



# Credit Rating Process and Key Rating Factors

Michigan Community College Business Officers Association

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# Municipal Bond Rating Basics

- ◆ **What is a credit rating?** A credit rating is simply an opinion on the ability of a borrower to repay an obligation.
- ◆ **State Law** Credit ratings are required for issues of \$5 million or more unless the bonds are Unlimited Tax or sold to sophisticated investors.
- ◆ **Why do we need one?** To attract and secure investors.  
Unless an issuer cannot achieve an investment grade rating, a rating is considered obligatory for the sale of any major bond issue.



# Municipal Bond Rating Basics

◆ **Who are the rating providers?** The three main rating agencies are Moody's Investors Service ("Moody's"), S&P Global ("S&P"), and Fitch Ratings ("Fitch"). Kroll Bond Rating Agency ("KBRA") also recently began providing municipal bond ratings.

Long-Term Municipal Ratings

	<u>Moody's</u>	<u>S&amp;P / Fitch/</u> <u>Kroll</u>
<u>Investment</u> <u>Grade</u>	Aaa	AAA
	Aa	AA
	A	A
	Baa	BBB
<u>Non-Investment</u> <u>Grade</u>	Ba	BB
	B	B
	Caa	CCC
	Ca	CC
	C	C

Short-Term  
Municipal Ratings

<u>Moody's</u>	<u>S&amp;P</u>	<u>Fitch</u>	<u>Kroll</u>
MIG1	SP-1+	F1	K1
MIG2	SP-1	F2	K2
MIG3	SP-2	F3	K3
MIG4	SP-3		



# Rating Modifiers

	Moody's	S&P Fitch Kroll
INVESTMENT GRADE RATINGS	Aaa	AAA
	Aa1	AA+
	Aa2	AA
	Aa3	AA-
	A1	A+
	A2	A
	A3	A-
	Baa1	BBB+
	Baa2	BBB
	Baa3	BBB-

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## INVESTMENT GRADE LINE -->

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SPECULATIVE GRADE RATINGS	Ba1	BB+
	Ba2	BB
	Ba3	BB-
	B1	B+
	B2	B
	B3	B-
	Caa	CCC
	Ca	CC
	C	C



## Rating Outlooks

**Rating outlooks are another modifier used to reflect the likely future direction of a credit rating**

◆ **Typical rating “outlook horizon” is a two year period**

### ◆ **Outlooks Used**

- Positive Outlook
- Stable or No Outlook
- Negative Outlook



# Rating Outlooks

## ◆ Impact of Rating Outlooks

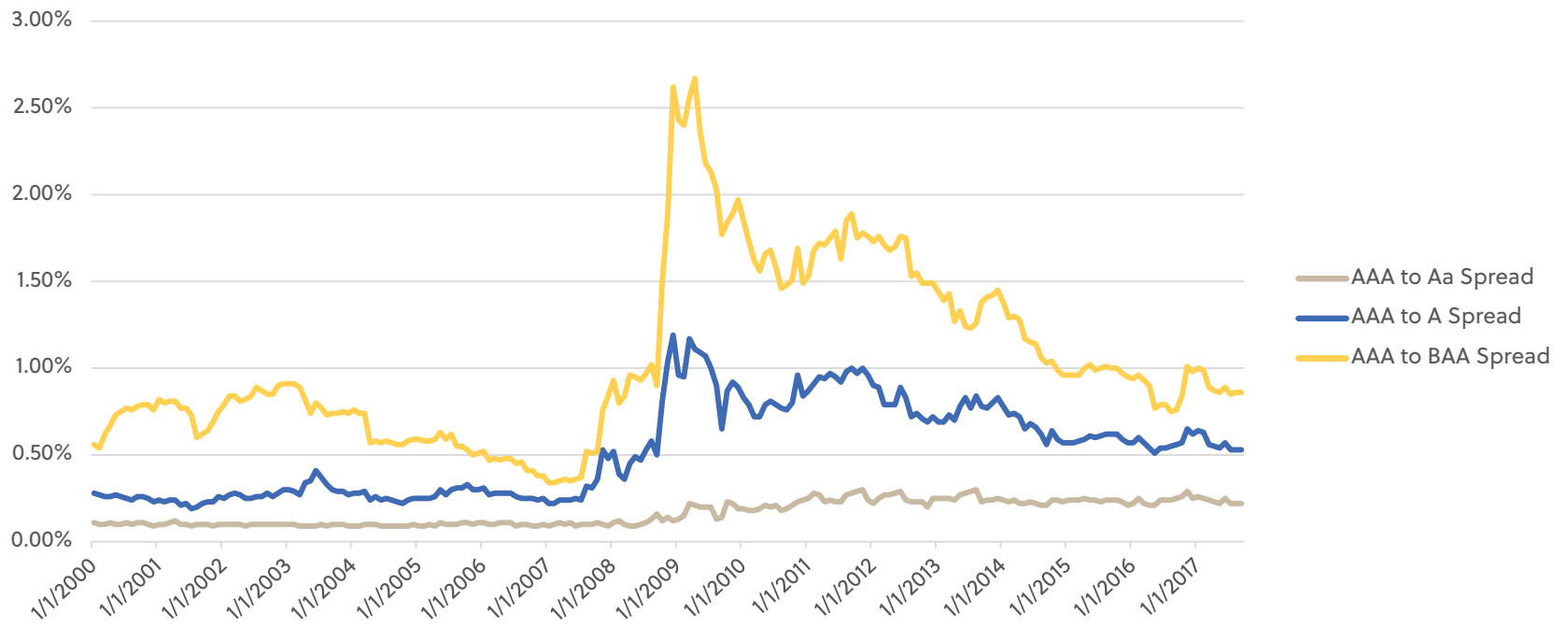
- Stable Outlook – No market impact
- Positive Outlook – Value of likely future rating will not be fully reflected in lower interest rates
- Negative Outlook – Possible future rating downgrade is already factored in, causing higher interest rates



# The Value of a Strong Credit Rating

◆ Strong credit ratings will result in lower cost of borrowing. The table below shows the spreads between interest rates of various credit rating categories.

**Long-Term (20 Year) Municipal Credit Spreads**  
January 2000 to October 2017





# What do Rating Agencies Look for?

## External Factors (Generally Beyond Your Control)

### ◆ Economy

- Broad economic base that can withstand economic downturns
- Character and diversity of largest employers
- Current and Projected Development





# What do Rating Agencies Look for?

## External Factors (Generally Beyond Your Control)

### ◆ Tax Base

- Demonstrated tax base stability & growth trend
- Concentration or diversity of tax base (by sector & property type)
- Concentration or diversity of largest taxpayers
- Future Growth Opportunity (% built out vs open space)
- Significant tax appeals



# What do Rating Agencies Look for?

## External Factors (Generally Beyond Your Control)

### ◆ Wealth Indicators

- Per Capita Property Values
- Per Capital & Per Household Income levels

### ◆ Employment Conditions

- Percentage Unemployment
- Comparison to State and National Averages



# What do Rating Agencies Look for?

## External Factors (Generally Beyond Your Control)

### ◆ Enrollment Trends

- Stable or growing enrollment
- Future enrollment projections and basis for projections

### ◆ Student Tuition and Auxiliary Charges

- Review of recent tuition changes (past few years)
- Process for determining tuition
- Flexibility to raise tuition
- Tuition rates relative to competition



## What do Rating Agencies Look for?

### Internal Factors (Within Your Control)

#### ◆ Maintain Sound Financial Position and Reserves

- Financial flexibility to address unforeseen circumstances
- Liquidity levels
- Fund balance (actual & projected) as % of operations

#### ◆ Recent & Projected Financial Results

- Most recent audit will be accepted truth
- Current year budget assumptions & expected results
- Following year's budget & budget assumptions



## What do Rating Agencies Look for?

### Internal Factors (Within Your Control)

#### ◆ Manageable Debt Burden

- Direct and overlapping debt as well as pension and other post employment benefit liabilities
- Debt service as percent of operating expenditures
- Rapid or slow amortization of debt

#### ◆ Other Debt

- Privately placed debt and concern for default and acceleration provisions
- Cash flow borrowing - timing issue vs weak finances
- Expected future financing



## What do Rating Agencies Look for?

### Internal Factors (Within Your Control)

#### ◆ Pension and Other Post-Employment Benefits

- Current payments in comparison to overall financial position
- Funded status of pension plans
- Potential for increases in employer contributions

#### ◆ Labor Relations

- No history of strikes
- Settled contracts
- Contract wage and benefit provisions



## Financial Management Assessment

### ◆ Revenue/Expenditure Assumptions for Annual Budgeting

- How many years of history do you use when forecasting trends?
- What outside sources of information do you use or consult? Or is it all done in house?
- What methodology do you use for budgeting (line item, zero base, etc)?

### ◆ Budget Amendments & Updates

- How many times per year do you provide the board with budget-to-actual reports? Please provide most recent report.
- In case of an emergency, how quickly could an amendment to the budget be made?
- Provide a copy of most recent budget to actual



## Financial Management Assessment

### ◆ Long-Term Financial Planning

- Is any type of multiple-year financial forecasting utilized? Or is it just the budget year?
- How frequently are these projections updated?
- Provide a copy of projections.

### ◆ Long-Term Capital Planning

- Is a written, multiple-year capital improvement plan maintained? If so how many years does the plan look forward?
- If so, how frequently is the plan updated?
- Provide a copy of the plan.





## Financial Management Assessment

### ◆ Investment Management Policies

- Is there a formally approved investment management policy, or are the state guidelines simply followed when making investments?
- How often are investments and holdings reported to the board?
- Provide a copy of the policy and most recent report.

### ◆ Debt Management Policies

- Is there an approved debt management policy that goes beyond statutory limitations to restrict the structure or amount of debt issued?
- Provide a copy of the policy.



## Financial Management Assessment

### ◆ Reserve and Liquidity Policies

- Has the board approved a formal fund balance or reserve policy or is there a target to maintain a certain fund balance?
- If there is a target, why was that particular target chosen?
- Provide a copy of the policy.



## Red Flags

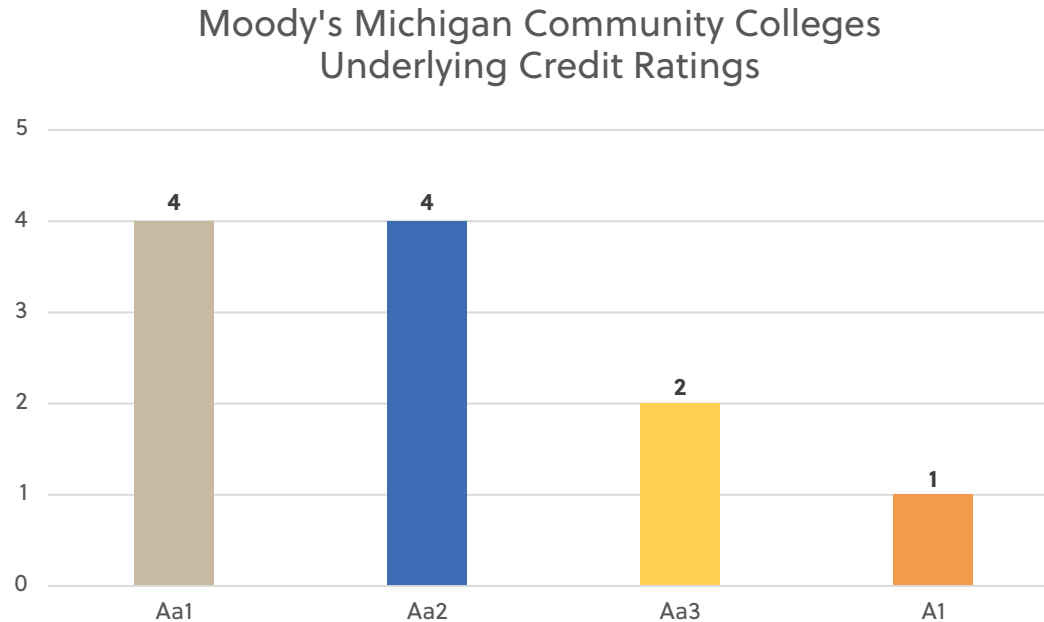
### ◆ SUSPECT PRACTICES AND INDICATORS

- Operating and Capital Expenditure Deferrals
- Revenue Accruals - Accruing Receivables and not Payables
- Fund Balance Fluctuation & Deterioration - 10% + Preferred
- Cash Flow Borrowing and Deficit Bonds
- Asset Sales and Debt Restructuring to Relieve Cash Flow
- Liberal Budgeting Assumptions - Escalated Revenue Projections



## Michigan Community College Ratings

- The following chart shows the underlying Moody's ratings for Michigan community colleges as of October 13, 2017.
- All 11 of Michigan community colleges rated by Moody's carry an underlying rating of A1 or better, and 8 of the 11 carry Aa2 or better underlying ratings from Moody's.



Source: Moody's Investor Service, October 13, 2017



## Key Data Points for Moody's Community College GO Bond Scorecard

• The Moody's Community College General Obligation Bond Scorecard is broken down into 4 weighted categories. Below is a listing of each category and its weighted factor.

	Sub-factor Weight
<b>• Economy / Tax Base (30% weight)</b>	
• Tax Base Size (full value)	10%
• Full Value Per Capita	10%
• Wealth (median family income)	10%
<b>• Finances (30% weight)</b>	
• Fund Balance (% of revenues)	10%
• Fund Balance Trend (5-year change)	5%
• Cash Balance (% of revenues)	10%
• Cash Balance Trend (5-year change)	5%
<b>• Management (20% weight)</b>	
• Institutional Framework	10%
• Operating History	10%
<b>• Debt / Pensions (20%)</b>	
• Debt to Full Value	5%
• Debt to Revenue	5%
• Moody's-adjusted Net Pension Liability (3-year average) to Full Value	5%
• Moody's-adjusted Net Pension Liability (3-year average) to Full Value	5%



## Moody's National Community College Medians

● The table below provides some of the median community college data at various rating categories for 2016.

NATIONAL COMMUNITY COLLEGE MEDIANS														
Tax Base Statistics & Ratios					Financial Statistics & Ratios					Debt Statistics & Ratios				
Rating Category	Total Full Value (\$000)	Avg. Annual Increase in Full Value (%)	Full Value Per Capita	Top Ten Tax Payers as % of Total	General Fund Balance as % of Revenues	5-Year Change in Fund Balance as % of Revenues	Operating Net Cash as % of Operating Revenues	5-Year Change in Cash Balance as % of Revenues	5 Yr Avg of Operating Revenues / Operating Expenditures	Direct Net Debt as % of Full Value	Net Direct Debt / Operating Revenues (x)	Payout, 10 Years, General Obligation Debt (%)	3-Year Avg of Moody's ANPL / Full Value	3-Year Avg of Moody's ANPL / Operating Revenues
Aaa	\$69,024,740	0.9	\$ 92,450	2.5	33.2	11.9	43.2	12.4	1	0.2	95	88.8	0.2	108.6
Aa3	\$17,758,291	2.7	\$124,518	6.7	17.5	6.8	26.7	17.8	1	0.3	152.4	56.2	0.3	148.6
Aa1	\$49,948,375	3.1	\$ 85,825	2.8	25.5	4.7	35.7	8.3	1	0.2	93.5	81	0.3	119.7
A2	\$18,198,401	3.1	N/A	6	32	13	29.1	42.8	1	0.5	137.8	41.5	0.4	116.5
A1	\$ 9,709,324	1.4	\$ 64,701	14.2	14.3	9	26	21.5	1	0.7	122.1	35.4	0.6	154.7

Source: Moody's Investor's Service, November 2017



## Timing and Selection of Ratings

◆ The bond rating process will typically occur:

- When new bonds are issued
- When the rating agency is in the process of surveilling the rating.

Both will typically require providing the rating agency with updated information as well as a conference call with the rating analyst.

Strongly recommended to include your financial advisor on any rating call, as they can help direct questions and/or responses to the rating analyst questions.

◆ The size and term of a bond issuance will determine if more than one bond rating is beneficial.

- If using only one rating, your advisor should review the district's outstanding credit ratings, the dates the ratings were last issued, financial and economic information on the District, as well as current market preferences in order to determine the rating agency to use.

# Questions?

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