

THE BOND BUYER

Commentary Historic hurricanes present a challenge for muni market

By John Hallacy

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As Hurricane Harvey's floodwaters begin to recede in Texas and Louisiana and Hurricane Irma bears down on Florida, we are just beginning to focus on the many tasks ahead. The focus of this comment is the consideration of public assets in everyday life; the prospects for accomplishing the rebuilding with municipal financing, and the effect on credit quality for the credits affected by these forceful and devastating storms.

John Hallacy

I have a great deal of empathy for the challenges and the suffering that people face in the Greater Houston area and along the coast. Having had to deal with the tragedy of 09/11 and the damage and disruptions of Sandy first hand, I truly know what you are going through and I hope for the best for you.

In Texas, we will need to begin to focus on the fine points of damage estimates and the challenging tasks of recovery, debris removal and rebuilding. Given the fact that access at this point to properties is just not practical, drones are really proving their worth. Assessments must be made by claims adjusters no matter which approach is utilized. Early estimates of industrial and commercial damage have been in the \$20 billion range for the commercial insurers, though at this point the number is just an educated guess. The number will be revisited many times before the aggregate total is more accurate.

The damage estimates when they become formal are likely to lead to property tax appeals that are likely to exert additional pressure on local property taxes. The latter is the fundamental support for school districts in Texas and for local governments.

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In the municipal market we are concerned about all aspects that will affect the outcomes, especially for public assets. As reported, the preliminary ask to Congress is going to be approximately \$180 billion. The rationale for this number

will need to be strongly supported with facts and refined damage estimates. In a post Sandy world this aspect has become highly politicized. However, when the final vote comes I would trust that we will do right by the people in the zone.

The Municipal Promise

What can be accomplished by tax exempt financing? The programs authorized for the Sandy recovery were very specific as to amount, time and purpose. In the case of Harvey, this consideration may take more than one week when Congress is in session. The pressing needs will still dictate that swift action will be a factor in the process. But it is probable that the recovery package that is formulated by Congress will be patterned after what has come before.

The muni industry can get a lot of supply to market very swiftly. The market is starved for supply and a surge of Texas paper could be absorbed easily. It does not matter that the bond paper constitutes national names versus specialty state paper. There is the added kicker to the prospective buyer that in addition to sufficient yield that the buyer is assisting in the effort to rebuild.

The impact on the states and its localities is quite real and discernable. In a different market than the one we are in at present, bonds would potentially trade off more given the potential for credit concerns. In this market now, this condition is not quite the case.

Most local governments have some kind of specific event, blanket insurance, or self-insurance policies against property damage and loss. Flood coverage is often the most difficult to obtain and is not as prevalent. It is impossible to obtain flood when the improvement is in the flood plain. Ultimately, this means that the Issuer is question has to go out of pocket to the extent there are no other reimbursements pending.

In light of this event, we may want to revisit whether relaxing regulations for building in the flood plain should be acceptable. In the event there is no other coverage, FEMA is called upon.

Lessons Learned

The lessons learned from Katrina and Sandy are many. We should hearken back to some of those lessons but we should also be very cognizant of where we may make improvements in the recovery effort so as not to disturb the underlying credit quality.

I had the opportunity to visit New Orleans just a couple of weeks after Katrina. I did not fully appreciate what the Army Corps of Engineers was talking about when they referred frequently to the "bathtub". There I was standing in the Ninth Ward viewing the destruction. I looked at the one structure that was standing on that block and realized that

the lip of the levee was higher than the roof of that structure. All was clear. I just relay this experience because actual inspections will make a difference.

Different structures will have an array of specific damage incidents. Many structures will be affected by electrical and HVAC damage. Concerning the former, in the case of Sandy, the salt water did a great deal to compromise cables and systems. Generators were overcome by the flooding. HVAC systems were water logged.

The Potential Credit Impacts

In Texas, on average, the physical plant is much more youthful particularly in an area such as Houston that has experienced a great deal of growth in recent years. In many cases, the HVAC systems for schools, civic centers, and other important structures are on the roof. It is not likely that all of them are situated this way. Electrical cables generally are run from the street in heavy conduit, but, eventually they have to come above ground.

Primary and Secondary schools for the most part are among the best designed structures around. It is just that there is no way to fully design and prepare for an event such as this one. Most of the schools in the state have the Permanent School Fund backing for their bonds. The integrity of the payment stream for school bond payments is well protected. What will take time is what damage that is not covered by any kind of insurance will have to be repaired with the proceeds of a financing. Of course, some schools have relatively large fund balances but those balances are primarily maintained due to the unevenness of the cash flow. Some repairs will be done out of pocket or with bank loans. Extensive damage will require bonding of some kind.

I have focused on schools because there are just so many of them. Houston ISD on its own has 283 schools serving over 210,000 students.

Now we need to turn our attention to all of the other public assets out there. We cannot fully cover these in a commentary of this kind but they include roads, bridges, airports, governmental centers, civic centers, police & fire stations, water & sewer systems, levees, etc. You have the picture. Each asset has its own discrete set of considerations and challenges for recovery.

Turning to credit quality of the local issuers, most of the credits in the state are evaluated at an A or higher. Fund balances of 5% or more and relatively steady assessed valuation growth are common features. Most of the GOs at the local level are covered by specific millages that are dedicated to the repayment of debt. What this means is that the damage would have to be very significant before the GOs would have an insufficiency. However, downgrades for localities with weaker financial positions going into the event may be harder to forestall. There may be some cheapening in the trading of local paper.

The state itself is reliant on the sales tax for over 50% of its general fund revenues. A depressed level of activity in the Greater Houston area is likely to have some impact on the state's budget in the near term. In the longer term, the state is likely to experience a boost when the repairing, rebuilding and refurbishing commence. This effect would only be somewhat mitigated by any programs to grant sales tax breaks on the rebuilding materials. However, the hours paid for in the rebuilding will still yield some economic uptick. This effect is likely to be delayed for some months. Given the state is AAA, we do not think that these factors will have an overly pronounced effect on the state's creditworthiness.

Revenue bonds will need to cope with a diminution or cessation of revenues for a period of a couple of months or longer. Some of the outcome depends on whether the asset that is linked to the cash flow is in service or not. This is part of the reason that revenue bonds have excess coverage and reserve funds. Water & Sewer systems tend to operate with somewhat tighter coverage due to rate pressures. Most systems have more coverage than what is called for in the rate covenant as a buffer against events both large and small. Water & Sewer systems are also somewhat easier to repair and need to be due to public health considerations. We could discuss the other sectors, but, you have the idea by now. Some sectors may trade off than others for a time. Analysts will be poring over reports to see which bonds may be more subject to challenges.

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Irma in some ways may pose an even greater challenge to Florida, Georgia and the Carolinas depending on the trajectory of the record winds associated with this event. Florida has anticipated a storm such as this one with the creation of the CAT fund. The fund has had the benefit of a long period of time to build assets without the incidence of any major events. The fund has also had a long standing practice of issuing relatively short term debt to have ready cash available for just this kind of event. The protection afforded by the presence of the CAT fund would prove its worth if a major event develops over this coming weekend.

In the end, the repairs and the rebuilding will be pursued apace. Few credits, if any, will experience such a degree of damage that even with the consideration of state and federal aid programs they cannot sustain their operations.

We are hoping for the best outcomes for all. The municipal market will do its best to create and place any financing that is required and we will do it in a fashion that is efficient and at the lowest possible cost. We know how to deliver.