STRATEGY INSIGHT

August 2014

The Long and Winding Road

We have been closely following the twists and turns of the debates over the Highway Trust Fund (HTF). Many observe the latest continuing resolution as yet another 11th hour Washington band aid. Others perceive this as another example of politicians "kicking the can down the road" and a refusal to address the HTFs long-term sustainability, threatening bondholders. We see it differently. The following commentary outlines the program and explains our view that Grant Anticipation Revenue Vehicles ("GARVEE") bonds represent durable credits[1].

In the latest switch-back on July 31st, Congress passed a continuing resolution extending the current transportation funding plan, Moving Ahead for Progress in the 21st Century (MAP-21), by 10 months to next May. MAP-21 is the current transportation spending plan that governs the funding of the HTF. We own several attractive opportunities in GARVEE bonds that are secured by HTF disbursements.

The HTF is split into two programs, with 80% earmarked for the federal funding of highway projects and the remaining 20% for mass transit projects. Highway and mass transit GARVEEs may have slightly different credit profiles due to differences in funding mechanisms. Beyond that, individual issues contain support features such as pre-funding mechanisms and debt service reserve funds. Many highway GARVEEs also enjoy the additional support of state revenues which provide more than ample coverage. In this article we will focus only on standalone programs which are more sensitive to reauthorization risk.

When contemplating a new investment or reviewing an existing one, we think about its risks first. For GARVEEs, reauthorization is our predominant concern. We view GARVEE bonds as appropriations of the federal government. *All federal transportation plans require periodic reauthorization by Congress.* Timeframes vary and we prefer long-term plans as opposed to short-term continuing resolutions. The use of continuing resolutions until a longer-term spending plan can be crafted has been an unfortunate hallmark of this program as illustrated in the table below. In fact, there were nine continuing resolutions between the expiration of prior program and the passage of MAP-21.

Authorization	Period
Intermodal Surface Transportation Efficiency Act (ISTEA)	December 1991 — September 1997
1 Extension	October 1997 — May 1998
Transportation Equity Act for the 21st Century (TEA-21)	June 1998 — September 2003
12 Extensions	October 2003 — July 2005
Safe, Accountable Flexible Efficient Transportation Equity Act: A Legacy for Users (SAFETEA-LU)	August 2005 — September 2009
9 Extensions	October 2009 — July 2012
Moving Ahead for Progress in the 21st Century Act (MAP-21)	July 2012 — September 2014
1 Extension	October 2014 — May 2015

Source: Department of Transportation

For us, the key to analyzing appropriation debt in any jurisdiction, federal or state, is the concept of "essentiality." We ask ourselves, "Is the project or asset requiring the appropriation essential to government services?" With transportation, the answer is almost always a resounding yes. Unlike some other notable defaults and near misses on non-essential appropriation bonds such as hockey rinks and gaming studios, the essentiality of bridges, highways, and infrastructure assets to the nation's economy is undeniable.

Transportation infrastructure projects support inter-state commerce and employ hundreds of thousands of people. Not surprisingly, the federal highway program has enjoyed broad bipartisan support since its inception in 1916. Recent discussions in Congress over MAP-21's successor still demonstrate this support. In a departure from the now all-too-common dysfunctional political

[1] Credits are fixed income obligations that include bonds, notes, loans, leases and other forms of indebtedness.

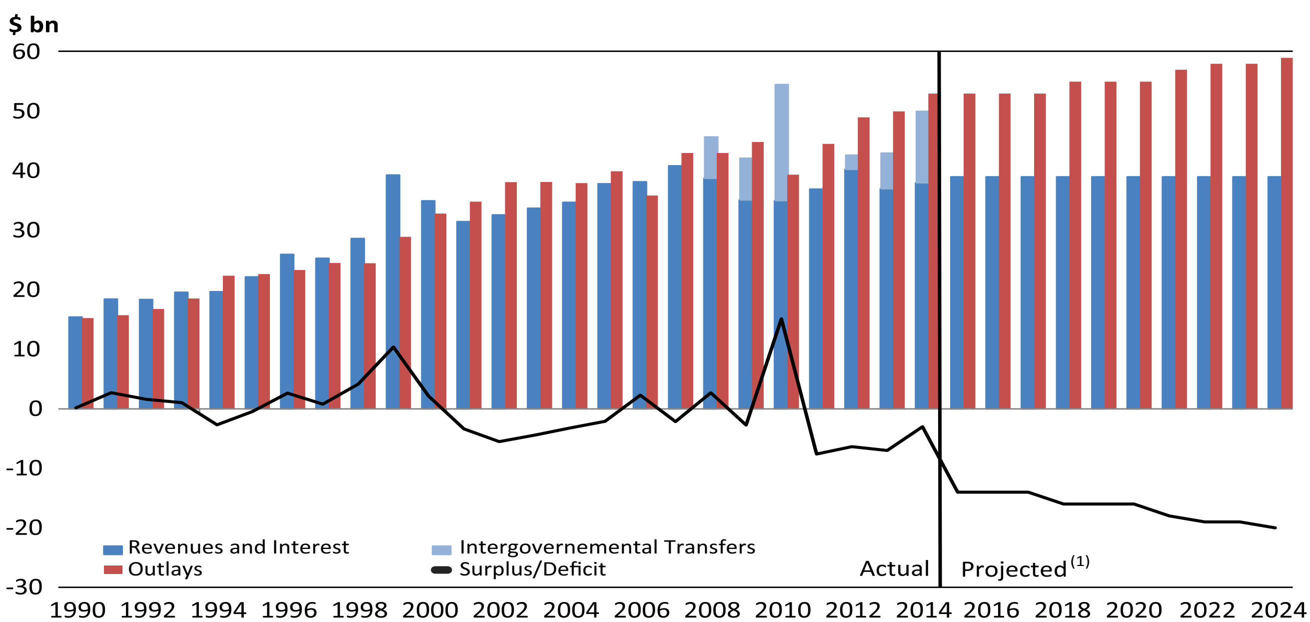
discourse, debates have centered on what level of increases to the gas tax are needed to ensure the HTF's long-term ability to meet the nation's infrastructure needs. The crux of the problem is that the 18.4 cent per gallon gas tax has not been increased since 1993, and has remained unadjusted for inflation. This, combined with better fuel efficiency and a decrease in vehicular travel, has resulted in stagnating revenues that are simply insufficient to meet the nations' growing infrastructure needs. Consequently, since 2008, the HTF has relied on government transfers to fund its full spending plan. These transfers have grown and now comprise just about 20% of the program's $53 billion annual budget. Absent a meaningful reform measure, required transfers will continue to grow over the next several years.

In addition to the essential nature of transportation needs, our holdings possess additional strengths that protect against potential HTF disbursement delays and cuts in appropriation, satisfying other credit criteria we apply to this sector.

Ample debt service coverage: All of our holdings have strong debt service coverage. Maximum annual debt service (MADS) coverage across our holdings ranges from about 1.7 times for Alaska Railroad to 20 times for Alabama. This means that the weakest GARVEE bond we hold could withstand a 40% drop in funding and still have sufficient revenues to cover the maximum debt service amount. On a more macro level, HTF's annual revenues of about $38 billion will be more than enough to repay all $14 billion of GARVEE bonds currently outstanding.

This ample coverage cushion is especially important to offset planned HTF cash management measures that would be triggered if the balance falls below $4 billion, which could happen as early as the end of this month. According to the US Department of Transportation, cash management measures would reduce spending on highway programs by 28%. With an average MADS coverage margin of over 9 times for our highway holdings, we remain comfortable when this occurs. Since transit accounts are projected to have sufficient cash

Highway Trust Fund



[1] The Congressional Budget Office (CBO) has assumed no chnages of current taxes. Projections do not assume future government transfers.

Sources: Congressional Budget Office (CBO), U.S. Department of Transportation Federal Highway Administration and BBH Analysis balances, they will remain unscathed in the near-term. Although average coverage levels for mass transit GARVEEs are lower than those on their highway counterparts, we expect our bonds to comfortably withstand future cash management measures, if enacted.

Debt service as a priority: On the federal level, HTF officials have stated that they would prioritize debt service before other programs if the need arises. Furthermore, our programs contain covenants that apply grant receipts to debt service before any other program expenditures. In other words, debt service comes first and project spending second.

Debt service reserve funds: Most of our GARVEE holdings benefit from reserve funds to pay debt service in the event that federal grants are disrupted for a prolonged period of time. These reserve funds are generally sized at either half of MADS or the standard three-pronged test: the lessor of maximum annual debt service, 10% of principal outstanding, or 1.25 times average annual debt service.

Pre-funding mechanisms: Many programs also have set aside mechanisms to pre-fund debt service well before their payment dates. With the exception of one highway GARVEE, all of our holdings have either strong set aside mechanisms or debt service reserve funds, if not both.

Unlike many others, we do not view reauthorization risk as hazardous potholes because we view GARVEEs as essential-purpose appropriation debt. We would have preferred a longer extension or a new multi-year plan to the current 10-month extension, but at least the transportation funding will not be swept up in the political rancor of the upcoming mid-term elections or the debt ceiling debates in March. If GARVEE bonds hit a bump in the road in the context of further political discord, we would view it as an opportunity to increase our holdings.

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