

KILEY PARTNERS, INC. CREDIT REPORT

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State of California General Obligation Bonds

Ratings	Moody's A2 (S)	S&P A (S)	Fitch A (S)
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Opinion Let's be clear about this: there is virtually no way that the State of California, or any other state, will default on its general obligation bonds in our lifetime. Zero chance. I challenge *anyone* who thinks differently to posit a likely scenario in which this could happen.

The legal protections for state general obligation bonds are very strong. Further, every elected official in California knows that if a default occurs on their watch, they will be summarily turned out of office in the next election. So in addition to strong legal protections, the managerial incentives strongly favor the timely payment of debt. Finally, California has revenues of the highest quality, better than any corporation's revenues: taxes. Even Exxon Mobil (Moody's Aaa) can't force people to buy their products, but California can raise taxes and cut programs. Despite the scary headlines, California, as a governmental unit, does not face financial problems in the same way that a corporation might face financial problems, it is facing a problem of political will. It spent every penny it took in and then some when times were good. Now, as in every recession, California faces a reduction in revenues of several percent. **It can fix the budget and revenues will be back to normal in two years.**

The last defaults on state bonds occurred back in the 1870s when several southern states repudiated railroad bonds issued by corrupt carpetbagger governments. There has never been a default due to economic distress. As Moody's noted in a 2007 report, defaults on rated general obligation bonds of all governments have been so rare as to barely be measurable, a small fraction of the default rate on identically rated corporate bonds. In fact, in the same report, Moody's admitted that a state general obligation bond rated A2 would be rated Aa1 if it were a corporate bond. Even this is probably too low a rating. If there are any triple-A bond issuers left in this country, certainly they should include the states.

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Fitch downgraded California a notch in February; Moody's and S&P followed suit a month later. All three rating agencies have Stable Outlooks. The rating could well be cut a notch if, as likely, the State fails to face its budget problems squarely, but if the ratings are cut, they will probably rise again in a few years. This has been the rating agencies' pattern.

California is richer than average, has a bigger housing problem than average, has a higher debt burden than average, and faces a yawning budget gap. None of this is relevant to the State's willingness and ability to pay its bonds. California's bonds are a screaming buy because they are so cheap. Buyers of tax-exempt bonds should see an opportunity to buy bonds with upside potential. Buyers of corporate bonds should see an opportunity to diversify at good yields with virtually zero default risk.

- Key Points**
- Default risk: zero
 - Ratings risk: low
 - Higher than average wealth, high debt burden
 - Budget problems are political, not financial

Security California's general obligation bonds are full faith and credit obligations of the state, payable from any moneys in the General Fund, subject only to certain moneys, which are pledged to the support of the public school system.

Description California is the most populous state in the nation. The population is currently 38 million, and has grown modestly faster than the population of the nation as a whole in each of the last ten years. Historically, unemployment exceeds the national rate modestly in good times and by a lot in bad times. In February, California's unemployment rate was 10.5% versus 8.1% nationally. The distribution of employment in California is similar to the distribution nationally. Median family income, at almost \$60,000 in 2007, exceeded the national median by 18%. The poverty rate in California is 12.4% versus 13.0% nationally.

After many years of above average growth in both new construction and value, the housing market in California contracted severely in the last two years with falling values and very little new construction. In 2005, the value of new single family house permits was \$155 billion; last year it was \$33 billion. Even with the huge decline in home values in California, average home prices still substantially exceed the national average. In

2007, the median value of owner-occupied houses in California was 8.3 times median family income compared with a national average of 3.2 times. Lending excesses and speculation led to high foreclosure rates. California has 10% of the nation's housing units but accounted for 34% of the foreclosures last year. In 2008, 2.57% of California homes were in foreclosure versus a national rate of 0.79%.

Debt California has \$56 billion in general obligation debt outstanding, about \$10.5 billion of which is self-liquidating from non-tax sources, mainly single family mortgage revenue bonds for veterans that the state has guaranteed in order to obtain a lower interest rate. In total, the state has about \$72 billion in tax-supported debt outstanding, including non-self-liquidating general obligation debt, appropriation-backed debt, and the current issue. The voters and the legislature have approved an additional \$58 billion in tax-supported debt that is likely to be issued over the next few years. Debt per capita exceeds \$1,600, more than twice the median. In a few years, debt per capita could reach more than \$2,700. Debt to personal income was 4.4% versus a median of 2.4% and could reach 6.0% or more in a few years. Despite being higher than average, the debt burden is easily supportable and is simply irrelevant to creditworthiness.

Finances Governments have strong incentives to spend as much as possible. With a biennial election cycle, elected representatives have an incentive to spend money to get votes today, and a negative incentive to save money in good times for use during bad times. Thus, governments are always shocked, *shocked* when recessions – which occur on average every six years – actually occur, no matter how much warning there is. Recessions are treated as black swan events and crises. California is no different. In late February, the legislature faced a budget “shortfall” then estimated at \$41.6 billion for fiscal years 2009 and 2010, an amazing number, equal to 40% of the fiscal 2008 General Fund expenditures. The legislature responded with several temporary tax increases. The sales tax, which accounted for 27% of General Fund revenues in 2008, was increased from 5% to 6% effective April 1, 2009. The sales tax increase sunsets June 30, 2011 unless extended by the voters in a special election scheduled for May 19. Voter approval is highly unlikely. The income tax accounted for 55% of General Fund revenue in fiscal 2008. The income tax is graduated, with a top tax rate of 9.3%. The legislature increased each income tax rate by one-fourth of one percentage point (0.25%). Unless approved by the voters on May 19, the income tax surcharge sunsets after fiscal 2010. Voter approval is highly unlikely. The budget also relies on obtaining \$5 billion from securitizing future lottery revenues.

This is a one-shot that takes revenues away from future years. Voter approval is needed and is unlikely. In short, the legislature has made substantial progress to get the State through the recession, but will have to revisit the budget several times over the next year to close recurring gaps.

The table below summarizes the performance of the General Fund over the last several years, and the expectation for the next two years.

General Fund							
\$MM	FY2010p	FY2009p	FY2008	FY2007	FY2006	FY2005	FY2004
Revenues							
Personal income taxes	47,600	44,400	54,214	52,351	49,903	42,425	37,723
Sales taxes	31,800	26,500	26,599	27,403	27,613	25,783	23,847
Corporation taxes	10,000	9,600	11,201	11,210	10,710	11,192	8,379
Other	<u>14,000</u>	<u>8,400</u>	<u>5,760</u>	<u>5,346</u>	<u>5,186</u>	<u>4,881</u>	<u>15,593</u>
Total Revenues	103,400	88,900	97,774	96,310	93,413	84,281	85,541
Expenditures							
Education	48,000	44,000	51,091	49,344	46,649	40,877	36,350
Health and human services	32,500	31,200	29,148	28,945	26,158	24,811	23,556
Corrections	10,000	9,500	9,695	8,811	7,528	6,623	5,230
Other	<u>10,000</u>	<u>9,389</u>	<u>10,102</u>	<u>13,790</u>	<u>10,592</u>	<u>10,243</u>	<u>8,578</u>
Total Expenditures	100,500	94,089	100,036	100,890	90,927	82,553	73,714
Surplus (Deficit)	2,900	(5,189)	(2,261)	(4,580)	2,486	1,728	11,827
% Revenues	2.8%	-5.8%	-2.3%	-4.8%	2.7%	2.0%	13.8%
Fund Balance	(6,457)	(9,357)	(4,169)	(1,908)	2,673	187	(1,541)
% Expenditures	-6.4%	-9.9%	-4.2%	-1.9%	2.9%	0.2%	-2.1%

As noted above, the income tax accounted for about 55% of General Fund revenues. After double-digit increases in 2004, 2005 and 2006, income tax revenues are expected to decrease about 18% in the current fiscal year (due mainly to a decrease in capital gains), income tax will fall to about 50% of General Fund revenues. The sales tax accounts for about 27% of General Fund revenues. It is expected to decrease about 3% in the current fiscal year. California had a negative fund balance after the short, 2001 recession. Then came a few good years of surpluses, and all memory of bad times was forgotten. Revenues increased 10% in 2006 and the very next year California spent its entire accumulated surplus and then some, returning to a negative fund balance. Another deficit followed in 2008, and in the current fiscal year, as noted above, the State faced a major deficit, which it is seeking to close with a combination of tax increases and program cuts. It is unlikely to be successful and may well end the year with the largest deficit in memory. Next year should be much

better as the higher tax rates will be in effect for the full year. California is expecting as much as \$8 billion in federal stimulus money to help fix its budget. Expect action late throughout the fiscal year to solve the problems as they become apparent. Expect the situation to improve dramatically in 2011 as the economy fully recovers and the legislature remains fiscally conservative for one extra year.