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Development District Bonds: How "Dirty" Are They?

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Development district bonds are paid from special taxes or assessments on a new neighborhood or development not within a city's limits. Therefore, essential water and sewer service is the district's responsibility. Here's the problem: bonds issued to build water/sewer systems are usually issued before building in the development/neighborhood takes place. This is why many of these bonds are called "dirt bonds"—if the district cannot repay debt, bondholders can only seek taxes and fees on undeveloped land ("dirt") from the developer building homes and businesses within the district. The risk is that development and property sales don't occur, and the developer could be heading for bankruptcy.

Because of "construction risk", it is no surprise that yields and interest coupons are higher than average. Even after a district is developed, it is likely to be smaller than a small incorporated city. Because they are so small, there is always economic risk that the district could feel severe economic disruption because of the closing or bankruptcy of a major employer that provides income to the small district. Not all development bonds are "dirt". Once a development is built-out, the risk of bankruptcy by a large developer gets eliminated. At that point, the district might see their bond rating rise to BBB category, perhaps even "A' rated if the district is large and diversified.

Investors should discuss their appetite for risk/loss with their advisor before investing in this sector. Yields are highest when the district can't demonstrate sufficient building to eliminate construction risk. After successful building/sales, districts could represent opportunities for investors with moderate risk appetite. Yields could be higher than average because of the small size of the district's debt in the market.

About the Author

***RICHARD P. LARKIN, Stoever Glass & Co., Inc*.**

Richard Larkin, a recognized 40 year industry veteran, has joined SG & Co. as Director of Municipal Credit Analysis. Mr. Larkin began his career in credit rating analysis at Standard & Poor's in 1975. After rising through the ranks in various analytical and management positions, Dick left S&P as its Chief Municipal Rating Officer, responsible for municipal rating policy, practices, governance and criteria. In 1998, Mr. Larkin joined Fitch Ratings as Chairman of its Public Finance Criteria Committee.

"Dick will be a unique resource to Stoever Glass' municipal clients. His knowledge in specific issues and areas of the municipal bond industry will aid our representatives and their clients in making educated decisions, in a sector where this type of research is unique," said Roland Stoever of Stoever Glass.