MONTHLY REVIEW

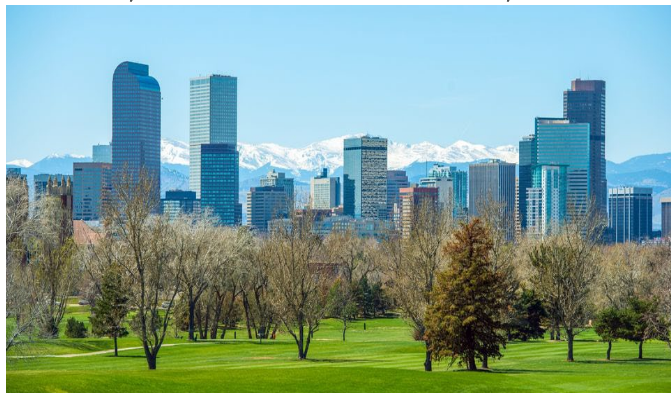
August 2023

MAINLINE WEST

Colorado Metro Districts – What's all the Fuss?

MainLine has been a disciplined investor in Colorado Metropolitan District bonds for years. So, when the Denver Post decides to trash the financing technique used to meet booming housing demand in a state with political and legal constraints that restrain it, it is time to sort things out and determine what goes in compost and what we can recycle. *This month, MainLine discusses the use of Met Districts in our home state and reviews the Denver Post article and our SWAN approach to investing in them.*

The month of August was rough on munis, as they gave up most of their year-to-date outperformance in just 30 days. Year-to-date, munis are up 1.59% versus US Treasuries at 1.37%. Technicals and history predict the next 30 to 60 days may not be any different. ***This could be a good time to invest any allocation to fixed income.*** After munis work through this tough stretch, the opportunity to receive tax-equivalent income of 7+% could be coming to an end by the close of the calendar year.



Muni Market Review

After building a case for solid outperformance, munis now look to be facing a tough road for the next 30 to 60 days. August finished with munis not keeping pace with taxables and, after reviewing the last 18 years of fall performance, munis have outperformed only twice. Combine this with a recent pick up in outflows, munis only represent fair to rich value and supply seems to be picking up. You can see the making of a tough stretch. That being said, MainLine feels munis will finish the year strong as tax equivalent yields are attractive.

Other August highlights:

- Bloomberg composite indices for August show munis down -1.44% US Treasuries down only -.52%. Muni yields for the month were up 22 to 37 bps versus taxables up only 6 to 18 bps.
- Supply is still lower by 13% versus 2022, but this is up from 20% just two months ago. New issuance is slowing up. We explain a bit more about why in the credit news update below.
- Fund flows are back to negative and barely even for the year. Investors are still concerned with where the economy is going, and if the Fed is really done.

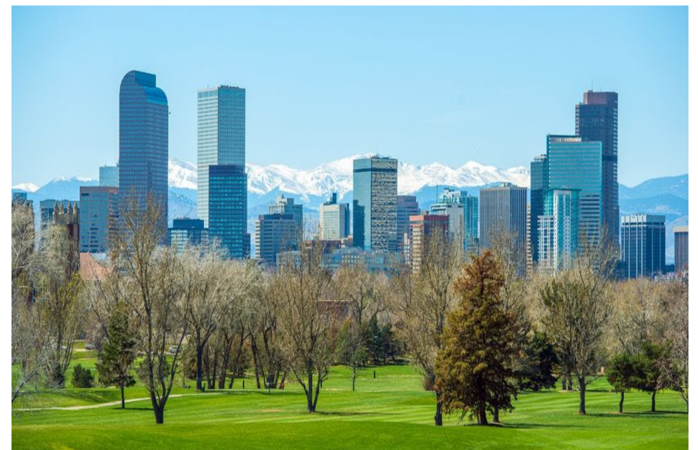
MainLine recommends that, if you have any cash you have been waiting to invested, *the next 30 days should present some opportunities to lock in 7+% tax equivalent income for years to come.*

Market News & Credit Update:

The volatility of interest rates in 2023 has caused Municipal issuers to rely more on negotiated underwriting versus using the competitive process to sell their bonds. As of early August, only $41 billion has been competitively underwritten, which is a 20% drop from the same time last year and 26% lower than the ten-year average. Issuers are seeking the expertise of the senior underwriting to help them with the timing of issuance and how to structure the deals to create more demand. The uncertainty in the market is a bigger concern than saving a few basis points using a competitive bid process. Underwriters are having to prove their worth and work for their fees in 2023.

Year-to-date muni new issuance is down over 13% and at the lowest level in four years. This comes after an abundance of Federal government programs that were supposed to increase infrastructure spending. Morgan Stanley proposes that DC's red tape is slowing up the issuance of bonds, and that it will not be until 2024 that supply could get back on track. The biggest culprit is the necessary "environmental assessment" mandated by the National Environmental Policy Act.

Review Of Colorado Metropolitan Districts:



Introduction:

On August 17th the Denver Post released a study on Metropolitan Districts in the State of Colorado and how they are allowing developers to get rich at the expense of homeowners. As with anything that involves money, there is always corruption and greed involved, but not all Met Districts are created equal. ***Met Districts play an important role in developing and meeting the demand for homes in Colorado in the post-TABOR era.*** Below is a summary of the article, and then MainLine's approach to Met Districts for our client accounts.

Background:

Met Districts are taxing authorities created by subdivision developers, with the consent of the local government, for the sole purpose of selling general obligation municipal bonds to finance their projects. Repayment of the bonds is tied to future property taxes assessed to the homes that will eventually be built. This includes infrastructure needs for the homes to be built that are also financed within the debt sold by the district and repaid with this "growing" tax revenue.

The Denver Post investigation into the inner workings of the state's 1,800 metro districts found a governmental system that operates without the usual oversight of voters, without the usual restrictions on conflicts of interest, and without the usual checks and balances to ensure communities won't spiral into insolvency.

The Post found at least a dozen large metro districts in Colorado that are dangerously underwater with hundreds of millions of dollars of debt and homeowners swimming in hefty property tax bills. The debt obligations are so much higher than the assessed value of the homes leveraged to repay them – some as much as 200% higher – that they are unlikely to ever catch up. A few will never stop paying.

Why Met Districts?

Use of metro districts has exploded in the last 20 years. In each of the 1980s and 1990's roughly 100 districts were created, in the 2000's 936, in 2010's 623, and now the total is at 1,800. Most every home sold in the Denver metro area is now in a Met District. Why so popular?

The counties and municipalities see Met Districts as a way to shift costs of public services onto these districts and away from their current taxpayers. Instead of the county paying for the needed infrastructure, the homeowner in the met district pays it, as it is built into the debt backed by property taxes. This keeps those in other districts from having to pay for services they are not going to use.

In 1992, TABOR (Taxpayer's Bill of Rights) required any tax increase to be put before the electorate for approval. Voters have refused to approve increases to pay for someone else's construction. Without this infrastructure, new home developments would not be viable.

The Issue:

Some of the met districts' mill levy to pay off debt is very high versus other districts, causing affordability issues for homeowners. What has caused the high debt costs and, therefore, the high mill levies for certain met districts discussed in the study?

Institutional investors such as banks and pension funds often buy the metro district's senior bonds, but the district developers (according to the Denver Post) with increasing regularity, are issuing and keeping the smaller junior bonds for themselves. These junior bonds generally have a higher interest rate of return and are repaid only after the senior bonds are retired. These are usually structured as a 0% coupon, with full proceeds due at maturity. Debt service costs balloon as the repayment date approaches and, in some cases, the property tax owed by the homeowners goes up to meet this debt obligation.

Poor oversight, planning, costs exceeding budget all can lead to an increase in mill level, regardless of the prospect of junior bonds. The willingness to pass the added debt costs and expenses on to the homeowners by increasing their property tax to levels twice that of successful districts to pay back junior investors is concerning. If the developer is the owner of the junior bonds and did a bad job, this may cause a huge increase in mill levy to "bail" themselves out at the expense of homeowners. In particular, when these increases occur years after the home is bought, due to the "balloon" payment, the homeowner gets caught by surprise.

Conclusion:

The article seems to assume that the Met Districts are set up to provide developers with a 9+% bond return at the expense of abusing homeowners with high property taxes. This could be the case for a few Districts, but for most the growth of the Met District accommodates the increase debt cost, as more homes are built and costs are spread out over the whole district. The cases focused on in the article most likely occurred due to poor planning, bad execution of budgets, and/or lack of Met District growth - all factors the institutional investor reviewed before buying the senior debt. The presence of the junior bonds (and the developers owning them) places an additional strain on the district and motivates them to pass on costs it should never have had to.

The counties and municipalities issuing met district bonds need to do a better job of restricting this "golden parachute" for a job done poorly. The idea of junior bonds at 9% to reward developers is not all bad, but if they do not meet their budgets, timelines, and growth plans, mill levies should not become out of touch with reality to pay them back. Junior bond holders should not get rewarded at the expense of the homeowners. There is a reason they are called "junior".

MainLine's SWAN Strategy:

MainLine has always taken a conservative approach to Met Districts, as they have a long history of credit issues and, when they are new, require continual monitoring. MainLine has the following criteria we follow to purchase Colorado Met District bonds:

Credit ratings of A-/A3 or higher and/or insured.

- Senior level bonds only.
- Districts that are established and demographically attractive for new homes.
- To read the Denver Post article in its entirety, please view the link on our website at:

Denver Post - Colorado Metro Districts

This document is for informational purposes only and is summary in nature. No representations or warranties express or implied, are made as to the accuracy or the completeness of the information contained herein. Any prior investment results presented herein are provided for illustrative purposes only and have not been verified by a third party. Further, any hypothetical or simulated performance results contained herein have inherent limitations and do not represent an actual performance record. Actual future performance will likely vary and vary sharply from such hypothetical or simulated performance results. This document does not constitute an offer to invest in securities in the funds. No offer of securities in the funds can be made without delivery of The Fund's confidential private placement memorandum and related offering materials. An investment in securities of The Funds involve risk, including potential risks that could lead to a loss of some, or all, of one's capital investment. There is no assurance that the fund will achieve its investment objective. Past performance does not guarantee future results. There can be no possibility of profit without the risk of loss, including loss of one's entire investment. There are interest and management fees associated with an investment in The Funds which are disclosed in The Funds' offering materials.