SPECIAL COMMENT

U.S. Public Finance First Quarter 2011 Rating Revisions: Downgrades Outpace Upgrades by 3.9 to 1

Summary
The first quarter of 2011 marked the ninth consecutive quarter in which downgrades exceeded upgrades for U.S. Public Finance ratings. 2011 is expected to be another challenging year across all major municipal sectors and the toughest year yet for state and local governments since the beginning of the economic downturn in 2008.

The first quarter saw 66 downgrades and 17 upgrades, a ratio of 3.9 to 1. This is the second highest downgrade to upgrade ratio since the first quarter of 2002, trailing only the fourth quarter of 2010 when the ratio measured 4.6 to 1. The ratio for full-year 2010 was 2.2 to 1.

In the tax-backed sector, which includes state and local governments, downgrades continued to outpace upgrades. Rating changes for the first quarter included 39 downgrades and 10 upgrades for a downgrade to upgrade ratio of 3.9 to 1. This is down from the 5.0 to 1 ratio during the fourth quarter of 2010.

To provide a more meaningful measure of rating activity in an environment when downgrades exceed upgrades, this report focuses on the downgrade to upgrade ratio, instead of the upgrade to downgrade ratio that we discussed in previous reports. For historical comparative purposes, upgrade to downgrade data is provided in Figure 3 on page 2.
In the revenue enterprise sector, which includes healthcare, higher education, other not-for-profits, housing and infrastructure, downgrades also outpaced upgrades in the first quarter. Of the 34 rating changes in the sector 27 or 79% were downgrades producing a downgrade to upgrade ratio of 3.9 to 1. This is down slightly from the 4.2 to 1 ratio during fourth quarter of 2010.

By par amount, the ratio of downgrades to upgrades was 8.1 to 1 as downgraded par of $23 billion significantly outpaced upgraded par of $2.8 billion.

Of the 66 downgrades during the quarter, 23 (34%) were double notch downgrades. Of these, 13 or 56% were attributable to local governments. There were only two multi-notch upgrades.

A summary of rating actions is provided in Figure 3; a full list of affected credits and historical data can be found on Moodys.com.
For the ninth consecutive quarter, as shown in Figure 6, downgrades have outpaced upgrades.

**FIGURE 6**
Net Rating Changes (Upgrades minus Downgrades)

In addition, the ratio of downgrades to upgrades remains at historic highs, though down a bit from the last quarter of 2010, as shown in Figure 7.

**FIGURE 7**
Ratio of Downgrades to Upgrades-Q1 2002 to Q1 2011
State Ratings

<table>
<thead>
<tr>
<th></th>
<th># Upgrades</th>
<th># Downgrades</th>
<th>Upgrade ($Mm)</th>
<th>Downgrades ($Mm)</th>
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<tbody>
<tr>
<td>2011 Q1</td>
<td>0</td>
<td>2</td>
<td>0</td>
<td>10,800</td>
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<td>2010 Full Year</td>
<td>7</td>
<td>6</td>
<td>3,977</td>
<td>47,096</td>
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State rating actions in the first quarter of 2011 reflected continuing credit stress. The two state downgrades – Nevada and Kentucky – were driven by budgetary imbalances, weakened reserve positions, and structural economic changes. We expect downgrades to continue to exceed upgrades throughout 2011 as the effects of weak revenue growth and significant spending obligations combine with the loss of federal stimulus funding to intensify pressure on state financial positions.

The two rating changes in the sector were:

» State of Nevada, downgraded to Aa2/Stable from Aa1/Stable, $2.3 billion of debt affected.
   Ratings drivers:
   - Structural shift in economy caused by the profound impact of recession
   - A narrow economy that relies on gaming and tourism
   - Limited financial flexibility in the form of depleted reserves

» State of Kentucky, downgraded to Aa2/Negative from Aa1/Negative, $8.5 billion of debt affected.
   Rating drivers:
   - Persistent structural imbalance and use of non-recurring actions, including deficit financing to achieve budget balance
   - Depletion of reserves and lack of near term capacity to replenish
   - Weak and declining pension system funding
   - Ongoing vulnerability of the state economy, including above average exposure to a sluggish manufacturing sector and a recovery that is expected to lag the nation
## Local Government Ratings

<table>
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<tr>
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<th># Upgrades</th>
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<th>Upgrade ($Mm)</th>
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<tr>
<td>2011 Q1</td>
<td>10</td>
<td>37</td>
<td>338</td>
<td>8,220</td>
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<tr>
<td>2010 Full Year</td>
<td>128</td>
<td>257</td>
<td>8,462</td>
<td>44,759</td>
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Downgrades of local governments outpaced upgrades by nearly 4 to 1 in the first quarter of 2011. Of the downgrades 18 (49%) were attributable to Aa-rated credits while 15 (40%) were A-rated credits. Cities and towns represented nearly half of all first-quarter downgrades, followed by school districts (25%). Significantly, 35% of city and town downgrades moved two or more notches, due largely to the significant fiscal stress facing certain issuers in the sector. In addition, we maintain a negative outlook on all cities and towns downgraded by two or more notches, reflecting our view that continuing near-term rating pressure is likely for these entities. Although school districts comprised only one-fourth of first-quarter downgrades, debt affected represented 60% of downgraded par. Going forward in 2011, we expect downgrades will continue to outpace upgrades as municipalities struggle to maintain structural balance in an environment of declining state aid, lower assessed valuations, and fewer budgetary options.

Notable rating changes included:

- **City of Providence (RI),** downgraded to A3/Negative from A1, $617 million of debt affected. Rating drivers:
  - Weakened financial position and reliance on deficit borrowing
  - Above average unemployment and low income levels

- **Clark County School District (NV),** downgraded to Aa2/Negative from Aa1/Negative, $4.2 billion of debt affected. Rating drivers:
  - Dramatic declines in tax-base and narrowed reserve levels as well as significant uncertainties regarding state-level funding

- **Oakland Unified School District (CA),** downgrade to A2/Stable from A1, $844 million of debt affected. Rating drivers:
  - Continued operating deficits resulting in narrow reserve levels
  - Absence of audited financial statements since fiscal 2008

- **City of Annapolis (MD),** downgraded to Aa3/Negative from Aa1/Watchlist for Possible Downgrade, $86 million of debt affected. Rating drivers:
  - Rapid financial deterioration and weakened liquidity position driven by insufficient budget assumptions
  - Financial and liquidity position unlikely to improve given the city’s limited ability to implement revenue enhancements
Not-for-Profit Hospital Ratings

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<th>Upgrade ($Mm)</th>
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<tr>
<td>2011 Q1</td>
<td>5</td>
<td>6</td>
<td>2,107</td>
<td>1,012</td>
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<tr>
<td>2010 Full Year</td>
<td>41</td>
<td>46</td>
<td>13,222</td>
<td>7,995</td>
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Rating volatility slowed in the first quarter of 2011 as only 11 hospitals were downgraded or upgraded, the lowest quarterly total in over ten years. The overall trend of rating downgrades outpacing upgrades continued with six downgrades and five upgrades for a ratio of 1.2 to 1. This trend represents a material shift from the first quarter of 2010 when upgrades (15) significantly outpaced downgrades (8) and follows 15 downgrades in the fourth quarter of 2010.

Even with more downgrades than upgrades, the absolute dollar amount of upgraded par ($2.1 billion) was double the absolute amount of downgraded par ($1.0 billion), due to the upgrade of three large healthcare systems with over $400 million of debt each.

Looking ahead, we expect the trend of downgrades to continue to outpace upgrades in the remaining quarters of 2011. U.S. not-for-profit hospitals will likely continue to face difficulties achieving strong revenue growth as reimbursement pressures mount, patient volumes remain flat or continue to soften, and the nation’s slow economic recovery contributes to increased levels of uncompensated care and a weaker payor mix. Much of the “low-hanging fruit” has already been removed from hospital expense structures, pressuring performance margins and challenging hospital boards and management teams to revisit their model of healthcare delivery.

Notable rating changes included:

- **Saint Barnabas Health Care System (NJ)**, upgraded to Baa3/Positive from Ba1/Positive, $864 million of debt affected. Rating drivers:
  - Turnaround in financial performance and liquidity growth under the direction of new management
  - Favorable resolution of a large one-year line of credit

- **West Penn Allegheny Health System (PA)**, downgraded to B2/Negative from B1/Negative, $748 million of debt affected. Rating drivers:
  - Significant volume declines and weakened operating performance
  - Significant execution risks related to the system’s strategy to downsize and restructure operations
Higher Education and Other Not-For-Profit Ratings

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<tr>
<td>2011 Q1</td>
<td>1</td>
<td>7</td>
<td>124</td>
<td>324</td>
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<tr>
<td>2010 Full Year</td>
<td>10</td>
<td>38</td>
<td>812</td>
<td>4,167</td>
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During the first quarter of 2011, downgrades continued to outpace upgrades in the higher education and not-for-profit sector reflecting credit pressures facing borrowers with less diversified sources of revenue combined with weaker market positions. Private universities accounted for 6 of the 7 downgrades and the single upgrade. One not-for-profit institution was also downgraded. Four borrowers, including three below investment grade credits, experienced multi-notch downgrades. The multi-notch downgrades affected borrowers with a weak market niche, very limited ability to raise revenue, weak governance and management, and increasing bank debt risk relative to liquidity. Over the near-term, we anticipate downward rating pressure to continue as many universities and not-for-profits are expected to experience weakened pricing power and reductions in state appropriations.

Notable rating changes included:

- Charitable Leadership Foundation (NY), downgraded to Ca/Negative from Caa2/Watchlist for Possible Downgrade, $48 million of debt affected. Rating drivers:
  - Suspension of rental payments from a primary tenant in a research facility and unclear expectations as to when payments will resume to cover future debt service requirements adequately
  - Decline in cash position and liquid investments, resulting in reduced value of guaranty on the bonds

- Birmingham-Southern College (AL), downgraded to Caa2/Negative from B1/Watchlist for Possible Downgrade, $28.3 million of debt affected. Rating drivers:
  - Deep structural operating deficits and lack of unrestricted resources. Uncertain ability to meet debt obligations if management’s focus on building tuition revenue and unrestricted gifts is unsuccessful
  - Expected stress from reduced enrollment.

- Dowling College (NY), downgraded to B3/Watchlist for Possible Downgrade from B1/Watchlist for Possible Downgrade, $14.8 million of debt affected. Rating drivers:
  - Thin balance sheet cushion to debt and operations. Narrow operating margins and debt service coverage. Reliance on a bank line of credit for seasonal operating cash requirements
  - Sharp enrollment declines

- Massachusetts College of Pharmacy and Health Sciences (MA), upgraded to A2/Stable from A3/Stable, $127 million of debt affected. Rating drivers:
  - Consistently very strong operating performance contributing to rapid increase in unrestricted liquidity
  - Steady enrollment growth and program diversification
Infrastructure Ratings

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<tr>
<td>2011 Q1</td>
<td>0</td>
<td>6</td>
<td>0</td>
<td>1,701</td>
</tr>
<tr>
<td>2010 Full Year</td>
<td>10</td>
<td>33</td>
<td>18,630</td>
<td>19,841</td>
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Negative rating actions dominated rating changes for the first three months of the year. There were no upgrades and six downgrades. Of the six downgrades, three were airport and airport-related issuers, reflecting weaker financial metrics and enplanement levels. Looking ahead, we expect the trend of downgrades to continue as challenging operating conditions continue to pressure infrastructure issuers.

Notable rating changes included:

- **South Jersey Transportation Authority (NJ),** downgraded to Baa1/Stable from A3/Stable, $494 million of debt affected. Rating drivers:
  - Multi-year traffic declines, low liquidity and negative pressures in the service area

- **Kansas City Airport Enterprise (MO),** downgraded to A3/Stable from A2/Stable, $332 million of debt affected. Rating drivers:
  - Weak financial performance, increased liquidity pressures and higher debt costs

- **LL&P Wind Energy (WA),** downgraded to Baa2/Negative from A3/Stable, $50 million affected. Rating drivers:
  - Lack of long-term contract, which exposes the issuer to both merchant prices and wind resource risk
  - Weaker than expected financial performance as a result of depressed market for power prices
Housing Ratings

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<tr>
<td>2011 Q1</td>
<td>0</td>
<td>1</td>
<td>0</td>
<td>9</td>
</tr>
<tr>
<td>2010 Full Year²</td>
<td>5</td>
<td>77</td>
<td>1,271</td>
<td>14,171</td>
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The housing sector’s sole rating action during the first quarter of 2011 was a downgrade³, marking the second consecutive quarter the sector did not experience any upgrades. We expect further downgrades and limited upgrades in 2011 for the single family and multifamily sectors due to rising single family foreclosure rates, low reinvestment rates, counterparty downgrades and weaknesses in the rental housing market.

The only rating action of the sector was:

» Multifamily Housing Revenue Bonds Pass-Through of Beneficial Ownership (“PT Certificates”), downgraded to Baa1 from A3, $9.3 million of outstanding debt affected. Rating drivers:
- The downgrade followed the one-notch downgrade of American International Group, Inc. (AIG) from A3 to Baa1 on January 12, 2011.
- Payments of principal and interest on the bonds are passed to the PT Certificate holders and are guaranteed by SunAmerica, Inc., the obligations of which are further guaranteed by AIG. As such, the rating of the PT Certificates is contingent upon the creditworthiness of AIG.

² In addition to the rating actions reported in the 2010 data in this report, 35 mortgage-backed securities and Federal Housing Administration supported transactions issued by local housing authorities were downgraded, affecting approximately $240 million in outstanding debt. Additionally, a similar $7 million transaction was upgraded.

³ Excludes Q1 2011 downgrades of 7 local transactions as described above in footnote 1, affecting approximately $134.7 million in outstanding debt.
Moody’s Related Research

Sector Outlooks:
» 2011 Sector Outlook for U.S. Local Governments - Toughest Year Yet, March 2011 (131659)
» Annual U.S. State Outlook: 2011, March 2011 (131366)
» Negative Outlook for U.S. Not-For-Profit Healthcare Sector Continues for 2011, February 2011 (131016)
» Annual Sector Outlook for State Housing Finance Agencies Remains Negative for 2011, February 2011 (123131)

Special Comment:
» U.S. Public Finance Rating Revisions for Q4 and Full Year 2010: The Stress Continues, February 2011 (130863)

Newsletter:
» MuniMonitor: Lingering Challenges for US Munis, February 2011 (131425)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.
Appendix: Calculating Rating Changes

For the purposes of this report if an issuer's rating is changed more than once during the quarter each rating change is counted however the debt affected will only be counted once. If an issuer's rating is changed more than once across quarters each rating change will be counted and the debt affected would be counted again for that quarter.

Further, other debt securities impacted by the downgrade of an issuer, such as certificates of participation (COPs) are counted as one rating action however all debt affected is included.
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