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January 2023

MASS TRANSIT SYSTEMS: LAWMAKERS ALL ABOARD (FOR NOW)

Current federal, state and local support for mass transit recovery may present opportunities for bond investors, but questions remain around the long-term impact of hybrid work.

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THE NEW STANDARD IN WEALTH MANAGEMENT

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About Evercore Wealth Management

Evercore Wealth Management is the wealth management division of Evercore (NYSE: EVR) and is an investment advisor registered with the U.S. Securities and Exchange Commission. Founded in 2008, the firm has been named a leading registered investment advisor (RIA)[1] and now manages $9.9 billion (as of September 30, 2022) in assets for families, foundations, and endowments across the United States. Partners at the firm work directly with clients, providing a more personal and modern alternative to big banks and traditional trust companies. Please visit www.evercorewealthandtrust.com for further information or contact the Evercore Wealth Management office near you.

Overview

Mass transit systems in the United States are confronting serious operational and maintenance challenges. Reduced revenues and rising wage pressures, along with capital demands and uncertain fiscal support, are destabilizing these critical systems, which include subways, light and commuter rail services, and buses. That's the bad news.

The good news is that most politicians care about mass transit systems and are likely to support investment. Mass transit is widely perceived by voters as an essential public good in urban areas and it serves a strategic role in facilitating economic growth, reducing carbon emissions traffic, and promoting equity through transportation connections. Federal money for big transit projects is already on its way, thanks to the overall $110 billion allocated by four COVID-19 federal stimulus aid packages, including $40 billion from the 2021 Infrastructure Investment and Jobs Act, earmarked specifically for capital projects.

We believe that there is considerable opportunity in this sector for bondholders, in New York and in other U.S. metropolitan areas.

Background

Ridership on mass transit systems has not fully recovered from the pandemic – and there's a good chance it may never, as many white-collar workers now work at least partially from home. Fewer riders overall means lower fare revenues, potentially making transit more unaffordable for the many blue-collar workers who need to commute and may struggle with large fare increases. Attracting white-collar riders back to mass transit systems requires improvements in safety, cleanliness, and timeliness, all of which will increase the systems' costs. Indeed, many systems will require changes in service, fares, and operating and capital plans to provide adequate service.

Other challenges to these systems include the potential halt to the significant federal aid that was used to stem revenue losses during the pandemic, uncertain inflation-related wage pressures, and uncertain dedicated tax revenues, which are used to subsidize operations.

Mass transit systems are capital intensive, and many have a significant amount of debt outstanding, with a variety of security pledges. For example (and discussed in depth in this report), the Metropolitan Transportation Authority of New York, or MTA, has $47.1 billion in outstanding debt. That equates to 1.2% of the entire $4.04 trillion municipal debt market, which has over 36,000 issuers.[2] But mass transit bonds are generally creditworthy, given the critical importance of the systems to the regional economies. We expect that mass transit systems will continue to receive broad political and financial support from parent governments in identifying and implementing solutions to their operating and capital challenges.

As noted later in this report, there was over $6 trillion in federal COVID-19 relief monies allocated to individuals, businesses, states, cities, school districts, hospitals, airports, airlines, and universities, with mass transit systems receiving $71 billion as well as capital monies from the Infrastructure Investment and Jobs Act. With these funds, at least for now, mass transit systems are more secure than they might seem to anyone who has had the pleasure of riding in them recently.

Ridership

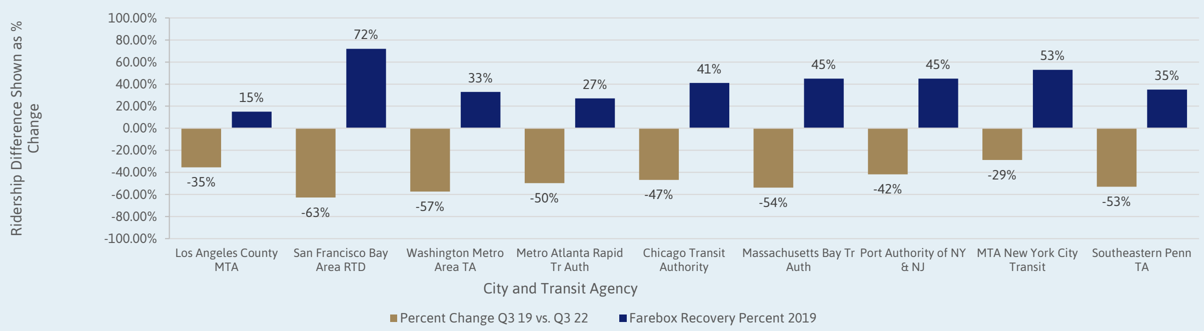
Currently, mass transit ridership in the United States is at only 50%-70% of pre-pandemic levels.[3] The systems need to adjust services and/or find new revenue to meet changing consumer behavior and balance budgets. Of course, ridership could recover more fully if an economic recession reduces corporate willingness to support hybrid work arrangements. Conversely, ridership recovery could weaken if health and safety concerns increase, potentially due to another rise in COVID-19 cases.

No mass transit systems in the country are self-supporting, meaning that no system covers all its operating expenses from farebox revenues. However, ridership levels are widely perceived as a proxy for a system's social and economic importance to a region and, as such, are likely to attract political and financial support from government funding sources. The chart on "Mass Transit Ridership Trends" on the following page lists major U.S. transit systems, along with their pre-COVID-19 farebox recovery ratios and declines in ridership. Systems that are relatively less reliant on farebox revenues, such as Atlanta (27%) and Los Angeles (15%), can more easily withstand declines in ridership without suffering outsized losses in revenues.

Scheduling flexibility is also an issue, as the ridership changes. It's one thing to get trains to run on time; it's another to get them to run on different schedules. The U.S. regional rail systems have long been oriented toward suburban white-collar commuters and therefore provide fewer options on the weekends or weekday non-peak commuting periods. Although ridership on all forms of public transit plunged in 2020, commuter rail ridership has recovered much more slowly than that of buses or subways, which are obviously more frequent and serve more blue-collar workers. Transit agencies generally can better adjust frequency of service to lower operating costs. However, service reductions in response to ridership declines could exacerbate customer losses.

If ridership remains low, transit systems may have to rethink and retool their operations and business models, particularly for transportation that relies heavily on farebox revenues, such as the New York MTA at 53% and the San Francisco Bay Area Rapid Transit District at 72% (see Mass Transit Ridership Trends chart for a more complete comparison). Mass transit debt that is more heavily reliant on farebox receipts requires a different analysis than debt secured solely by a regional sales tax, with investment opportunities commensurate with

Mass Transit Ridership Trends



Source: American Public Transportation Association, ENO Center for Mass Transportation the heavier reliance. Most systems are better positioned, with farebox revenues representing just about 20% of operating funding sources for large, urbanized areas (greater than one million population). Transit operators that rely on non-fare sources, such as tax collections, and on a more diverse stream overall, should experience greater revenue stability and less sensitivity to fluctuation in ridership. While we expect all mass transit systems to balance their budgets through the various combinations of revenues, mass transit debt secured solely from sales taxes mitigate, to a great degree, the risks of operational problems and budget imbalance.

Federal Programs

Transit operators received $71.7 billion in federal grants during the pandemic, as illustrated below, providing them with financial credit flexibility and credit stability. However, potential operating deficits loom once federal stimulus aid is depleted if operators are unable to adjust to lower ridership levels.

In addition to these four federal COVID-19 programs providing operating assistance, the 2021 Infrastructure Investment and Jobs Act, or IIJA, allocated $1.2 trillion in spending for capital programs, including increasing funding for transit

Federal Stimulus Aid – Allocations to Mass Transit Providers

ACT	DATE ENACTED	TOTAL PROGRAM AMOUNT	AMOUNT ALLOCATED TO MASS TRANSIT
Coronavirus Aid, Relief and Economic Security Act (CARES Act)	3/27/20	$2.2 trillion	$25 billion
Coronavirus Response and Relief Supplemental Appropriation Act (CRRSAA)	12/27/20	$2.3 trillion	$14 billion
American Rescue Plan Act (ARPA)	3/11/21	$1.9 trillion	$30.5 billion
American Rescue Plan (ARP) additional assistance funding	9/27/21	$2.2 billion	$2.2 billion
TOTAL			$71.7 billion

Source: American Public Transportation Association capital projects by $40 billion, which provides flexibility as transit systems replace exhausted stimulus aid. This additional federal capital funding is reducing or delaying borrowing needs, preventing fixed cost growth while revenues are down. In addition, with more federal funding available, state and local governments have more flexibility to shift capital aid to operating purposes to help plug a gap from lost federal stimulus aid. It is tempting to shift portions of capital aid to operating expenses, providing a short-term benefit. However, if the total capital investments and thus service performance decline, then a rise in deferred maintenance and a consequent decline in service quality would eventually hinder ridership recovery.

As the federal government continues to refine its rules on how IIJA dollars can be spent, the pressure is growing on local governments and transit agencies. Unlike the COVID-19 relief bills, which included funding to support operational expenses, much of the IIJA's public transit funds must be spent on capital projects. And the Capital Investment Grants program can only aid local agencies in completing a capital program. It is not designed to fund the entirety of a new bus rapid transit service, an expansion of a train line, or purchases of new vehicles. Even if the federal government did pick up 100% of capital spending, new transit services would require more drivers, more vehicle maintenance, and a host of additional operating expenses.

Dedicated Taxes

Depressed ridership leads to lower farebox revenues, which requires transit agencies to modify their operating and capital budgets. However, many outstanding mass transit bonds are generally well protected by other revenues separate from or in addition to farebox revenues that are pledged to debt service. Broader-based revenues, such as sales taxes, often enhance transit agency debt, reflecting the important public service that transit represents, and they offset the volatility of farebox collections.

Transit system taxes are primarily comprised of sales and use taxes and/or payroll taxes. For many transit systems, the past two years of pandemic-related tax growth has accelerated a growing reliance on taxes, which transit systems themselves don't control, for an increasingly larger share of revenue. This dependence may increase further if transit systems receive money from tax increases to offset declining federal stimulus aid. In addition, while tax growth has provided welcome budget relief during the slow ridership recovery, it could be slower and less predictable in 2023. If economic conditions do slow, tax-dependent systems are exposed to greater revenue uncertainty than systems more dependent on fares. It's also worth considering if local or regional taxpayers who use mass transit less frequently than in the past will continue to view it as an important public service worthy of financial support.

Capital Needs

The $110 billion in federal money allocated to big transit projects brings with it a new problem for transit agencies: balancing the need for repairs with demands to expand service, while ensuring that the windfall doesn't go to waste.

U.S. public transportation systems operate on equipment and infrastructure that is often decades older than its useful life. Federal grants could fund improvements in train signals to allow more frequent service on subways and railroads; rail electrification to improve speeds and cut pollution; and replacement of train and bus fleets and garages to improve reliability. The United States is among the most expensive counties in the world in which to construct a transit project.[4] The reasons range from the politicization of project management to the expanding role of consultants, the costs of labor, and efforts to limit disruption to normal traffic flow during construction.

As transit agencies apply for a limited pool of federal money, some will choose between shoring up existing assets and expanding into new markets. Transportation patterns altered by the pandemic have added additional uncertainty: The agencies are trying to make sure that this one-off infusion of federal money isn't wasted on the wrong projects. Of the $40 billion for public transit in the infrastructure law, about $8 billion is set aside for expansion projects, while the rest is intended to pay for repairs and modernization of existing systems, such as track-signal upgrades and electrification.

Every four years, the American Society of Civil Engineers' Report Card for America's Infrastructure depicts the condition and performance of American infrastructure in 18 categories ranging from aviation to wastewater. While the overall America infrastructure grade is a C-, mass transit has the lowest category grade at D-.[5] Based on the most recent report, there is a $176 billion transit backlog, a deficit that is expected to grow to more than $250 billion through 2029. Clearly, while the IIJA is providing welcome financial relief in dealing with the mass transit maintenance backlog, there is still a significant gap to address before performance improves.

NY Metropolitan Transportation Authority

The MTA is the largest transit system in the nation, providing nearly 40% of the nation's public transit trips.[6] The agency has the most extensive rail and bus transit system in the nation with a dense service area and the lowest car ownership rates.[7] The MTA warned in July that it's racing toward a fiscal cliff. Transit officials initially projected $15 billion in federal pandemic aid to cover the agency's annual operating deficits through 2025; they now expect that money to run out by the end of 2024. The agency is now scrambling to come up with cash to plug billions in projected operating deficits, and it is calling on federal, state and city lawmakers to come up with money to fund the MTA—starting with $600 million by next year. Otherwise, the MTA says, riders must brace for drastic service cuts, widespread layoffs and hefty fare increases. The looming budget shortfalls also threaten crucial infrastructure upgrades that are needed to keep mass transit functional, including new subway cars, electric buses and accessibility upgrades.

New York City's vast public transportation network has been integral to the city's economic success and the strength of New York's business districts: The more people who can easily reach their jobs, the more the economy can grow. Prior to the pandemic, eight million people in the New York region—including over 50 percent of the city's population—rode public transit every weekday.[8]

Now that New Yorkers increasingly have choices about where to work, many are opting out of their daily commutes. Weekday ridership has plummeted across almost every regional system. Across all weekdays in November 2022, subway use averaged 62% of pre-pandemic levels, and bus use averaged 64%. Regional rail fared slightly better, with Long Island Railroad (LIRR) and Metro North Railroad (MNR) weekly ridership averaging 67% and 68%, respectively, compared to February/March 2020.[9] Nevertheless, as illustrated by the chart on page 4, the MTA's ridership losses are still not as dramatic as those of other major U.S. transit districts.

Another risk for the MTA's budget is the expected increase in labor costs. The 2023 spending plan factors in a 2% growth in wages, as it will negotiate with its largest labor union, the Transport Workers Union Local 100, on a labor contract that's set to expire on May 15. That may be inadequate in this inflationary environment. The MTA estimates an additional one percentage point increase above the 2% boost would cost $100 million per year and further add to the projected deficit.

New York State has continued to support the MTA through appropriations and by directing dedicated taxes to its operations. These include fuel taxes, a portion of sales tax, franchise tax, motor vehicle fees, the Urban Tax (commercial real estate transactions), mortgage recording fees, the payroll mobility tax, and others. The MTA is also unique in that surplus revenues from the affiliated Triborough Bridge and Tunnel Authority are used to further balance operations. These diverse revenue streams don't include the congestion pricing program that the state legislature passed in 2019 and is yet to be implemented. This type of charge is the first in the United States and is expected to bring in $1 billion a year with the purpose of leveraging these monies to secure $15 billion in bond proceeds for mass transit projects.

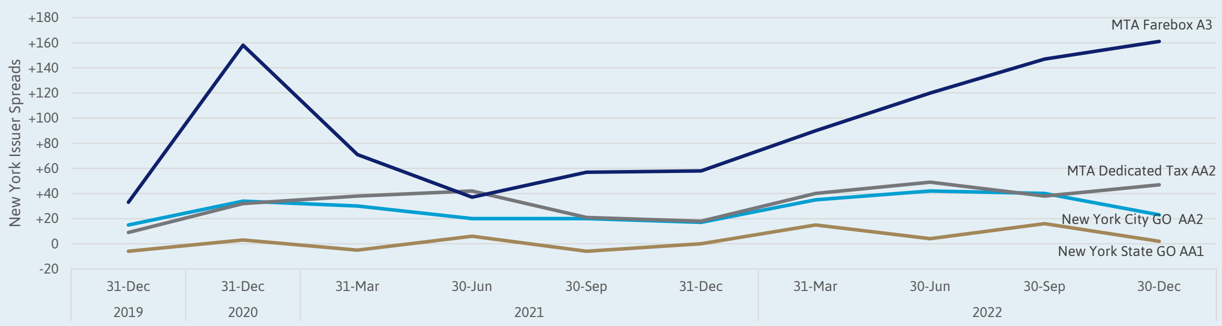
In 2020, the state allowed the MTA to use money restricted for capital for operating expenses, and it also granted the MTA permission to deficit borrow. The state also issued $1.1 billion of bonds to redeem the MTA's Bond Anticipation Notes (BANs) as part of its capital commitment to the MTA, which aided the MTA's liquidity. This history suggests that the state of New York, which is generally in good fiscal shape as evidenced by its Aa1/AA+/AA+ ratings, is likely to help its mass transit system more, as needed.

MTA and New York Spreads

The spreads refer to the difference in trading values between the highest rated, gilt-edged AAA municipal securities and the specific issuers on the chart, including the MTA Transportation Revenue (Farebox), Dedicated Tax Bonds along with the general obligation bonds of New York City and New York state. As illustrated in the chart on the following page, New York City and New York state, along with the dedicated tax bonds, all had relatively small fluctuations in their spreads during the pandemic era. But the MTA Farebox bonds experienced major fluctuations, depending upon the receipt of federal monies back in 2020-21, along with enacted New York state legislation. There was then a gradual rise in spreads as the MTA received poor press as a result of lagging ridership and growing public expectations that it would run out of federal monies sooner rather than later. Another reason for the gradual increase in the MTA's spread could be that after several too-eventful years, investors are in a risk-averse and headline-averse mode for the near future, a sentiment that would favor higher quality bonds.

New York issuer spreads: 10-year yields vs. AAA benchmark

10-Year Yields vs. Triple-A Benchmark



Source: CreditSights, Bloomberg BVAL benchmark yield curves

- *The BVAL Municipal AAA Benchmark is constructed using data from municipal market new issuance, Municipal Securities Rulemaking Board (MSRB) trades and contributed data.*
- *MTA Farebox bonds are secured by pledged revenue consisting of fares and other operating receipts from the MTA system*
- *MTA Dedicated tax bonds are secured by a lien on dedicated transportation-related taxes and fees that are levied statewide or on the MTA system.*
- *New York City General Obligation Bonds*
- *New York State General Obligation Bonds*

Conclusion

U.S. mass transit systems are facing difficult operating challenges. These challenges, and the need for enhanced supplemental revenues away from basic farebox receipts, will fall to state and local governments, supported by any further federally funded programs. We believe that there is widespread recognition among politicians and others of the importance of mass transit systems to the economic vibrancy of metropolitan areas and that they should benefit from continued public, financial and legislative support.

Our expectation is that the Los Angeles MTA, Metro Atlanta Rapid Transit and others with debt secured solely by regional sales taxes in vibrant economic areas, should maintain their strong and stable outlooks. The New York MTA, which has secure debt and a combination of revenues, including substantial farebox receipts, will also provide attractive investment opportunities, depending on market conditions and the faith of the state to continue to economically support the system.

We are monitoring these challenges and seeking to identify investment opportunities for our clients in what promises to remain a volatile market.

Notes

[1] We were named a leading registered investment advisor for 2022 by *Financial Advisor* (07/28/22). We were named among the Top 100 Independent U.S. Registered Investment Advisors by *Barron's* for 2022 (09/19/22).
[2] SIFMA US Municipal Bond Statistics
[3] Federal Transit Administration's "National Transit Database"
[4] Governing Magazine: "Why Are U.S. Transit Projects So Costly? This Group Is on the Case," 11/1/22
[5] American Society of Civil Engineers' 2021 Infrastructure Report Card: Transit
[6] New York State Comptroller: "Existential Questions Facing National Public Transit Systems Create New Fiscal Pressures for the MTA," July 2022
[7] U.S. Public transit Faces Multi-Year Recovery: Fitch Ratings Report, 8/10/22
[8] "Making New York Work for Everyone," December 2022, Sponsored by NY City and State
[9] Day-by-Day Ridership Numbers, MTA, November 2022

About the Author

Howard Cure is a Partner and the Director of Municipal Bond Research for Evercore Wealth Management. He has over 30 years of experience in analyzing municipal securities.

Prior to joining Evercore in 2009, Howard was a director at the Public Finance Department of Financial Guaranty Insurance Company for 11 years. He previously was a vice president with the investment banking firm of Prager, Sealy & Co. and, earlier, a vice president at Moody's Investors Service. He began his career as an economist with the New York State Senate Finance Committee in Albany, New York.

Howard is widely quoted in the media, including in *The Wall Street Journal*, *Bloomberg News/Business Week*, *Barron's*, *Reuters*, *The Financial Times* and *The Bond Buyer,* and he has appeared on CNBC, National Public Radio and Bloomberg News.

Howard received a Bachelor's Degree in Economics from the State University of New York at Albany, and a joint Master's Degree in Public Affairs from the Lyndon B. Johnson School of Public Affairs and an M.B.A. from the McCombs School of Business.

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