Essential Service Revenue Bonds: A Safe, Conservative Investment

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C.W. Henderson and Associates is a defensively-styled investment manager. Our business philosophy is centered on preserving our clients' wealth by maximizing total returns on an after-tax basis and seeking to never have a negative total return in any year. We seek to minimize credit risk by only purchasing strong credits with good liquidity characteristics in client portfolios. Essential service revenue bonds, which we define as water, sewer, or electric enterprises, are among the safest and most stable sectors in the municipal market and represent a conservative, highly liquid investment opportunity. Bondholder security most always lies in customer willingness and ability to pay his or her utility bills. We view this security favorably, as continued failure to pay usually results in loss of water, sewer and electric services.

Credit Features

When considering an essential service revenue bond for purchase, our research team reviews and assesses numerous credit components. We evaluate the enterprise's service area and examine the primary economic drivers, growth prospects, and socio-economic profile. Careful attention is paid to management quality and whether or not they have the unilateral ability and willingness to raise rates. Our analysts review absolute debt service coverage ratios and reserve/liquidity levels and consider historical and projected trends. We evaluate enterprises' debt profiles, review regulatory compliance, and assess the systems' age. Pension and health care costs tend to be relatively minor because the systems are more capital intensive and less labor intensive. Nuanced credit aspects are also analyzed, including water supply and reliability, susceptibility to drought conditions, treatment capacity, and energy portfolio composition. Below, we provide illustrative examples of three credits we approve and own, as well as one we don't like, accompanied by Moody's and S&P ratings.

Phoenix Water (Aa2/AAA)

Phoenix boasts a large, diverse economy anchored by a significant governmental presence. Its water system provides service to a stable and diverse customer base of ~1.5 million people. Management maintains full rate setting ability and has demonstrated a historical willingness to raise rates. Debt service coverage was 2.4x in 2016 and is projected to exceed 2.0x over the next five years, a coverage ratio we view as very strong. Unrestricted liquidity approximates a year's worth of expenditures, and debt levels are moderate and declining. Extensive planning, an ample water supply, strong conservation measures, and significant storage supplies have left Phoenix well-prepared to handle any future drought conditions.

Honolulu Wastewater (Aa2/AA)

Honolulu is the state capital of Hawaii. Its wastewater system serves a large, diverse customer base with above average income levels. Currently operating at only 67% of potential capacity, the system is well-positioned to accommodate additional customer growth utilizing existing infrastructure. Management retains full rate setting authority and historical rate increases have occurred with broad political and community support. Debt service coverage was 2.5x in 2016 and is projected to exceed 1.8x over the next five years. Unrestricted liquidity is extremely strong, representing nearly seven years (~2500 days) and serves as a significant mitigating factor to the above average debt burden.

Jacksonville Electric Authority (Aa2/AA-)

JEA serves a mature, diverse, modestly-expanding service area. Given its status as state capital, the Jacksonville economy is anchored by a large governmental presence. We have met the management team on several occasions and view them to be extremely capable. They maintain full rate setting autonomy and have a history of strong financial performance. Debt service coverage is presently 2.8x, and the system had over 6 months of unrestricted liquidity at year-end 2016. Debt levels have declined significantly in recent years and are expected to continue falling given a lack of additional issuance plans over the next five years. In an effort to mitigate exposure to future anticipated environment regulations, JEA has been proactively diversifying its energy portfolio away from coal, which comprised 45% of 2016 energy needs, and towards cleaner energy sources such as natural gas and renewables.

Credit We Do Not Approve - Madison WI Water (Aa2/NR)

The Madison water system serves a large, diverse, and growing service area. The local economy is anchored by the University of Wisconsin at Madison as well as a significant governmental presence. Unlike the aforementioned credits, Madison cannot adjust rates unilaterally and must obtain approval from the state's Public Service Commission. The last rate increase in 2015 took 12 months to be approved. Debt service coverage declined from a healthy 2.2x in 2011 to a narrow 1.3x in 2016 while unrestricted liquidity declined from 110 days to 94 days over the same period. When adjusted for the $4.7 million the system owes the city for prior cash advances, however, the liquidity position is negative. Debt levels are manageable but will rise in the near term, as management expects to issue additional debt to fund its capital plan.

Conclusion

Essential service revenue bonds present a safe, liquid, and often attractively priced sector of the municipal market that dovetails nicely with C.W. Henderson and Associates philosophy of preserving our clients' wealth. We purchase high-quality, liquid bonds with strong credit characteristics and exercise diligent oversight on all the bonds we own by reviewing AA- or lower rated credits biannually and higher rated bonds annually. Our research team would gladly discuss in more detail our thought process regarding credit criteria.