Mega projects in an uncertain economy

While the U.S. economy is in its tenth year of economic expansion, the longest on record, concerns regarding the global economy are flashing red. In this report, we highlight two large bellwether municipal project financings – American Dream and Virgin Trains USA Passenger Rail Project.

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Introduction

While the U.S. economy is in its tenth year of economic expansion, the longest on record, concerns regarding the global economy are flashing red. As the U.S. wages a protracted trade war with China, long-term interest rates have declined sharply around the world. In the U.S., the spread between the two and ten year treasury yields was briefly inverted or negative in August, typically a harbinger of a looming recession. In major economies, such as Germany, France and Japan, interest rates are yielding negative.

Despite concerns regarding the economy, the yield penalty borrowers pay for additional credit risk remains at near all-time lows. Credit spreads for both corporate and municipal borrowers are lower today versus the start of the year. More recently, however, corporate BBB spreads have started to widen slightly, while muni spreads continue to grind lower due to insatiable appetites. It remains to be seen whether municipal credits are as resilient as current yields may suggest. Particularly speculative high-yield debt issued to finance a new project, a downturn in the economy will require a reassessment of the underlying fundamental credit assumptions.

In this report, we highlight two large bell-weather municipal project financings – American Dream and Virgin Train USA Passenger Rail Project – to see how the credits are performing to date and whether they are prepared for the next downturn. While they are unrelated, each project's success is tied to future demand (untested at the moment) – one is based on consumer tastes/expectations and the other is necessity.

Muni credit spreads remain tight driven by strong muni demand

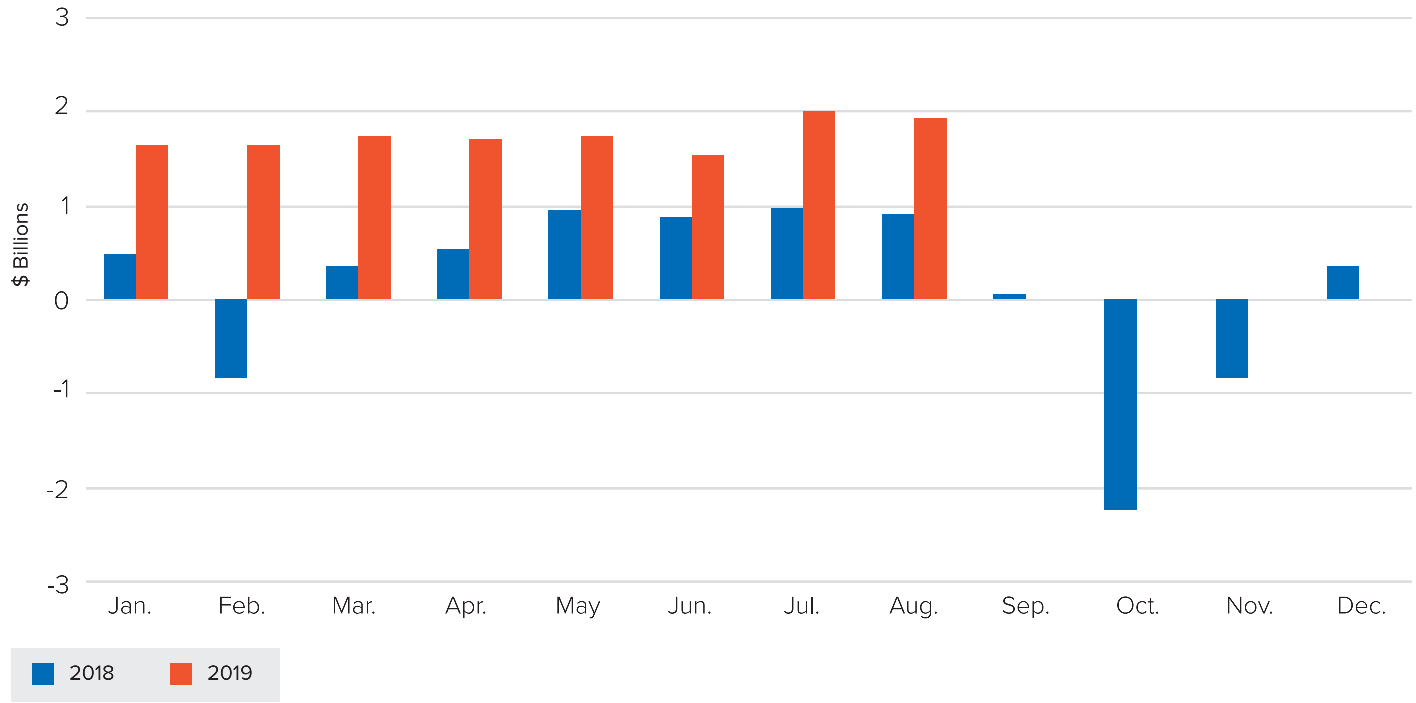
Current credit spreads paint a different picture of the economy. Both BBB muni and corporate spreads are lower today than where they started the year. More recently, for corporate bonds, there has been a slight spread widening due to worries about weaker earnings in a slower growth environment. Meanwhile, muni BBB spreads are near all-time lows, consistently trending lower this year.

EXHIBIT 1. MUNI AND CORPORATE BBB SPREADS REMAIN TIGHT

Source: Refinitiv; S&P 500 BBB Investment Grade Corporate Bond Index. Data as of Aug. 21, 2019.

Munis remain bolstered by strong demand due to changes in tax laws and relatively light volume to date. Fund flows into municipal bond funds, particularly those in high yield, have been particularly strong this year. Through the end of August, fund flows into high yield totaled $13.9 billion this year compared to $4.2 billion for the same period last year. As a result, multibillion dollar high-yield new issue deals such as American Dream and Virgin Trains USA are being issued at oversubscribed levels, lowering borrowing costs for the issuer.

EXHIBIT 2. ROBUST MUNI HY FUND FLOWS



Source: Refinitiv via Lipper® U.S. Fund Flows database. As of Aug. 31, 2019.

American Dream still alive

History of a long, delayed project

After nearly two decades, American Dream, as the current development is known, is now within sight. The once barren stretch of land along the New Jersey Turnpike in the Meadowlands has long been plagued by developer defaults, a downturn in the national economy and construction delays. Once open, American Dream will feature 3 million square feet of retail, dining and entertainment — including more than 250 stores and restaurants, an amusement park, an indoor water park, an indoor ski slope and an indoor ice-skating rink. Opening is planned for this fall. With consumer spending making up around 70% of the U.S. economy, the project will serve as a barometer of its future health.

There's a lot at stake. Around $5 billion of various forms of capital has been injected into the development. The opening of the project would represent a significant milestone for state and local officials, who first conceived of the project in 2002, only to see it languish for 17 years. It has the potential to spur significant economic development in the area. For state and local municipalities, the development will help spur growth in employment and tax revenues. For the developer, Triple Five Group, their hope is that the development will transform the entertainment and shopping experience of an entire region.

Construction nearly complete, opening planned for fall 2019

As it currently stands, the opening of American Dream is expected sometime in October 2019, a date already pushed back twice this year. This is around seven months behind schedule as originally planned during the late 2017 bond financing – not entirely unexpected given the scale/unique nature of the development project. According to the most recent August 2019 construction report, around 91% of the construction has been completed to date and most of the construction is expected to be completed by July. In terms of the construction budget, costs are running close to the original projection. The developer's budget allocation for the final cost of the project is currently within the construction manager's guaranteed maximum price (GMP) contract of $1.944 billion.

Ramp-up phase presents unique risks

As construction wraps up, the project will transition over to the ramp-up/operational phase. For long-term bondholders of American Dream, this next chapter presents its own unique risks and challenges. With entertainment venues making up more than half the development, the project will need to attract patrons from the broader New Jersey/NYC metro area to an area that up until now has been known for its sporting events. Further, attracting retail foot traffic, especially at large malls, has been a challenge for some time. Whether American Dream will be an exception to this secular trend remains to be seen. At the end of June, of the 3 million square feet of leasable space, there are contracts on 82%, and 15% are being negotiated.

EXHIBIT 3. AMERICAN DREAM MEADOWLANDS PROJECT PILOT REVENUE BONDS 7% OF 2050

Source: Refinitiv; Municipal Securities Rulemaking Board. Data as of Aug. 26, 2019. Trade prices are the average price for trades of $750,000 and greater as reported by the MSRB.

Foot traffic and spending will all help drive the bottom line for the developer as well as for state and local government tax revenues. For bondholders, the profitability of the development will determine the amount of revenues, in the form of payment-in-lieu-of-taxes (PILOT) payments made by the developer, that flow to pay off the first tranche of bonds. The PILOTs are tied to the assessed "market value" of the project, which is largely based on the economic value and tenant rental income generated from the project. Another second tranche of bonds is repaid directly from sales taxes generated by the project.

Virgin Trains USA, all aboard?

Is high-speed rail in the U.S. becoming reality?

If the American Dream project represents the future of shopping/entertainment venues, Virgin Trains USA may represent the future of inter-city rail transit. While high-speed rail is common overseas, in the US it is uncommon. Virgin Trains hopes to change that. Its model is based on city pairs that are “too short to fly and too long to drive,” making passenger rail a viable alternative. The sweet spot are highly populated city centers that are within 200 to 300 miles from one another. Its plan is to create a network of high-speed passenger trains along the busy highway corridors so that travelers and commuters can get where they need quicker and easier.

Florida, the litmus test for high-speed rail

Whether high-speed rail in the U.S. is a boom or bust will be decided in Florida. Known as Brightline – before its branding deal with Richard Branson’s Virgin Group – Virgin Trains Florida commenced rail operations between Fort Lauderdale and West Palm Beach in January 2018 and between Miami and Fort Lauderdale in May 2018 (known as the South Segment). Virgin Trains Florida is the first privately owned/operated passenger rail system in the U.S.

Significant capital has already been injected. Municipal bonds totaling $3 billion have been issued to date to fund the rail line. In addition, Virgin Trains’ owner Fortress Investment Group has already injected $1.5 billion of equity into the venture. Municipal bonds issued earlier this year will be funding the extension of the existing line to Orlando (North Segment). Construction is already underway for this second phase as all major permits, real estate and track rights have already been secured. No major delays/construction issues have been reported to date.

With completion of the North Segment expected in 2022, Virgin Trains’ line will span 235 miles allowing for speeds of up to 125 mph (current speeds average 70 mph). With an expected travel time of slightly more than three hours from Miami to Orlando, Virgin Trains is expected to provide travel time savings of 25%-50% compared to existing modes of surface transportation and is competitive with air travel on door-to-door travel time. It is Virgin Trains’ expectation that Florida travelers will be willing to pay average fairs of around $70 apiece by 2023, all the while consuming food and merchandise.

Virgin Trains, the next Acela?

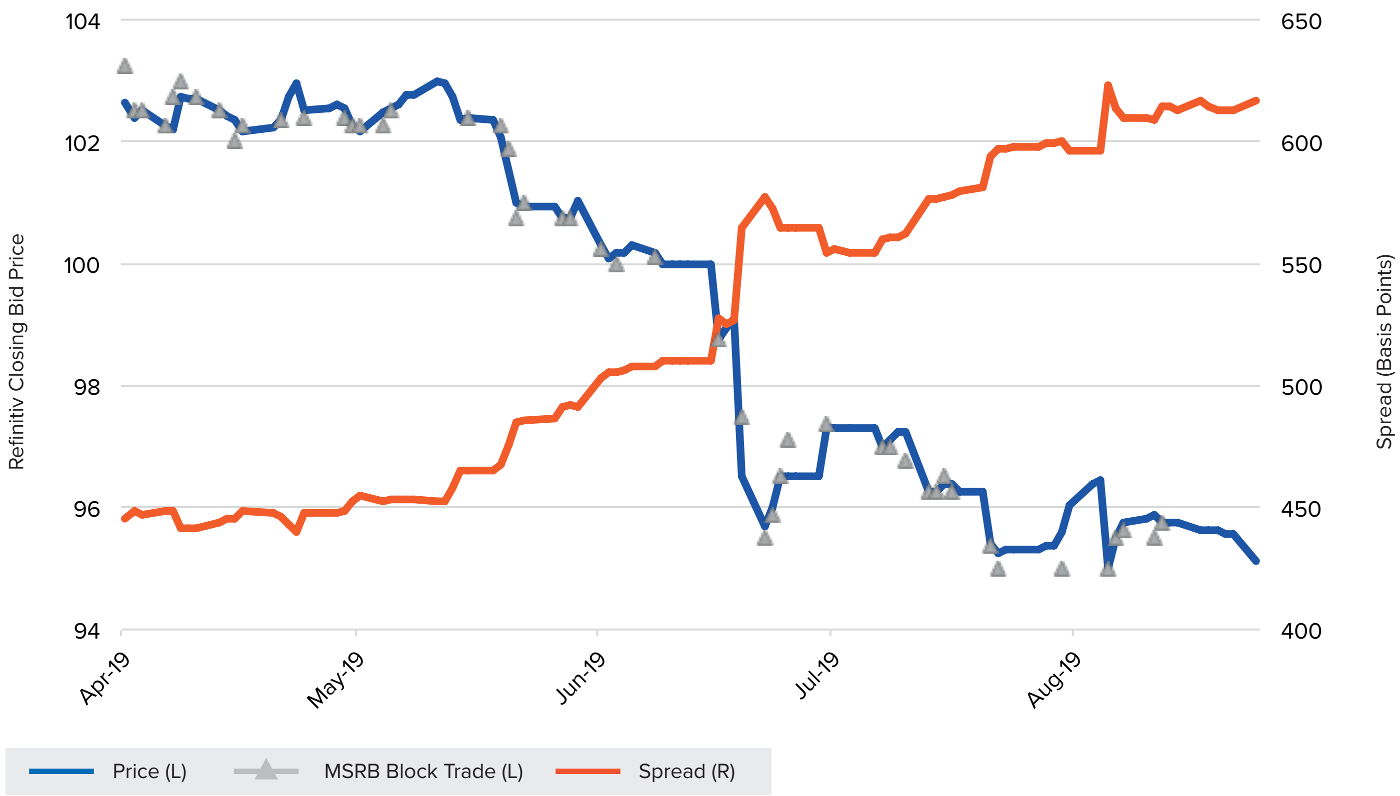
If successful, Virgin Trains is expected to generate a nice windfall for its investors. The only current high-speed rail system in the U.S. is Acela, which is owned by Amtrak. Acela serves the densely populated northeast corridor – made up of Washington, D.C.; Philadelphia; New York City and Boston. Since debuting in 2000, Acela is now a mainstay for business travelers in the region, generating significant profits for Amtrak.

Whether applying the same model – pairing densely populated city centers – will work in Florida is a big unknown. Demand in Florida remains untested. For Acela, the population density in the Northeast region is higher than anywhere else in the nation and there is an extensive transit and regional rail system to complement intercity rail traffic. This means fewer people need to jump in a car to get from point A to B. In fact, car ownership in major cities in the Northeast is amongst the lowest in the nation.

In contrast, in Florida, where mass transit is a more limited option, there remains a strong driving culture. For Virgin Trains, convincing travelers to forego their cars will be a key challenge. Further, not only will Virgin Trains need to attract the business traveler, but more importantly the leisure traveler as well, who is more price conscious. We note negotiations are underway to add a stop at Walt Disney World (the current North Segment construction only extends the rail lines to Orlando International Airport) and to extend service to Tampa.

Performance falling behind forecasts

EXHIBIT 4. VIRGIN TRAINS USA PASSENGER RAIL PROJECT 6.5% OF 2049



Source: Refinitiv; Municipal Securities Rulemaking Board. Data as of Aug. 26, 2019. Trade prices are the average price for trades of $750,000 and greater as reported by the MSRB.

While still early in the ramp up phase, ridership and revenues to date are falling behind projections. In its first full year of operation of the South Segment, Virgin Trains USA forecasted over 2 million riders under a base case and 1.435 million under a break-even scenario. Through the first seven months ended July, actual ridership is just 565,000. Ridership is currently running around 40% of capacity, well below the original estimate of 82% in 2019 and 92% in 2020. Management's projected revenues total $56-$78 million in 2019, while actual revenues to date are just shy of $13 million.

Given the underperformance to date, it is likely Virgin Trains will need to raise additional working capital. Given the strong financial backing from its owners, we don't foresee any issues on its ability to raise capital at this time. Success of the project will ultimately be driven by demand from the expansion into Orlando, which won't be done until 2022. It is Virgin Trains' hope that over 7 million riders will be reached by 2026 with the North Segment making up around three quarters of its revenues.

Conclusion

While investor demand for high-yield municipal bonds remains very strong leading to little compensation for credit risk, this can sharply reverse with a downturn in the economy. In that scenario, fundamental credit research will be even more vital. A reassessment of underlying demand assumptions will be required. For the American Dream and Virgin Trains projects, one has seen spreads tighten, while the other has widened. Whether their fates will end in such divergent paths, only time will tell.

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