

# DETROIT

## DISTRIBUTABLE STATE AID GO

### JANNEY FIXED INCOME STRATEGY

JULY 7, 2010



Constitutionally mandated state aid - a portion of Michigan's sales tax - secures these bonds using a "lockbox" mechanism to protect bondholders.

#### DISTRIBUTABLE STATE AID GENERAL OBLIGATION (LIMITED TAX) BONDS

\$249 million outstanding

Aa3/AA-

Serials 2014 - 2021 and 2024

Term Bonds 2023, 2030, 2035

#### RATINGS OF RELATED ENTITIES

City of Detroit GO

Ba3/BB/BB+

State of Michigan

Aa2/AA-/AA-

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#### SUMMARY

- Detroit, a city in severe fiscal crisis, faces serious long term financial challenges
- These bonds are a key element of the city's deficit elimination plan
- The state aid which secures these bonds has two components, a constitutionally mandated provision and a more substantial component which is subject to legislative appropriation
- Pro forma debt service coverage and a strong additional bonds test offer significant bondholder security provisions

#### DETROIT

Detroit is a city in crisis. The motor city has seen a significant population decline since 1950, along with severe erosion of its economic base. As of March 2010, the unemployment rate was 25.3%. Declining revenues, persistent budget deficits and negative fund balances are symptoms of the city's financial distress. The city's primary revenue sources - property, income, and casino taxes as well as aid from the state - have all declined precipitously in the past three years. With ratings below investment grade on its GO debt, the city is effectively shut out of the capital markets.

As of June 30, 2009, Detroit has an accumulated budget deficit of \$325 million with an additional \$60 to \$70 million estimated for the current fiscal year. Michigan requires that a local unit of government with a deficit formulate and file with the state a Deficit Elimination Plan. Detroit's plan, filed in November 2009, was certified by the Michigan Department of Treasury in January 2010, contingent on the issuance of Distributable Aid Bonds. Other components of the plan include staff reductions, furloughs and enhanced procedures for revenue collection. The plan projects a positive fund balance by the end of FY 2012.

#### THE BONDS

In March 2010, the city issued \$250 million of Distributable State Aid (DSA) Bonds with maturities ranging from 2014 to 2035. Although these bonds are general obligations of Detroit, the real security is a pledge of the city's share of expected state aid receipts. An important security feature is a lockbox arrangement whereby the state Treasurer deposits state aid payments directly into accounts held by the trustee (U S Bank) for the benefit of bondholders.

DSA is comprised of two components. The first component is mandated by the state's constitution and is not subject to legislative appropriation. The state levies a 6% sales tax on retail sales. The constitution provides that one tenth of the tax collected be distributed on a per capita basis to townships, cities and villages. The second, statutory component is subject to state legislative appropriation. The formula for determining the amount to be distributed is complicated and has been adjusted multiple times, but in recent years it has generated three times as much revenue for Detroit as the constitutional component.

Pro Forma State Aid Coverage of Bond Debt Service

Fiscal year ending Sept 30 in \$ millions	2006	2007	2008	2009	2010 (est)
Total DSA (Constitutional and Statutory)	\$281.1	\$272.7	\$272.7	\$269.0	\$234.7
Constitutional Component	\$65.2	\$63.8	\$65.9	\$62.2	\$58.1
Maximum Annual Debt Service	\$18.9	\$18.9	\$18.9	\$18.9	\$18.9
Coverage From All State Aid	14.9x	14.4x	14.4x	14.2x	12.4x
Coverage From Constitutional Component	3.4x	3.4x	3.5x	3.3x	3.1x

Source: Detroit DSA Official Statement and Janney Fixed Income Strategy

DEBT SERVICE COVERAGE

Pro forma debt service coverage based only on revenues from the constitutional component is strong at more than three times. If all state aid is included, coverage is above ten times, but the non constitutional (statutory) component can be changed by the state legislature and is subject to annual legislative appropriation. Standard and Poor’s noted that in a stress scenario, if tax revenue from the constitutional component declined by 10% each year and the city’s share of total revenue dropped 1.5% and finally if no revenue was received from the statutory component, debt service coverage would still exceed 1.5x through 2016.

An further security feature is the additional bonds test - before any parity bonds can be issued, coverage from the constitutional component must be at least 150% (1.5x).

MICHIGAN

The state, rated Aa2/AA-/AA-, has been hurt by the decline and restructuring of the domestic auto industry, however all three rating agencies maintain a stable outlook on the state’s rating. Michigan has a history of sound financial management practices, and in a recent report (April 2010) Standard and Poor’s cited “Good budget management and operational controls” and “a low debt and pension burden” as positive considerations for the state. The state’s unemployment rate is significantly above the national average, topping out in January and March of 2010 at 14.9%, before falling back to 13.7% in May.

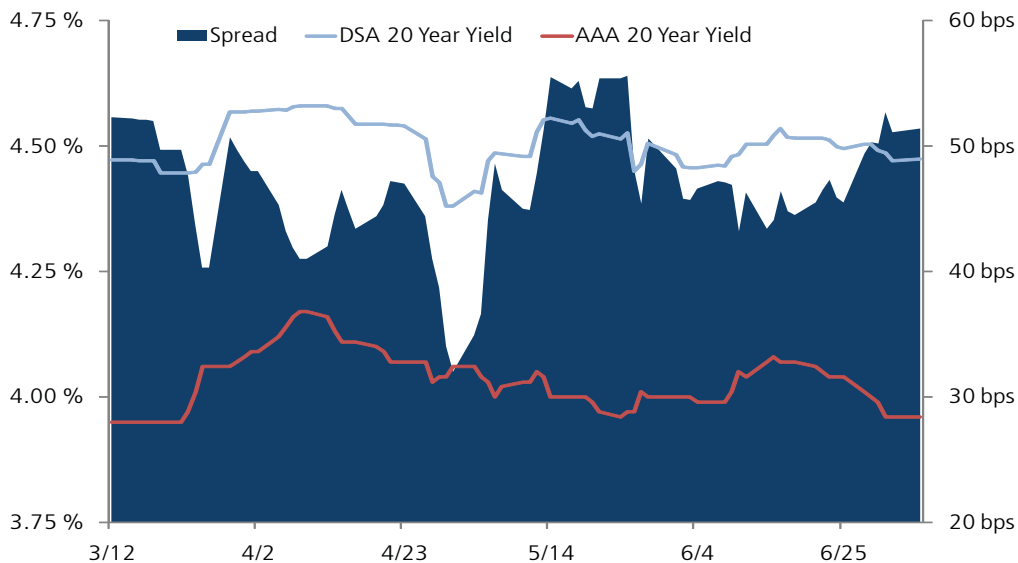
OTHER CONSIDERATIONS

State aid is distributed on a per capita basis, so if and as Detroit’s population continues to decline, the state’s distributions will likely trend lower. Debt service is covered by a comfortable margin with a strong additional bonds test. Another consideration addressed in the Official Statement is bankruptcy. If Detroit filed for bankruptcy, how would the revenue and security features of these bonds be impacted? It seems unlikely that these revenues, collected and generated at the state level, would be redirected away from bondholders. Bond counsel’s opinion is that a judge would not rule otherwise although notes that “the issue is not free from doubt.” The legislature could fail or decline to appropriate state aid, but the constitutional component is not subject to appropriation, and estimated debt service coverage based only on the constitutional component is strong.

Since sales tax collections finance the state aid payments, the economic prosperity of the state impacts the revenue stream. Total sales tax revenues in fiscal year 2009 (est.) were down 9% from the prior year and below levels for any year of the past decade, though a drop that threatens a coverage ratio decline below 2.5x seems very unlikely.

Pro forma debt service coverage from constitutionally mandated state aid is over 3x.

Yields and Spreads vs AAA MMA Benchmark



Source: Janney Fixed Income Strategy, MMA, MSRB

The additional yield and strong credit features of these bonds offset the headline risk of owning the Detroit name.

RECENT YIELD INFORMATION

Trade data from the Municipal Securities Rulemaking Board indicates that yields on the twenty year maturity of this issue (CUSIP 251093S35) have ranged between 32 basis points and 56 basis points above the MMA twenty year benchmark. MSRB data, which is based on reported trade levels, can be volatile, reflecting both purchases and sales as well as large institutional trades and smaller retail trades, but offers a reasonable indication of relative yields. Up to date price data is available at [www.emma.msrb.org](http://www.emma.msrb.org).

CONCLUSION

Detroit Distributable State Aid bonds are well secured. The supporting revenue stream is not dependent on the city's financial strength. Substantial pro forma debt service coverage margins and a significant additional bonds test offer strong bondholder security. Further population declines in Detroit could erode coverage, but margins are adequate in a stress scenario. Negative market perception of the Detroit name causes the bonds to trade at higher yields than like rated issues. The additional yield and strong credit features of these bonds offset the headline risk of owning the Detroit name.

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