



SAVADER ASSET
ADVISORS LLC
SPECIALISTS IN MUNICIPAL SECURITIES

The Current State of Municipal Credit Risk

Philadelphia Council for Business Economics

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Savader Asset Advisors - A Company Overview

Savader Asset Advisors LLC (SAA) is an independent provider of municipal asset advisory services, based on fundamental credit research, to institutional investors seeking to improve their understanding and ability to manage municipal securities.

- SAA's greatest strength is its analytic team which consists of thirteen veteran municipal credit analysts, many with more than twenty-years experience assessing the creditworthiness of municipal securities at rating agencies, bond insurers, buy-side firms, and pricing services
- Our analytic team is led by Mitchell Savader, a twenty-five year veteran of the municipal securities industry and former group manager and rating committee member in the Public Finance Department of Moody's Investors Service
- SAA's advisory services are regularly utilized by a range of institutions including publicly-listed municipal bond funds, private asset managers, investment banks, financial advisory firms and direct investors such as community banks and insurance companies
- We cover a broad range of municipal credits ranging from high-grade to high-yield and including virtually every sector and structure seen in the municipal securities market
- SAA also works with originators of certain non-securitized municipal assets and makes them available to its client base

What is driving this perception?

Articles, News Reports and Blog Discussions:

“Protect Yourself as States Implode”

“Is a Major Municipal default on the Horizon?”

“The Municipal Bond Crisis Is About to Begin”

“Who Will Default First: Greece or California?”

“The Coming Collapse of the Municipal Bond Market”

Commentators on TV business networks often discuss the possibility of certain states declaring bankruptcy

What is the perception?

Do you believe this could be a real headline within 1-2 years?

*“California in
Bankruptcy”*

(Hold That Thought!)

What is the reality?

Many municipal issuers and specific securities are under pressure, but things are not as bad as the pundits would have you believe:

- General economic weakness
- Specific economic events did not “play out” as anticipated
- Reduced revenues
- Weakened balance sheets

But weakness is a relative concept,
more a matter of degree than an absolute

What's behind the financial weakness of many municipalities?

A weak economy produces less taxable economic activity

- Stalled housing market
- Increased unemployment
- Decline in retail sales
- Fall in corporate and individual income

The more sensitive the revenue stream is to changes in economic activity, the less dependable it becomes

What is the recent trend in tax collections?

Analyzing state and local government tax collections

State and Local Tax Collections (\$Millions)

Year Ending	Total Tax Collections	Individual Income Tax Collections	Corporate Income Tax Collections	Property Tax Collections	Sale and Gross receipt Tax Collections
December 31, 2009	\$1,234,613	\$251,255	\$47,830	\$442,834	\$283,614
December 31, 2008	\$1,307,918	\$303,383	\$51,944	\$419,949	\$306,298
December 31, 2007	\$1,276,110	\$292,142	\$59,585	\$403,088	\$305,205

Source: U.S. Census Bureau

- Income and sales taxes—which states rely upon—have fared poorly
- Property taxes—which local municipalities rely upon—more stable

How will typical state and local governments be impacted?

The question now becomes: What do we mean by “impacted?”

- Weakened, downgraded, default, bankruptcy -

- States’ credit quality will weaken given general economic and financial deterioration, but default is not likely, bankruptcy not presently possible
- General purpose municipalities (cities, counties, towns, etc.), general obligation security will weaken, some defaults are possible, perhaps even some bankruptcies, but these will be few and far between and typically represent special circumstances rather than general deterioration
- School districts may fare a bit worse than general purpose municipalities, due to heavy reliance on state aid, with a few more defaults and bankruptcies possible
- Essential purpose enterprises (water, sewer) should hold-up fairly well, some weakening, but essentiality of service is the key

What does this mean for specific states and municipalities?

Extent and nature of impact is dependent upon several factors:

- What is the severity of the problem?
- What options are available?
- How has management handled things in the past?
- What is subject entity's revenue mix?
- What kind of flexibility does the entity have?
- How is entity interconnected to other governmental units?
- Are current or future prospects tied to specific economic events?

Where are we most likely to see defaults and bankruptcies?

Different sectors and individual credits for different reasons:

- Special tax bonds
- Special assessment / tax-allocation districts
 - Six Mile Creek Community Development District, FL
- Senior living facilities
 - Sedgebrook Continuing Care Retirement Community, IL
- Communities with vulnerable tax bases
- Poor historical or current management practices
 - Vallejo, CA
 - Harrisburg, PA

The Bottom Line

What is the potential for widespread defaults and bankruptcies?

Very unlikely

- States and local general purpose municipalities do not appear likely to default or enter bankruptcy—though not impossible

More likely

- Special purpose districts and financings are the vulnerability
- Defaults likely to increase significantly, but the historical base of 10-20 a year is very small, even 100 defaults while substantial on a historical basis is tiny against a base of 60,000 outstanding securities

Where do we go from here?

No reason to overreact, there are steps to take to protect yourself:

- Understand bond ratings: both level and AGE!!!
- Where ratings are low, on negative watch, or old, establish baseline understanding
- Understand relationship of obligor to other entities (IE. school districts and state)
- Maintain ongoing surveillance - annual and interim data
- Political (personal) issues must be watched

How is this playing out in Pennsylvania?

- The Commonwealth of Pennsylvania
- General purpose municipalities
- School districts
- Special districts and assessment bonds
- The City of Harrisburg
- The City of Pittsburgh
- The City of Philadelphia

Contact Information

For more information on Savader Asset Advisors' Municipal Asset Advisory Service, please contact:

Ralph Giraud
(212) 354-6500 (ext. 379)
rgiraud@savaderassetadvisors.com

Mitchell Savader
Chief Executive Officer
Savader Asset Advisors LLC
120 West 45th Street, 14th Floor
New York, NY 10036
(212) 354-6500 (ext. 333)
msavader@savaderassetadvisors.com

THE CURRENT STATE OF MUNICIPAL CREDIT RISK

WITH A SPECIAL LOOK AT THE COMMONWEALTH OF PENNSYLVANIA AND SOME OF ITS HIGHER PROFILE ISSUERS OF MUNICIPAL DEBT

The U.S. public finance market has recently been the focus of a series of articles, news reports, and blog discussions speculating on the potential for widespread credit deterioration, default and even bankruptcy of both state and local governments. These reports have triggered widespread concern among not only individual investors, but large institutional investors as well, causing some to forestall or downsize investment in the almost \$3 trillion municipal debt market.

We believe these are highly speculative and unnecessarily harsh conclusions drawn by just a handful of commentators and do not accurately reflect true conditions or prospects. This is not to say that the potential or even likelihood for credit deterioration does not exist. It is highly probable that should significant improvement in the national economic outlook be delayed; weakened revenue generation and the depletion of reserves could lead to broad deterioration in credit quality over the next one to two years. Circumstances, however, do not point to widespread defaults and bankruptcies.

CREDIT QUALITY IN THE U.S. MUNICIPAL MARKET

The pressures created by the recession have clearly challenged a number of state and local governments across the nation as many of their revenue sources have ceased to grow or have declined. A substantially weakened economic scenario challenges credit analysts to distinguish between those municipal credits encountering severe fiscal stress that could lead to default and those confronted with cyclical forces that will necessitate difficult choices, but not endanger the payment of debt service.

Going into the current recessionary period, municipalities were coming off a period of generally strong financial performance that allowed for the build up of liquidity and carryover operating reserves. These reserves have provided a cushion against revenue shortfalls and growing service demands. Beyond that, many municipal governments have shown a growing willingness to raise not only fees and charges, but property taxes as well—reflecting a generally difficult political decision for elected officials—while at the same time reviewing and cutting expenditures of every sort.

Presumptions of default risk for state and local governments need to consider statistical data which show that default is a rare event. This has been the case through economic down-cycles, in the face of tax limitation measures, the imposition of unfunded mandates, in the wake of natural disasters (Hurricane Katrina being an excellent example) and other events that can affect a municipality's credit position. All of the major rating agencies have published credit rating transition and default studies which show defaults on unenhanced, rated, municipal bonds have been exceptionally uncommon, falling in the range of 0.2-0.4% of outstanding debt issues.

At the most fundamental level, there are key characteristics of municipal government that many recognize as contributing to the overall stability and general creditworthiness of the sector. Put bluntly—municipalities do not “go out of business”—they deliver essential public services that are often legally mandated and rarely change, and

they have continually evolved to improve the efficiency of service delivery and also their ability to budget, track, and report on these activities.

CHALLENGES FACING STATE AND LOCAL GOVERNMENT

As the current recessionary period has progressed, it has become clear that there are broad differences in performance among different sectors of the public finance market, as well as among the credits within each sector. There is typically a lag of 12-18 months before municipal governments actually feel the full effects of an economic downturn, e.g. the associated declines that occur in property values that need to be factored into property reassessments that follow at a later date. This would imply that there are still difficult months, or even years, ahead for local governments throughout the nation. Up to now, property taxes have proven to be a less volatile source of revenue with most of the revenue shortfalls among specific municipalities occurring among more economically sensitive revenue sources such as sales and income taxes.

Data recently released by the U.S. Census Bureau provide evidence as to the extent of the decline in governmental tax revenues. For the year ending December 31, 2009, tax revenues collected by state and local governments totaled \$1.235 trillion or 5.6% less than \$1.308 trillion collected in 2008. An examination of the finer detail reveals additional points that reflect the vulnerability of state and local government finances to economic pressures. Between 2009 and 2008, collections of property taxes rose 5.5% while collections of far more economically sensitive individual income taxes, corporate income taxes and sales & use taxes fell by 17.2%, 7.9% and 7.4% respectively. Those entities more reliant on the economically sensitive revenue streams—such as state governments—have been hit harder by the national recession than most general purpose municipalities such as cities, counties and towns, which tend to have a significant reliance on more stable property taxes.

Over the past year, reserves, intergovernmental aid and federal stimulus dollars have helped bolster operations at the state level, and to a generally lesser extent at the local level. But the likely non-recurring nature of some of these measures must also be considered. A host of factors will come into play in 2010 and 2011, including: the pace of recovery of the real estate markets and housing values, the trend of unemployment, reduced support at the state and local level, pressure from rising healthcare and pension costs, availability of affordable credit and pent-up demand for previously cut services.

At the end of the day, a key determinant of where an individual municipal security ends up on the credit quality spectrum is the quality and experience of its management team as measured through the comprehensiveness and sustainability of its financial practices and policies. How deftly management can maneuver through the political processes at hand to make timely decisions and implement plans of action may be the most important factor of all in evaluating future credit quality.

State governments as sovereign entities have much greater control over their own destinies in terms of tax rates and expenditure patterns. Decisions made may not be broadly popular and at times may be subject to judicial intervention, but states generally have the power to effectively address a challenging environment in order to sustain their credit position. Ironically, their revenue streams tend to be dominated by more volatile tax sources, namely sales and income taxes. Having said this, however, some state governments such as California and New York, find themselves in particularly weak positions without much in the way of financial flexibility. While it is doubtful that the outcome will be default, the weak credit profile for governmental entities in this position may result in future rating downgrades.

Current credit conditions in other key sectors are mixed. For basic water and sewer utilities, the stability of their demand and consumption patterns help insulate them from economic forces, presuming management is raising rates as necessary and doing a good job of capital planning. Electric utilities, while also stable, remain somewhat vulnerable to decreased demand in a poor economy, changes in purchased power costs and the impact of future environmental related actions on operations. In addition, colleges and universities have experienced weakened endowments and balance sheets as the stock market plunged, but these have been slowly recovering. Greater sensitivity to the costs of tuition has been noted and a downturn in fundraising has been experienced as well.

Healthcare has been the one subsector also under pressure for an extended period prior to the recession and it continues to be vulnerable to ongoing credit deterioration as the economics of the industry evolve and competitive pressures continue. In addition, the impact of health care reform, once implemented, may have a substantial impact on operating performance, but we believe it is too early to make a meaningful evaluation of the situation.

SPECIAL CIRCUMSTANCES

Some municipalities have already encountered severe fiscal stress such as Vallejo, California, which in May 2008 filed for federal bankruptcy protection. Although the City found itself confronting a large and growing budget gap, reflecting a combination of falling revenue and growing operating expenditures—as is the case to some extent with many California municipalities—Vallejo’s financial crisis was due more to its own poor practices regarding employee pay and benefits. At the heart of the problem was the City’s long-time pattern of agreeing to generous union contracts during flush fiscal times. The result was a growing structural imbalance that was only exacerbated and brought to a head by the fiscal weakness created by the recent economic downturn.

The problems of Vallejo appear to represent the special circumstances of a solitary municipality and not a widespread pattern to be expected throughout the municipal market. This is not to say that there are not other communities out there facing similar circumstances. While it’s likely that over the next several months to years additional troubled communities will come to light as victims of their own practices; the fact is that most municipalities have practiced appropriate restraint and prudent behavior in their budgeting and have not boxed them in with unmanageable future expense growth. Therefore, while there is the possibility of other communities such as the City of Harrisburg that may be considering bankruptcy a viable alternative, these cases are likely to be few and far between.

CHAPTER 9 BANKRUPTCY

Given past comments by those unfamiliar with municipal finance and related law, a few comments on municipal bankruptcy are in order. A municipality's decision to file for bankruptcy is always an extreme step, something to be considered as a last resort. In the current environment of weak economic and financial performance, speculation is rising as to whether the U.S. is in for a round of increased Chapter 9 filings under the U.S. Bankruptcy Code. Chapter 9 filings have typically been identified with severe financial loss events, as occurred with Orange County, California's massive investment losses in 1994, or perhaps in the case of a municipal insolvency brought about by a structural operating deficit that depletes unrestricted reserves.

Many options for resolution are available to municipalities facing fiscal stress that fall far short of bankruptcy. Among these are revenue raising, service cuts, deficit financings, restructuring of long term debt, and submitting to fiscal oversight by a higher level of government, such as the case with the cities of Philadelphia and Pittsburgh. A bankruptcy filing can clearly offer a distressed municipality some advantages, but there are distinct disadvantages as well. The act of filing brings into play a federal court injunction to protect a municipality from actions that might be taken by creditors. The protection extends to elected officials and employees as well. In effect, it buys the municipality time to work out its cash flow difficulties and reach agreements with its creditors in an orderly, comprehensive fashion and in a single venue. In the absence of an ability to fully repay creditors, a negotiated adjustment of debt and other obligations—through reduction or deferral—can give the municipality a chance to re-emerge and regain stable operations.

On the other hand, it’s likely that if a municipality was to even contemplate bankruptcy in a public forum, its credit rating would be downgraded and its standing in the credit markets severely damaged. This situation has the potential to linger for a protracted period, perhaps limiting market access entirely, thereby making it much more expensive to borrow funds in the future. A bankruptcy can also have a dampening effect on a community’s business climate, suppressing new development and weakening general economic conditions. Finally, there are real financial costs involved in required legal representation and the probable reallocation of staff time to work through the bankruptcy process.

One major misconception that has been making the rounds in some of the recent media reporting on state and local government is that there are a number of states in danger of going into bankruptcy. The U.S. Bankruptcy Code carefully defines the term "debtor" to mean a "person or municipality". States are sovereign entities and are therefore not municipalities. As such, states are not permitted to file for bankruptcy.

COMMENTS ON KEY PENNSYLVANIA CREDITS

COMMONWEALTH OF PENNSYLVANIA

For many years leading up to the current recession, Pennsylvania's mature economy was characterized by a declining population, sluggish growth, and a shift from a manufacturing-based economy to one predominantly based in services. Today, the economy is much more diversified with far greater reliance on less recession-prone industries such as the health care and higher education sectors. It is this shift that has allowed the Commonwealth to weather the recession better than most states. Indeed, these sectors—led by the University of Pittsburgh Medical Center, the Jefferson Health System and the University of Pennsylvania as the state's three largest employers—continue to hire. Although the Commonwealth's unemployment rate of 8.9% as of February 2010 was at its highest level since 1984, it was still lower than the national rate of 9.7%.

While the Commonwealth has weathered the recession better than many other states, it has still experienced significant erosion in its financial position. During the Fiscal Year that ended June 30, 2009, the revenue base of Pennsylvania's general fund—the state's primary operating fund—declined by over \$2.2 billion or 8.6% resulting in a general fund operating deficit of approximately \$2.5 billion or 5.4% of annual expenditures. These figures resulted in a general fund ending balance of \$515 million or only 1.1% of annual expenses. Indeed, sales tax, personal income tax, and corporate net income tax revenues, which account for roughly 90% of all general fund revenues, were down so severely from their budgeted levels that the Commonwealth depleted its \$379 million rainy day fund known as the Budget Stabilization Fund. Not surprisingly, liquidity at FYE 2009 was also significantly affected with cash and investments standing at \$3.4 billion—down 49% from FY 2008 levels. While full and timely debt service payments were not at risk, in order to supplement its liquidity position the Commonwealth accessed the short-term note market in December 2009 for an \$800 million borrowing, the first time it has needed to issue cash flow notes since 1998.

Overall FY 2010 revenue collections through February 28, 2010 were down 2.9% from earlier estimates for the year with sales and use tax revenue showing the weakest performance with collections down 3.1%. In contrast, the year-to-date Realty Transfer Tax collection rate was 1% higher than budgeted as of the end of February, helped in large part by the extension of the federal tax credit through April, 2010. Despite this positive trend, as of February 9, 2010, the Secretary of the Budget projects a FYE 2010 general fund shortfall of \$525 million.

Just four months after the FY 2010 budget was adopted, the Governor proposed his FY 2011 budget that projects an effectively break even general fund which the House passed earlier this month. While this proposed budget does not include any broad-based tax increases, it does contain a number of material changes to the Commonwealth's revenue base, i.e. cutting the sales tax from 6% to 4% but broadening the scope of products and services subject to the sales tax, requiring more businesses to pay the corporate income tax, and instituting a new severance tax on natural gas extraction. Much of this new revenue would be dedicated to the establishment of a new Stimulus Transition Reserve, a recognition that supplemental federal aid is scheduled to end in FY 2011. In addition, the proposed budget also assumes that the general fund will receive \$2.8 billion of American Reemployment and Recovery Act (ARRA) dollars of budget stabilization funds to support both educational and correctional programs.

On a longer term budget basis, Pennsylvania will need to tackle the sharp increase in employer pension contributions scheduled to take place in FY 2013 for both the Public School Employees' Retirement System (PSERS) and the State Employees' Retirement System (SERS). As a result of changes made in 2003 when the systems appeared overfunded, combined with the losses caused by the stock market decline, the Commonwealth's

contribution is projected to more than double in FY 2013 to over \$1.1 billion. Moreover, school district contributions are also scheduled to almost triple to approximately \$1.9 billion. To address this significant financial challenge, the proposed budget calls for the issuance of long term bonds in order to refinance and restructure this liability over 30 years.

Although the House passed the budget on March 23rd, passage in the Senate as proposed is highly unlikely. In addition, the House has not yet passed the accompanying revenue bill necessary to enact the new and expanded taxes. Therefore it is unclear which new initiatives will survive the final budget or if a final budget will be adopted by the legal deadline of June 30th. Indeed, last year's budget was not signed until October 2009. The much delayed FY 2010 budget and relatively slow corrective steps that were taken to address declining revenue does not bode well for current budget negotiations and represent a negative reflection on the political and managerial forces at play in the Commonwealth during this period of economic stress.

CITY OF HARRISBURG

Harrisburg's enormous debt load—exacerbated by its full faith and guaranty on certain incinerator bonds—and its inability to find sufficient funds to meet upcoming debt service payments has led to extensive speculation regarding the possibility of the City declaring bankruptcy. In addition, ongoing political battles within city hall appear to make agreement on any resolution that much harder. While the Mayor has stated her opposition to a bankruptcy filing, several other city officials, past and present have publicly advocated this option. To date the City has not yet finalized a formal plan to address its debt issues, but any bankruptcy action would require approval from the Commonwealth.

Harrisburg's precarious financial position reflects its backing of \$285.7 million of resource recovery bonds issued with the City's guaranty. Cost overruns relating to the retrofit of a resource recovery plant led to the need to issue additional debt. The inability to raise rates to support these additional obligations—denied by Dauphin County which had veto power over such increases—resulted in the failure to meet scheduled debt service on the bonds in March 2009. Since then, three sources of revenue have been used to pay bondholders: (1) approximately \$7 million from City coffers, (2) \$11 million from multiple debt service reserve funds (triggering a technical bond default) and (3) almost \$2.6 million contributed by Dauphin County pursuant to a second guaranty on the bonds.

The City, therefore, is legally responsible for reimbursing Dauphin County for its payment, replenishing the depleted debt service reserve funds and paying future debt service on the incinerator bonds. Overall, Harrisburg's scheduled debt service payments for 2010 and replenishment of advanced funds total more than \$60 million, several times greater than the amount the City collects in annual property taxes and more than Harrisburg's entire general fund operating budget.

While the City ended FY 2008 with an adequate carryover fund balance of almost \$13.6 million, they do not show the effects of the fiscal crisis, even though preliminary results from FY 2009 predict a negative carryover fund balance of (\$1.485 million)—a fund balance shift of more than \$15 million. The amended FY 2010 budget does not include a clear path to resolving the fiscal crisis and the newly elected Mayor and the City Council have disagreed on various proposals to address the problem, including the sale of city-owned assets.

Even without the sizable budget imbalance caused by the City's enormous debt load, Harrisburg has weak credit fundamentals including persistently low wealth levels, a declining population and a stagnant tax base that stood at \$1.65 billion in 2008. Moreover, like many state capitals, Harrisburg contains a significant portion of tax-exempt property that constrains its ability to generate revenue through traditional ad valorem taxes.

CITY OF PHILADELPHIA

In recent years, the City of Philadelphia has made significant strides in reversing its long history of weak credit fundamentals by promoting new development, attracting new businesses, stemming its once sizable population loss, tackling its widespread poverty and high property taxes, as well as above average unemployment numbers.

Over the last decade, the City's management team, in conjunction with its state appointed oversight entity, the Pennsylvania Intergovernmental Cooperation Authority (PICA), was able to reverse its long succession of annual operating deficits and correct its long standing structural imbalance. While the City showed positive trends from Fiscal Years 2005 to 2007, recessionary pressures have counteracted these efforts and once again, Philadelphia's financial position and overall credit profile appears to be deteriorating.

The City's revenue base and liquidity have contracted significantly over the past two years. Indeed, Philadelphia's general fund—the City's primary operating fund—ended Fiscal Year June 30, 2009 with a negative fund balance of \$75.6 million, a net decrease of \$310 million from the prior year end or more than 8.1% of annual expenditures. Moreover, due to the uncertainty relating to the delay of the Commonwealth's Fiscal Year 2010 budget, liquidity was so thin in FY 2009, the City had to prioritize certain payments in order to preserve cash despite regularly accessing the note market for cash flow borrowing purposes. Full and timely debt service payments, however, were maintained although the City ended FY 2009 with only \$54.4 million of liquid assets equal to just 1.4% of annual expenditures.

These 2009 financial results occurred despite the City's and Commonwealth's actions to plug a projected \$1.7 billion deficit from FY 2009-2014 that included state legislative approval for a three year, temporary sales tax increase (1% to 2%), which the City plans on dedicating to its pension fund liability, as well as a deferral of pension contributions for FY 2010 and 2011. Despite the breathing room these measures were designed to provide, the City Controller projects another general fund deficit of \$48.6 million for FYE 2010.

The City's FY 2011 budget includes a number of initiatives to tackle Philadelphia's fiscal challenges including a new "Clean Philly Fee" that charges residents an annual fee of \$200 or \$300 (based on income) that is expected to raise \$107.7 million. In addition, the "Healthy Philadelphia Initiative" would establish a new tax on sugar-sweetened beverages that would raise an estimated \$38.6 million. These two revenue sources are intended to save the City from drastic cuts in services. Final action on the budget is not expected to be acted on until May with a scheduled deadline of May 31st.

Despite some better economic news on sales tax collections in February, the City's unemployment rate rose to 11.4% in January—its highest level since 1984. This rate was materially higher than the state and national averages of 8.9% and 9.7%, respectively.

CITY OF PITTSBURGH

Pittsburgh has had great success in recent years modernizing its economy away from its historical reliance on "smoke stack industries" to one that relies much more on service sectors, particularly finance and banking as well as health care and higher education. As a result of this shifting economy, much of the decades-long population decline, shrinking tax base and weak finances have been stemmed or reversed. Much of the City's revitalization efforts have focused on downtown Pittsburgh repositioning itself as a regional entertainment destination.

The City has a large and diverse tax base of \$13.3 billion and development in recent years has been brisk and has included three new sports facilities, a new casino, expansion of the convention center and significant new office space erected for such companies as ALCOA, GNC, PNC Bank and Heinz. Last year was particularly good for Pittsburgh's status as a revitalized city as it hosted the international G-20 financial summit and was home to both the Superbowl and Stanley Cup champions. Moreover, unemployment in January 2010, while still relatively high at 8.5%, was lower than both the state and national rates of 8.9% and 9.7%, respectively.

To date, Pittsburgh has weathered the recession better than many municipalities—either inside or outside of the Commonwealth. Revenues received by the City's general fund—its primary operating fund—were down only \$2.2 million or 0.5% for Fiscal Year December 31, 2008 compared to the year prior. A number of revenue sources realized growth in FY 2008 including the City's income tax. While the general fund ended FY 2008 with an operating deficit of \$36.6 million, its carryover fund balance stood at \$52.9 million, of which \$46.5 million

was unreserved representing 9.5% of annual expenditures. Liquidity was sound with an ending cash balance of \$44.8 million, equivalent to 13.4% of annual expenses.

Although the City's FY 2009 financials have not been released yet, the City reported that it expected to end the year with an operating surplus of \$8.6 million. This satisfactory financial position is in sharp contrast to the City's situation in 2003 when Pittsburgh sought state support as a "financially distressed" municipality under the Commonwealth's Municipalities Financial Recovery Act (Act 47). Pittsburgh's Mayor has announced his intention to request the Governor remove the City from Act 47 distressed status.

Pittsburgh's most noteworthy financial challenge is solving its significantly underfunded pension obligation. As of September 30, 2009, the pension fund was valued at \$280.7 million as compared to the \$500 million it needs to have in hand by the end of 2010 to avert a state takeover. In order to meet this requirement, the City expects to raise approximately \$200 million from the leasing of its parking facilities. It is also looking for a new revenue source that would generate at least \$15 million per year to continue to bolster the pension fund. The Mayor's highly controversial plan to tax the City's 100,000 college students was dropped after the affected higher educational institutions, along with other large not-for-profits agreed to contribute payments in lieu of taxes to the City. The timing and the specific amounts, however, have yet to be determined.

CONCLUSION

We do not believe that there will be widespread bankruptcies or defaults across the U.S. public finance market. Given the prolonged economic downturn combined with a likely sluggish turnaround and the propensity for local governments to experience a time lag before economic shifts are fully registered, it is entirely reasonable to assume further credit erosion in the municipal sector. The logical result would be an increased number of credit rating downgrades. Therefore, a decline in the value of bonds should be more of a concern to investors who may seek to liquidate their municipal holdings as opposed to a significant number of outright defaults. For those investors utilizing a buy and hold (to maturity) strategy a loss in value may never be realized.

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ILLINOIS FINANCE AUTHORITY
\$98.145 MILLION REVENUE BONDS
(SEDEBROOK, INC. FACILITY) SERIES 2007A
CUSIP 45200B7M4

Internal Credit Rating: **'SINGLE-C'**

Bondholder security is extremely weak as the Bonds that financed the Sedgebrook Continuing Care Retirement Community are currently in default and future operating and financial performance will likely depend upon a plan reportedly under development to address the present situation. The weak ongoing operating performance is due primarily to the effects of the recession that has caused the number of residential contract executions to be far below original projections. This critical occupancy challenge has affected financials considerably with the Borrower experiencing recurring operating losses, negative cash flows, and a negative asset position. As a result of its strained financial condition and resulting default, Sedgebrook is seeking forbearance agreements with bondholders in order to give it time and flexibility to pursue a restructuring. Sedgebrook has hired a workout team (Healthcare Management Partners LLC) to manage the forbearance process and formulate a restructuring option. Sedgebrook and its advisors expect to have a formal plan to present to lenders by the end of November.

- The Bonds are limited obligations of the Authority and secured by a general obligation pledge of Sedgebrook Inc. (the "Borrower" or "Corporation") payable from a pledge of revenues from the operation of the continuing care retirement community (CCRC). Pledged revenues include all fees, third party payments, gifts, donations, and contributions legally available to the Corporation. The Bonds are further secured by a leasehold mortgage on the community's facilities and the facility site pursuant to the master lease as well as a collateralized first lien mortgage on an affiliate's fee simple interest in the facility and the facility site. Moreover, the Bonds are secured by a debt service reserve fund equal to maximum annual debt service. Other legal covenants are generally satisfactory and include a 1.20-times rate covenant and a 180-days-cash-on-hand liquidity covenant after the first year.
- The Borrower is a Maryland-based not-for-profit entity incorporated in 2003 to acquire and operate the CCRC known as Sedgebrook, which is located on 92 acres in Lincolnshire, Illinois—approximately 33 miles northwest of Chicago. At the time the Bonds were sold, it was expected that at scheduled completion in 2014, Sedgebrook would offer as many as 1,618 units, including 1,390 independent units, 96 assisted living units, and 132 skilled nursing units as well as numerous supporting facilities and common areas. As of August, 2009, Sedgebrook reported a total of 557 available units composed of 469 independent living units, 44 assisted living, and 44 skilled nursing beds. August 2009 occupancy was reported to be 77.4%, 9.2%, and 24.3%, respectively.
- Erickson Retirement Communities provides certain services to Sedgebrook including management, development, and construction services. Moreover, it owns 100% of Lincolnshire Campus LLC, the fee simple owner of the facility's buildings and 92 acre site. Due to the absence of sufficient entrance fees from new residents, Sedgebrook is no longer receiving working capital advances from Erickson or Lincolnshire. As a result, the Corporation has been retaining the entrance fees rather than submit them to the Trustee as required. The Borrower reports it has sufficient working capital only through year end 2009 (assuming no payments of debt service and no payment for management services).

- The Trustee (M&T Bank) reported a notice of material event after Sedgebrook failed to make debt service payments totaling \$556,631.35 due on August 15, 2009. This default was the direct result of very weak financial performance that included recurring operating losses, negative cash flows, liquidity issues, and a negative asset position. Specifically, FY 2008 ended with a net asset position of (\$27.7 million) and an operating loss of almost \$9.5 million—equivalent to 38% of annual operating expenses. Indeed, Sedgebrook’s auditing firm, PricewaterhouseCoopers LLP, was unable to express an opinion on the Borrower’s Fiscal Year 2008 audit and raised doubt about Sedgebrook’s ability to continue as a “going concern”.
- The inability to give the Series 2007B letter of credit bank (Sovereign Bank) audited financial statements caused a default on the variable rate bonds and all \$39 million of VRDBs have been tendered to the Bank pursuant to a draw under the LOC.
- The future course of events will depend upon the issuer’s plan—reportedly under development—to restructure their outstanding debt as well as adjust operating and financial performance. No detail is presently available regarding the detail of this plan due to be released in November 2009.

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**SIX MILE CREEK COMMUNITY DEVELOPMENT DISTRICT
(ST. JOHNS COUNTY, FLORIDA)
CAPITAL IMPROVEMENT REVENUE BONDS, SERIES 2007
CUSIP 83005TAA5
JULY 16, 2009**

INTERNAL CREDIT RATING: “DOUBLE-C”

SUMMARY CREDIT OVERVIEW

Bondholder security is under substantial stress as development within the District has apparently stalled. Reports indicate that while most of the infrastructure has been completed, no residential units have been constructed or sold to date. Moreover a member of the Developer team has filed for Chapter 11 bankruptcy. Although the May debt service payment including both principal and interest was made, concern for the on-going ability to meet subsequent debt service requirements is mounting. In addition, weak economic conditions, and particularly the severe downturn in the Florida housing market, make any near-term improvement unlikely.

SECURITY DESCRIPTION

The Bonds are payable from and secured by pledged revenues consisting of all non-ad valorem special assessments levied by and on behalf of the District, including any interest and penalties. Also pledged are any amounts received by the District from the sale of tax certificates or from the collection of delinquent assessments which are imposed, levied and collected with respect to properties specifically benefited by the improvements funded by the Bonds.

The Bonds are additionally secured by amounts on deposit in certain funds and accounts, other than the Rebate Fund, created pursuant to the indenture including the series reserve account, which functions as a debt service reserve fund. Interest on the Series 2007 bonds was capitalized through November 1, 2008.

Additional bonds secured by the trust estate established for the Bonds may be issued only on a subordinated basis. Additional bonds payable from special assessments other than those securing the Series 2007 bonds are also permitted. Also noted, while prepayment of bonds is not required, the issuer retains the right to pre-pay the bonds at any time.

BORROWER PROFILE

The Bonds were issued for the purpose of financing the cost of acquiring, constructing and equipping assessable improvements comprising part of the District’s Capital Improvement Plan (CIP). Bond proceeds will also fund deposits to the related accounts for capitalized interest and the series reserve account. The CIP totals \$156.3 million, of which approximately \$40.2 million was to be funded from debt proceeds. The CIP includes: neighborhood and roadway improvements, land acquisition, water and waste water projects, and entryway improvements. Approximately 60% of the District is planned residential with the remainder comprised of parks, recreation, wetlands and other amenities.

The District was established in March 2007 as a local unit of special purpose government and encompasses approximately 1,282 acres in the unincorporated portion of St. Johns County. Development was originally projected to include 2,278 dwelling units consisting of single-family, town home and condominium lots, as well as parks and recreational facilities. Construction was to occur in two phases starting in October 2006.

The owner of the land within the District is Six Mile Creek Ventures, LLC (the Developer). The Developer has three members, Intervest Construction of Jax, Inc., LandMar Group LLC, and W.R. Howell. Under an Operating Agreement LandMar Management oversees development activities for the Developer. Intervest, operating under ICI Homes, was given the right to construct and sell homes on the lots owned by the Developer. It was also anticipated that lots and/or bulk land was to be sold to third party builders.

FINANCIAL PROFILE

The project appears to be under considerable stress lacking the ability to generate funds to meet debt service according to the original plan. As a result, a private individual (an owner of ICI Homes) reportedly contributed funds sufficient to make the May debt service payment on the Bonds. While it has been suggested that parties with significant equity stakes in the project may have an economic interest in seeing taxes and special assessments paid, this does not assure such payments will in fact be made in either the near or long-term. It is also notable that the senior lien status of property taxes and special assessments (senior to the aforementioned equity stakes) such as those that secure these bonds has reportedly been upheld in cases decided by the Supreme Court of the State of Florida (see "Collections and Payment Enforcement" below).

Further weakening the potential for payment of debt service on the Bonds, the original underwriter for the Bonds has reported that a member of the developer team, LandMar LLC, has recently filed for Chapter 11 bankruptcy and is seeking to withdraw from the project. The other two members of the team were not party to the filing.

Specific financial figures are not currently available as the District's audited financial statements as of September 2008 are not yet on file with the NRMSIR. According to the underwriter, these are not expected for at least another month. Additionally, interim financial figures have not been reported. Audited results for fiscal year 2007 offer no meaningful information, as there was no meaningful activity other than the expending of bond proceeds for infrastructure development.

Continuing disclosure with respect to development and sales of properties, as well as statements made by the underwriter, indicate no residential units exist within the District. A future site visit is being planned to determine the current overall status of the project. Given recent economic trends, particularly with regard to real estate development in Florida, construction targets that shifted all 2008 residential development into 2009 remain unmet. Furthermore, given the uncertainty of future trends and related timing, no projections of future development and the payment of assessments by residents appear practical at present.

COLLECTIONS AND PAYMENT ENFORCEMENT

The special assessments that secure the Series 2007 Bonds are collected utilizing the Uniform Method of Collection whereby amounts due are collected together with county, municipal and other ad valorem taxes, all of which appear on the tax bill issued to the respective landowners within the District. Taxes with a 4% discount are billed starting November 1st each year, with discounts declining 1% per month to 0% and the non-discounted amount payable as of March 30th of the following year.

All unpaid taxes become delinquent April 1st. Commencing in April a 1% penalty per month accrues on the unpaid tax notice. Collection of delinquent taxes is based on the sale by the Tax Collector of "tax certificates" and the remittance to the District of the proceeds of the sale. It is likely any action to enforce payment of the 2007

Assessment will proceed under the provisions of Chapter 173, Florida Statutes, which provides that after the expiration of one year from the date any assessment or installment thereof becomes due, the District may commence a foreclosure proceeding against the lands upon which there are unpaid liens. After 30 days' written notice to any record owner and at least 4 weeks prior published notice, a judicial hearing will be conducted in which any interested party may appear and contest the foreclosure. Any party contesting the assessment or the lien must deposit with the court the amount which such party claims is the amount due for such assessment.

Upon judgment for delinquent assessments a special master will be appointed to sell the property at public auction, at which the District may also bid. Proceeds from any such foreclosure sale are required by the statute to be shared for the payment of state, county, city or other taxes and assessment in the manner determined by the special master. However there can be no assurance any such sale will provide proceeds sufficient to satisfy the District's 2007 Assessment and may affect its ability to make payments on its Series 2007 bonds.

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