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# Engagement, Municipal Style

## Working with municipal bond issuers is a subtle art, and has more potential in some areas than others.

*In our* Engagement Series, *we present insights and case studies on our dialogue with companies, government entities and other securities issuers. In this column, James A. Lyman, who heads research for our Municipal Fixed Income team, weighs in on differences he sees between engagement in municipal and equity contexts, and he explains where engagement can (and sometimes can't) foster positive outcomes in the municipal market.*

Investors typically understand the idea of engagement in the world of corporate equities. High-profile "activist" investors often take a stake in companies and lobby for change; others (including my Neuberger Berman equity manager colleagues) may take a more subtle, constructive approach, working with management to reform governance, operations or financial practices in ways designed to benefit the business and shareholders over time. Either way, the well-lighted path between investor and manager often makes the desired outcome visible if not always a reality.

In municipal bonds we have meaningful engagement, but it emerges in different ways, based on the unique characteristics of the market and its various subsectors.

### Traditional Munis: Voicing Opinions, Taking Defensive Action

From a structural point of view, most major traditional issuers are highly rated with easy access to capital, providing municipal bond investors with limited leverage to assert change. In contrast, issuers with lower credit ratings and/or weaker financial profiles may have a smaller market audience; and where they need financial liquidity, investors exert more influence. In either case, voters and/or taxpayers often hold more power over elected decision-makers than do providers of capital.

Let's assume, for example, that our team owned bonds in a city water treatment system, and we believed that debt coverage levels were too low. If we sent a note to the mayor suggesting that she raise water rates, she might pay attention, but make the counterargument that voters don't want their costs to go higher. Between those voters and bondholders, it's not hard to imagine who will win out.

Tactically, this means that our engagement is likely to take two forms:

First, we can make our views known when the opportunity arises, primarily to senior staff members who understand bond markets and are in a position to influence senior leaders. For example, we might engage them on improving disclosures and the presentation of budget policy. In situations where rating agencies are considering downgrades, we might intensify these communications to explain our views and offer ways the issuer can address agency concerns.

Second, we can employ defensive measures—whether simply avoiding certain bonds, or exiting them if pricing doesn't merit the risks we see. Eventually, the issuer will get the message, and we may revisit its bonds in the future.

## Nonprofits: Active Engagement

Looking past more traditional municipal bonds, there are more ways to actively engage.

We often have extensive communications with nonprofit organizations like hospitals and museums around various challenges they may face. For example, one of our holdings, a charter school, had its charter up for renewal with the local school district. Before the negotiations began, a new superintendent for the charting authority voiced concerns about transparency and compliance with special education mandates. Relations soured, and bondholders were notified that the charter would likely be revoked and the school closed.

This outcome would not have been in anyone's best interests. Both sides would have suffered losses, the charter school's students would have been relocated to an overcrowded public school, and investor cash flows from the charter would have been in jeopardy. As one of the three bondholders, we took the lead to mediate. After many discussions, we were able to help repair their relationship and set the school on the path to charter renewal.

## Infrastructure Projects: Equity-Like Access

Probably the most equity-like engagement we have involves infrastructure projects, which operate like corporations and look to the bond market for extensive financing to achieve their goals.

Recently, I was at a meeting about a recycling facility we invest in. The project is up and running, but there were mechanical issues affecting the sorting machines that separate recycling from waste. As a result, the plant was not producing enough salable recycling.

With activity below the level needed to achieve sustaining revenues, the developer came to the bondholders and said: We need to get through the next six months from a cash perspective; can we sit down together and figure this out? The bondholders and management did so, and came up with a short-term solution that would allow continued operations but would also not hurt the securities. Because everyone worked together in good faith, management was comfortable putting more capital into the deal to help get through this lean period.

## Keeping Constructively Engaged

To sum up, the degree that engagement "works" in the municipal space varies, depending on the kind of issuers and the influence an individual bondholder may exert. In most circumstances, I believe that constructive dialogue can make a difference, in some cases simply to advocate positive actions, but in others to work through temporary setbacks that, if not addressed, could lead to negative outcomes. Being prepared, with a deep understanding of individual credits and the environment in which they operate, can make such interactions more fruitful, and help foster financial strength that can benefit issuers and investors alike.

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