Gurtin Municipal Bond Management

Credit Research Flash

San Bernardino's Forseeable Bankruptcy Filing Presents Buying Opportunties

July 2012

Executive Summary

The City of San Bernardino voted to pursue bankruptcy protection on July 10, 2012; we believe this should have been seen as a possible outcome, because the city has had extremely weak credit fundamentals for several years.

- City's financial and economic metrics have been poor for a considerable period of time

We anticipate that there will be guilt by association to the San Bernardino name which will lead to potential opportunities as market participants rush to sell completely unrelated and unaffected obligors

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On July 10, 2012, the San Bernardino City Council voted to seek bankruptcy protection. Many market participants have stated that this was unexpected, and indeed it seemed to surprise the ratings agencies as Standard & Poor's maintained an investment grade BBB+ rating on the city's lease obligations until the day after the council's vote. However, Gurtin Municipal Bond Managmenet believes this situation should have been seen as a predictable risk for quite some time due to the city's deteriorating credit quality in recent years.

City's financial and economic metrics have been poor for a considerable period of time

Gurtin Municipal Bond Management's clients have no exposure to the city's debt and have not had any exposure for at least the past five years. The City of San Bernardino is an example of an obligor with credit quality characteristics that we avoid. The city had a frail tax base and weak local economy well before the recent recession, as evidenced by resident wealth levels that have always hovered at a very dismal 50% of California's averages – levels that are commensurate with the poorest regions of the nation. The recession's impact on the city has been substantial: unemployment reached 20% by July 2010 and still remains above a very disturbing 15%. The city's tax base has declined considerably as evidenced by the 15% plus drop in the two-year period between the beginning of 2010 and the end of 2011. Due to California's Proposition 13 and the fact that property taxes are California's largest revenue source, a valuation decline of this magnitude is difficult to endure, because a reduction in tax base value has a direct negative effect on property tax revenues.

The city's financial trends further support a credit rating that should have been below investment grade for quite a few years. The table below shows how weak the city's financial position had become by 2009 and 2010 relative to even the weakest portion of investment grade cities nationally. In 2009, the city essentially exhausted its reserves after a $13.4 million operating deficit left the city with only $2.7 million in reserves, or conversely a scant 2% of its expenditures. In average, these metrics are well below the medians for cities rated in the BBB category.

In 2010, the city's finances further deteriorated with total reserves falling to an alarming 0.3% of its expenditures. This left only a measly $410,000 in reserves. To put this in perspective, the average reserve level for California cities is over 20% of expenditures. By year end 2010, the city's operating deficit totaled more than 5.6 times its remaining reserves. And if at the end of 2011 the operating deficit were to exceed $410,000, the city would essentially be insolvent. Although its audited financial statements are heavily delayed and not yet available, the city reported that the 2011 estimated operating deficit was $1.6 million. To make matters worse, as far back as 2009, the city's cash on hand had eroded to a dangerously low $135,909 or just 0.11% of its total budget. When we review an obligor, one of our litmus tests is that reserves should be more than sufficient to cover any future projected budget deficits and any unforeseen expenditures. San Bernardino clearly would not have passed this test.

When Standard & Poor's made the shockingly misguided assertion in its April 2011 rating report that the city's reserves were "adequate", San Bernardino had actually depleted any cushion they may have had in the past. At this point, the specter of bankruptcy surely should have been clear to any analyst if they had reviewed the city's 2009 or 2010 financial statements – both of which had been published long before April 2011. Standard & Poor's surprising 2011 report combined with the fact that the city was afforded an investment grade rating until the day after the city council voted 4-2 to authorize a bankruptcy

Table 1: City of San Bernardino's 2009 and 2010 selected financial ratios compared to medians for BBB rated cities nationally

	BBB Medians	San Bernardino – FY10	San Bernardino – FY09
Total General Fund Balance as a % of Revenues	*10.6%*	0.35%	2.15%
Unreserved General Fund Balance as a % of Revenues	*7.5%*	-0.6%	1.98%
General Fund Cash as a % of Revenues	*8.4%*	0.29%	0.11%

filing is yet another black eye for the ratings agencies. This follows a string of instances where a ratings agency was reactive and moved its ratings only after a credit event had occurred. Investors who held San Bernardino's debt were left with debt that in one day moved from investment grade (BBB+) to junk (CC), a remarkable 12 notches in a single action and only after media reports of the bankruptcy vote by the city council. This is yet another instance that supports our assertion that it is extremely risky to use the ratings agencies as the arbiter of credit quality.

We anticipate that there will again be guilt by association to the San Bernardino name which will lead to potential opportunities as market participants rush to sell completely unrelated and unaffected obligors

In the coming weeks and months as the news surrounding the City of San Bernardino unfolds, we expect a rush amongst uninformed market participants to exit any bonds that they believe (many times erroneously) are tied to the city. We anticipate that this will present investment opportunities as sellers exit positions in obligors that are completely separate legal entities and that are entirely unaffected by the city's bankruptcy. We will diligently seek to take advantage of any new and appropriate opportunities that we discover.

Please feel free to contact us at research@gurtin.com for additional information.

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