Municipal Market Update: 2016 Recap and 2017 Outlook

Up until the November 2016 election, the municipal market exemplified stability with attractive borrowing rates. Last year, local governments capitalized on the lowest tax-exempt rates in over 50 years with the municipal bond market volume exceeding $444.79 billion on over 13,000 issues. As a result, 2016 reached a new peak with the largest par amount of state and local government debt issued in a calendar year, surpassing the volume during the American Recovery and Reinvestment Act of 2009 which authorized the Build America Bond program. Spurred by attractive savings possibilities, many issuers actively pursued refoundings, most notably the State of Illinois returned to the market for the first time in two years with four issues aggregating $2.8 billion in par. 2016 also saw large issuance upticks in the States of Wisconsin, Alabama, Montana and the Commonwealth of Massachusetts; total par issued increased in 2016 by more than 37% from the prior year. Volume in January of this year, which is historically a low issuance month, neared the 2010 record of $32.6 billion with $31.5 billion of issuance.

After the election, uncertainty surrounding new federal policy triggered a market sell-off that caused the 10-year Municipal Market Data (“MMD”) – tax-exempt benchmark – yield to increase more than 85 basis points by late November, settling at a 60 basis point increase through January. Consequently, municipal bond funds registered their worst negative returns since the 2008 economic crash as fund flows reversed direction for the first time in 54 weeks to end the year with ten consecutive weeks of outflows, which turned slightly positive in mid-January. The severe post-election correction reset valuations and sent Municipal to Treasury ratios above 105%. Heading into 2017, refunding volume was expected to decline due to the increase in rates and negative cash flows. As January stabilized, issuers were able to capitalize on potential savings that they may have missed in 2016.

The new federal administration has indicated that changes in infrastructure spending, healthcare directives, banking regulation, tax policy and trade would unfold shortly after the election. Despite the whirlwind of activity thus far, uncertainty still persists as to how these changes will take shape and what overall impact they will have on local governments. Infrastructure needs in the United States are projected to be near $3.6 trillion by 2020. The new administration has proposed using $137 billion in federal tax cuts to generate private-sector investments to complete infrastructure projects. The President’s public-private partnership (“P3”) preference over the use of traditional bond proceeds for infrastructure programs brings a new dynamic to the market which may include structuring tools for needed infrastructure that has been backlogged by strained governments.

The recovery from the Great Recession has been gradual for both the economy and state tax revenues. States and State Authorities, which comprised 38% of the 2016 issuance volume, experienced elevated credit pressures throughout the year due to slow tax revenue growth and increasing pension contribution requirements. Sluggish revenues have made it difficult for states to rebuild budget reserves and invest in needed infrastructure, while also
accommodating the rising Medicaid and pension contribution cost. It has been reported that state tax revenues declined by 2.1% in the second quarter of 2016 relative to a year ago. Of the 26 states that have delivered their annual addresses, 54% have identified infrastructure as a priority for the coming year, which is lower than the previous two years where infrastructure was a priority for 75% of states in 2016.

Further in 2016, revenues fell short of budget assumptions in 25 states. It should be noted that, in general, the local government sector has benefitted from strong autonomy and has satisfactory financial positions with adequate pension funding. States carry a median rating in the AA category; however, a select few states have supplemented multi-year budget gaps with reduced pension funding. Rating actions for states from the three primary rating agencies weighed positive in 2016, with pension funding pressures triggering downgrades for Connecticut, Illinois and New Jersey. The looming pension problems also caused credit issues for multiple cities, prompting downgrades for Houston, Dallas and Springfield, Illinois.

The low interest rate environment that was present throughout most of last year encouraged riskier asset allocations by many investors, including pension funds. The search for yield created a contraction in credit spreads, and by early June; credit spreads for a single A-rated credit to a double A-rated credit were at their tightest points in over six years, with average spreads of 25 basis points throughout the curve. It is worth noting that throughout January, credit spreads between BBB credits and AAA credits remained below the five year average.

The actual rate of return for pension fund assets has not been able to achieve the actuarial assumptions due to the declining interest rate environment in 2017. Investors’ search for return helped facilitate the contraction in credit spreads elevating high yield fund flows throughout most of the year, indicating that portfolio managers were willing to take on additional risk for improved fund performance. The pursuit of yield also caused a strain on local governments, as investments in higher risk equities and other asset classes caused increased volatility in pension system funding ratios and actuarial contribution requirements. More than 20 large state pension systems, including the Illinois Teachers Retirement System, the State of Florida Retirement System and the Pennsylvania Public School Employees’ Retirement System, reduced their actuarial rate of return which in turn reduced their funded ratios.

Additionally, the new federal administration has expressed strong support for significant shifts in healthcare funding. Changes to Medicare and Medicaid funding may have a significant impact on state and local governments as Medicaid is the largest portion of state budgets, and reduced funding could cause additional strain on states and affect local level funding for universities, hospitals, infrastructure grants and economic development projects.

President Trump campaigned on lower federal tax rates for higher income households as well as corporations. Many taxpayers deferred capital gains from 2016 to 2017 in anticipation of a lower marginal income tax under the Trump administration, an action which has contributed to the slow tax revenue growth in 2016. Additionally, upcoming tax reform seems likely with a Republican-controlled House and Senate. Lower income tax rates would dilute the value of municipal bonds which could cause tax-exempt borrowing rates to increase.

In early February, the Federal Reserve decided not to increase rates after the December action. There have only been three periods since 1995 in which the Fed has raised its federal funds rate consecutively; each of the three rate-hike periods were of different durations and produced different levels of total increases. The most recent series of increases that occurred from June 2004 through June 2006 totaled sixteen consecutive increases of 25 basis points, resulting in a total increase of 425 basis points, including the first action.

An increase in interest rates in 2017 would provide some relief to pension funds as well as strengthen the U.S. dollar. A stronger dollar depresses commodity prices, hurting countries that rely on commodity exportation as a source of national income. Foreign buyers of U.S. exports could also face higher costs, which could affect states such as California, Illinois, Florida and New York, that have exports equivalent to or more than 3.5% of their gross domestic product (GDP).

Although the new administration has expressed strong stances on trade, immigration, healthcare, and tax reform throughout the campaign season, it is still vague on how these changes will be executed. Regardless of the outcome, these changes are likely to have a substantial impact on the municipal market and the public finance industry as a whole.

1 American Society of Civil Engineers
2 The Rockefeller Institute for Government
3 National Association of State Budget Officers
4 Standard & Poor’s
Market Snapshot: Middle-Market Mergers & Acquisitions

Resilience in the Global M&A Market

- Global M&A deal value and volume in 2016 fell short of the record highs set in 2015. Overall, global M&A value fell by 18.1% over the course of the year to $3.2 trillion, while volume declined by 670 to a total of 17,969 deals.
- North America ended its third-highest valued year on record since 2001 with 5,585 deals worth $1.5 trillion, despite being down 22.6% in value compared to the 5,983 deals worth $2 trillion in 2015.
- Despite the overall drop in M&A globally, the number of private equity buyouts reached a five-year high in 2016. There were 2,785 deals, which is 41 more than the previous high set in 2014. Buyout value reached $399.4 billion.
- While global deal value in 2016 fell short of the 2015 M&A boom, we expect 2017 to be another strong year for M&A, as many driving factors of deal activity still remain.

Significant Opportunities Exist to Capitalize on the Favorable Financing Environment

- Borrowers continue to capitalize on the favorable financing environment.
  - Covenant protections remain loose.
  - Interest rates remain near historic lows.
- Total leverage in 2016 for middle-market issues with less than $50 million of EBITDA averaged 5.3x, which is the second-highest leverage multiple on record since 2007.
- Equity contribution for middle-market LBOs averaged approximately 43.4% in 2016, a decrease from 44.7% in 2015.
- Senior stretch loans (hybrid asset-based and cash flow loans) are prevalent given current market dynamics.
  - Conditions exist for debtors to cover all leverage needs with senior debt at senior debt pricing (versus higher mezzanine debt pricing).
Market Snapshot: Municipal Bonds

Municipal Bond Fund Flows and Municipal Market Data (MMD)

Over the last several months there have been negative fund flows averaging more than $800 million per week. 20-year MMD has remained attractive based on a historical basis, but has risen slightly. We expect future Fed decisions to have an impact on weekly fund flows going forward.

As of the weekly reporting date of 2/1/2017.
Source: EPFR Global Fund Flows and Allocations Data – All Muni Funds (Retail and Institutional Funds).

Credit Spreads

- As we discussed in our November Market Update, mutual fund flows turned modestly negative in September and credit spreads began to widen. In the wake of November’s presidential election, there was a volatile and negative reaction in fund flows, reflected by a violent widening of credit spreads.

- The impact of credit spread widening was most dramatic in the healthcare sector, where market liquidity was impaired as a result of the Trump administration’s campaign rhetoric around reversing/reforming the Affordable Care Act. After six weeks of extreme volatility, fund flows have moderated and credit spreads began to stabilize at wider levels. In addition, credit quality fears driven by a stalled and highly adversarial State of Illinois budget process have affected bonds across the Illinois/Chicago credit complex, which has led to rating actions, widened spreads and increased volatility.

- This volatile market environment is one that should reward disciplined and credit-savvy investors who remain focused on identifying value.
Market Snapshot: Corporate Debt

Corporate Debt Spreads – Finance Market Summary

- Although yields have risen post-Brexit and after the U.S. presidential election, interest rates and spreads remain historically “low” across the credit spectrum. Interest rate volatility is likely, given the uncertain domestic and international political and economic environment.
- Despite continuing commentary predicting rising interest rates, a mitigating factor is that corporate spreads, particularly those of lower rated investment and non-investment rated credits, are stable and actually narrowing.

Historical Corporate Bond Yields – 10-Year Maturity

Data as of January 27, 2017.

Strategic Opportunities Involving Real Estate Are Worthy of Consideration Given Favorable Market Conditions

Opportunity Knocks:

- Structuring subordinate debt tranches on a zero amortizing or partially amortizing basis are enabling borrowers to realize greater proceeds from those generated historically. This has increased transaction volume over the past few years, with the trend continuing given stable to increasing real estate valuations.
- Many corporations are considering sale-leaseback opportunities due to favorable real estate valuations, leasing terms and strong capital market conditions for all financing capital tranches.
- Capital availability on favorable terms for acquisitions and refinancing of strategic properties remains robust for involved borrowers.

Corporate Bond Spreads to 10-Year UST
(Based on Standard & Poor’s Corporate Credit Ratings)

Data as of January 27, 2017.
Featured Mesirow Financial Deals

**Acquisition Financing for Unilever’s North American Headquarters**

Mesirow Financial successfully acquired the 22.85 acre, 321,000 square foot property, which is located across the Hudson River from New York City and is in the midst of a substantial redevelopment. Unilever has a long operating history at this location, dating back to the mid-1960s, and has reaffirmed its commitment to the location by executing an 18-year lease with multiple options to extend. Mesirow Financial’s Sale-Leaseback Capital group arranged for the purchase of the facility and the acquisition financing was structured in collaboration with Mesirow Financial’s CTL and Structured Debt Products and Institutional Sales and Trading groups. At completion, Unilever’s North American Headquarters aims to be one of the most energy-efficient and technologically advanced corporate facilities on the East Coast. “This supports our strategy to maintain a strong presence in New Jersey and continue to attract and retain great talent across the tri-state area,” said Ian Dunning, service delivery director, Unilever. This transaction is the capstone to an incredibly successful year for Mesirow’s Sale-Leaseback Capital group, with the group having purchased in excess of $500 million of single tenant properties despite a challenging capital markets environment.

**M&A Advisor on the Sale of Supreme Oil Company**

Supreme Oil Company, Inc. has been sold to Stratas Foods LLC, a joint venture between Associated British Foods plc and Archer Daniels Midland Company. The Court of Chancery of the State of Delaware previously appointed a custodian to conduct a sale process. Mesirow Financial acted as the exclusive financial advisor to the custodian in the sale of Supreme Oil. Supreme Oil is a manufacturer, packager and distributor of edible oils and oil-based food products that are sold primarily to the foodservice and retail industries. Supreme Oil’s extensive product portfolio includes frying oils, blended oils, salad oils and dressings, margarines, shortenings, mayonnaises, sauces, vinegars and mustards that are sold under several recognizable trade brands. This transaction is yet another example of the strength of the Mesirow Financial’s relationships with key strategic acquirers in the food manufacturing and distribution industry.

**Sole Senior Manager for Rosemont**

Mesirow Financial served as sole manager for the aggregate $100,000,000 General Obligation Corporate Purpose Bonds, Series 2016A&B on behalf of the Village of Rosemont (the “Village”). The Series 2016A tax-exempt bonds and 2016B taxable bonds were issued to fund the construction of a 6,500 seat minor league baseball stadium facility, a 40,000 square foot restaurant and entertainment complex and two parking garage facilities, with spaces for 2,010 vehicles. The Series 2016A&B Bonds are rated “Baa1” by Moody’s and “A” by S&P. The Mesirow Financial Public Finance group worked in collaboration with the Village, bond counsel and the Village’s municipal advisor in crafting a financing structure that maximized the amount of tax-exempt bond proceeds, resulting in interest cost savings of approximately $6,000,000. Further, due to the post-election market volatility, Mesirow Financial committed over $35,000,000 (35% of the transaction) of firm capital to purchase remaining bond balances and reduce market risk for the Village, thus supporting the best possible pricing for the transaction.
Capital Markets
Established broker-dealer offering a suite of innovative financial products and services combined with extensive market expertise to serve the unique liquidity needs of your institution.
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- Fixed Income Sales and Trading
- Public Finance
- Sale-Leaseback Capital
- Structured Debt Products

Investment Banking
Boutique M&A advisor serving middle-market clients globally and providing customized solutions to meet their unique needs.
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- Board of Directors Advisory
- Fairness and Solvency Opinions
- Restructuring and Special Situations
- Private Capital

About Mesirow Financial
Mesirow Financial is an independent, employee-owned firm founded in 1937. As specialists in investment, risk management and advisory services, we are committed to helping our institutional, corporate and individual clients achieve their objectives. Our professionals are inspired by an entrepreneurial desire to develop tailored solutions designed to deliver measurable results. To learn more, please visit mesirowfinancial.com.

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