Lazard Insights
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Summary

Deconstructing the **Municipal Bond Market:** Challenges and Opportunities

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Overview of the Municipal Market

The municipal bond market is highly fragmented, as it has the smallest amount of outstanding debt and the largest number of issuers, roughly 6.5 times as many issuers as the corporate bond market. Municipalities also have approximately two million bonds in circulation in the marketplace, while the corporate bond space has approximately 70,000. In addition, relative to the U.S. public corporate market, reporting by municipalities is much more inconsistent from issuer to issuer. For municipalities there are no quarterly reporting requirements, and annual reporting requirements are much more lenient than the corporate market.

Municipal Market Participants

As of 30 June 2009, individuals, through the direct purchases of bonds and through mutual funds, made up the majority (approximately 70%) of the municipal investor universe. The largest issuers (year to date through 30 September 2009) are illustrated in Exhibit 1.

The larger states typically dominate the issuance in the municipal market. While the municipalities shown in Exhibit 1 have issued a large amount of debt, the number of issues is also high. In contrast, U.S. corporations generally issue much more debt in fewer issues. For example, Pfizer has 15 issues for $30 billion of outstanding debt, and IBM has 26 bonds for $19.2 billion of outstanding debt.

Exhibit 1: Largest Municipal Issuers

	Amount ($ billions)	Number of Issues
California (State)	13.40	9
New York State Dormitory Authority	5.96	36
Puerto Rico Sales Tax Financing	5.57	4
New York City Transitional Finance Authority	3.57	7
New York City	3.51	8
Illinois Authority	2.93	29
Wisconsin (State)	2.27	8
Washington (State)	2.24	15
University of California	2.22	5
California Statewide Communities Development Authority	2.11	15

Year to date through 30 September 2009.
Source: Thomson Reuters.

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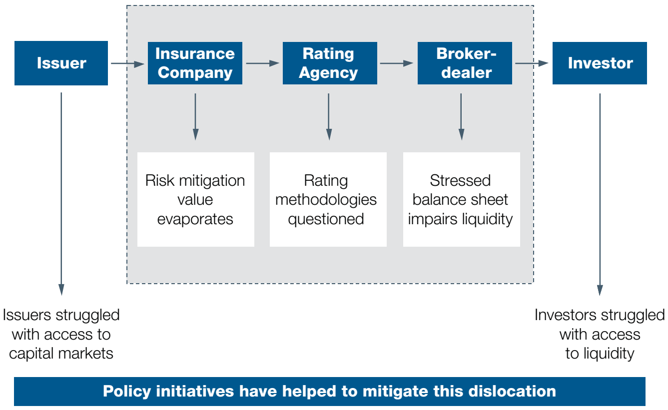
Structural Dislocation

Exhibit 2 illustrates how issuers met investors prior to the crisis. Intermediaries—including bond insurance companies, ratings agencies, and broker-dealers—were key in bringing buyers and sellers together. However, the crisis created major structural dislocations in the market, causing bond insurance companies' risk mitigation value to evaporate, investors to question rating agencies' methodologies, and stressing broker-dealers' balance sheets, which impaired liquidity. As a result of this dislocation in the intermediaries, issuers have struggled to find access to the capital markets and investors have struggled with access to liquidity. Government policy initiatives have helped to mitigate this dislocation, as evidenced by the rally of municipals in 2009; however, the structural dislocation still exists. We believe that these government initiatives are temporary and are not the long-term answer to address the dislocation in the municipal market.

Exhibit 2: The Dislocation of the Municipal Underwriting Process



Source: Lazard

Bond Insurers – The End of Commoditization

The role of the bond insurers was to provide the credit enhancement necessary for blanket AAA ratings, essentially commoditizing the municipal market from a credit perspective. As shown in Exhibit 3, only 9% of bonds were insured for the first nine months of 2009, while approximately 56% of all new deals were insured in 2005. Downgrades have effectively ended the commoditization of the municipal market and issuers now must stand on their own. There are new entrants into the bond insurer industry; however, the amount of bonds that these new players have been underwriting has not been close to what it was in the past. For example, new entrant Berkshire Hathaway has underwritten only five issues for a total of $583 million of debt for the year to date through June 30, 2009. In addition, only one of the original four major bond insurers—FSA, which was purchased by Assured Guarantee in July of 2009—has financial strength ratings that are high enough to continue to underwrite.

Exhibit 3: Bond Insurers – Then versus Now

	2005	2009 (first 9 Months)
Ambac	Aaa/AAA/AAA	Ca2/CC/WD
FGIC	Aaa/AAA/AAA	WD/CC/WD
FSA	Aaa/AAA/AAA	Aa3/AAA/AA-
MBIA	Aaa/AAA/AAA	Baa1/A/WD
% of Issuance Insured	56%	9%

Source: Bond Buyer.

Rating Agencies – Loss of Confidence

Ratings agencies, which were validating the AAA status of the insurers, suffered an extreme loss of confidence during the crisis, as evidenced by the litigation against them over the past two years. What effect policies and ratings methodology changes will have is unclear at this point.

Broker-Dealers – Continued Volatility

Previously, broker-dealers provided a consistent source of liquidity. Due to the dislocation, both the companies in this industry and their risk appetite have changed dramatically. The differences are clear when considering the top ten broker-dealers in 2007 versus the top ten broker-dealers for the first nine months of 2009, as illustrated in Exhibit 4. These changes have made it much more difficult to access liquidity.

Exhibit 4: Broker-Dealers – Then versus Now

2007

Rank	Firm	Amount Underwritten ($M)	Issues
1	Citi	$ 61,861	603
2	Merrill Lynch	$ 47,927	423
3	UBS	$ 36,253	613
4	Goldman Sachs	$ 28,004	182
5	JPMorgan Securities	$ 25,566	338
6	Morgan Stanley	$ 25,495	255
7	Lehman Brothers	$ 24,804	250
8	Bear Stearns	$ 24,630	133
9	Bank of America	$ 17,051	402
10	RBC Capital Markets	$ 14,307	568
Total		$ 305,898	3,767

2009 (first 9 months)

Rank	Firm	Amount Underwritten ($M)	Issues
1	Citi	$ 42,713	298
2	Bank of America Merrill Lynch	$ 41,483	373
3	JPMorgan	$ 33,655	268
4	Morgan Stanley	$ 27,260	242
5	Goldman, Sachs & Co.	$ 19,376	132
6	Barclays Capital	$ 18,253	123
7	RBC Capital Markets	$ 12,464	433
8	Wells Fargo & Co.	$ 8,529	284
9	Piper Jaffray & Co.	$ 8,202	379
10	Morgan Keegan & Co.	$ 8,099	389
Total		$ 220,032	2,921

Combined entities　Exited the market　New entrant

Source: Bond Buyer

Challenges for Issuers

The dislocation of the three key intermediaries in the municipal market has led to a host of challenges for both issuers and investors. States, or the issuers, are experiencing very steep revenue declines in all three income sources for the first time in 15 years: personal income taxes, corporate income taxes, and sales taxes. This decline is illustrated in Exhibit 5.

In addition to the revenue declines, states are facing mandatory spending increases and a higher debt burden. Costs of Medicaid have increased, there are looming public pension payments, and the rise in unemployment has led to significant increases in benefit payments. Simultaneously, debt per capita, debt to income, and debt service as percentage of expenditures went up significantly, limiting the municipalities' financial flexibility.

Challenges for Investors

How can investors bridge the gap left by the dislocated intermediaries? First, it is important for investors to understand that there are many different issuers with different credit risks in the market. Second, investors should acquire independent credit review, which is necessary to assess the quality of the issue, as intermediaries are generally unreliable at this point.

Exhibit 5: % Change in State Tax Collections vs. Same Quarter One Year Before

	2007 Q1	2007 Q2	2007 Q3	2007 Q4	2008 Q1	2008 Q2	2008 Q3	2008 Q4	2009 Q1	2009 Q2	2009 Q3 (prelim)
PIT*	8.5	8.9	7.0	3.8	5.0	8.0	1.4	-1.4	-17.7	-27.5	-11.4
CIT**	14.8	1.7	-4.3	-14.5	-1.3	-7.3	-12.8	-21.9	-20.1	2.9	-19.4
Sales Tax	3.1	3.5	-0.7	4.0	0.6	0.3	4.6	-5.3	-8.3	-9.5	-8.2
Total	5.2	5.4	3.0	3.6	2.6	5.0	2.7	-4.0	-11.7	-16.6	-10.7

Source: The Nelson A. Rockefeller Institute of Government

*Personal Income Tax

**Corporate Income Tax

Also, investors must be patient: Inventories are more dispersed, making it tougher to find bonds, and the over-the-counter market structure creates wide bid-offer spreads and liquidity challenges.

Reality Check: Are the Risks Acceptable?

We often begin our analysis by reviewing the risks of a potential investment. The good news is that municipalities have a great history regarding bankruptcies and defaults. States and municipalities cannot file for bankruptcy; however, when required, they can restructure the terms of the debt, which is not necessarily a good outcome for investors. While bankruptcy or default may not be common, there have been many near-misses and investors should be aware of the fiscal stress on a municipality. In addition, municipalities are just beginning to feel the effects of the credit crisis and to deal with problems such as budget gaps and revenue decreases. Investors should be cognizant of how a municipality might manage these gaps given the amount of debt that the municipality itself carries.

Opportunities

There is currently a high amount of credit differentiation in the municipal market, creating opportunities for those that can recognize value, not just quality. For example, two states with the same credit rating may have very different fund balances, historical financial performances, debt per capita, or tax bases. There is also a high level of legal structure differentiation in the municipals market. Municipals come in different shapes and sizes, and paying attention to details in the terms and conditions and priority of the pledge can be critical. Due to the inconsistencies of reporting in the municipals space, considering the management team is also important. We believe that a municipality that posts disclosures frequently, in a timely fashion, and makes its management available to investors is key to the value of the issue. Last, we believe there is value in new issues, such as the Build America Bonds program.

Conclusion

Despite the fact that structural changes have occurred and there appears to be no fast or simple resolution, the dislocation in the municipal market has created opportunities for those who actively engage risk. However, not all credits are equal, and we believe it is important for investors to focus on strong issuers and those securities that have acceptable risk characteristics.