Gurtin Municipal Bond Management

Municipal Credit Research Report

Stockton-East Water District Highlights How Market Misperceptions Provide Opportunities

June 2012

Executive Summary

Stockton-East Water District provides an excellent example of how market misperceptions provide opportunities for Gurtin Municipal Bond Management's Alpha Strategy

Many market participants likely confuse Stockton-East Water District with the City of Stockton despite its standing as a completely separate legal entity that is independent of the city

Standard & Poor's took aggressive action on the District's ratings following the City of Stockton's default, which we believe is inconsistent with Stockton-East's true credit quality and with rating agencies' historical rating methodology

- Stockton-East has a robust balance sheet with more cash than total outstanding debt

Beyond the balance sheet: Stockton-East exhibits other fundamental strengths that we believe Standard & Poor's has ignored

- The District is a wholesale water provider with strong legal contracts with the underlying water providers that purchase water from it
- Water is the most essential of services, and just because Stockton has financial difficulties does not mean that its residents will cease to need water

- The District's revenues from Stockton are an operating expense of the city's water utility and are paid prior to Stockton Water's own bondholders

Stockton-East Water District provides an excellent example of how market misperceptions provide opportunities for Gurtin Municipal Bond Management's Alpha Strategy

Gurtin Municipal Bond Management's Alpha strategy focuses on discovering municipal market pricing inefficiencies in order to purchase undervalued high quality bonds. The most common pricing inefficiency catalysts in our opinion are: 1) misinformed media reports, 2) bonds misrated by the ratings agencies or with no underlying ratings, and 3) ambiguity of who the actual obligor is or what the actual security is. We believe that the Stockton-East Water District (the District) example shows these catalysts contributing to misinformation in the market, and explains why the bonds trade at yield levels well above where the District's credit quality suggests they should trade.

Many market participants likely confuse Stockton-East Water District with the City of Stockton despite its standing as a completely separate legal entity that is independent of the city

Following news in late February 2012 that the City of Stockton would default on $330 million of bonds as it attempts to negotiate concessions from bondholders, many market participants began to associate contagion with other obligors that seemed to be tied to the city or even possibly assume that other entities were part of the city. The Stockton-East Water District was formed in 1948 as an independent political subdivision of the State of California and has its own publicly-elected Board of Directors and is in no way governed by the City of Stockton. Despite its independence, the presence of "Stockton" in the District's name has likely led the market to grossly exaggerate the credit risk tied to the District's outstanding bonds seemingly corroborated by the ratings agencies.

Standard & Poor's took aggressive action on the District's ratings following the City of Stockton's announcement, which we believe is inconsistent with Stockton-East's true credit quality and also with rating agencies' historical rating methodology

On February 29, 2012, the same day the Stockton city council voted to suspend debt payments, Standard & Poor's lowered its ratings on Stockton-East Water District's bonds to BBB+ from A and kept the District on negative credit watch suggesting a likelihood of further downgrades. In the rating agency's report, they cited concerns over the City of Stockton's role as one of the District's customers and the potential financial impact resulting from the city's decision to possibly pursue Chapter 9 bankruptcy protection.

We believe Standard & Poor's rating action was a knee-jerk reaction to the City of Stockton's announcement and does not actually consider the District's own credit strengths, which we will outline below, and does not follow Standard & Poor's own rating methodologies used to rate similar bonds.

Stockton-East has a robust balance sheet with more cash than total outstanding debt

The District maintains a balance sheet that alone sets it apart from the vast majority of its peers and suggests well above average credit quality. Starting in

1992, the City of Stockton and San Joaquin County began collecting development fees and contributing a portion of them to the District. Since then, the District has irrevocably pledged these fees to the punctual payment of its outstanding debt and has deposited the fees with a trustee. Importantly, these funds are held by a third-party that serves bondholders and are segregated from the District's operating funds. By the end of the District's 2011 fiscal year, these fees had accumulated to over $87 million and are shown in the District's audited financial statements as being restricted for debt repayment. According to the same financial statement, at the end of 2011, the District had a total of just over $68 million in total debt outstanding. Therefore, the District could in theory cease generating any revenues and still have sufficient cash on hand to retire the principal of all of its debt outstanding. The table below shows the consistent reporting of cash levels that exceed the debt outstanding.

Standard & Poor's downgrade report makes no mention of the District's cash accumulation that is not only devoted to debt repayment, but is also in fact readily available to the trustee to draw on in order to pay bondholders. This significant credit strength alone sets the District apart from the vast majority of municipal market obligors as few exhibit a balance sheet with cash resources that exceed debt outstanding.

	2009	2010	2011
Restricted Cash on Hand	$80,876,696	$81,586,053	$87,586,053
Total Debt Outstanding	$71,961,383	$70,288,201	$68,544,244

Beyond the balance sheet: Stockton-East exhibits other fundamental strengths that we believe Standard & Poor's has ignored

The District's balance sheet alone provides a compelling argument for a high quality credit rating; however, we believe there are other fundamental factors that Standard & Poor's and the market are ignoring including: 1) the District's role as a wholesale water provider with strong contracts with the underlying water purchasers; 2) the essential nature of the service that is provided; and 3) how the District derives its revenues from the City of Stockton, which pays the District before it pays its own bondholders.

The District is a wholesale water provider with strong legal contracts with the underlying water providers that purchase water from it

The District's role as a wholesale water provider gives it significant credit strength in our opinion. The District has established water rights from two sources, the Calaveras River and the Stanislaus River, and provides treated water from these sources to five different entities: the City of Stockton, California Water Service Company, the Village of Lincoln, the City of Colonial Heights, and San Joaquin County. As part of its contract with these entities, which does not expire until 2035, the District can charge these utilities the amount necessary to reimburse the District for all operating expenses and principal and interest costs regardless of the amount of water delivered to its customers.[1] Therefore, given the contract, the District

[1] The contract does stipulate that the customers may suspend payments if the District is unable to deliver 7,500 acre feet of water in any year. Even in the worst drought years, the District has delivered more than 6 times this amount.

is well within its rights to charge its members whatever it needs in order to pay bondholders. Even if one of the members is unable to make its scheduled payments to the District, the District has the ability to distribute those uncollected costs to the other members.

Water is the most essential of services, and just because Stockton has financial difficulties does not mean that its residents will cease to need water

The City of Stockton relies on the District for over 75% of its water supply. In fact, all of these entities, with the exception of San Joaquin County, rely on the District for the majority and in some cases nearly all of their water supply. The District provides the most essential of essential services to its contract members, and despite Stockton's financial woes, its residents will not suddenly cease to need water. Gurtin Municipal Bond believes that given the service the District provides and the relative scarcity of water in this part of California, it is nearly unthinkable that any of the District's contractual partners will decide to walk away from their payments and thus walk away from receiving the bulk of the water that their residents rely on. Stockton has no other cheap water alternatives, and arguably no other alternatives that it could turn to should it decide to walk away from its contract with the District.

The District's revenues from Stockton are an operating expense of the city's water utility and are paid prior to Stockton Water's own bondholders

A final factor that we believe Standard & Poor's has neglected in its analysis is the District's superior place in line in Stockton's payment structure. All of the District's payments from its contracted members are operating expenses of those utilities. Essential service revenue bondholders are typically paid after utilities pay the operating expenses of their system; however, the City of Stockton's payments to the District are an operating and maintenance expense of the city's water utility and are therefore paid prior to the city's water utility paying its own bondholders. These payments represent the cost of purchased water for these utilities and are not considered "debt payments." The city is not approaching the District to seek concessions on these payments, and in fact at this point, the city is adamantly stating that its utilities will not be affected by its financial turmoil.

We are currently avoiding the city's direct utility debt as we continue to analyze the situation, but there is no current evidence that the city will seek to or is even able to renegotiate its payments for water from the District. If they do so, the District is well within its rights to forgo water sales to the city and distribute those costs to other members.

Given all of the misinformation in the market, we were able to seize on the opportunity to buy Stockton-East's bonds at attractive levels. Despite our internal A+ rating on the District's debt, which is based on all of the strengths outlined above, the bonds traded at levels consistent with BB rated bonds – or bonds well below what is commonly considered "investment grade" and at least 6 notches below our internal rating. We were able to purchase $28.7 million of Stockton East bonds at these attractive levels and spread them across all municipal alpha accounts, generating considerable alpha for our clients.

Conclusion

Gurtin Municipal Bond Management believes

Stockton-East Water District provides an excellent example of how municipal market pricing inefficiencies allow us to generate substantial alpha for clients while maintaining solid credit quality. Many market participants reacted to news of the City of Stockton's default by rushing out of any debt that appeared to be linked to the city. This example shows that while obligors may share a name, they often share little else. With many firms having no research capabilities, they were left to rely on the ratings agencies, and Standard & Poor's again proves the danger of relying on these firms, which have alternated between incremental or non-existent action when actual risk exists and aggressive, knee-jerk responses that bow to headlines. By having our own experienced research team, we were able to move quickly on news of Stockton's difficulties to find obligors that we believed would fall victim to misunderstanding and thoroughly analyze their credit quality. At a time when other managers were scrambling to determine if they had exposure to obligors that they believed were affected by the City of Stockton, we were able to proactively look for opportunities. We look forward to continuing to search diligently for other opportunities to buy mispriced high-quality bonds.

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

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