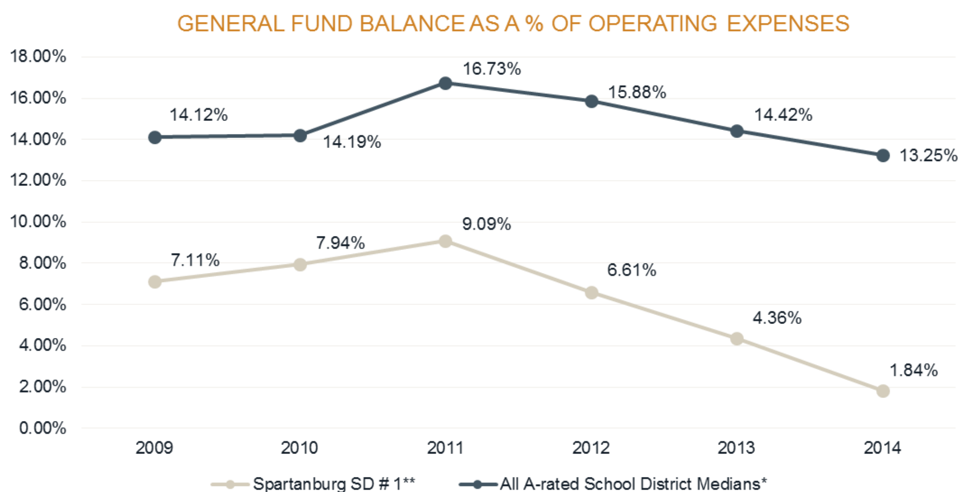
SCHOOL DISTRICT BONDS CONTINUED

CREDIT HIGHLIGHTS: In February 2015, the Horry County School District issued $110.8 million general obligation bonds to refund bonds issued in 2005 and 2006. Although the County has a high exposure to the tourism industry, population has increased significantly since 2000, up approximately 50%. Given the significant increase in population, the district's enrollment has been growing almost 2% annually over the past five years. It's growing enrollment has triggered increases in state-aid, however only 39% of the district's revenues are derived from the state, a credit positive. The district's financial position has rebounded nicely since the recession; general fund balance has increased each of the past 5 fiscal years and represents approximately 26% of annual operating expenditures, a healthy level. The District's cash position remains strong and overall debt burden is low, less than 1% of the total value of taxable property. Future school capital plans will be financed through the use of bonds and available cash, thus we feel future bonds issued by the district will be sound investments should financial conditions and metrics remain steady.

CREDIT WARNINGS: The County of Spartanburg as a whole (Aa3, Pos / AA+, Sta) has been improving annually as a credit. However, the County has seven school districts within its boundaries, each able to issue bonds under the state constitution. In March of 2015, the Spartanburg School District #1 (A3/A- Neg) issued $13.5 million Installment Purchase Refunding Revenue Bonds to refund bonds issued in 2006. At first glance, an investor may gravitate to the Spartanburg name and assume the school district is directly tied to the credit rating of the county as a whole. However, School District #1 is located in the rural northwest section of the county. The rural school district's financial position has been eroding since 2008, general fund balance has declined from $3 million in 2009 to $700,000 in FY 2014, a narrow 1.7% of annual operating expenditures. The district is also heavily reliant on state aid with approximately 65% of operating revenue derived from the state. As the state is forced to deal with its unfunded pension liability in the future, we believe districts who rely heavily on state funding could be subject to future credit pressure. In Spartanburg School District's #1's case, that could mean additional downgrades (BBB- arena) and subsequent widening of credit spreads.



* Ratings and Ratios provided by Merritt Research Services/Creditscope
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HOSPITAL SYSTEM 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: McLeod Health, located in Florence, is a non-profit hospital system which serves the healthcare needs of a 12-county region in eastern South Carolina. McLeod has been particularly proficient at finding synergies through strategic consolidation; for example, it's consolidation with Loris Healthcare System which increased its market reach into Horry County. These consolidations typically weaken financial performance, but McLeod has shown consistent solid operating profitability and coverage levels while going through periods of strategic growth. McLeod's credit metrics when compared to the medians of other similarly-rated hospital systems are impressive, debt service coverage (7.8x), profit margin (10.8%) and days cash on hand (405) all rank toward the top of its peer group. Bonds issued by McLeod present a sound opportunity for investors to gain the additional yield that accompanies the hospital system sector without taking on additional credit risk within the sector.

	MCLEOD HEALTH (2015)*	AA - RATED HOSPITAL MEDIANS (2014)*
Coverage: Debt Service Coverage	7.8x	6.2x
Profitability: Profit Margin	10.80%	6.40%
Liquidity: Days Cash on Hand	405	262

*Ratings and Ratios provided by Merritt Research Services/Creditscope

CREDIT WARNINGS: Hospitals are subject to an abundance of risk factors, both expected and unexpected, that 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 Clarendon Hospital District had been incurring financial setbacks for several years, punctuated in FY 14 by a 40% decrease in cash to defease a private placement loan in technical default. In the past three years, expenditures ballooned (partly due to costly ACA implementation) while patient revenue failed to keep pace, resulting in a trend of operating deficits. The limited cash position leaves little cushion for any near-term financial stress. Even though the district benefits from a general obligation pledge from the county, the county has its own challenges to face in the form of below average wealth levels (23% live in poverty) and elevated unemployment (9%). In 2015, Moody's acted on the poor performance and downgraded the district two notches to Baa1 and assigned a negative outlook, while S&P rates the debt single-B (Neg. outlook). These financial trends are something a casual investor may miss if not carefully reviewing quarterly disclosures. The Clarendon story highlights the difficulties that smaller hospitals in poorer parts of the country face, and it demonstrates why we prefer larger, more established hospitals.

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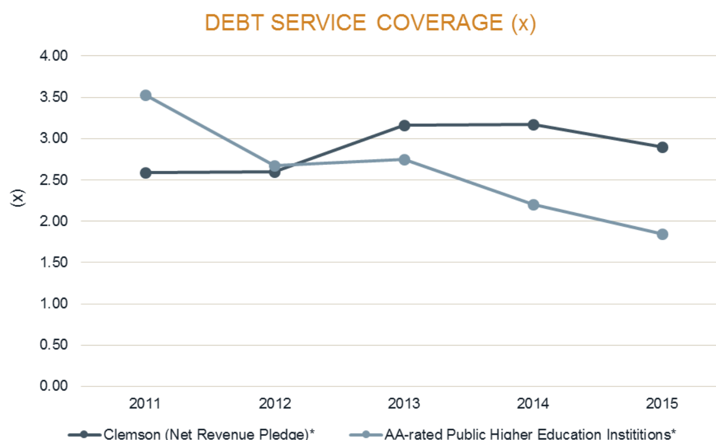
HIGHER EDUCATION BONDS

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 South 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, South 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: Clemson University is the land-grant research university of the state and has achieved substantial growth in not only undergraduate and graduate education, but also sponsored research. The university has experienced recent growth in grant revenue and continues to invest in research, FY 2015 research expenditures totaled $139 million. It also holds the distinction of being classified as a Doctoral/Research University-Extensive by the Carnegie Foundation – an honor only 4% of universities in the U.S. currently hold. Although increased borrowing due to a capital expansion plan has put pressure on leverage metrics, the university benefits from a broad revenue stream and strong liquidity, as cash and liquid investments could cover 75% of annual operating expenses. Clemson's financial profile remains sound with consistently positive operating margins and is supported by strong fundraising abilities. Operating revenues have been increasing steadily, jumping 5% in FY15. Enrollment has been healthy over the past several years, growing the full time equivalent (FTE) student body to 21,359. Clemson's debt burden remains relatively low when factoring in future planned capital outlays, and debt service coverage is expected to remain at levels above similarly-rated public higher education institutions (historical coverage in chart above). We view Clemson as an established university, and, even with some minor deterioration in its financial position, it is large enough and flexible enough to weather any short-term financial pressure.



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CREDIT WARNINGS: Coastal Carolina University (CCU) issued bonds in February 2015 to finalize its aggressive 5-year, $206 million expansion plan. The plan has put considerable stress on the university's financial position, and management must employ careful expenditure controls until its estimated 12,500 (9,437 in FY14) student body is…

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HIGHER EDUCATION BONDS CONTINUED

CREDIT WARNINGS CONTINUED: …enrolled by 2020. Liquidity declined sharply after the university made a planned drawdown of approximately $17 million in cash to support the capital campaign. Notably, operating leverage has increased sharply to 1.54x, putting pressure on debt service coverage levels that have decreased to multi-year lows (1.6x). Like other public universities in the state, Coastal Carolina does not receive strong support from the state, thus operating revenues are highly dependent on student charges. To offset some of the challenges, CCU does benefit from local support (in the form of a penny tax) from Horry County, and enrollment trends have been positive of late. CCU has put a lot of pressure on itself in the form of an aggressive expansion plan and future financial performance is dependent on cost controls and an approximate 32% increase in FTE students over the next 5 years. Time will tell if CCU's plan will pay off, but we recommend the larger, well-established research universities as the higher education sector will continue to battle headwinds.

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DISCLOSURE:

ADDITIONAL INFORMATION IS AVAILABLE UPON REQUEST

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

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1802 Bayberry Court
Suite 202
Richmond, VA 23226
804] 648-3333
CAPRINBONDS.COM