INTEROFFICE MEMORANDUM

TO: BOB LIND

FROM: JOHN MCCARTHY

SUBJECT: TWENTY GOOD QUESTIONS

DATE: MARCH 31, 2021

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1. **What might cause Illinois or Chicago face a possible "Detroit style" restructuring in the coming years and what might be needed to avoid this?**
   Illinois and Chicago are both plagued by unfunded liability issues, pension and OPEB. Failure to successfully address these issues will likely result in continuing fiscal challenges as these expenses consume an increasing percentage of annual operating budgets. The Illinois Constitution effectively states that pensions cannot be altered, even with the consent of both parties and that was affirmed by the Illinois Supreme Court. So, to alter pension benefits, an amendment to the Illinois Constitution is likely necessary. To date, no politician has been willing to address the issue from a Constitutional Amendment perspective.

   Additionally, Illinois does not allow municipalities to file for bankruptcy, as Detroit did. A change to Illinois law would be required for the City of Chicago to file for bankruptcy. Unlike Detroit, that suffered population decline of nearly 50%, Chicago remains a vibrant economic, albeit technically insolvent, financial engine. There are still plenty of levers for the City to employ to stabilize its' financial condition, including increasing property taxes, an income tax or other revenue generating taxes.

   Illinois, like all states, is not permitted to file for federal bankruptcy protection. The US Constitution prohibits a **federal** bankruptcy judge having jurisdictional authority over **state** finances.

   In our opinion, a greater concern would be a "GM" restructuring where the federal government engages to "encourages creditors to work with the Borrower" to resolve issues without necessitating federal interference.

2. **Are municipalities allowed to go bankrupt?**
   As mentioned above, states are prohibited from filing for federal bankruptcy protection. At the municipal level, the ability to file for bankruptcy is governed by state and local law.

3. **What are some big changes on Wall Street municipal finance departments over your career?**
   Consolidation and increasing sophistication. The municipal bond business was historically the market where corporate attorneys, investment bankers and other high-profile members of the business community sent their misfit children to toil away. Financial engineering was largely absent from the municipal bond market due to the need to preserve the integrity of the tax-exempt status of interest payments.

   In the early 1980s, every large bank had a municipal bond department. At that time, there were hundreds, if not thousands, of small broker dealers that participated in the municipal bond market.

Packaged product was limited to UITs which were passively managed. The emergence of open-end funds, closed-end funds and ETFs has increased the institutional participation for retail investors in the market. Today, the municipal market, from a capital commitment perspective, is largely limited to less than 10 primary firms, and really more like 5 or 6. 30 years ago, underwriting was executed in meeting rooms at the underwriter's offices with representatives calling via telephone to their respective underwriting desks at their own firms. Today, it is all completed electronically. Secondary trading was accomplished over the phone utilizing a "Blue List", a daily publication of dealer offerings distributed by messenger to every market participant each morning. Today, trading is increasingly electronic, with both dealers and investors making offerings via electronic platform.

Consolidation is evident from an investor's perspective, as well. The proliferation of ETFs, open-end and closed-end mutual funds has taken over the investing landscape. Additionally, there has been significant growth in professionally managed SMAs. The common trust fund at banks and creation of laddered portfolios by retail brokers have been disappearing from the market.

Finally, prior to the financial crisis in 2008, over 50% of all new issue volume was additionally secured by a monoline insurance company, resulting in Aaa/AAA ratings. At the time, bonds traded at spread differentials based on perceived credit quality of the insurer, not the underlying security. Today, bond insurance constitutes less than 10% of the new issue market.

4. **Most investors see municipal bond investing as safe and hopefully boring. How do you see it differently?**

Investors tend to view the municipal market as a largely homogenous class of securities backed by the unlimited taxing authority of borrowers. Per Moody's Moody's Investors Service, the 10-year average cumulative default rate for investment grade municipal bonds was 0.10% vs. 2.25% for similarly rated corporate bonds. This contributes to the view of many municipal bond investors that the market is "safe and boring". Investors willing to endure price volatility will get their investment back at maturity, barring a monetary default, which is rare. Municipal bond investors often think of their municipal portfolios as their "sleep at night" money. There is nothing wrong with this perspective. The municipal market can also offer investors higher levels of tax-exempt income, on an absolute basis, than the corporate high yield market with lower default rates and higher recovery rates than high yield corporate bonds. Additionally, while the municipal market is largely correlated to the US Treasury market and interest rates, in general, the high yield municipal market is far less correlated.

We view the municipal market as a vast landscape of inefficiency created by the diverse nature of the borrowers. According to the MSRB, there are 50,000 issuers and approximately 1 million individual CUSIPs in the $4 trillion municipal bond market, making effective "market surveillance" impossible. As a result, trading is often "by appointment" and typically revolves around a new issuance. With the exception of the largest issuers, states, cities and counties most bonds do not trade with any frequency. Price discovery can be challenging. The municipal bond market is comprised of 50,000 unique and often interesting individual credit stories. Diligent investors can find really compelling credit stories at very attractive yields levels. It is hard to imagine how the municipal bond market can become homogenized, short of a federal guaranty for all municipal debt. The municipal bond market should maintain its position as the largest inefficient market across the investment landscape.

5. **You and colleagues do credit research. What is the opportunity, generally, in taking credit risks in municipals, and why don't more firms offer this strategy?**

As mentioned above, there are 50,000 different issuers and 1.2 million CUSIPS. The sheer size and vastness of the market virtually guarantees inefficiency. Investors willing to engage in thorough credit analysis and ongoing surveillance can exploit this market inefficiency. Retail brokers tend to have good distribution for **locally issued** non-rated bonds. Underwriters are familiar with the project as are their clients. However, distribution is limited to local broker-dealers with familiarity of the project. As a result, liquidity is often limited. Mutual funds are the largest holders of non-rated and lower rated

municipal bonds. Due to economies, they tend to focus on the largest issues leaving the smaller, regional issues to local retail and investors like Lind Capital. We believe, within the revenue bond segments of the market, credit risks are identifiable, measurable and can be monitored on an ongoing basis. Revenue bonds generally do not have unfunded pension liability issues, OPEB issues or inherent political risks. General obligation bonds can be exposed to all of the above. While these issues are unlikely to lead to credit default, they do result in price volatility. We have long argued that investors in general obligation bonds are incurring risks they are not able to measure and are not being adequately compensated for taking.

Traditional municipal bond managers often do not have the expertise or resources to navigate the credit landscape in the municipal bond market. As a result, many become dependent on the rating agencies for their credit analysis and surveillance. The non-rated market is reserved for local broker-dealers in the communities of the underlying projects and high yield investment managers. Broker dealer research coverage is limited to the largest issues outstanding and issues a particular dealer underwrote at original issuance. Mutual fund managers tend to focus on the largest issues for economies of scale purposes. In turn, this leads to outsized impact of fund flows on bond pricing and volatility because there is a lot of overlap in portfolio holdings among different high yield funds. This was never more evident than March through April of 2020 when the municipal market experienced historic outflows.

6. **How many municipal bonds are out there and why don't we always know the price?**
$4 trillion par value, approximately 1 million individual bonds. Infrequent trading leads to lack of accurate price discovery. Municipal bonds are priced by independent pricing services that utilize a matrix for daily pricing. Generally speaking, bonds get "slotted" into a matrix at the time of the original pricing (spread to a benchmark) and maintain that spread until actual trading activity dictates a change. Similarly structured bonds may alter the spread for other bonds when they are priced in the new issue market. Should an A rated hospital come to market +70 bps to the benchmark, existing A rated hospitals will be widened to +70 bps. Note, this methodology does not incorporate individual or unique credit characteristics or credit events unless a bond actually trades. Again, this phenomenon can lead to incredible inefficiency. Mispriced bonds are often the norm, not the exception. Particularly as investors go "down the credit curve". We often utilize a strategy to target bonds we view as grossly undervalued by the pricing services. We can offer a portfolio manager a significant "gain" to their valuation and still realize considerable value from an underlying credit perspective for our clients. In our opinion, institutional portfolio managers often use the pricing services as a guide to value despite pricing services are often behind the curve relative to current credit trends. Again, the pricing services rely on market activity in pricing securities, a lack of trading activity can lead to stale pricing. An accounting professor of mine in graduate school frequently stated that accounting should measure not motivate. We seek to exploit the portfolio manager that uses it for motivation rather than measurement.

7. **Have there been many landmark legal cases in municipal finance recently?**
Detroit and Puerto Rico are both landmark cases. Detroit for the treatment of bondholders vs. pensioners (to the substantial benefit of pension holders). Puerto Rico has a number of important legal cases for the different types of securities in the bankruptcy filing. Senior COFINA bond holders took a haircut while subordinate COFINA holders were able to get recovery. In a traditional senior-subordinate structure, the subordinate position would not recover anything until senior bondholders were "made whole".

8. **There seems to be long and short cycles where municipal bonds become very popular, then unpopular, and then back. Why is this?**
We believe the primary drivers of cyclical demand (long-term) are relative value to other asset classes and changes to federal tax law. Increasing and decreasing federal marginal tax rates affects the taxable equivalent of municipal bonds and tends to have a big impact on the demand component. As importantly and often not considered is the impact of other federal tax legislation. The limits on SALT

deductions and itemized deductions dramatically increased the demand for municipal bonds, because taxable income levels increased (due to reduced deductions) and federal income taxes increased. Historically, the federal government has been curtailing deductions via a variety of means, increasing the relative attractiveness of municipal bonds compared to other investment alternatives.

The primary driver (short-term) of municipal demand has been perceived credit concerns leading to outflows from mutual funds. Meredith Whitney in November 2010 and the COVID-19 crisis in March 2020 are examples of retail investors leaving the municipal market en masse creating tremendous investment opportunities. Passage of the most recent stimulus bill combined with the prospect of higher marginal tax rates has led to dramatically increased demand for tax-exempt municipal bonds.

9. Bond rating agencies came under much scrutiny in 2008. What has changed, if anything?
The rating agencies were caught off-guard in 2008 as investors found their ratings too optimistic or stale. In essence, the ratings did not reflect the underlying credit quality and the risks associated with the unprecedented financial crisis. Municipal credit was dramatically affected as property values plummeted necessitating increases in property tax rates to offset the decline in valuations. Defaults rose dramatically.

Post-2008, rating agencies were determined to not find themselves in a similar position going forward. We believe the rating agencies have become far more proactive, often too proactive. Prior to the financial crisis, investors were concerned the rating agencies were too optimistic in their views. Today, investors are concerned the rating agencies are too pessimistic. We view the current environment with the rating agencies as an opportunity because they can be too aggressive in downgrading borrowers which often leads to indiscriminate selling. Too many market participants outsource their credit analysis to the ratings agencies, without any internal credit analysis and are completely reactive to the actions of the rating agencies from a portfolio management perspective.

10. Why did municipal bond investors historically want bond insurance?
The municipal bond investor has always been a "belt and suspenders" investor. Ironically, the municipal monoline insurers largely insured bonds with solid underlying credit quality. As the insurers competed for market share, the cost for insurance plummeted making the enhancement incredibly inexpensive. It commoditized the market. The commoditization of the market led to enhanced liquidity for investors.

There were certainly exceptions to the underlying credit quality of insured bonds. Puerto Rico, Detroit, and Allegheny West Penn Hospital among others. However, the vast majority of insured municipal bonds never had underlying credit issues.

11. In 2010, Meredith Whitney warned of "hundreds of billions" in municipal defaults. What did she get wrong?

In our view, **EVERYTHING**. She took a "traditional corporate" approach to credit analysis and concluded many municipalities were insolvent. Too much debt and too many obligations to former employees in the form of pensions and OPEBs. It remains a long-term problem, not an imminent problem. Additionally, she probably failed to incorporate the incredible levers municipalities have to raise revenue, including raising taxes. Unlike a company with a product falling out favor, state and local governments can raise their property tax levies or income tax rates. That said, we would welcome another "Meredith Whitney event". The period following her 60 Minutes prognostication was one of the best investing periods in municipal bond history.

12. Higher Education Bonds or Charter Schools: what type of attributes do you seek?
While both Higher Ed and Charter Schools are members of the education sector, the credit underwriting attributes are somewhat unique. Ultimately, enrollment drives operating performance in both Higher

Ed and Charter Schools. A key part of our analysis of individual credits in both sectors is their ability to grow and/or maintain enrollment numbers…which drives revenue.

Demand/Revenue characteristics:

The sources of revenue are very different. **Higher Ed** – we invest mainly in private non-profit colleges and universities (vs. public), which are very tuition driven. Net tuition revenue (sticker price less scholarships, etc.) is both a function of price elasticity compared to peer institutions, as well as student demand. We look for long-standing institutions that have a strong reputation vs. their competitors or fit a local/regional niche. **Charter Schools –** revenue is derived from state and local taxes, usually paid at the same per pupil rate as their public school district. The per pupil rate is out of the control of the charter school and is more a function of political favorability towards charters. We look for charters in states that are supportive of charter schools (disputes with public teacher unions are persistent). With the per pupil rate "locked," what we concentrate on is the student demand for the school, which can often be measured by the waitlist vs. enrollment numbers and the test scores compared to local and state comps. If the school is outperforming, offers a niche curriculum, or has a strong mission-driven agenda (i.e., filling a need in underserved community) the parent & student demand will be strong. We tend to shy away from charter schools that have grand expansion plans with little proof that the demand exists.

Profitability:

Both Higher Ed and Charter Schools (in general) run pretty thin profitability. We don't mind this, as the profit **should** be reinvested in the educational mission, which will improve the quality of the school and support the demand characteristics we look for. Many Higher Ed institutions even run a consistent net deficit, and rely on endowment gains to support operations. We carefully measure the reliance a college or university has on its endowment assets, and how much "runway" they have.

We look for 1.10 – 1.25x debt service coverage ratios, and it is unlikely to see >1.50x from normal operations (especially in non-rated issues).

Liquidity:
This is more important for Higher Ed than Charter Schools. **Charter Schools** generally do not carry very large days cash on hand (DCOH) balances…usually 30-50 days. This is acceptable, given the dependability of their revenue & less need for a cash back-stop (ex. even during COVID, when kids were sent home, charters received the same per pupil revenue)

Higher Ed…a key component we look at is not just unrestricted cash on the balance sheet, but the size and dependence on the endowment. Endowment funds can be both restricted and unrestricted, but in either case serve as support to the college's operations. We favor institutions with a large endowment relative to their size and operating budget, as well as a strong track record of fundraising.

Collateral:
Although we underwrite assuming on-going operations and debt service, real estate & physical asset value is important. In addition to gross revenue pledge, we almost always require a first mortgage on the asset in a worst-case foreclosure and liquidation scenario.

Management:
A qualitative factor important in both sectors. We look carefully at the experience & background of the management teams. In **Higher Ed** the President can be very effective driving donations & endowment growth. Prominent Board members can also be large donors. In **Charter Schools** experience is critical. We stay away from "start-ups," and prefer multi-school systems to stand-alone schools. One thing we

also look for is a CPA or experienced accounting professional on the board or management team, which we believe to be very important for the financial management of the school, especially smaller charters.

13. **Are private colleges, often with large endowments, subsidized by the municipal bond market?**
Indirectly. They are able to issue tax-exempt bonds for capital expenditures such as buildings and student housing projects which lowers their cost of capital. Private colleges and universities have been big issuers in the taxable municipal market, for general corporate purposes or advanced refunding, which does not qualify for tax-exempt financing. There is no federal subsidy for taxable municipal bonds as interest in subject to federal taxation. Interest may be exempt from state income taxes, depending on state tax regulations.

14. **Are Charter Schools growing, shrinking, or stable?**
Charter schools utilizing the municipal market to finance capital programs including construction or facilities acquisition is increasing and likely to continue increasing as alternative educational delivery mechanisms increase. Investor reticence to the sector has dissipated and it has become an important sector within the municipal bond market.

15. **Senior Living Bonds and/or Hospital Bonds: what type of attributes do you seek?**
LCP has not been very active in Hospital bonds for several years due to rich valuations, political and policy uncertainty/risk, and complexities of the business models. Over time, our view has evolved. We used to invest actively in rural, critical access hospitals due to favorable reimbursement model that has since been diminished. Critical access hospitals were also disproportionately affected by the cost of electronic medical records, more easily absorbed by larger hospitals and healthcare systems Following the passage of ACA in 2010, we found opportunity in hospitals located "second-tier" cities, but little competition, within states that expanded Medicaid coverage. Most recently, our largest healthcare exposure has been in Federally Qualified Health Centers (FQHCs), which serve at-need communities. These are primary care health centers (non-emergent), that also provide dental, mental health, and pharmacy. LCP believes these to be very effective healthcare delivery models for these demographics, as evident by their strong bipartisan support. In addition to many other benefits of the FQHC designation, they received enhanced Medicare and Medicaid reimbursements and federal grant eligibility.

Senior Living
LCP's largest exposure. We can bucket the sector into a few sub-groups: new development, expansion, stabilized community, and distressed.

New Development:
Careful consideration of construction timeline, budget, contract contingencies, and liquidity support. We monitor very closely through construction phase: project costs vs. budget, change orders, delays, and change in depositors. The biggest factors that we've seen sink new development deals are delays and going over-budget. Most new-development CCRCs are funded by a large percentage of "TEMP" debt, that is refunded when initial entrance fees are collected. If move-ins are delayed, the proforma schedule is shot, and these TEMP bonds start to have a "Pacman" effect on the project.

Market need…detailed in consultant feasibility study at issuance. We look at existing and planned competitive facilities in the primary market area (PMA), and the penetration rate needed to stabilize the facility. We also look at the price competitiveness vs. other facilities in the PMA, and how the entrance fees compare to local home values…since the sale of a home generally funds a resident's entrance fee.

Strength of management organization: single-site operator or multi-site? We prefer an experience management company with a portfolio of properties. Involvement of development consultant is a positive. A general contractor with experience in senior living is a must.

Strength of depositor list…we like to see 70-75% depositors at issuance and maintained or increasing through the construction phase.

Unit mix…. favor independent living weight vs. less profitable skilled nursing

Leverage ratios…long-term debt/unit (by unit type)

TEMP debt as % of entire deal, and at what % occupancy all TEMP debt is refunded

Financial feasibility study and sensitivity analysis. These are often wrong in significant assumptions, but helpful to understand where financial vulnerabilities may exist.

Expansion:
Many of the same construction related risks as new development

Ongoing operations provide support to the project…so you have a mix of Stable and New Development considerations. Existing operations can help mitigate the risk in delay and cost overruns, especially if a large liquidity base at the sponsoring entity already exists.

Reason for expansion: strategic repositioning (i.e. change in unit mix weighting)? Outsized demand in PMA (waitlist, depositors, etc.)? We

Stable:
Occupancy (current & historical trends)… usually >85% across all levels of care can be considered "stabilized," although low-to-mid 90%'s is preferable.

Management…also system vs. stand-alone. Facilities that are members of an obligated group provide diversified collateral as well as operational support.

Current & historical financial ratios: DSCR (debt service coverage ratio) and DCOH (days cash on hand) being the most important

Reserve balances and additional liquidity support

Distress:
Every situation is unique and takes a significant amount of work the understand the story. However, in general what we look for: is this a temporary distress/forbearance situation or heading toward hard restructuring? We value the asset based using a few different methodologies: Debt Capacity (max amount of debt the project could support at current market rates) vs. EVAL or trading price; Per unit valuation; cap rate by unit type. Regardless of the type of distress, we need to have confidence that there is value in the asset above where we can purchase the bonds, in case of a hard restructuring or asset sale. In these situations, we place extra importance on the management/sponsor, which can influence the direction of the restructuring and provide additional capital to the project. We also look at the differing classes of debt and how they would be treated in a restructuring.

16. **Economic Development Bonds: what type of attributes do you seek?**
Type of project being financed – What are the risks being financed?
  Technology Risk – We do not finance technology risk
  Scale-Up Risk – Limited scale-up risk
  Economic Risk – Supply and Demand.

Political Risk – How important is continued political support for viability and success of the project (See below). If project based on political support for survival, we would avoid.

Essentiality of a project to local community

Ultimate beneficiary an important provider of jobs to community

Project success contributes to long-term economic well-being of community

Scope of economic development debt to overall capital structure – equity investment of beneficiary

Do all participants have same economic incentives?

Does sponsor have economic stake in the project?

Source of revenue to secure debt, historical operating performance to substantiate pro forma?

Greenfield project or expansion of existing facility

Role of political support for ongoing economic success.

Ford Heights tire burning project was based entirely on legislatively granted rate subsidy. When subsidy was removed, the project filed for bankruptcy in the days that followed passage.

Lombard, Illinois needed to pledge an appropriation from the general fund to finance construction of convention center hotel project. When called upon to make the appropriation, the Village Board declined and bonds went into default.

Greenfield pro forma debt service coverage and reasonableness of assumptions

Hockey rink financing in Illinois was based on financial models experienced in Minnesota, a very different hockey and youth sports culture. Assumptions proved unattainable and Illinois rinks went into default.

17. Tax Lien Bonds, where the bond is secured by off the top tax revenue, is this growing or shrinking?

Assuming tax lien bonds secured by off the top tax revenue to be tax-increment financing and special assessment bonds for economic development seem to be stable to shrinking. California was a big issuer of redevelopment tax allocation bonds until the authorizing legislation was revoked. Special assessment bonds were a highly popular vehicle to finance infrastructure for new housing developments, particularly in Florida. The 2008 financial crisis all but ended that financing vehicle in Florida. There have been a few notable large projects utilizing this financing technique, including the American Dream Mall in New Jersey. Colorado remains an exception with special assessment issues continuing to finance infrastructure for housing developments in the fast-growing areas within the state.

18. Things like wind power, solar power, charging stations, or power storage: what role, if any, for municipal bonds?

Probably fairly limited, unless the projects are owned or sponsored by municipalities or public utilities. Investor-owned utilities have issued municipal debt for resource recovery purposes but not traditional capital expenditures, generally.

19. It appears that we will be spending more on infrastructure in the coming years. How will this affect municipal finance?

That depends on how the infrastructure is financed. To the extent is funded via direct federal funding, would likely be a net negative to the municipal market. Traditional infrastructure projects that would have been financed with municipal debt would receive direct federal funding and no new bond debt. If the federal government provides a matching program, an increase in municipal debt would likely follow. If the federal government would match funds it would essentially cut the municipal costs in half. Finally, if the federal government revives a "Build America Bond" program, it would result in increased issuance, but all taxable in nature. A net positive for the municipal market, but again lowering tax-exempt issuance and increasing taxable issuance.

20. Are professional sports subsidized by municipalities?

Yes, but indirectly. Historically, municipalities issued tax-exempt municipal bonds to finance the construction of professional sports team stadiums. The Las Vegas Raiders received $750 million in tax-exempt bond proceeds to assist in financing construction of their $1.9 billion stadium. There have been repeated efforts to eliminate this "loophole", to no avail. Since 1986, $17 billion of tax-exempt dent has been issued for stadium construction. Additionally, municipalities will often finance the infrastructure surrounding a stadium project with tax-exempt debt, providing an ancillary subsidy to the franchise, to the extent they would have otherwise been required to finance the infrastructure improvements.

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