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One year later: Municipal bond sectors weather the coronavirus crisis

Insights from
Nuveen Municipal Credit Research

The $1.9 trillion American Rescue Plan Act (ARP) includes a large allocation to municipal issuers. The credit impacts will vary by sector, also influenced by the severity and duration of the outbreak in a particular location. Credit ratings are generally a good barometer of a borrower's ability to withstand unexpected financial stress. Most municipal issuers provide essential services and generally have a long history of functioning through varying economic cycles, credit cycles and temporary disruptions. We expect this to continue.

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STATES

Only nine states are expected to see budget gaps of 10% or greater. States most impacted by the recession were those that depend on tourism and energy production.

State governments will receive $195.3 billion from the ARP Act. Half will be available in the next few months and the remainder one year from now. States have until the end of 2024 to spend stimulus aid. Funding cannot be used for pension payments or to fund tax cuts.

State revenues have proven far more resilient than initially anticipated, though the fiscal impact of the pandemic varied widely. Most states faced manageable fiscal stress and some even saw budget surpluses. Between April and December 2020, state revenues were down only 2% from 2019.

Significant federal stimulus, enhanced Medicaid spending and faster-than-anticipated vaccine availability positively impacted the fiscal outlook for all states. The fiscal gap is now projected at only half the size expected at the outset of the pandemic. A net revenue shortfall of $56 billion is projected for states between FY20 and FY22, about 6% of FY19 state general fund revenues.

Most states rely heavily on income taxes, and the initial spike in unemployment did not bode well for state revenues. But job losses have been concentrated in low wage sectors like tourism and hospitality, mitigating the net impact on state revenues. Enhanced unemployment benefits have also propped up income tax collections and consumer spending, but states without income taxes like Texas and Florida still saw larger revenue declines.

LOCAL GOVERNMENTS

Municipalities most impacted include areas that depend on tourism or oil/gas and those with increased public health care costs, outsized unfunded pension liabilities, high fixed-cost burdens or low reserves.

Local governments will receive $130 billion from the ARP Act, split evenly between counties and cities. Half will be available within 60 days and the rest 12 months later. Governments have until the end of 2024 to spend the funds, which are mostly unrestricted and can be used to replace lost revenue.

Local governments face the same headwinds as most states, including declining revenues and budget gaps. The degree of these challenges has generally been less than originally projected. But local governments have less budgetary flexibility than states, and we expect some costs to be shifted down to local governments.

$130B

ARP FUNDS FOR LOCAL GOVERNMENTS

Local government general obligation (GO) bonds are largely secured by ad valorem taxes, which are not expected to experience widespread decline. In fact, for the first three quarters of 2020, state and local property tax revenue increased 3.2% versus 2019. Home prices also increased, signaling likely stability in property tax receipts. If assessed values decline, the tax rate could be adjusted upward. Taxpayers are being supported through stimulus checks and increased unemployment benefits, allowing greater ability to continue making mortgage and property tax payments.

Local government reserves were at a five-year high leading up to the economic downturn. The median reserve level for the 25 largest cities was 32% of revenues in 2018, up from 24% in 2007.

SCHOOL DISTRICTS

School districts' financials have held up well, despite transitioning to remote learning and facing increased coronavirus-related costs.

Nationwide, K-12 schools received nearly $130 billion from the ARP Act, in addition to $13 billion under the Coronavirus Aid, Relief and Economic

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Security Act (CARES) and $54 billion under the Coronavirus Response and Relief Supplemental Appropriations Act (CRRSA).

The stability of school districts is not surprising, as they rely on dependable revenue sources, primarily property taxes and formula-based state aid. Schools also typically receive substantial financial assistance from their state governments. Though many districts anticipated cuts in state aid, most states have kept their K-12 funding stable.

In addition to property taxes, many school district bonds also benefit from a state aid intercept. In this scenario, if a school district does not meet its bonded debt service, the state holds back a portion of that district's state aid to pay debt service. In most instances, state aid covers bonded debt service costs by multiple times.

WATER AND SEWER

The water and sewer sector has proven to be stable, given the essential services provided, monopolistic nature and ability to increase user rates.

Many states have implemented moratoriums on service shutoffs for nonpayment. But delinquencies have not been materially impacted, likely due to the increased income support from unemployment aid.

Total usage has generally held steady, despite usage changes due to stay-at-home orders. Systems with a high concentration in industrial, institutional or commercial users (especially retail, offices and hotels) have seen larger usage declines. However, some of this decline has been offset by increased residential usage. Positively, most systems cover a diverse, largely residential service area.

Water and sewer providers were generally well positioned entering the pandemic, with strong reserves and low debt burden. Liquidity has been increasing for years. Utilities also delayed capital spending during the pandemic to provide additional financial flexibility should there be disruptions in customer payments or declines in usage.

Water and sewer providers were generally well positioned entering the pandemic.

Capital spending is expected to pick up in 2021, funded with a planned spend down of reserves or an increase in leverage. However, the ARP Act may offer capital spending relief, as funds are available for water and sewer infrastructure.

Rate affordability will continue to be a concern, as rate increases are outpacing CPI growth. Additionally, providers may find it more difficult to implement rate increases during an economic downturn.

DEDICATED TAX BONDS

Dedicated tax bonds are generally well positioned to recover quickly as the economy reopens and consumer spending and pent-up travel demand return to more historic norms.

Many states and municipalities issue these bonds, ranging from a single sales tax pledged to debt service, hotel and car rental taxes, a narrow restaurant tax applied to a defined geographic footprint, or to a broader-based income tax applied to an entire state.

Some dedicated taxes, especially those directly tied to tourism, saw steep declines in 2020. Reduced travel, conference cancellations and consumers staying home impacted tax collections.

Most dedicated tax bonds benefit from debt service reserve funds and rate and coverage covenants. Last year saw an uptick in refunding transactions to defer or restructure debt service, but no major credit events or defaults. Some issuers tapped reserve funds or relied on backstop pledges from parent governments.

Consumer spending, fueling many of these tax revenues, fell sharply in April 2020, but has generally increased since then. State and local sales tax collections have nearly recovered. Fourth

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quarter 2020 collections were down just 0.5% from 2019. As of February 2021, retail and food sales were up 6.3% over the prior year and 36.1% higher than the low in April 2020.

AIRPORTS

Solid liquidity, extraordinary government support and favorable debt markets helped the airport sector navigate the pandemic.

The airport sector received $8 billion from the ARP Act, in addition to $10 billion through the CARES Act and $2 billion under CRRSA. Funding has been an important liquidity infusion and bolstered the already strong unrestricted cash balances and debt service reserve funds that most airports had heading into the crisis. Unrestricted cash has historically been 500 days, on average.

Passenger traffic remained down 50% to 60% through early 2021 versus prepandemic levels. However, volume had improved to down 40% as of mid-March. This is significantly better than the 90% decline from March to July 2020. We expect the recovery to improve as vaccinations continue and state and local governments loosen restrictions.

We do not envision returning to prepandemic traffic levels for a few years, as corporations will be slow to fund business travel, and a portion of consumers will remain wary of the virus.

Ongoing financial support is consistent with our expectations from early 2020. Most airports have used the stimulus to fund debt service and ongoing operational costs, or retire debt altogether.

We believe the major airports will manage through the crisis, albeit with weakened credit metrics. The sector has seen a number of downgrades, but we do not envision monetary defaults.

AIRLINES

With the severe decline in passenger travel and resulting revenues, the airline industry as a whole continues to face liquidity and cash burn challenges.

> *United, Delta and American raised billions of dollars by securitizing their frequent flyer rewards programs.*

The airline sector received $14 billion from the ARP Act, in addition to $25 billion from the CARES Act and $15 billion under CRRSA.

The airline sector also benefitted from secondary market support from the Federal Reserve, which led to debt and equity markets offering attractive opportunities to raise capital to support airline liquidity until more normal air travel volume resumes.

United, Delta and American raised billions of dollars by securitizing their frequent flyer rewards program in a new debt security structure for the sector.

Most airline bonds issued in the municipal market finance airport-related facilities that are essential to airline operations, even when these operations are downsized.

Many airline bonds have security interests in the essential facilities financed by these bonds. This key feature has proven the resiliency of these types of bonds through previous economic downturns and airline bankruptcies.

We believe the airline industry will survive this unprecedented situation given its essential nature. Airline-backed municipal bonds should continue to be well positioned, particularly due to their security features. While downgrades may continue, federal support and improving reopenings should lead to a gradual recovery in 2021 and into 2022. A full recovery won't occur until 2024 or later.

MASS TRANSIT

The latest stimulus package accounts for 78% of projected needs of $39 billion through 2023, and fully funds combined projected needs through 2022.

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82%

MTA DEBT COVERED BY ARP FUNDING

U.S. mass transit received $30.5 billion from the ARP Act, as well as a combined $39 billion from previous stimulus. The magnitude of this stimulus is a testament to strong bipartisan support and acknowledgment of the sector's importance to the economy.

Nationwide, transit ridership was down 80% year-over-year at the lowest point in April 2020. Ridership improved to down 62% at the end of 2020 versus the fourth quarter of 2019. Federal stimulus has largely allowed transit agencies to maintain balanced budgets, provide normal service levels, avoid significant layoffs and meet their obligations with bondholders.

New York City's Metropolitan Transportation Authority (MTA) benefited most from the ARP Act, receiving $6.5 billion (21%) of the funds allocated to U.S. transit agencies. As recently as February, MTA projected an $8 billion deficit through 2024. The $6.5 billion accounts for 82% of the deficit and allows MTA to balance the budget through 2023 without service cuts or layoffs.

TOLL ROADS

Toll roads have seen significantly reduced traffic and revenue generation over the past 12 months, but less than some experts initially forecasted.

Volumes fell by 40% to 60% during April 2020, then improved to down 15% to 25% by June. The rebound continued to 10% by September, due to the lifting of lockdowns. New restrictions implemented during the fall flattened the trend, which remains fixed into 2021.

Heavy uncertainty remains over when activity will return to prepandemic levels. While traffic could continue to be impacted by future commuting trends of working from home, people driving more to avoid mass transit could be a mitigating factor.

Most toll road operators entered the pandemic with healthy debt service coverage, solid liquidity and strong track records of surviving downturns. While some ratings downgrades have occurred, we believe operators will continue prudently managing financial conditions pending a return to normalcy.

PORTS

After early double-digit declines, large container ports in the U.S. experienced strong volume growth beginning in the latter half of 2020 due to a massive surge in U.S. consumer demand for overseas goods.

The ARP Act does not specifically allocate funding for ports. Any support would come from state or local government aid or improving economic conditions. Port authorities that also operate airports and public transit will benefit from the funding designated for those sectors.

Ports that rely on passenger traffic will experience a more protracted recovery. This includes port authorities that also operate airports or depend on the cruise industry.

U.S. ports with sizable cruise operations continue to suffer. The CDC issued a no-sail order for U.S. cruise ships from March to October 2020, later replaced with the Framework for Conditional Sailing Order. This order requires cruise ships to have testing, quarantine/isolation areas, as well as a testing laboratory. Most cruise companies have canceled sailings through at least May 31, and the industry will not likely return to remotely normal operations until the vaccine is widely available.

Ports with a high exposure to the cruise industry have managed thus far because they entered the crisis with fairly strong financial positions and substantially reduced costs early on. Strategies to stabilize financial performance included reducing headcount, deferring capital projects and using lines of credit.

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HIGHER EDUCATION

Higher education has shown more resiliency and greater flexibility than expected. Institutions pivoted quickly to a different mode of instruction and made necessary spending cuts.

Higher education received $40 billion from the ARP Act, in addition to a combined $37 billion from previous stimulus. At least half of the funds must be used for emergency financial aid grants. While the increased funds are welcome, they will not fix long-term systemic issues such as declining demographics for high school students. For institutions struggling prior to this crisis, additional funds will not likely change their longer-term downward trajectory.

Enrollment declines were less than many anticipated, for both public and private institutions. Overall, undergraduate drops were partially offset by favorable growth in graduate enrollment. The largest enrollment declines occurred at community colleges. Expectations for fall 2021 are still in flux, as the pandemic remains a considerable factor influencing enrollment trends and methods of instructional delivery.

State aid for public universities was on the chopping block during budgetary sessions last spring and summer. But better-than-projected state revenues and additional federal support allowed most public universities to experience smaller cuts than originally expected or to be spared completely — for now. Large, higher-rated institutions with diverse revenue streams are positioned to weather any future cuts better than smaller, regional public institutions. Public universities in states with challenged financials are more at risk of revenue disruptions.

Brand name institutions will remain attractive to students, and we anticipate that higher investment grade credits, with robust balance sheets and good student demand, will generally maintain credit quality or face only modest rating pressure. Smaller, lower-rated institutions with weaker market positions are more at risk for severe ratings pressure and credit concerns.

STUDENT HOUSING

Student housing projects could indirectly benefit from additional stimulus funding for colleges and universities.

Outcomes for individual projects will depend on a number of factors: strength of connection to the university, liquidity options outside of debt service reserve funds (including university support) and project density requirements.

Draws on debt service reserve funds could increase in July 2021 year-over-year, since some projects have had lower occupancy to comply with density requirements, and previously available liquidity options may now be exhausted (liquidity accounts, unused bond funds, construction savings, etc.).

Fall 2021 lease-up is a focus, since March and April are important months in the student housing leasing cycle.

Projects that have remained open for the 2021 school year will likely be in a stronger position than closed projects, as closed projects likely need additional guidance from state and local health departments regarding density requirements.

HEALTH CARE

Overall, the hospital sector weathered the pandemic fairly well. Most hospitals had more than adequate liquidity, especially with Medicare advances, which are only now beginning to be repaid.

At the outset of the pandemic, among the biggest concerns facing hospitals was the potential for strained capacity. “Flattening the curve” initiatives included mandates to cancel/defer all nonurgent or elective procedures and services.

These mandates caused hospital volumes and associated revenues to drop precipitously in spring 2020, while expenses escalated. The issue was exacerbated by the fact that most states did not experience an initial surge in COVID-19 patients.

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Hospitals were near the front of the line for government subsidies:

- Received direct subsidies under the CARES Act and benefitted from delayed implementation of sequestration cuts and scheduled disproportionate share (DSH) payment cuts.
- Collected advance payments for Medicare services and a 20% increase in Medicare reimbursement rates for COVID-19 patients.

Many hospitals increased existing bank credit lines and/or entered into new credit lines to offset operating cash flow declines. Due to Medicare payment advances, most did not need to draw on the bank credit lines or quickly repaid them.

$8.5B

ARP FUNDS FOR RURAL HOSPITALS

Most states eased restrictions on nonurgent care by summer, and most hospitals soon reported volumes at or above 90% of prepandemic levels. As deferred volume returned, hospital margins began to recover.

Few ratings actions occurred, and most were changes in outlook rather than downgrades. Ratings agencies recognized the temporary nature of the pandemic and the various initiatives designed to cushion its impact.

The bulk of the credit issues were limited to hospitals that struggled going into the pandemic, particularly small, rural providers with low liquidity and thin margins.

The ARP Act contains little direct aid for hospitals:

- $8.5 billion is targeted for rural hospitals, which didn't fare as well in initial stimulus funding.
- Medicare advances must be repaid, as there was no reference to converting them to direct subsidies. The repayments were to begin last fall by withholding a portion of current payments over several years, but were extended to spring 2021.
- 2% cuts to Medicare payments are delayed at least through the end of 2021. At the onset of the pandemic, Congress suspended the 2% cuts to Medicare payments brought about by sequestration in 2012. The cuts were set to resume in April, but hospitals asked for an extension. While the ARP Act did not include this, Congress successfully passed separate legislation to delay the cuts.
- The ARP Act provides two additional years of federal funding for Medicaid expansion to convince the 12 states that did not originally expand Medicaid to do so now. The extra federal funding will eventually end, leaving those states responsible for the costs of expanded Medicaid.
- The ARP Act extends eligibility for premium subsidies under the Affordable Care Act by two years and increases the income level threshold for these subsidies. Fewer uninsured patients will benefit hospitals, but the magnitude is unclear.

CONTINUING CARE COMMUNITIES/ SENIOR LIVING

We expect a fairly quick recovery in occupancy as communities reopen, but full recovery is unlikely in the first year.

Early COVID-19 outbreaks spurred most senior housing communities to lock down, and marketing was generally downsized or put on hold. This disruption, along with normal attrition and COVID-related deaths, led to a drop in residency. Senior housing occupancy across all levels of care decreased by nearly 7% since the first quarter of 2020. Skilled nursing occupancy declined by more than 13% to a record low 71% since February 2020.

The sector initially received modest CARES Act assistance. Most providers procured PPP loans, which have been forgiven. Nursing providers received extra Medicare money. Ultimately, government assistance has not fully covered pandemic-related losses and nearly all borrowers are weaker financially. We are seeing a wave of covenant violations as borrowers reach the end of their fiscal years.

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The ARP Act offered no direct new money to providers, and few qualify for the next round of PPP loans. In fact, the ARP Act offers more than $12 billion in funding to expand Medicaid home- and community-based waivers for one year, which is likely to hurt health care center occupancy. Providers hope states will use the latest stimulus to support senior living providers, but this will vary from state to state.

Recent start-up communities are opening with a handicap. Many may run out of cash before reaching stabilization. Communities opening in the coming year may be less affected, as presales appear to be steady.

The biggest question is how the pandemic will affect marketing and public opinion. Large numbers of nursing home deaths, lockdowns and negative press have inflicted public relations damage. We expect these memories to fade, but it may take time.

Actuarially speaking, nearly all continuing care retirement communities have emerged weaker. Most take on insurance-like risk and rely on ongoing cash flows to fund actuarial liability. The actuarial impact will not be immediate, but the financial difficulties of 2020 to 2021 will be a factor over the next decade.

Legal liability for COVID-related issues is a real fear for providers. Florida is considering legislation that provides immunity, but Democrats do not appear to support blanket immunity at the national level. If Congress does not act, we can expect lawsuits from employees and residents. It is too soon to judge the threat level.

Low interest rates have bolstered mergers and acquisitions. Facility valuations have been solid, so we are fairly optimistic about the value of collateral in distressed situations.

CHARTER SCHOOLS

Funding flowed without interruption in FY20, largely continuing in FY21. Most state budgets look stronger than expected for FY22, with most projecting stable funding or even small increases.

Charter schools have faced challenges relating to operating remotely, enrollment fluctuations and the cost of added safety precautions as students return to campus.

Charter schools, as part of the K-12 education system, received $137 billion from the ARP Act, in addition to $13.2 billion from the CARES Act and $54 billion under CRRSA. The bulk of the dollars will be distributed to states through the federal Title 1 formula for funding schools with higher populations of poverty. Charter schools are funded by per-pupil payments from a state or local school district.

Some schools have benefited from PPP loans, which convert to grants if proceeds are used for approved expenses. As these loans are forgiven, it has bolstered the liquidity of participating schools.

Charter school bonds are typically secured by a debt service reserve fund and a mortgage on the school facility, which would benefit bondholders in a credit stress scenario. Many charter school bonds also have a state funding intercept, and debt service is paid before operating expenses in these situations.

INDUSTRIAL DEVELOPMENT REVENUE/POLLUTION CONTROL REVENUE (IDR/PCR)

Corporate-backed municipal bond credit quality generally correlates with the U.S. economy. Credits that depend on consumer spending may continue to experience stress, but many cyclical sectors began to recover as the economy started reopening.

Commodity prices increased significantly from the second half of 2020 and into 2021. The economic shutdown from March to July 2020, followed by a quick recovery in the second half of 2020, caused demand to outpace supply. Prices of steel,

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Prices of steel, lumber and other materials are at or near all-time highs.

lumber and other materials are at or near all-time highs. Numerous steel companies have municipal IDR bonds outstanding and are benefitting from the high prices.

Oil refining has been challenged. Many refining spreads have tightened, as the rapid increase in oil prices from 2020 pandemic lows combined with sluggish demand for refined products such as gasoline and diesel. We expect spreads to widen as the economy reopens and demand increases.

PCR bonds issued by regulated utilities should continue to show minimal impact compared to the more GDP-sensitive IDR segment. Regulated utilities provide a necessary item (electricity and gas delivery) and generally have good working relationships with regulatory authorities.

SINGLE FAMILY HOUSING

Single family housing agencies were well positioned going into the pandemic and continue to receive direct and indirect federal support.

Strong balance sheets and high reserve levels cushioned against potential liquidity pressures associated with increased delinquency rates and forbearances. Additionally, the underlying mortgages typically carry insurance, further insolating agencies from revenue shortfalls.

> *The ARP Act created a $9.96 billion homeowner assistance fund.*

On 18 Mar 2020, President Trump directed the U.S. Department of Housing and Urban Development to suspend all foreclosures and evictions of HUD-backed mortgages for 60 days, and HUD directed the Federal Housing Administration to implement a similar moratorium on FHA mortgages; Fannie Mae and Freddie Mac followed suit. President Biden extended the moratorium through 30 Jun 2021.

The CARES Act granted special forbearance rights to certain homeowners with federally backed mortgage loans. Ginnie Mae implemented a pass-through assistance program through which sellers/servicers with payment shortfalls may request that Ginnie Mae advance the difference between available funds and the scheduled investor payments.

Expanded unemployment benefits and stimulus checks helped mitigate delinquency rates.

The ARP Act created a $9.96 billion homeowner assistance fund that makes grants to state programs that assist low- to middle-income homeowners with mortgage or utility payments. This program runs through 30 Sep 2025 and provides additional support to housing agencies' underlying loan pools.

LAND SECURED

We are constructive on the sector, driven by housing supply shortfalls in the face of increased demand. Potential for rising mortgage rates and certain affordability constraints temper our outlook.

Land-secured bonds are paid from property taxes levied in the issuing district from which the bonds are payable. The payments are secured by tax liens on the underlying land. Most land-secured bonds are issued for residential communities.

Mature, largely developed districts with diversified tax bases are generally unaffected by changing economic conditions. However, the credit outlook of newer, less-diversified districts is generally highly correlated with the strength of the economy and the consumer/home buyer.

The pandemic brought uncertainty to the credit outlook for newer-stage developments. But the housing market proved resilient, supported by a supply/demand imbalance, low interest rates and consumer desire for larger homes. Further, federal stimulus provided direct aid to consumers.

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PUBLIC POWER

Public power has been among the most stable municipal sectors during the pandemic, as these essential systems provide safe and reliable electricity to their service areas.

Industrial and commercial power consumption generally declined, but residential usage increased. Many utilities have posted declines of a just few percentage points for 2020.

Disconnection was halted for customers who did not pay their bills, so receivables have increased and liquidity has declined in some cases. But electric utilities generally have enough cash reserves to absorb short-term declines in bill payments.

Municipal utilities generally have rate setting autonomy. If sales and revenues impact profitability, utilities can pass on higher costs to customers, thereby continuing to pay debt service comfortably.

Lower natural gas and other fuel prices are positive for most electric utilities because their cost of purchased power is generally lower.

We have seen little to no impact on the credit quality of these bonds during this disruption.

Municipal credits have proven resilient during these unprecedented dislocations. We believe this resiliency, along with substantial federal support, supports an optimistic credit outlook as we move past the one-year anniversary of the pandemic.

For more information, please visit nuveen.com.

Endnotes

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