S&P Global Ratings

RatingsDirect®

U.S. Local Government Mid-Year Sector View: Unprecedented And Unpredictable

July 29, 2020

Mid-Year Sector View: Negative

Disruptions caused by COVID-19 and the related recession came on quickly, but will create fiscal strain for local governments for some time to come. In light of this, we expect revenue shortfalls and imbalanced budgets will lead to credit pressure through 2020 and beyond, and in many instances long after much of the rest of the economy has normalized. Falling revenues from sales and other user taxes will pressure ratings, particularly for issuers with limited revenue and/or expenditure flexibility. Uncertainty regarding the amount of federal stimulus that may be forthcoming only adds to issuers' short-term planning pressures. We expect many issuers will use reserves to bridge gaps in revenue shortfalls. In our view, that would not necessarily exert downward pressure on ratings; we expect downgrades will be more likely for issuers who do not address issues that jeopardize structural balance over the next two to three years, and beyond.

PRIMARY CREDIT ANALYST

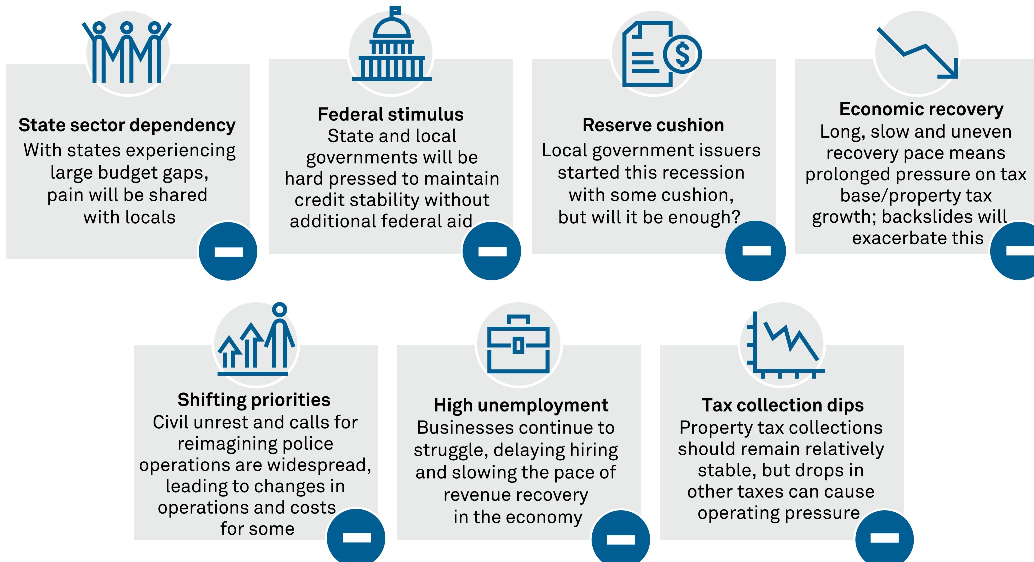
Jane H Ridley
Centennial
(1) 303-721-4487
jane.ridley@spglobal.com

SECONDARY CONTACTS

Geoffrey E Buswick
Boston
(1) 617-530-8311
geoffrey.buswick@spglobal.com

Lisa R Schroeer
Charlottesville
(434) 529-2862
lisa.schroeer@spglobal.com

Downsides Dominate For Local Governments During 2020's Second Half



THIS WAS PREPARED EXCLUSIVELY FOR USER SARAH L SMAARDYK.
NOT FOR REDISTRIBUTION UNLESS OTHERWISE PERMITTED.

What We're Watching For In The Second Half And Beyond

Ratings in the diverse local government sector include counties, cities, and school districts, GO, lease, and revenue-backed debt. Many of the challenges and opportunities we identified to start 2020 have shifted dramatically due to the COVID-19 induced sudden stop recession. Despite the variety of issuers and security types, there are common themes we are watching across all local governments during the second half of 2020:

- Potential state aid shortfalls or cost shifts, and how they are managed.
- The uneven health recovery and how it affects short- and long-term economic and revenue growth.
- Liquidity pressures brought on by revenue and expenditure mismatches, particularly for those with a weaker financial position and/or lower reserve levels.
- Expenditure pressures related to the pandemic.
- How issuers are projecting revenues, particularly those supported by sales and hospitality taxes.
- Long-term budgetary impact of social unrest and the probability of more across the U.S.

Rating Actions To Date

On April 1, 2020, S&P Global Ratings revised its sector outlook (since renamed sector view) for all of its U.S. public finance sectors to negative, which includes over 10,000 local government credits. Given the historic stability in the sector, revising the sector outlook was an unprecedented step. Four months later, we continue to see signs of credit weakening across the sector, and expect more to come.

Since the start of the pandemic, there have been 616 rating actions related to COVID-19 on local government issues, primarily outlook changes (see "COVID-19 Activity In U.S. public Finance"). The biggest changes have come for debt backed by convention center and/or hospitability taxes; that group also includes some multi-notch rating changes (for more, see "Changing Landscape Threatens Credit Quality Of U.S. Convention Centers, Arenas, And Stadiums," published June 27, 2020, on RatingsDirect). We also revised most of our positive outlooks to stable reflecting a very different landscape for rating upgrades over the near to medium term.

Priority Lien Revenues Are The Most Exposed

We have performed portfolio reviews across local governments and these efforts confirm that priority lien ratings are the most exposed to revenue declines related to social distancing, specifically convention centers and hospitality taxes like hotel, food and beverage, etc. Hospitality taxes across the U.S. performed unevenly based on the extent of local closures, re-openings, re-closures, etc., but all experienced decline considering the large-crowd nature of their operations. Given the vulnerabilities seen in these two sectors, we are keeping a very close eye on revenue flows and credit pressure, particularly for signs of liquidity issues.

A sustained period of lower hospitality tax collections can lead to sharp drops in debt service coverage for bonds secured by those taxes, and this has been a particular pressure for convention center and sports facility issues. Significant deterioration in hospitality related revenues has led

THIS WAS PREPARED EXCLUSIVELY FOR USER SARAH L SMAARDYK.
NOT FOR REDISTRIBUTION UNLESS OTHERWISE PERMITTED.

to imbalanced budgets, reduction in debt service coverage, and in many cases drastically reduced liquidity available to pay debt service. Such a notable shift in a very short period has led to deterioration in credit quality for many issuers and resulted in 16 downgrades since March.

Although not as hard-hit as hospitality taxes, sales tax collections have also been uneven. Like hospitality taxes, we expect the impact to sales taxes will mirror reopening patterns, but given ongoing e-commerce the impact is not as pronounced as tourism and business-travel based taxes. "As The North American Retail And Restaurant Sector Braces For Another Wave Of Downward Rating Actions, A Few Subsectors See Signs Of Hope," published July 17, 2020, describes a struggling situation for most retail and restaurants, indicating tax collections associated with those purchases are not expected to rebound quickly. This creates additional uncertainty for debt service coverage levels in a sector where we've already seen some significant revenue deterioration and pressured liquidity.

General Obligation And Lease Secured Debt Won't Go Unscathed

In general, local governments started 2020 with reserves that had been growing, and we expect this will provide some flexibility to offset revenue declines. However, reserves will likely not be sufficient to offset a prolonged recession and slow recovery.

Since local governments, school districts, and charter schools can be heavily dependent on state shared revenues for general operations, the overall strength of the states is critically important, so we are watching state budget revisions and any projected cuts closely to see which states may start to see pressure first. This is of particular importance for school districts and charter schools that generally carry lower reserves, are more likely to experience state aid cuts when state revenues fall short, and are also being hit with COVID-19 school preparation costs. For more on our view of state credit quality, see "U.S. States Mid-Year Sector View: States Will Continue To Be Tested In Unprecedented Ways," July 13, 2020.

Overall, we expect local property tax bases to remain stable, which should help insulate the governments that rely on them for revenue generation. We expect that there could be longer term implications for the commercial and residential real estate market related to the recession. However, despite some expected stability in property tax revenues, local governments that rely on non-property tax sources will likely experience greater budget volatility. Regardless of revenue mix, we feel that governments with low reserves and liquidity have less flexibility and will be most exposed from a credit standpoint. We will continue to analyze shifts in the property tax base as well as taxes generated by business and consumer demand and incorporate those factors into our analyses.

Federal Support Is Critical To Long-Term Credit Quality

Federal funding for COVID-19 related expenses has helped offset unanticipated expenditure pressures for some local governments. However, without a replacement for revenues lost during shutdowns, while the expenditure reimbursement dollars can be helpful for short-term liquidity, they are less so for maintaining structural balance. As the virus and economic landscapes change, support from the federal government will remain a critical part of the overall health of governments in this challenging chapter of local government finance.

Without support for state and local governments from the federal government as needed, premature austerity--where the federal government abandons support for locals sooner than what may be needed to maintain financial stability--would likely lead to credit deterioration for

THIS WAS PREPARED EXCLUSIVELY FOR USER SARAH L SMAARDYK.
NOT FOR REDISTRIBUTION UNLESS OTHERWISE PERMITTED.

many issuers. The latest stimulus plan being negotiated in Washington seems likely to include support for local governments, including schools. However, should the negotiations take a different turn and not include money for locals, the potential for downgrades in the current recession would increase markedly.

How A Slower Economic Recovery Influences Credit Quality

With reemergence of virus transmission rates nationally, economic uncertainty is elevated and it appears that even the slow recovery S&P Global Economics forecasted may be losing steam. (For more from our economists, see "U.S. Economic Update: A Recovery At Risk As COVID-19 Surges," published July 22, and "Economic Research: The U.S. Faces A Longer And Slower Climb From The Bottom," June 25.) Considering the belief that the U.S. is facing a long, slow recovery, and given our expectation that the health recovery will be uneven, we believe some states will lag behind others in the recovery. How this affects revenues for local governments, schools, and charter schools is also likely to vary widely and will create differentiation in credit quality.

In the meantime, since many taxes are disbursed one to two months after collections--and given our expectation for no immediate impact to property taxes--local governments have had the opportunity to plan for the revenue shortfalls they know are coming. Those that address potential budget imbalances pro-actively will be best-positioned to weather economic volatility, in our view. However, considering projections for slow economic growth through 2021, we expect local governments will be facing an uphill battle for some time.

This report does not constitute a rating action.

THIS WAS PREPARED EXCLUSIVELY FOR USER SARAH L SMAARDYK.
NOT FOR REDISTRIBUTION UNLESS OTHERWISE PERMITTED.

Copyright © 2020 by Standard & Poor's Financial Services LLC. All rights reserved.

No content (including ratings, credit-related analyses and data, valuations, model, software or other application or output therefrom) or any part thereof (Content) may be modified, reverse engineered, reproduced or distributed in any form by any means, or stored in a database or retrieval system, without the prior written permission of Standard & Poor's Financial Services LLC or its affiliates (collectively, S&P). The Content shall not be used for any unlawful or unauthorized purposes. S&P and any third-party providers, as well as their directors, officers, shareholders, employees or agents (collectively S&P Parties) do not guarantee the accuracy, completeness, timeliness or availability of the Content. S&P Parties are not responsible for any errors or omissions (negligent or otherwise), regardless of the cause, for the results obtained from the use of the Content, or for the security or maintenance of any data input by the user. The Content is provided on an "as is" basis. S&P PARTIES DISCLAIM ANY AND ALL EXPRESS OR IMPLIED WARRANTIES, INCLUDING, BUT NOT LIMITED TO, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE, FREEDOM FROM BUGS, SOFTWARE ERRORS OR DEFECTS, THAT THE CONTENT'S FUNCTIONING WILL BE UNINTERRUPTED OR THAT THE CONTENT WILL OPERATE WITH ANY SOFTWARE OR HARDWARE CONFIGURATION. In no event shall S&P Parties be liable to any party for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs or losses caused by negligence) in connection with any use of the Content even if advised of the possibility of such damages.

Credit-related and other analyses, including ratings, and statements in the Content are statements of opinion as of the date they are expressed and not statements of fact. S&P's opinions, analyses and rating acknowledgment decisions (described below) are not recommendations to purchase, hold, or sell any securities or to make any investment decisions, and do not address the suitability of any security. S&P assumes no obligation to update the Content following publication in any form or format. The Content should not be relied on and is not a substitute for the skill, judgment and experience of the user, its management, employees, advisors and/or clients when making investment and other business decisions. S&P does not act as a fiduciary or an investment advisor except where registered as such. While S&P has obtained information from sources it believes to be reliable, S&P does not perform an audit and undertakes no duty of due diligence or independent verification of any information it receives. Rating-related publications may be published for a variety of reasons that are not necessarily dependent on action by rating committees, including, but not limited to, the publication of a periodic update on a credit rating and related analyses.

To the extent that regulatory authorities allow a rating agency to acknowledge in one jurisdiction a rating issued in another jurisdiction for certain regulatory purposes, S&P reserves the right to assign, withdraw or suspend such acknowledgment at any time and in its sole discretion. S&P Parties disclaim any duty whatsoever arising out of the assignment, withdrawal or suspension of an acknowledgment as well as any liability for any damage alleged to have been suffered on account thereof.

S&P keeps certain activities of its business units separate from each other in order to preserve the independence and objectivity of their respective activities. As a result, certain business units of S&P may have information that is not available to other S&P business units. S&P has established policies and procedures to maintain the confidentiality of certain non-public information received in connection with each analytical process.

S&P may receive compensation for its ratings and certain analyses, normally from issuers or underwriters of securities or from obligors. S&P reserves the right to disseminate its opinions and analyses. S&P's public ratings and analyses are made available on its Web sites, www.standardandpoors.com (free of charge), and www.ratingsdirect.com (subscription), and may be distributed through other means, including via S&P publications and third-party redistributors. Additional information about our ratings fees is available at www.standardandpoors.com/usratingsfees.

STANDARD & POOR'S, S&P and RATINGSDIRECT are registered trademarks of Standard & Poor's Financial Services LLC.

THIS WAS PREPARED EXCLUSIVELY FOR USER SARAH L SMAARDYK.
NOT FOR REDISTRIBUTION UNLESS OTHERWISE PERMITTED.