Capital Group

Municipal bond sector view: Initial COVID-19 impact assessment

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Here, we share insights from Capital Group's municipal bond investment team* on how some key sectors will likely be affected by the COVID-19 outbreak.

General obligation

- The volatility in the equity market negatively impacts pension funding, and the pending recession will put further strain on sources of revenue.
- Generally, states have multiple sources of revenue and significant cash reserves, but personal income taxes are a major source for some. For example, income taxes account for more than 70% of tax revenue for California, Virginia, Oregon and New York. Those states should expect to see greater volatility in revenue than others.
- Pension funding will be negatively impacted by the downturn in the equity market — many plans have allocations to equities, hedge funds, private equity and alternative investments that exceed 70%.
- Many states have the ability to weather market and economic volatility, while others that are already in a weak position will be under greater stress and forced to make difficult decisions.

Health care

- It is difficult to predict the magnitude of challenges the hospitals will face. Broadly speaking, we view this as stress to the system and a near-term negative credit event as a result of the following:
  - A surge in COVID-19 and ventilator/ICU patients, which creates higher costs.
  - A new payor mix that is highly skewed toward lower-paying patients and crowding out commercial patients; most U.S. hospitals have canceled all elective surgeries and reduced general outpatient visits.
  - It's possible that hospitals will broadly report weakened operating results in the near term, and many will report negative operating margins.
- Larger and better-capitalized hospitals should be able to deal with these challenges. Given the likelihood of operating pressures, cash will be key. Additionally, larger hospitals will likely have better disaster planning strategies in place.
- A Federal aid package to address the challenges from COVID-19, including supplies and financial support, is being worked on.
- We continue to prefer multi-state systems and children's hospitals to stand-alone hospitals and single-state systems.

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Transportation

- Airports are negatively impacted by COVID-19 in the near term. Airlines are slashing capacity, and air travel is slowing significantly (it could largely halt for a few months, at least). We do not believe the desire to fly will be structurally impaired, so this is likely a short-term phenomenon.
- Spreads have widened significantly over the last month and are starting to price in some of this risk.
- Despite near-term difficulties, airports generally have significant cash. Most have sufficient unrestricted cash and debt service reserve funds (DSRFs) that could last an entire year if they don't get any revenues. That seems like an unrealistic scenario given that the airlines are generally on the hook for covering the costs of the airport. But there is more concern about airline bankruptcies, so cash is extremely important.
- Within the transportation sector, mass transit systems are among the most exposed to the economic fallout of COVID-19. Data is trickling in, with the Bay Area Rapid Transit (BART) reporting recent ridership was down 61% and the New York MTA reporting subway ridership was down 18%. This could be the start of a more meaningful drop-off in ridership and associated farebox revenues.
- Systems with diversified revenue streams and above-average liquidity (unrestricted cash/investments, revolving lines of credit, and reserves) are best positioned in this environment.
- Toll revenue will similarly decline, as more employees telecommute, more schools/universities are canceled and broader social distancing measures take hold. Within the toll sector, we view managed lane projects to be most at risk.
- In the near- to mid-term, the transportation sector is challenged. We may see further spread widening and credit deterioration. This could provide opportunity to add high-quality names at attractive levels. Over a longer term horizon, many toll/transit credits will continue to be highly essential for regional mobility and should benefit from strong/rebounding demand.

Community care and retirement centers

- The senior living sector is under pressure given that the virus is a particular threat to the elderly — especially the 80+ age cohort population.
- The tax-exempt senior living credits are not-for-profit communities. Typically, they have a longstanding religious affiliation, or are university or VA affiliated. The management teams have provided investors updates on the many precautions taken within their community to limit any transmission or spread of the virus, and are actively monitoring the situation to best protect the residents of their communities.
- These bond issues typically have a first mortgage on the underlying real estate. The longstanding history of the communities often involves high-value real estate holdings that would be prohibitively expensive to replicate today (examples include large land holdings in Downtown Seattle, Washington D.C. metro area and Long Island). These providers maintain well-established lines of credits with banks, giving them the ability to draw on more funding when needed. We believe the bond security and additional levers these communities must pull in difficult times give an advantage to other segments of the senior living industry.
- Our investment approach is to select tax-exempt senior living credits that we believe have the operational bandwidth, depth of liquidity, high real-estate collateral value and management expertise to withstand economic cycles.

Education

School districts

- Among school districts in the western states, we have tended to have a favorable view of certain insured bonds from Texas.
- Texas school districts, for example, tend to be very strong on their own — very healthy general fund balances averaging around 30% of general fund revenue. Growing populations and relatively favorable labor laws are also evident.
- Some bonds are secured by a property tax levy, where assessed value growth has been strong.
- Some bonds are also insured by the Texas PSF enhancement program. There's a pool of around $45B insuring about $90–100B of school district bonds. There's never been a default in the underlying insured bonds, but the program could withstand half of the bonds defaulting and recovering 0%.
- Currently, schools are out of session with COVID-19, but the state has instituted waiver policies for districts to still get revenue despite the lost days.

Charter schools

- This has been a growing sector: About 6% of public-school students nationwide attend a charter school.
- We focus on schools that have standout academics, strong enrollment demand and reasonably conservative approaches to their finances (cash balances, coverage and overall leverage).
- Almost all our charter school investments are closed for at least the next few weeks with COVID-19; however, the school year is nearly complete and the states that have ordered school shutdowns have put in place revenue mitigation measures for school attendance.

Higher education

- Among these issuers, we look for strong balance sheets (defined as cash/investments-to-debt) and margins. When we calculate margins, we remove gifts and endowment income from our calculations (which are heavily reliant on equity returns as is willingness to give by donors) and favor schools that can stand on their own (that is, positive margins after adjustments). Our approach in this sector is, therefore, defensive by nature. As secondary metrics, we look at enrollment trends and net tuition per student trends (i.e., does the school have pricing power).
- We have tended not to favor high-yield credits because many small private schools have razor-thin or nonexistent balance sheets. Our limited exposure tends to be in issuers where we have deep relationships (including consistent calls with management teams and regular in-person visits) stretching over many years.
- Further, revenue impacts from the COVID-19 outbreak (assuming this is not a multi-year phenomenon) should be minimal, as all schools we know of are transitioning to online learning (and, therefore, tuition is still being collected and learning is still happening). If we were to enter the school year in the fall with COVID-19 worries still prominent, online learning would continue to take place.
- International students are a concern, but these are U.S. schools and the vast majority continue to get students from the U.S.

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