



Gurtin

Municipal Bond
Management



Credit Research Flash

California and Michigan Schools Highlight Inconsistent Municipal Recovery

November 2014

Though many media pundits and municipal market investors are declaring that a broad national recovery for municipal credit quality is occurring, Gurtin Municipal Bond Management posits that the recovery has been more uneven than many believe. The credit cycle has indeed turned positive for many obligors; however, conditions remain tenuous for many distressed obligors. Vastly differing budgetary trends in California and Michigan schools districts illustrate the more nuanced narrative that we believe exists.

School districts in many states have begun a gradual fiscal recovery given increasing state support and improving local property tax bases; however, the recovery in Michigan has been mixed.

Last month, the State of Michigan's Department of Education released a report on the current status of "Deficit Districts" which indicates that the outlook in Michigan is stagnant at best. Michigan school districts are declared Deficit Districts by the state when their General Fund balance is negative, or projected to be negative, by the end of the current fiscal year. These districts are required to notify the state and submit a deficit elimination plan or they face a possible interruption of their State School Aid funding. Over the last three years, the number of Deficit Districts has hovered around 50. Within this time frame, districts experienced flat or steep reductions in state aid and in the most recent year received only a modest increase which did little to repair the damage done in prior budget

cycles. Weaker school districts in Michigan have struggled with a convergence of negative factors which include weak regional economies, an inability to increase revenues, declining enrollment and, above all, a steep reduction in state aid. These factors have resulted in increased debt ratios, weak balance sheets and sharp budget reductions which have constrained management's ability to absorb additional budgetary pressures. We believe distressed school districts in Michigan will continue to face the negative implications of enrollment declines, as local economic trends remain pressured with only modest and potentially temporary recovery and susceptibility to additional state aid reductions.

Conversely, California school districts, which shared similar reductions during the economic downturn, exhibit a more positive recovery story. California schools have seen a dramatic 84% reduction in the California Department of Education's negative and qualified certifications, have gone from 188 to 30 in the same three-year period. These certifications are early indicators of a district's potential inability to meet financial obligations within a one-to-three-year time horizon and are similar state-monitored harbingers of potential distress. Clearly, this sharp reduction is indicative of a more favorable operating environment for districts within the state. California districts have benefitted from improving local economies and a stronger state budgetary position, which has allowed for increased state support. Furthermore, the contrast in recovery of the weakest segment of obligors within the same sector in two different states exemplifies the inconsistencies in recovery after the recession.

Discovery of these inconsistencies requires internal analysis rather than assumptions that the overall more positive credit environment means a recovery for all. As a result, we will continue to enforce stringent thresholds for underlying credit quality and look for sectorial indicators of potential recovery or additional distress from state to state.

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

Check out our Twitter [@followGurtin](#) and [LinkedIn](#) for news, information, and market updates.

Share the report:



Analysts:

Illiana Perez
Senior Associate
iperez@gurtin.com

Thomas Schuette
Partner, Co-Head of Credit Research, Co-Head of Portfolio Management
tschuette@gurtin.com

Important Disclosures

The contents of the report are for informational and educational purposes only. Each investor should make his or her own investigation and evaluation of the investments including the merits and risks thereof, and this report should not be construed as investment, tax, financial, accounting or legal advice. Gurtin Fixed Income Management, LLC, doing business as Gurtin Municipal Bond Management (“Gurtin”) is a registered investment adviser with the U.S. Securities and Exchange Commission (the “SEC”).

The analysis contained herein is based on the data available at the time of publication, certain assumptions, that if different could result in different outcomes, and the opinions of Gurtin. The opinions and information stated and relied upon herein may become outdated, change, or otherwise be superseded at any time without notice. Certain information contained in this report is based upon third party sources, which Gurtin believes to be reliable, but are not guaranteed for accuracy or completeness. Neither the SEC nor any other federal or state agency or non-U.S. commission has confirmed the accuracy or determined the adequacy of this document. Any report to the contrary is unlawful.

Each investor should inform himself or herself as to the tax consequences of the investments and services described herein. Clients should have the financial ability and willingness to accept the risks associated with the investments made by Gurtin. Gurtin reserves the right to modify any of the terms described herein.

No assurance can be given that the investment objectives will be achieved or that investors will receive a return of any capital. In considering any prior performance information, historical or hypothetical, contained herein, clients should bear in mind that prior performance does not guarantee nor is it indicative of future results. Performance includes the reinvestment of all income. Therefore, no current or prospective client should assume that the future performance of any specific investment or investment strategy (including those undertaken or recommended by Gurtin) will be profitable or equal to corresponding indicated performance levels.

Each recipient of this report acknowledges and agrees that the contents hereof constitute proprietary information that Gurtin derives independent economic value from. The recipient further agrees that the contents of this report are a trade secret, any reproduction or distribution of this report, in whole or in part, or the disclosure of its contents, without the prior written consent of Gurtin, is prohibited, and the disclosure of this report or its contents is likely to cause substantial and irreparable competitive harm to Gurtin. By accepting this report, each recipient agrees to the foregoing.

Copyright © 2014 Gurtin Municipal Bond Management