GW&K INVESTMENT MANAGEMENT

The Coronavirus Impact on Toll Roads

Sheila R. May, CFA, *Principal, Director, Municipal Bond Research*

The outbreak of the coronavirus earlier this year has produced numerous implications for a variety of sectors in the municipal market. As an array of "shelter-in-place" orders began to be unveiled in March, multiple impacts ensued, including significant declines in vehicular traffic on the nation's roadways. Although initial impressions for all transportation sectors have been unanimously negative, upon closer review, toll roads appear well-positioned to manage travel declines given several factors, including historically strong cash reserves, debt service protections, traffic mix and rate autonomy.

Established toll roads are generally characterized by strong, relatively inelastic demand, low operating costs and manageable debt levels, which allow for the generation of sizeable cash surpluses each year. In practice, toll systems accumulate excess funds to cushion against operating unknowns, including economic downturns and weather events, but also to finance ongoing maintenance and repair projects. The cash reserves held by the sector are significant. The most recent median statistics (based on the 2018 operating year) prepared by Moody's show rated publicly-owned toll roads carried over 900 days cash on hand or the equivalent of nearly 2.5 years of operating expenses.

Another consideration that lends liquidity and certainty to debt repayment centers on legal protections provided in bond documents. The security pledge for nearly all toll roads is net revenues after the payment of operating and maintenance expenses. The flow of funds under this pledge typically includes a monthly transfer of net revenues to a trustee-controlled account to advance fund the upcoming debt service payment. Additionally, most toll system bond indentures include a provision for the creation of a Debt Service Reserve Fund (DSRF) that is maintained at an amount equal to 12 months of bond payments. In the unlikely event of insufficient net revenues, the DSRF can be tapped to ensure principal and interest payments continue to be made in a timely manner for up to one year.

Given the severity of traffic declines in recent months, it is helpful to take a closer look at traffic mix and the implications for toll receipts. It is common practice on U.S. roadways that commercial vehicles pay higher toll rates than passenger vehicles. In a recent April 2020 sector report, Moody's found passenger transactions accounted for over 90% of all traffic for much of its universe, yet commercial vehicles contributed over 40% of toll revenues for one quarter of the rated systems. Simply stated, passenger vehicles dominate total transactions, but commercial vehicles represent a meaningful component of toll receipts for most networks, particularly those serving large metropolitan areas. To date, our analysis demonstrates the resiliency of commercial traffic as the revenue impact on toll systems in our portfolio has not been as severe as the traffic statistics would suggest.

Nonetheless, given uncertainty surrounding the duration of the pandemic, it is prudent to approach the analysis with caution. In its April 2020 report, Moody's anticipated traffic declines of 50% to 80% during the peak of the crisis, defined as a three-month period from mid-March through mid-June. In the same report, Moody's also considered an annual revenue decline of 30% and concluded debt service coverage would remain above breakeven. We performed a similar stress test on our portfolio using comparable parameters and reached the same conclusion: debt service payments will continue without interruption.

Some indicators suggest traffic declines may not be as severe as initially feared at the outset of the pandemic. The Federal Highway Administration (FHWA) reports vehicle miles traveled bottomed in April, before exhibiting improvement in May. Although June statistics have yet to be published, our surveillance reveals continued increases in travel for the majority of our issuers, as reopening efforts unfold across the country.

Percentage YOY Change - Vehicle Miles Traveled

	Mar-20	Apr-20	May-20
Northeast	-21.0%	-46.7%	-33.4%
South Atlantic	-18.8%	-41.2%	-26.1%
North Central	-17.7%	-38.2%	-26.3%
South Gulf	-16.2%	-35.9%	-19.8%
West	-20.1%	-39.3%	-24.3%
Total	**-18.6%**	**-39.8%**	**-25.5%**

Source: US DOT: Federal Highway Administration

The toll roads in our portfolio are primarily major networks serving large metropolitan areas. These roadways are essential transportation corridors with a combination of commercial and passenger traffic. Our credits are characterized by solid demand, strong cash-flow margins, reasonable debt levels and ample liquidity. It is also worth noting all have rate autonomy and a number of issuers have instituted automatic annual toll hikes. For these reasons, we believe our sector holdings will successfully navigate the challenges posed by the pandemic. We will continue to monitor the fluid developments associated with the coronavirus and look to add value as opportunities arise.