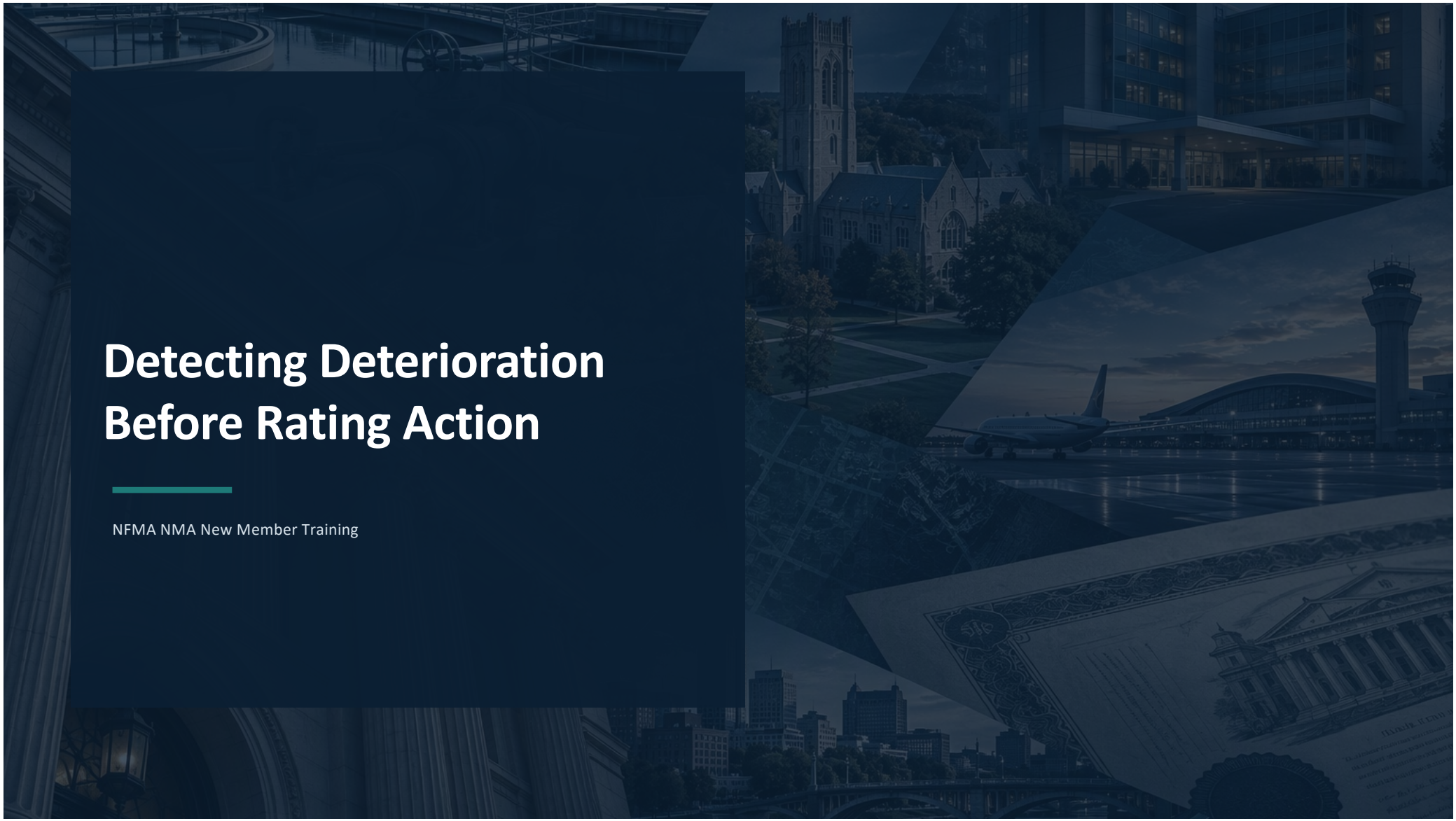


Detecting Deterioration Before Rating Action

NFMA NMA New Member Training

A surveillance process, not a list of anecdotes

The deck moves from common signals to sector-specific escalation thresholds.

01

FRAMEWORK

How weak credits evolve

02

SECTOR LENSES

Which KPIs matter where

03

CASE PATTERNS

What was visible beforehand

04

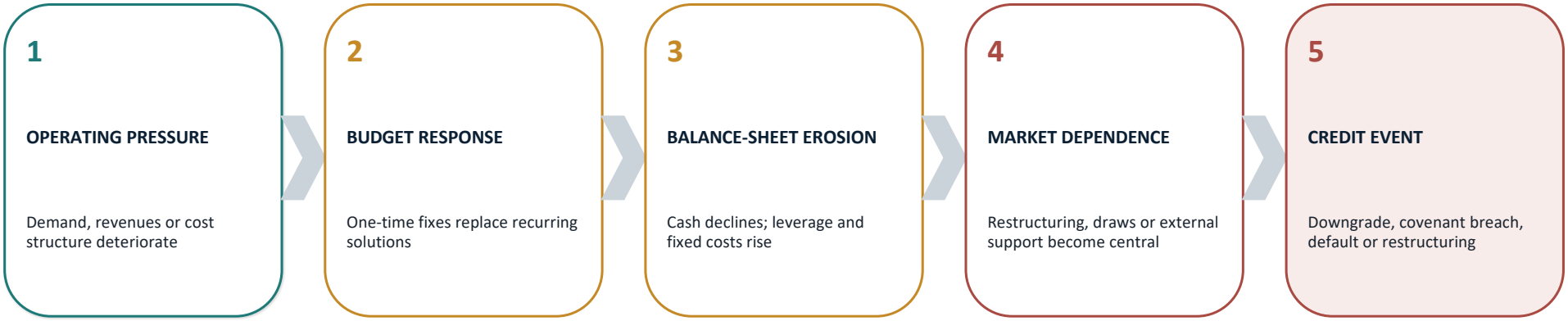
DESK TOOL

A repeatable escalation scorecard

Decision question: Is the observed weakness cyclical, correctable and liquidity-supported, or structural, compounding and increasingly dependent on market access?

Deterioration usually follows a recognizable sequence

Fundamentals weaken first; liquidity and financing flexibility absorb the pressure until they do not.



Six indicators that should change the surveillance cadence

One red flag is a question. Three related red flags are a thesis.

Liquidity

Unrestricted cash declines faster than the operating deficit suggests.

Watch: Cash burn, interfund borrowing, reserve draws

Structural balance

Recurring revenues no longer cover recurring costs.

Watch: One-time revenues, optimistic assumptions

Fixed-cost load

Debt, pension and OPEB crowd out service capacity.

Watch: Contribution deferrals, backloaded amortization

Market access

The credit needs refinancing, draws or external support.

Watch: Short tenors, private placements, restructurings

Governance

Disclosure quality or execution deteriorates.

Watch: Late audits, turnover, repeated findings

Bondholder protection

Legal or structural cushions weaken.

Watch: Covenant amendments, reserve releases, leakage

Translate universal pressure into sector-specific evidence

Do not use the same metric hierarchy across every pledge and enterprise.

SECTOR	EARLY SIGNAL	CONFIRMATION METRIC	ESCALATION TRIGGER
Local government	Tax-base / population decline	Fund balance, fixed-cost ratio, collections	Recurring deficit plus cash-flow borrowing
Higher education	Enrollment / demand erosion	Net tuition, discount rate, liquidity	Multi-year deficit plus unrestricted draw
Healthcare	Volume / margin weakness	Operating margin, DCOH, MADS	Liquidity covenant pressure
Water & sewer	Capex / affordability strain	DSCR, days cash, rate burden	Deferral or weak rate action
Airport / toll road	Demand concentration	Traffic, CPE / toll coverage, cash	Debt-funded capex with weak demand
Special tax / development	Tax-base concentration	AV, collections, buildout pace	Coverage loss plus refinancing need

Separate economic erosion from budgetary response

The core question is whether management is preserving flexibility or consuming it.

EARLY SIGNALS

- Tax base or population contraction
- Recurring expenditure growth above revenue
- Rising fixed-cost share
- Inability to replenish reserves
- Deferred capital and service degradation

DOCUMENT EVIDENCE

- Adopted budget vs. actual results
- General fund cash and interfund balances
- Pension contribution policy
- Tax collection and AV trends
- Notes on deficits, loans and contingencies

ESCALATION

- Cash-flow borrowing becomes routine
- Reserves fund recurring operations
- Pension deferrals
- Disclosure delays coincide with stress
- State oversight or restructuring enters discussion

Detroit: the warning was cumulative, not sudden

A long deterioration sequence weakened the tax base, operations, liquidity and legacy-cost capacity before the 2013 filing.



ECONOMY	OPERATIONS	BALANCE SHEET	FINANCING	EVENT
Population and tax-base erosion	Structural imbalance and service strain	Liquidity pressure and legacy costs	Increasing dependence on extraordinary remedies	Chapter 9 filing in July 2013

Discussion: At which point should an IG portfolio move from routine surveillance to an exit / recovery analysis?

Demand deterioration becomes a liquidity problem through operating leverage

Enrollment is the opening question; unrestricted liquidity is the closing question.

Demand	Applications, yield, retention, net freshman deposits	Leading
Price realization	Discount rate, net tuition per student	Leading
Operating model	Tuition dependence, compensation burden, margin	Concurrent
Balance sheet	Monthly liquidity, spendable cash to debt	Lagging / decisive
Strategic response	Program cuts, asset sales, affiliation discussions	Escalation

Watch for false comfort

- Endowment size without liquidity access
- Headcount stable only because discounting rises
- “Balanced” results supported by gifts or asset sales
- Debt-funded projects justified by stale demand assumptions

The operating problem can become a covenant problem quickly

Use both earnings and cash because timing differences can be material.

VOLUME / MIX	Admissions, outpatient volumes, payer mix, market share
MARGIN	Labor, supplies, reimbursement, operating EBITDA
LIQUIDITY	Days cash, unrestricted investments, working capital
DEBT / COVENANTS	MADS coverage, leverage, liquidity covenants
CAPITAL NEED	Age of plant, deferred capex, strategic project burden

ESCALATE WHEN

Margin recovery depends on assumptions rather than observed run-rate improvement.

Liquidity burn + capex need + covenant headroom compression should be analyzed together, not sequentially.

Rate-setting and demand resilience determine the path

Strong legal structure cannot fully offset weak economics or unwilling governance.

WATER / SEWER

Early: consumption pressure, regulatory mandates, affordability constraints

Confirm: DSC, days cash, delinquency, rate burden, CIP funding mix

Escalate: deferred rate action, compliance-driven capex without funding plan, customer concentration, reserve depletion

AIRPORT / TOLL ROAD

Early: traffic stagnation, carrier / corridor concentration, competitive leakage

Confirm: coverage, liquidity, CPE or toll elasticity, capex phasing

Escalate: debt-funded expansion using optimistic demand, weak downside case, reliance on future refinancing

Analyst discipline **Stress the revenue base before giving credit for rate or fee flexibility.**

Structure matters most when the tax base disappoints

The key risk is whether thin or concentrated revenues can survive slower development and refinancing friction.

01

Tax base

Concentration by taxpayer, parcel or project

02

Development

Absorption pace, permits, infrastructure completion

03

Coverage

Collections vs. modeled growth and debt service

04

Structure

Capitalized interest, reserves, ABT, maturity profile

05

Refinancing

Balloon exposure, market access, developer support

Capitalized interest is not liquidity. It is time purchased for the tax base or project to mature.

Covenant weakening is both a structural and governance signal

Read amendments in the context of operating trajectory and negotiating leverage.

NEUTRAL

- Technical cleanup
- Alignment with current reporting
- Replacement of obsolete provisions

WATCH

- Reserve release
- Broader permitted investments
- Looser additional debt test

ESCALATE

- Liquidity covenant relief
- Pledge leakage or carve-outs
- Repeated waivers / forbearance

Key question **Is the amendment increasing long-term flexibility, or transferring protection from bondholders to the obligor?**

A five-factor escalation scorecard

Score direction and severity; do not pretend the output is a rating.



Action bands: Green = routine | Amber = enhanced surveillance | Red = PM escalation, liquidity check and downside / recovery work

Would you escalate this credit?

Apply the framework; no rating-agency language required.

Liquidity	Unrestricted cash down 22% in two years
Operations	Second consecutive recurring deficit
Demand	Primary revenue base down 4% year over year
Debt	Near-term capex remains fully debt-funded
Governance	Audit is 70 days later than prior practice
Structure	Issuer requests release of a reserve requirement

1 Identify the three most consequential signals **2** Name the missing document or metric **3** Recommend routine / enhanced / PM escalation

The analyst’s edge is sequencing, not prediction

Recognize deterioration early, define escalation triggers and preserve optionality.

01

TREND

Focus on multi-year direction and rate of change.

02

INTERACTION

Connect operations, liquidity, structure and governance.

03

TRIGGERS

Define what evidence changes surveillance or recommendation.

04

DOCUMENTATION

Record the thesis, missing data and next diligence step.

Final prompt: What warning sign in your current coverage deserves a tighter surveillance cadence?

Questions?