RockFleet financial services

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MUNI MARKET UPDATE

July 19, 2010

INSIDE THIS ISSUE:

LAS VEGAS MONORAIL—BETTING AGAINST THE HOUSE

By Larry Levitz

Introduction

Many commentators and analysts are talking about the "muni-bubble," the coming crisis in municipal bonds which will rival the technology and housing bubbles of recent years. While investors should be concerned about municipal credit generally, given the stress of the current recession, market fundamentals do not suggest an imminent collapse of the entire municipal bond market.

However, investors are worrying about whether some recent market defaults are a harbinger of things to come. One high profile municipal default is the $450 million Las Vegas Monorail Project Revenue Bonds. Issued in 2000, the bonds financed the expansion of the Las Vegas Monorail serving a number of casinos and the convention center along the Las Vegas Strip.

The Monorail bonds are considered municipal bonds because they were issued by a State Agency (Nevada Department of Business and Industry), and the Las Vegas Monorail

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MARKET UPDATE

Congress approved a rewrite of rules touching every corner of finance, from ATM cards to Wall Street traders, in the biggest expansion of government power over banking and markets since the Great Depression. Rather than the bill itself, the legislation hands off to 10 regulatory agencies the discretion to write hundreds of new rules governing finance. Supporters said the measures would help prevent a repeat of the financial crisis, while critics said it would limit credit and hinder economic growth.

Fears of a "double dip" for the U.S. economy re-emerged last week and the two-year Treasury note, among the most sensitive to changes in the official rate policy outlook, touched 0.569% last Thursday, a record low.

The growing investor acceptance of taxable municipal bonds over the past year appears to have hit a stumbling block. Build America Bonds (BABs) had been on a long-term strengthening trajectory. But starting with May's Treasury rally, the spread to BABs has widened and more recently BAB rates are rising. The option-adjusted spread on BABs averages 242 basis points, according to a Wells Fargo index. That is up 75 basis points in the past 10 weeks, and is the highest spread since Wells Fargo began keeping track of spreads last August.

Tax-exempt yields edged lower across the yield spectrum last week. As measured by MMD's AAA scale, 5 year yields fell 5 basis points to 1.40%, 10 year rates were 6 basis points lower at 2.61%, while 20 year and 30 year yields ended the week with declines of 2 basis points to 3.68% and 2 basis points to 3.97%, respectively. ♣

THIS WEEK'S CALENDAR

E.D.T.	Amount	Ratings	Issuer	State	Structure	
Monday, July 19						
11:15AM	9,945M	NR/A+	East Stroudsburg ASD	PA	2010-2018	BQ
12:00PM	336,035M	Aa2/AA+	King Co	WA	2011-2050	
Tuesday, July 20						
11:00AM	10,517M	UR/UR	V/O Hempstead	NY	2012-2030	BQ
11:00AM	77,455M	AAA/AAA	Henrico Co Pub Impt	VA	2011-2030	
11:00AM	10,680M	UR/UR	Wallkill CSD	NY	2011-2026	BQ
11:15AM	15,000M	UR/UR	Elizabethtown ASD	PA	2011-2030	BQ
11:30AM	14,795M	Aa2/AA	S/O Vermont	VT	2011-2030	BQ
12:00PM	23,000M	A1/UR	Sonoma Valley Hlth Care Dist	CA	2015-2031	BQ
Wednesday, July 21						
11:00AM	400,000M	UR/UR	Port Auth of NY & NJ	NY	2017-2040	
11:00AM	190,000M	UR/UR	Univ of Virginia - BABs	VA	???????	
11:00AM	7,460M	UR/UR	Wallington Boro	NJ	2011-2030	BQ
11:00AM	17,274M	UR/UR	Morris Co	NJ	2011-2022	
11:00AM	4,650M	UR/UR	Hendrick Hudson CSD	NY	2012-2025	BQ
11:15AM	12,915M	NR/AA	West Chester Boro	PA	2011-2040	BQ
11:15AM	19,870M	UR/UR	Point Pleasant Boro	NJ	2011-2029	BQ
11:30AM	17,300M	UR/UR	El Dorado Union High School Dist	CA	2011-2035	BQ
11:30AM	3,825M	UR/UR	T/O East Haddam	CT	2012-2030	BQ
12:00PM	3,064M	UR/UR	Massapequa UFSD	NY	2011-2025	BQ
12:00PM	13,240M	UR/UR	C/O Norwalk - T/E or BABs	CT	2013-2030	
12;00PM	6,000M	UR/UR	C/O Norwalk - TAXABLE(RZED)	CT	2013-2029	
Thursday, July 22						
11:00AM	97,105M	UR/UR	Bellevue SD #405 - RFDG	WA	2010-2021	
11:00AM	46,092M	UR/UR	South Country CSD	NY	2011-2031	
11:15AM	4,525M	NR/AA	Franklin ASD	PA	2010-2016	BQ
11:30AM	2,459M	UR/UR	T/O Stillwater	NY	2011-2025	BQ
11:30AM	386,780M	Aa2/AA-	San Fran Pub Impt - BABs	CA	2019-2040	
Friday, July 23						
ROP	800,000M	Aa2/AA	NYC GO - Refunding	NY	???????	

Click here for calendar updates.

VISIBLE SUPPLY

The 30-day visible supply of municipal bonds totaled $9.073 billion, up $1.110 billion from the previous session, according to The Bond Buyer.

That comprises $4.287 billion of competitive bonds, which is up $1.087 billion and $4.786 billion of negotiated bonds, which is up $23.1 million.

Week of July 19, 2010

Total supply: $5.27B

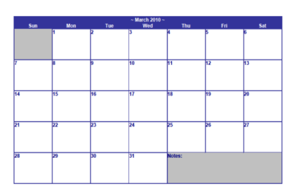
Taxable/BABs: $1.34B

Tax-Exempt: $3.92B

The 30-day visible supply is calculated by The Bond Buyer and reflects the total dollar volume of bonds to be offered at competitive bidding and through negotiation over the next 30 days.

Source: Thomson Reuters. 7/16/2010.

ECONOMIC CALENDAR



LAS VEGAS MONORAIL—BETTING AGAINST THE HOUSE (CONT'D)

Company, the non-profit company which runs the Monorail, was deemed to be an instrumentality of the state. However, the Monorail bonds are not typical municipal debt. No government revenues are pledged to secure the bonds and ultimate debt payment relies upon the Monorail's ability to generate a sufficient level of revenues to cover expenses and debt service each year.

The bonds were insured by AMBAC, so many investors at the time might have been less concerned about the viability of the project. However, with the subsequent demise of the insurers, the lesson is clear. Investors have to do their own research for the bonds they buy whether or not they are insured. This is especially true for project bonds such as the Monorail because the ultimate repayment of debt relies upon the success of the project.

Project bonds are usually sold with an accompanying consultant study which inevitably concludes that utilization will be at levels sufficient to cover debt service. Investors should not rely on these reports without a critical analysis of the consultant's assumptions and methodologies. Especially on high volume fixed rail system projects, actual usage tends to be lower than the original ridership projections of the consultants. This was true for the Monorail project as actual ridership and revenues came in woefully under the projections in every year since the Monorail was launched.

Las Vegas Monorail

The Monorail currently extends for 3.9 miles on an elevated duel-beam line that runs behind the casinos on the east side of the Strip. It begins at the MGM Grand Hotel and makes seven stops, including the Convention Center and the Las Vegas Hilton, before ending at the Sahara Hotel. The ride one way takes approximately thirteen minutes. An ambitious urban rail project, the Monorail has the distinction of being the first fully automated large-scale monorail in the U.S as well as the first privately -financed transit system built in the U.S. since World War II.

Opened in 1995, the original Monorail was a 0.8 mile people-mover between MGM and Bally's. Two mothballed Walt Disney World Mark IV Monorail trains were purchased and renovated to operate 16 hours of each day. There was no charge for its use.

In 1999, the System carried 4.9 million passengers. Given its success, city and state officials decided to expand the system north by three miles to the Sahara Hotel. Five more stations would be added so the seven stations would directly service eight casinos; MGM Grand, Paris, Bally's, Flamingo Hilton, Imperial Palace, Harrah's, Las Vegas Hilton and the Sahara. In addition, it would also stop at the Las Vegas Convention Center, the world's largest convention facility.

The Las Vegas Monorail Company, a non-profit organization, was set up in 2000 by the State of Nevada to acquire the rights to the existing system and oversee the expansion and operation of the Monorail. All of the Company's directors are appointed by the Governor of Nevada.

The project was financed by the issuance of $451 million of Las Vegas Monorail Project Revenue Bonds 1st Tier Series 2000. The 1st Tier Bonds were issued by the Nevada Department of Business and Industry as tax-exempt bonds. It was the largest bond issue ever in the State of Nevada.

In addition, $149 million of 2nd Tier Bonds were privately placed along with approximately $48.5 million of private sector loans from five of the casinos along the line and Monorail contractors Bombardier and Granite Construction. Total financing approximated $650 million. Proceeds were then loaned to the Company.

The ultimate security for the 1st Tier Series is net revenues of Monorail operations. No taxes or other government revenues are pledged to the Bonds.

The 2nd Tier bonds are also secured by net revenues of the System, but on a subordinate basis to payment of 1st Tier Bond debt service.

Bond insurer AMBAC insured the 1st Tier Bonds, which were rated AAA due to the guarantee. The underlying rating without insurance for the 1st Tier Bonds were Baa3, BBB- and BBB-, the lowest investment grade ratings from Moody's, S&P, and Fitch, respectively.

The viability of the seven station project was validated through a Ridership and Revenue forecast performed by URS Greiner Woodward Clyde (URS Greiner). Its report, which was incorporated into the bond offering document, forecast that 2004 base year ridership of the expanded Monorail would be 19.5 million passengers, rising to 21.6 million pas-

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sengers by 2010.

Assuming a starting one trip fare of $2.50 per ride with $.25 increases every three years, combined farebox and ad revenues would produce $56 million in 2004 and $74 million in 2010.

Utilizing these revenue projections and making some assumptions regarding operating costs, Monorail officials estimated that net revenues of Monorail operations would generate approximately 2.0 times coverage of 1st Tier Bond debt service throughout the forty year life of the bond issue. Debt service for the bonds was structured to rise each year in anticipation of consistent net revenue growth throughout the life of the issue. This report was intended to assure the AMBAC, investors and the rating agencies that the Monorail project would likely be able to cover its operating and debt service costs with some margin to spare.

Start-Up Problems

Like most large projects, the Monorail construction encountered problems. By mid-March 2004, the project was experiencing delays due to problems with the automated train control systems. The opening was put off until July 5 of that year with estimated losses of $85,000 per day.

However, operational difficulties persisted as train components began to drop off onto the street below. On September 1, 2004, a wheel fell off a train car leading to a six day shutdown of the System. The day after restart, a two-pound metal object dropped into the Paris -Las Vegas casino parking lot, this time raising much more serious safety concerns. A thorough review followed which shut the system down for three and a half months until late December.

The System Underperforms

Once the Monorail began operating on a consistent basis, it became abundantly clear that riders were not going to flock to it in numbers anywhere near those that were projected. Ridership was running 40% below projections while operating costs were 20% over budget, due in part to all of the

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maintenance issues.

By March 2005, Moody's downgraded the 1st Tier Bonds to junk status citing its concerns over the System's ability to meet its future debt service requirements. The Monorail never caught on. Ridership peaked in July 2005 at 33,000 per day, 39% below URS Greiner projections of daily 2005 usage of over 54,000.

By early 2006, with revenues coming in well below budget, the Company was forced to raise rates, increasing the one way fare from $3 to $5, a 67% hike. Fares for one day and three day Monorail passes were also increased significantly.

This fare hike completely changed the economics of the Monorail compared to alternatives such as buses and taxis. Ridership plummeted, falling 46% from the prior year's levels while revenues increased only marginally. Monorail revenues were barely covering operating costs, let alone the $30 million of annual 1st and 2nd Tier debt service obligations. The System began to eat into its reserve funds and the rating agencies openly discussed the possibility of default as they continued to downgrade the bonds.

By 2008 Fitch rated the 1st Tier Bonds CC and Moody's downgraded the Monorail bonds to Ca2. With the recession sinking its teeth into the Las Vegas gaming industry, the foundering Monorail was quickly eating through its reserve funds and default was only a matter of time.

On January 1, 2010, $16.8 million of debt service payment came due. With reserve funds depleted, AMBAC was forced to cover payments. However, AMBAC itself had become a victim of the recession due to its huge exposures to the housing market. AMBAC's ratings had tumbled to Caa2 and CC from Moody's and S&P, respectively, as it battled insolvency.

Investors had little faith in either the Monorail or the bond insurer. By then, the 1st Tier Bonds were trading at 22 cents to the dollar. On January 13, 2010, Monorail officials threw in the towel and sought Chapter 11 bankruptcy. They claimed $1.16 billion in future bond and loan obligations — debt which would not be serviced through operations.

Why it Failed

Why did the Monorail fail so spectacularly? A number of factors certainly played into the debacle. Although Monorail officials attribute the System's problems to the recession, the Monorail had been experiencing financial difficulties well before the economic downturn of 2008.

The Monorail's start-up difficulties initially generated bad publicity.

The failure of the Monorail line to extend to McCarran Airport limited ridership opportunities. Officials had planned to build a connection to the Airport, but financing disappeared with the poor performance of the existing System.

Unexpected competition from a double-decker bus running along the Strip at less than half the cost of the Monorail did not help matters. The bus, called the Deuce Bus, was averaging 32,000 riders daily after one year of operation in 2006, siphoning off passengers from the Monorail.

The recession of 2008, which cut convention attendance by 30%, also hurt.

The placement of the Monorail, running behind the casinos and the Convention Center, may have doomed it from the beginning. Casino owners did not want a monorail system blocking the views to the front of their facilities. Accessing the Strip from the Monorail stations required long walks through the crowded casinos minimizing the time advantage over other competitive transportation modes, including simply walking along the Strip. Burdened with the handicap of inconvenience, the $5 cost of a trip skewed the economics even more toward alternative ways of getting around.

Actually, as an urban monorail system, the Monorail would be considered a success. It continues to cover its costs from revenues generated. Few light rail systems can do even that.

But it was unrealistic to expect the Monorail to cover both operations and debt service given the experience of post-World War II light rail systems which all rely on subsidies from state and city governments. The wildly over-optimistic ridership projections used in selling the Project to AMBAC and investors created expectations that could not be met. Ridership and revenues failed to approach URS Greiner's projections.

Monorail ridership will likely total 27 million by the end of 2010. The consultant's report projected nearly 20 million riders for 2004 alone, the start-up year, and continued growth

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thereafter. Why were the projections so far off and why did investors, Monorail officials, and AMBAC believe them?

Unreliable Forecasts

In 2000, around the time the bonds were issued, transportation consultant Wendell Cox was hired by monorail critics to analyze the consultant's projections. While Cox definitely had an agenda, his report accurately predicted the Monorail's bankruptcy (in 2007, not 2010) and exposed deep flaws in URS Greiner's assumptions.

Cox's report labeled the projections "among the most aggressive in U.S. transit history and could emerge as the least accurate." The Monorail was "projected to carry more passengers per route mile than the New York subway, the London Underground, and the Stockholm Metro, and more than double that of the most heavily used new rail systems in the United States." "It is not likely that such an intensity of ridership would be attracted," Cox wrote.

The Cox Report critiques many of the assumptions of the URS Greiner study. Here are descriptions of some of the major ones:

- Projections for high volume fixed rail systems, both in the U.S. and internationally, have been uniformly overblown. Actual ridership of high volume fixed guideway systems such as in Jacksonville, Detroit, Miami, Washington D.C. and other U.S. cities were on average, 72% below their original projections.

- URS Greiner assumes a fare elasticity factor for the Monorail of -0.2%, which means that a fare increase of 10% would lead to a ridership decline of 2%. The national standard fare elasticity factor was -0.36%, so the Monorail consultants optimistically assumed that users would be half as sensitive to fare hikes as rail riders nationally. These differences in the projected effects of fares on ridership could have large impacts on cash flows. In fact, when fares were raised by 67% in early 2006, ridership declined not by 13% using the consultant's assumptions, but by nearly 50%, higher than the national average.

- URS Greiner projected that one third of ridership would come from the existing two station monorail. This would total approximately 18,000 riders per day out of the projected daily average of 54,000 first year riders. In 1999, the most recent year for the consultants, approximately 12,800 passengers rode the two station Monorail on a daily basis. So URS Greiner assumed that the original one mile MGM Grand and Bally's stretch, soon to be part of an extended System, would not only maintain its existing passenger counts but attract over 5,000 additional daily riders, all this while going from a free service to one charging $2.50 per ride. Assumptions like this one that strained credulity, should have been questioned and analyzed further.

- The consultant report also stated that one third of ridership would derive from those who now walk the Strip. As mentioned previously, the location of the Monorail stations in the back of the casinos away from the Strip minimizes the convenience and time advantage of taking the Monorail for many trips. In addition, the walk along the Strip by all the casinos and other attractions is a tourist attraction in and of itself.

AMBAC's Foray into Non-Traditional Financings

It would seem that such optimism would have raised some red flags with the bond insurer, who was putting $450 million of its capital at risk to insure the bonds. What prompted AMBAC to take on $450 million of exposure to this as yet unproven project?

At the time the Monorail bonds were issued, AMBAC had created a special group to underwrite "non-traditional" bonds. Non-traditional meant bonds which financed projects outside the usual scope of municipal activity and resembled private enterprises. These included start-up toll roads, stadiums, and military and student housing bonds.

The inherent economic risks and complexity of the projects allowed the insurer to charge a very high premium for bond insurance relative to premiums for bread and butter municipal debt. AMBAC was in fierce competition with other bond insurers for premium revenues and market share. The multi-million dollar premium and the large size of the transaction would benefit AMBAC on

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both fronts.

To speculate further, AMBAC may have felt that the bonds could be refinanced if the project was not performing as well as projected. Refinancing would involve issuing new bonds to refund the existing bonds. The refunding bonds would be structured to reduce or eliminate debt service requirements over the next few years while increasing debt service in the future. The hope would be that the refinancing would take immediate debt service pressure off the troubled project, giving officials time to work out their problems. Refinancing was a common technique in the bond insurance industry when dealing with sub-performing credits and could be used on repeated occasions.

However, refinancing bonds could only be sold with an insurer wrap since the credit was already troubled. A few years out, once AMBAC lost its investment grade ratings, it was unable to insure bonds in the market and refinancing ceased to be an option. The Monorail bonds hang around AMBAC and Monorail bondholders like an albatross.

Bankruptcy

Shortly after the Monorail declared bankruptcy, AMBAC sought a court challenge to the Monorail filing under Chapter 11 bankruptcy. AMBAC argued that since the LVMC was created by the state, who had control over the selection of directors, passenger rates, and other operational items, the non-profit company should be considered a 'municipality' under bankruptcy law and file under the provisions of Chapter 9 municipal bankruptcies.

While AMBAC has not disclosed its reasons for the challenge, legal experts have stated that Chapter 9 bankruptcies usually treat bond insurers and bondholders better than Chapter 11. However, since Nevada does not permit Chapter 9 bankruptcy, AMBAC most likely desired to try and directly work out an arrangement with LVMC outside of bankruptcy court.

The bankruptcy judge ultimately sided with LVMC and allowed the Chapter 11 proceeding to go forward.

Meanwhile, the Wisconsin insurance commissioner, Sean Dilweg, who has regulatory authority over AMBAC, has created a segregated rehabilitation account for $35 billion of AMBAC's toxic mortgage-backed securities in order to preserve AMBAC's remaining cash. The account includes the Las Vegas Monorail Bonds as the only public finance debt in the portfolio.

Dilweg imposed a moratorium on all claim payments for securities in the account until a rehabilitation plan can be worked out. Investors did not receive a July 1 Monorail bond debt service payment from either the Monorail operations or AMBAC. At this time, it is not certain whether AMBAC will have enough cash to service its distressed bond exposures.

The Monorail is covering its operating and maintenance costs and continues to operate as before. LVMC officials are hoping to move beyond Chapter 11 proceedings to extend the Monorail to the airport. Funding would come from either the federal government through a partnership with the Regional Transportation Commission or private sources.

Recently, LVMC President and CEO, Curtis Myles, traveled to China and met with potential investors and senior government officials about investing in the Monorail expansion.

Things might be a little tougher this time, according to Monorail director Bruce Woodbury. "For any new bonds, we would need multiple sources of independent analysis of future ridership," Woodbury said. "Extending to the airport could help ridership on the existing portion of the system, but any new bonds would be scrutinized carefully by potential investors."

Lessons Learned

The Las Vegas Monorail default is not a portent of a coming collapse of the municipal bond market. The Monorail resembles a private enterprise much more than a governmental operation. Its failure is attributable to overoptimistic expectations of passenger volume, which led to the System's inability to generate the revenues needed to pay its bonds.

Investors must be very cautious when investing in any project bonds like the Monorail. They must focus on the economic fundamentals of the project rather than just the high yields they may offer. Consultant reports provided in the offering documents should be read with a healthy skepticism and assumptions should be independently corroborated. Even if the investor reaches a reasonable level of comfort, project bonds should make up a relatively minor high-risk portion of a diverse portfolio. ♣

ROCKFLEET
financial services

515 Madison Avenue, 27th Floor
New York, NY 10022
Phone: 212-888-1301
Fax: 212-572-9814
Email: sales@rockfleetfinancial.com
www.rockfleetfinancial.com

ROCKFLEET UPDATE

Rockfleet continues to bid as member with our syndicate partners on competitive new issue on a national basis. Through July 15, 2010, the firm has underwritten, as member, 170 competitive transactions totaling $ 4.0 billion.

The firm continues to expand its ability to participate in negotiated contracts, and has been named selling group member for the Metropolitan Nashville Airporate Authority expected to price the week of July 26, 2010. ♣