Gurtin Municipal Bond Management

Credit Research Flash

Market Overlooks Kern County's At-Risk Local Governments as Oil Revenues Shrink

February 2015

Executive Summary

The media and ratings agencies have been focusing on Kern County, California's declaration of fiscal emergency in response to the drastic drop in oil prices. We believe the County's problems are ultimately manageable, however, a number of other obligors in the County that have escaped scrutiny face dire budget outlooks that far exceed the pain Kern County is forecasting.

As part of our proactive and thorough credit surveillance, Gurtin Muncipal Bond Management, LLC exited positions in three obligors located in Kern County that we suggest are at heightened risk for credit distress given tax bases that are far smaller than Kern County's and revenue streams far more concentrated in the oil and gas sectors.

One of the purposes of independent credit research is to proactively identify obligors that are exposed to nascent risk, thereby protecting investors well in advance of potential credit stress. Our decision to exit positions in West Kern Community College, Taft City Elementary School District, and Wasco Union High School District before the risks were noticed by the market is another example of the manner in which Gurtin's research team works to protect our clients.

Section 1: The media and ratings agencies are focusing on Kern County, California's declaration of fiscal emergency in response to the drastic drop in oil prices. We believe the County's problems are ultimately manageable, but a number of secondary obligors in the County have thus far escaped scrutiny even though their dire financial profile is imminently weaker than that forecasted by Kern County.

In late January, we detailed the circumstances surrounding Kern County, California's decision to declare fiscal emergency in a credit report entitled "Kern County, California Declares Fiscal Emergency: A Prudent Budgetary Maneuver and Not a Sign of Looming Distress." In the report, we suggested that while the drastic decline in oil prices would indeed result in a degree of budgetary stress for the County, we also highlighted the research metrics that support our claim that, in the short run, the County's financial position is strong enough to cover the strain. Additionally, we posited that the declaration of fiscal emergency was a prudent tactic that allows the County to begin to make budget adjustments that would not have been permissible without the declaration to prepare for the potential loss of revenues in its 2016 fiscal year.

Since the County declared fiscal emergency on January 27, 2015, the media has published scores of articles implying an imminent crisis for the County while only citing the specific obligor Kern County; on January 30, Moody's responded by placing only the County's ratings on review for possible downgrade. Though we do believe scrutiny of the County's situation is warranted, we are shocked by the lack of research depth and surface nature of the reporting. A prime example is that, in our opinion, a slew of secondary obligors in Kern County face far more dire budget outlooks than the more high profile County. These obligors are at risk of impending budgetary distress given their reliance on oil and gas related property tax payers that are likely to see their property devalued as a result of plunging oil prices.

Section 2: As part of our proactive and thorough credit surveillance, Gurtin Municipal Bond Management, LLC exited positions in three obligors located in Kern County that we suggest are at heightened risk for credit distress given tax bases that are not only far smaller than Kern County's but also far more concentrated in the oil and gas sectors.

In recent weeks, Gurtin Municipal Bond Management, LLC had commenced a thorough surveillance review of obligors across the nation that we believed may be at heightened risk given the drop in oil prices. As our earlier report stated, our review of Kern County led us to opine that its credit quality remains strong and the short term bonds held in our clients' portfolios retain high credit quality given the County's robust reserves and the manageable budget shortfalls that are projected in the coming year. As part of this process, we also thoroughly reviewed local governments in Kern County, California with priority given to those that were currently held in client portfolios. As a result of our swift, thorough, and timely surveillance, we ultimately downgraded West Kern Community College District, Taft City Elementary School and Wasco Union High School District to a Sell rating. Our analysis found that, due to the dramatic fall in oil prices, these obligors suddenly had risk profiles that had accelerated well beyond our extremely high credit thresholds. We exited all positions at attractive levels and before rating agencies took any action on their public ratings. It is interesting to note that, even given the scrutiny in Kern County, these three obligors continue to maintain deceptively high A1 or A+ ratings from Moody's or Standard & Poor's – only 4 notches removed from their highest AAA rating. As of yet, neither Moody's nor Standard and poor's had reviewed any of these three obligors.

The scrutiny of the County's financial position is driven by the degree of tax base concentration in oil companies – or in other words, the amount of taxable value and therefore property taxes that are derived from oil and gas companies. In 2014, the County estimated that approximately 30.9% of its tax base was concentrated in its top 10 taxpayers, most of which are oil and gas production companies. This concentration is what has led the County to proactively begin to address expected property tax declines in 2016. However, as Figure 1 below illustrates, Kern County is in an enviable position relative to the aforementioned local governments in the County. The three obligors that we downgraded have tax bases that are dwarfed in size by the County, the smallest of which is approximately 1/40th the size of the County. Equally as alarming is the fact that all have far higher levels of concentration in the oil and gas sector. These obligors face a far more daunting task of not only managing their operating budgets in light of expected material valuation declines in oil related properties, but also finding a way to increase the portion of their property tax rate devoted to repaying bondholders that is sufficient to pay outstanding debt. For example, West Kern Community College is likely to see significant devaluation of over 87% of its tax base – a level nearly three times as large as the impact forecasted for Kern County. How dire is the situation? Our research suggests that the College District and the two school districts we sold may face increasing likelihood of a credit event, default, or even bankruptcy should their tax bases be devalued as

Figure 1: Tax base size and oil and gas concentration in Kern County[1]

Obligor	Assessed Valuation ($000)	Top 10 Taxpayers as a % of Total Valuation	Oil & Gas Approximate Share of Top 10
Kern County	$101,158,113	30.9%	26.7%
West Kern Community College District	$14,428,679	91.3%	87.2%
Taft City Elementary School District	$2,842,232	82.4%	80.8%
Wasco Union High School District	$4,272,245	65.2%	55.3%

[1] All data is taken from each obligor's Fiscal Year 2014 continuing disclosure filings on EMMA and represents assessed valuation and taxpayer concentration data from 2014/15.

currently projected given the drastic declines in revenues coupled with the practical limitations on how high these obligors can raise the tax rates that pay outstanding debt.

Section 3: One of the purposes of independent credit research is to proactively identify obligors that are exposed to nascent risk, thereby protecting our clients from downside risk well before that risk is fully apparent to the investing public. Our decision to exit positions in West Kern Community College, Taft City Elementary School District and Wasco Union High School District before the risks were noticed by the market is an example of how Gurtin's research team works to protect our clients.

We believe this is yet another example that illustrates the crucial importance of independent credit research. Those investors who are relying on either the media or rating agencies to serve as their early warning signals of credit risk may be holding what in our opinion are ticking time bombs that have yet to be noticed by either Moody's or Standard & Poor's. These small local governments are unlikely to generate the kind of widespread media coverage that accompanied Kern County's decision to declare fiscal emergency until after the bomb detonates and a credit event occurs. Our strong and proactive surveillance efforts identified these obligors quickly, and Gurtin Fixed Income adhered to our stringent philosophy of avoiding downside risk by exiting the positions in a timely manner before their ratings were downgraded and the bonds lost value. While these obligors may ultimately find a way to muddle through the likely harrowing impact of massively reduced property taxes, we believe that it is not in our clients' interests to hold onto the debt and hope that they are able to navigate what looks to be a perilous path. When there are so many high quality bonds in the municipal market, why hold onto those that are subject to very real and potentially calamitous downside risk?

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