Buy Side

Barclays Sees Value in Bonds Funded by Deteriorating HTF

by Hillary Flynn

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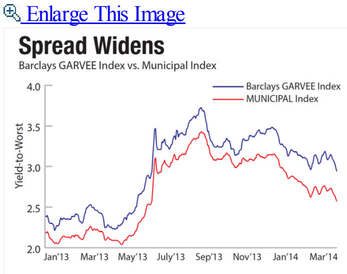

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Barclays Capital sees value in stand-alone Grant Anticipation Revenue Vehicle bonds now that yields have risen over concerns about potential shortfalls in U.S. highway funding.

Garvees are trading at roughly 40 basis points above the Municipal Index on a yield-to-worst basis. The spread has widened 20 to 25 basis points from the 15-to-20 basis point gap at the beginning of 2013, according to an April 21 Barclays report.

YTW is the lowest potential yield that can be earned on a bond without the issuer defaulting.

"We think they are wider right now than they should be, or have been," Thomas Weyl, senior credit analyst at Barclays, said in an interview with The Bond Buyer. "They should come back and outperform because they will tighten to the muni index."

Garvees are transportation bonds that are sold to provide upfront financing for projects that are expected to receive federal transportation aid and other revenues like state transportation taxes.

Stand-alone Garvees are backed solely by highway and transit grants made with revenue from the federal Highway Trust Fund.

But the HTF, which collects gasoline, diesel and related excise taxes that have dwindled because of more fuel-efficient cars and the failure of Congress to raise the federal gas tax, is projected to run out of money in August unless Congress provides more funds.

"I think it's reasonable that [Garvees] could outperform in the longer term," Matt Fabian, a managing director at Municipal Market Advisors, said in an interview.

Barclays listed the negative media hype that began last year about the anticipated HTF shortfall as the reason why investors have been wary of Garvees.

"After November 2013, the YTW differential between the two began to widen, given the increasing number of headlines about the looming HTF shortfall and despite the fact that the indices are comparable duration," Barclays said in the report.

Two main reasons the HTF is in distress are that authorization funding it is about to expire, and that the fund's expenditures exceed its revenue, the report said.

The HTF currently receives financing under the Moving Ahead for Progress in the 21st Century (MAP-21) law, an authorization that provides the fund with $118 billion for 27 months ending Sept. 30, according to the report. The HTF is not scheduled to receive any additional funding authorizations or resolutions at this time.

The HTF's financial problems are exacerbated by its expenditures outpacing its tax revenues.

In 2012 the fund's expenditures were $49 billion, exceeding tax revenues by $9 billion, the report said. Its expenses have outpaced its revenue since 2009.

"Overall, we believe stand-alone Garvees will be able to withstand potential payment reductions or delays, given their debt-service coverage or credit protection in place," the report said. "Issuers have discussed or are beginning to discuss ways to deal with potentially reduced HTF payments.

One issuer has commented that should FY15 payments be significantly cut, it would use its FY14 obligation to make payment of FY15 debt service."

Barclays constructed an index consisting of five stand-alone Garvee bonds with a 5.029% coupon maturing in 2024 which they used to get a sense of the bonds' debt-service paying ability and capacity to tolerate "shocks." The firm tested their maximum annual debt- service coverage, their performance under an additional bonds test, whether the HTF's flow of funds would go first toward Garvees over other services, and issuers' project management abilities.

Barclays acknowledges that its index is constrained by its very limited number of constituents and stand-alone Garvees' tendency to have a low secondary volume, meaning the index's pricing levels often show indicative rather than actual trade levels.

Weyl said in the interview that Barclays was mostly trying to pick stand-alones, and was not looking for Garvees that had other sources of revenue. He added that it was pulling from the Barclays Index, which limited them, and did not want to pull bonds that had yields of zero because that would change the way the index would be viewed.

In addition to the stress tests conducted on the stand-alone Garvees, Barclays believes the bonds should be looked at as a potential long-term investment, because of an expectation that the HTF will continue to receive money after MAP-21 expires.

"If history is any indication, a series of short-term extensions will likely be passed until a longer-term reauthorization is agreed upon," the report said.

With regards to the fund's expenditures outpacing its revenue, the report notes that the Highway and Mass Transit Accounts have established threshold levels of four billion and one billion, respectively, and when amounts go below such levels the U.S. Department of Transportation begins to take special action to stave off deficits, such as delaying or reducing reimbursements to states for highway projects.

"If they hit their critical point, special actions have to occur no matter what," Weyl said. "That's the rule of law;, that's how it works."

He said that there is "a lot of noise" over the HTF program, but that Garvee bonds make sense overall.

Fabian said that Garvees are built to minimize default risk, but notes that buyers will be looking at the bonds' gains.

"The risk of them defaulting is still relatively low," Fabian said. "But we are not talking about default risk, we are talking about performance. When you are talking about performance, and going into this election cycle, they are a more unexpected bet."

Weyl said the bonds are likely to outperform because they are reliant on the federal government.

"We think [stand-alone GARVEEs are] a decent buy because this is federal grant money," he said. "Federal grant money pays for bonds first, before they pay for projects."

Fabian said that in the short term, funding from the the federal government is unreliable.

"There is so much uncertainty in the near term about federal funding," Fabian said. "Any instrument that relies on future payments from the Fed is unreliable because the Fed is not a reliable source of cash."

Fabian pointed out that the midterm elections are this year. He said the Senate could turn Republican and described Congress as "completely unpredictable".

"Ahead of the midterm elections it's hard to say that Congress will do anything," he said. "The Tea Party side in particular has been willing to be highly destructive to the status quo."

Weyl said that Barclays is not optimistic that there will be a long-term fix for the HTF this year.

"We don't see Congress addressing on a bipartisan basis how to fund our infrastructure," he said.

The bonds used for Barclays' index were from the Chicago Transit Authority, the Kentucky Asset/Liability Commission, the Delaware Transportation Authority, the Southeastern Pennsylvania Transportation Authority and the Alabama Federal Aid Highway Finance Authority.

Weyl said that Barclays doesn't recommend any specific CUSIPS at this time.

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