EHLERS
LEADERS IN PUBLIC FINANCE

Blueprints

Bond Basics

Introduction

- Debt issuance & management <u>most</u> successful when issuer understands:
  - Financing options
  - Implications of decisions
  - Federal/state rules & regulations
  - The players, their roles and for whom each "works"
  - How bonds are bought & sold

What is a municipal bond?

It’s a debt instrument issued by a governmental body.

Evidence of debt that specifies:

1. An obligation to pay
2. A stated amount or “principal”
3. At a given time or “maturity”
4. With a stated interest rate

Governmental bonds…

…Finance construction, maintenance or repair of public infrastructure

- Streets
- Water & sewer
- Libraries
- Fire stations
- Other municipal facilities

Conduit revenue bonds (private activity bonds)…

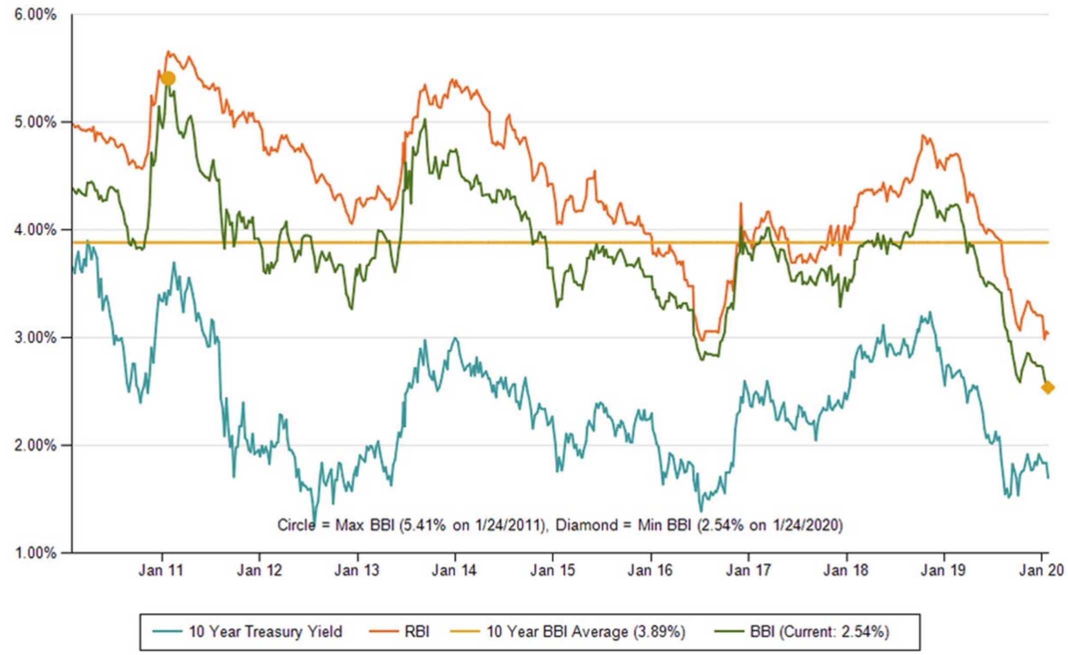
…Provide bond proceeds to 3rd parties for purposes authorized by law

- Bonds to finance affordable multifamily housing developments
- Facilities owned by 501(c)(3) organizations
  - ✓ Includes charter schools & hospitals

Bonds in the marketplace

Weekly rates over ten years:

January 2010 – January 2020



Bonds in the marketplace

Investor Objectives:	
Individual	✓ Retirement income ✓ Tax advantages ✓ Diversification
Institutional	✓ Revenue ✓ Active market ✓ Safety ✓ Diversification ✓ Yield over treasuries

Investment Factors:	
✓ Policy/objectives	✓ Duration
✓ Credit quality	✓ Security (G.O. v. Revenue)
✓ Yield	✓ Cash flow
✓ Taxable v. tax exempt	✓ Issuer geography risk

Debt issuance step 1: The decision to issue

- Two approaches to project financing
  - Pay as you go – use cash
  - Borrow – use bonds or other municipal debt
- Why borrow?
  - Payers use asset over life
  - Better manage tax rates & fees
  - Cash flow & fund balance considerations
  - Potential future levy limits – restrict ability to save & use cash
  - Timing

Key player – municipal advisor

- Municipal advisors help local governments:
  - Decide to borrow or pay cash
  - Understand financing options
  - Develop finance plan & debt structure
  - Choose method of sale
  - Complete sale, placement of debt
- <u>Represents only the issuer</u> in dealing with capital market participants (the other players)

Key player – municipal advisor

- Advises issuer to define capital finance strategies & policies
- Assists with preparation of offering & disclosure documents
- Owes fiduciary duty to the issuer
  - They can only work on behalf of issuer

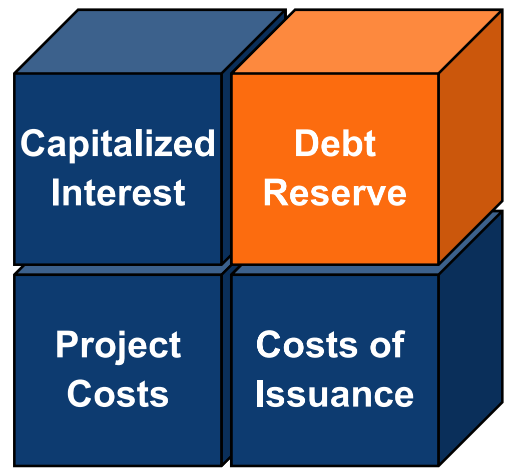
Debt issuance step 2: developing the finance plan

- When/how much to borrow
- Type of financing
- Source, term of payment
  - May dictate structure & type of debt
  - Market or rules/laws may limit options
- Existing & future considerations
  - Affordability
  - Capacity

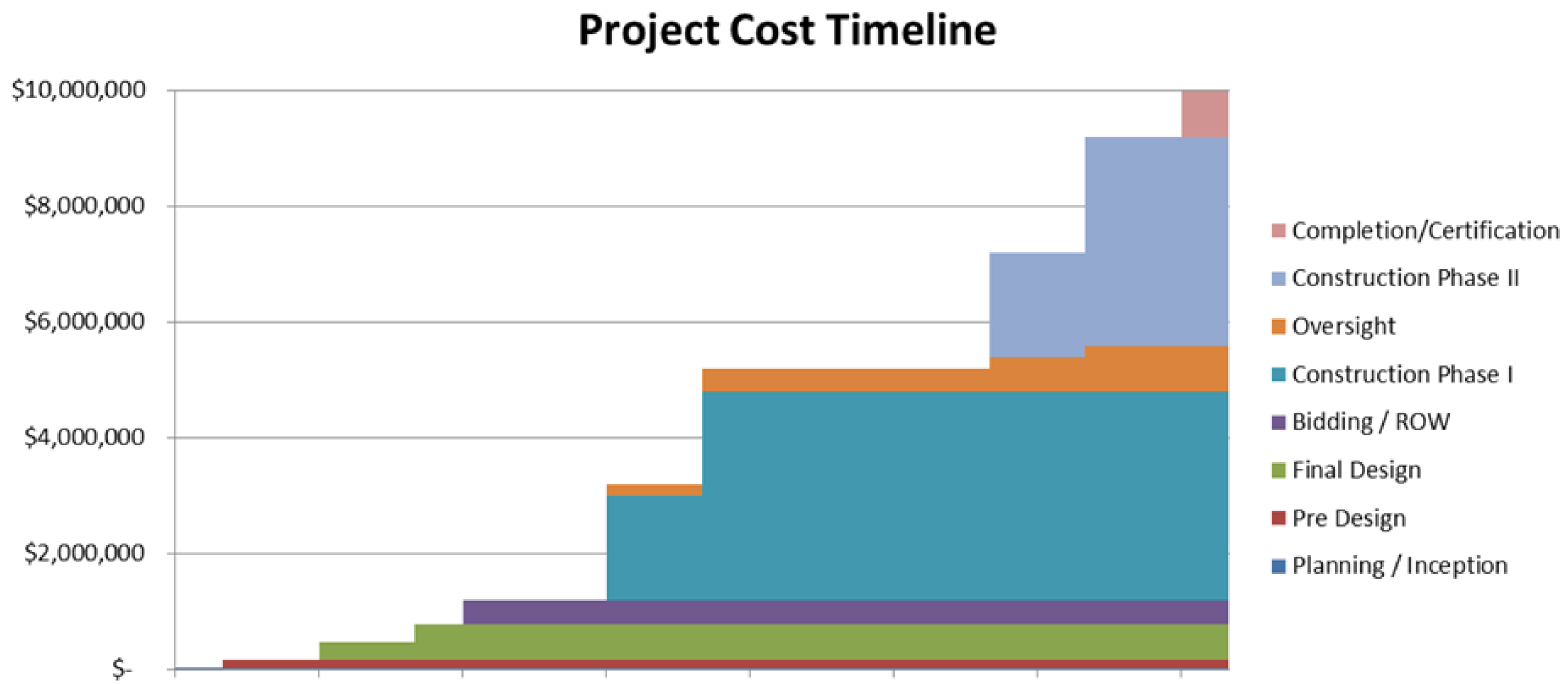
How much? Building a bond issue

- Include grant, cash contribution
- Consider all costs
  - Design, construction, legal & financing
- Capitalized interest
  - Revenue availability
  - Buffer fiscal impacts
- Debt service reserve
  - Applies to non-G.O. bonds
  - Investment earnings can pay debt service

Sources & Uses



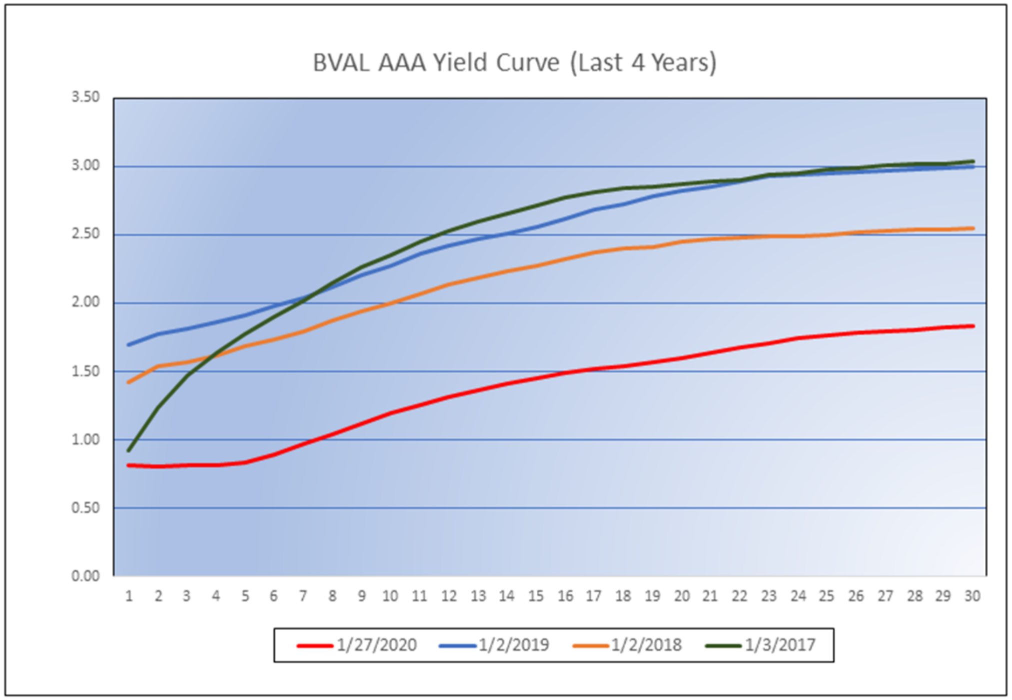
When? Timing a bond issue



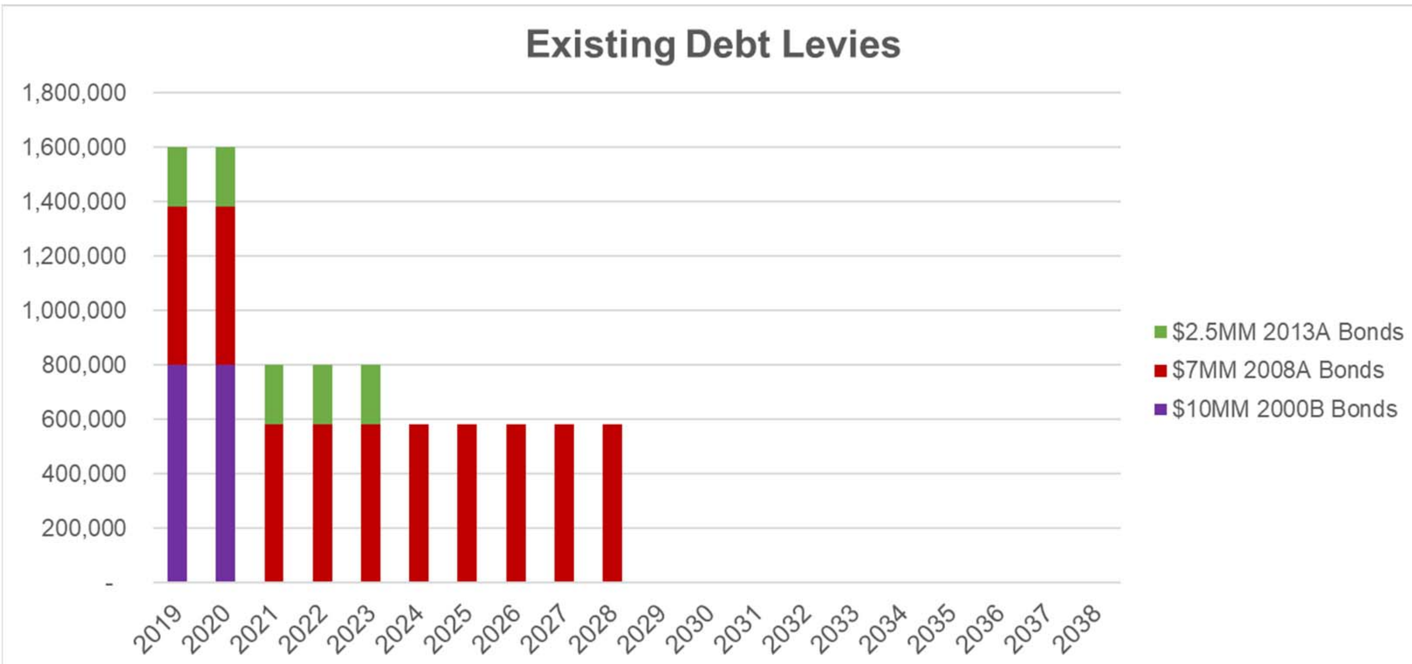
Structuring the issue

- Term: number of years for repayment
  - Call feature or prepayment provisions
- Match payments with revenue availability
  - Semi-annual interest, annual principal (typical scenario)
  - Fund balance & tax impacts
  - Bond covenants (conditions that MUST be met before additional debt can be issued)
- Understand statutory, regulatory constraints
- Market considerations

Market analysis

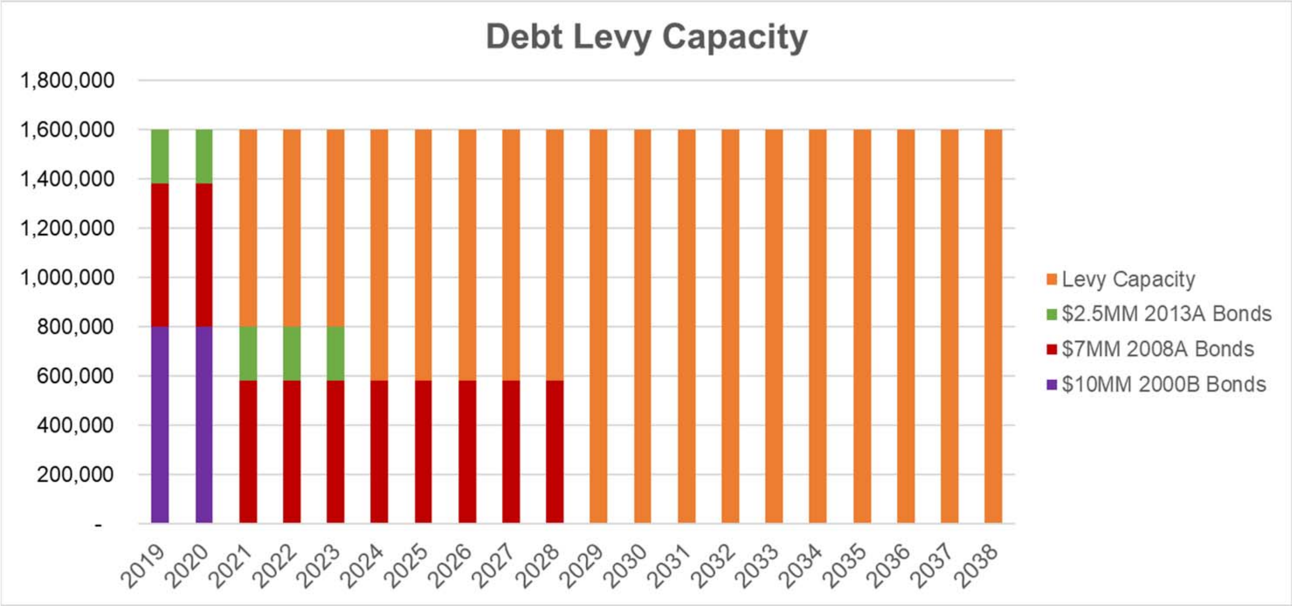


Debt capacity



Debt capacity

20-year capacity: $16.32 million at 3.00% discount rate:



Borrowing options

- Public offering – securities
- Bank financing or private placement
- State Public Facilities Authority (PFA) programs
  - Clean Water Revolving Fund (wastewater)
  - Drinking Water Revolving Fund (potable water)
  - Transportation Revolving Loan Fund
- USDA Rural Development Loan Program

Public offerings: security

- Debt must be secured by some asset
- Two main types:
  - General Obligation (G.O.)
    - ✓ Irrevocable pledge to levy ad valorem tax for debt service payment
  - Revenue – secured by specific revenue source
    - ✓ Utility system, lease payments, assessments, tax increment, etc.
    - ✓ State/Federal aids & grants

Unlimited tax G.O. pledge usually considered strongest & generally attracts lowest available interest rates.

Choosing a method of sale

Two primary options for public market offering:

1. Competitive: terms & conditions predetermined & bids solicited from underwriters
2. Negotiated: issuer selects firm to underwrite & market the transaction to investors

Competitive sale

- Preferred method for “off-the-shelf” offerings
  - Market understands security & structure (example: G.O.)
  - Frequent issuer or highly-rated (example: “A” or above)
- Open, transparent process
  - Bond underwriters (prospective purchasers) compete based on lowest cost proposal
- Should be default unless conditions dictate otherwise
  - GFOA best practices

When to consider a negotiated transaction

- Financing plan has unusual features, structure, provisions
- It will finance system or facility with no historical track record (revenues)
- Type of debt attracts only select class of investors
- It's a "story" bond, requiring active marketing efforts to attract investor interest

Debt issuance step 3: preparing for the sale

Steps include:

Initial authorization → Preliminary official statement → Bond counsel review → Credit rating (not for all) → 3rd party professional selection

Key player – bond counsel

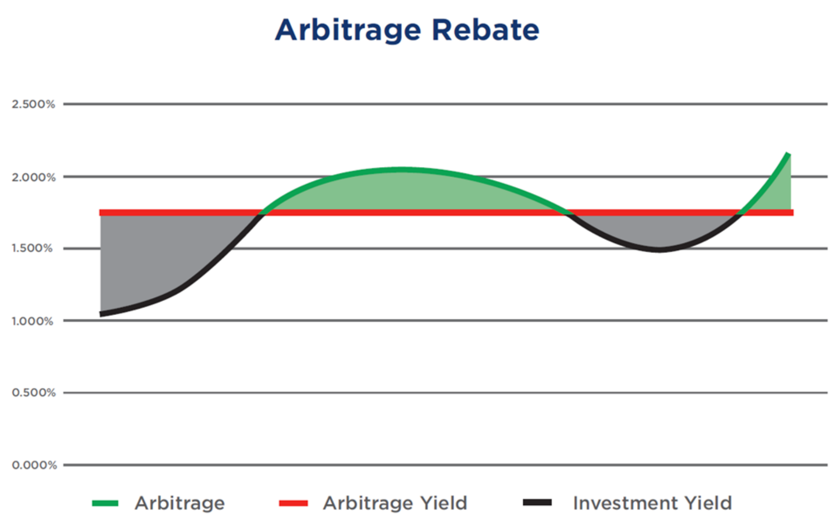
- Provides legal opinions to benefit issuer & investor
  - Legal, valid & binding obligation of issuer (valid contract)
  - Interest on bonds federally (and state for MN) tax-exempt
- Additional functions
  - Prepares legal documents
  - Renders tax advice
  - Reviews bond offering & disclosure documents
  - Develops post-issuance compliance procedures

Key player – bond counsel

- Who pays bond counsel fee?
  - Governmental bonds: issuer engages counsel, pays fee
  - Conduit bonds: 3rd party borrower pays fee

Federal regulations: Arbitrage

- Rules govern ability to earn interest above bond yield
- Arbitrage occurs when invested gross bond proceeds earn higher yield than bond yield



Federal regulations: Arbitrage

A. Yield restriction general rule:

- Issuer cannot invest gross bond proceeds at a yield “materially” higher than the bond yield.
- Exemptions include:
  - ✓ Temporary period (e.g. 3-year construction schedule)
  - ✓ Reserve or replacement fund
  - ✓ Minor portion (amount not > 5% of sale proceeds or $100,000, whichever is less)

Federal regulations: Arbitrage

B. Yield restriction general rule:

- Unless certain earnings on the gross proceeds of a bond are rebated to the U.S. Treasury, the bonds will be arbitrage bonds.
- Exemptions include:
  - ✓ Small issuer exceptions (governmental bonds)
  - ✓ Bond proceeds spent within certain timeframes (spending exceptions) at 6 months, 18 months or 2 years

Federal regulations: reimbursement

- Bond proceeds may be used to reimburse municipality for project expenses
  - Within 18 months of expenditure or date project placed in service, whichever is later
  - No later than 3 years after expense payment
- Issuer must declare intent to reimburse within 60 days of paying expense
- Exceptions include:
  - De minimus
  - Preliminary expenditures

Federal regulations: bank qualification

- Bonds designated/deemed “bank qualified” generally benefit from lower interest rates
- Municipalities can issue up to $10 million tax-exempt bonds/calendar year & maintain BQ status

State regulations

- Eligible use of debt: MN statutes, chapter 475
- MN municipalities have significant flexibility to issue G.O. debt without voter approval
  - Refunding obligations
  - Improvements payable from special assessments or tax increment revenue (at least 20% of project cost)
  - Capital improvements & street reconstruction

State regulations

- Voter approval required for:
  - Parks & trails
- Abatement & lease-purchase bonds alternatives to referendum
- Certain G.O. bonds subject to reverse referendum
  - Capital improvement plan (CIP) bonds
  - Street reconstruction bonds

State regulations

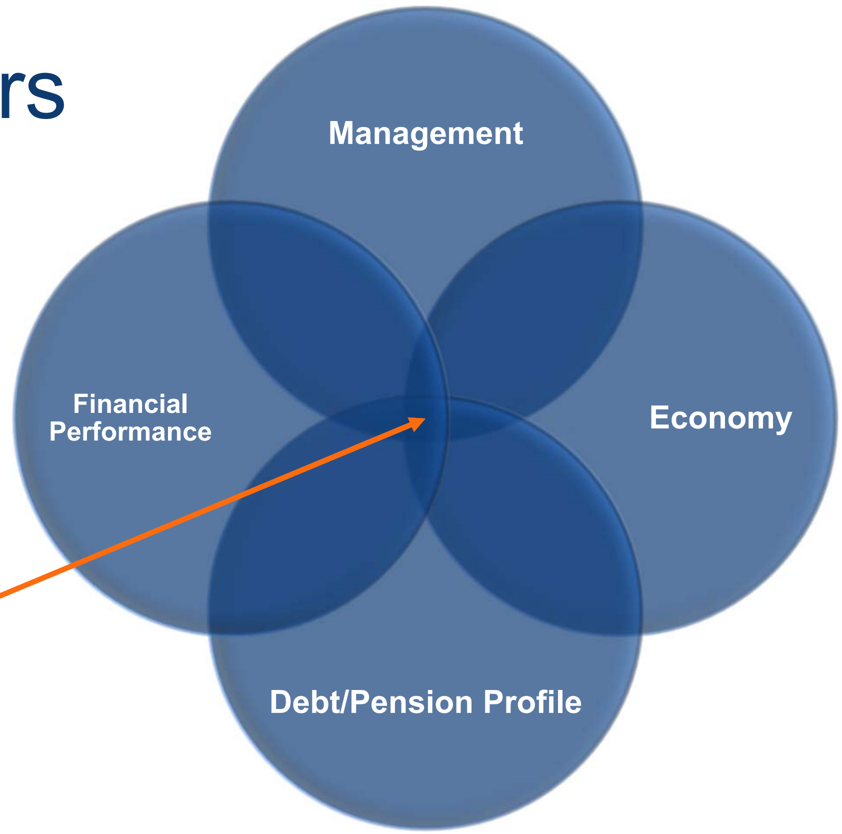
- Debt structure & term
  - Generally, 30-year max
  - Authorizing statute may limit debt amount, debt service
- Tax levy + pledged revenues must provide 105% annual debt service coverage for G.O. bonds
- G.O. debt limit
  - Can't exceed 3% of issuer's estimated market value (EMV)
  - Various exceptions exist

Key player – rating agencies

- Three primary agencies assess credit risk for holding a municipality’s debt
  - Standard & Poors (S&P)
  - Moody’s Investor Service (Moody’s)
  - Fitch
- Rating provides independent assessment of creditworthiness (issue/issuer specific)
  - Higher rating = more secure investment = lower interest rate

Not all issues benefit from obtaining a credit rating.

Credit rating factors



“The Secret Sauce”
Scorecard methodology

Credit ratings

	Moody's	S & P	Fitch
Highest	Aaa	AAA	AAA
	Aa1	AA+	AA+
	Aa2	AA	AA
	Aa3	AA-	AA-
	A1	A+	A+
	A2	A	A
	A3	A-	A-
	Baa1	BBB+	BBB+
	Baa2	BBB	BBB
Lowest (Investment Grade)	Baa3	BBB-	BBB-

Key player – other 3rd party professionals

- Bond registrar or paying agent
  - Facilitates movement of funds from issuer to bond holders
  - Commonly a bank or trust company, but can be issuer
- Trustee
  - Bank or trust company “oversees” funds for the benefit of bond holders
  - Generally only required for specific revenue bonds

Issuer pays both a flat fee at closing + annual fees through maturity

Debt issuance step 4: Day of sale & closing

- Municipal advisor receives bids (competitive) or final pricing (negotiated) from purchaser(s)
- Final adjustments completed
- Bond counsel prepares resolution with:
  - Final maturity amounts
  - Interest rate(s)
  - All other final debt terms (all **approved** day of sale, no changes post-sale)
- Closing occurs 2-4 weeks post sale (with bond counsel assistance)

Key player - purchaser

Underwriters: dealer firms that initially purchase bonds in a public securities offering

- “Underwrite” risk of distributing bonds to investors
- Paid by issuer via “underwriter discount”
  - ✓ In $s per $1,000 of bonds
    - – $5 (0.5%) discount on $1.0 million bond = $5,000
    - – Issue $1.0 million, but receive $995,000 at closing (for par bid)
- Can generate additional compensation after bonds are priced

Underwriters have <u>NO fiduciary duty</u> to issuers

Debt issuance step 5: ongoing management

- Post issuance compliance
  - Arbitrage & yield restriction
  - Continuing disclosure
  - Private use
- Bond proceeds management
  - Investing funds
  - Segregating funds
  - Unspent bond proceeds

Debt issuance step 5: ongoing management

- Debt profile management & monitoring
  - Timely debt retirement
  - Early optional redemption
  - Refunding opportunities
  - Levy adjustments

Refunding opportunities

- Municipalities can benefit from refunding existing debt
  - Restructure existing payments
  - Achieve interest savings
- Refundings generally cannot occur prior to a bonds' "call date"
  - Call date: when bonds can be pre-paid – usually at par (100%)
    - ✓ Subject to market conditions, negotiation
    - ✓ Typically 6-7 years for 10-year bonds, up to 10 years for longer issues
    - ✓ Shorter call dates generally result in higher interest costs
- Municipal bonds typically not pre-payable…at any time

Your presenters

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