CDIAC Municipal Debt Essentials

Financing Options:
Which Type of Debt is Best for Your Project, Part 2

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Land Secured Bonds

Land Secured Finance Overview

- **Basic premise**
  - Public agency sponsors creation of special district
  - Property owners agree to put lien on property
  - District boundaries can be tailored to project support
- **Bond financing**
  - Bonds generate up-front funds for capital projects
  - Repaid with special taxes levied on property tax bill
  - Issuer promises to foreclose on delinquent parcels
  - Upon foreclosure if taxes aren't paid, land value becomes ultimate collateral
- **Advantages**
  - New revenue stream created for projects
  - No payment obligation for public agency
- **Disadvantages**
  - Development projects can be risky in early stages

Two Types of Districts

Community Facilities District

Mello Roos

2/3rds approval

Flexible tax spread

Assessment District

1915 Act

50+% support

Proportional allocation of "special benefit"

Land-Secured Considerations

- **Bond capacity constraints**
  - Eligible public facilities identified
  - Land value relative to debt
    - Minimum 3-to-1 value-to-debt standard
  - Tax burden on end-user
    - All-in effective tax of 2% for residential
- **Considerations**
  - Issuer goals and policies
  - Developer may post letter of credit
  - Capitalized interest up to 2 years
  - Phased bond issuances
  - Land use entitlements and development momentum at issuance
  - Ability to refinance debt at lower rates once development is complete

Land Secured Credits

- ***Issuer*: reputation and experience**
- ***Local Economy*:** real estate cycle, sales activity
- ***Property***: location, attractiveness, environmental condition, value
- ***Strength of the Developer(s)***: financial resources, equity invested, development experience
- ***Development Plan***: entitlements, development schedule, approvals, absorption schedule, product mix
- ***Product Demand***: demographics of competing projects
- ***Special Tax***: burden on property, debt service coverage, value-to-lien
- ***Legal Structure and Covenants***: foreclosure provisions, reserve fund, type of debt

Comparison of Land-Secured Districts

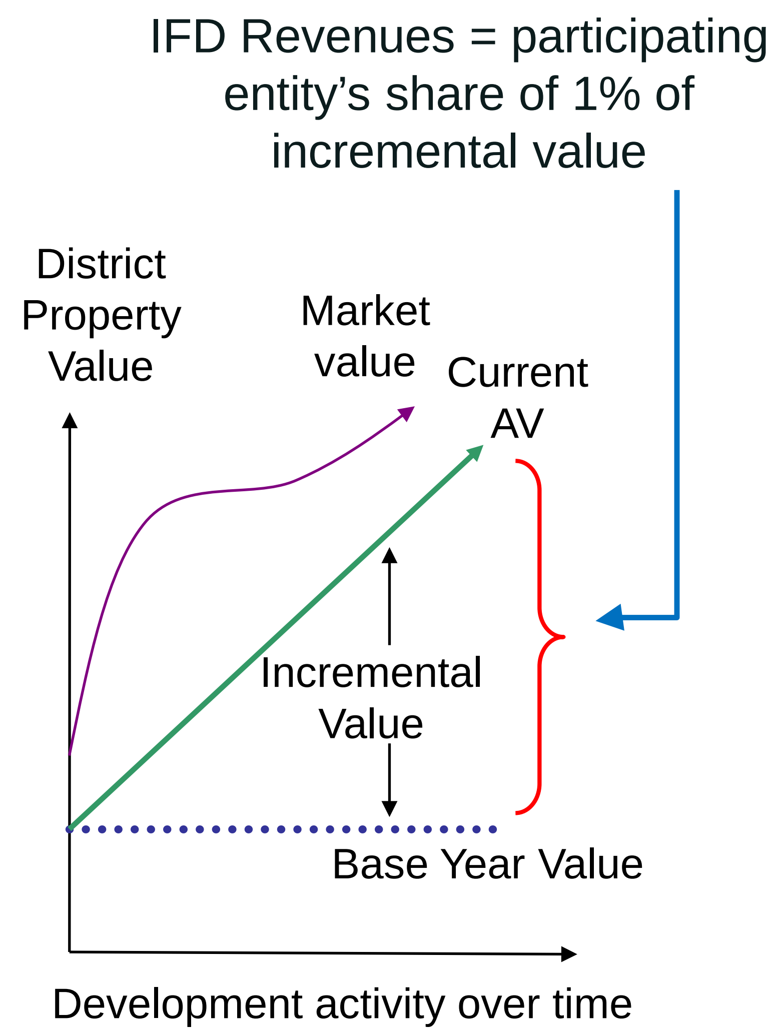
	Community Facilities District (CFD)	**Assessment District (AD)**
Statute:	Mello Roos	1915 Act/1913 Act
Security:	Annual special tax on property tax roll	Annual assessment on property tax roll
Vote:	2/3rds vote *	50%+ weighted by assessment
Scope:	Capital projects and maintenance	Capital projects with “specific benefit” only
Tax spread:	“Reasonable” spread of costs	Spread must be proportional based on *benefit*
Lien on Land:	Dynamic, can change as development proceeds	Fixed Assessment Lien

* By electorate if 12 or more registered voters; otherwise, by landowners weighted by acreage

Infrastructure Financing Districts

Infrastructure Financing Districts (IFDs)

- **Similar to redevelopment project areas**
  - Capture portion of property value increases within a defined area
  - Investment to spur growth
  - Statutory authority since 1990
  - New legislation modified powers
- **More limited revenue stream**
  - Share of 1% property tax revenues of participating agency(ies)
  - Schools are specifically <u>excluded</u>
  - Subordinate to successor agency debt
  - No revenue until growth occurs
- **Most likely applicability**
  - In combination with other tools, like a CFD
  - By issuers with a large share of 1% property tax rate



Three Statutory Alternatives

- **SB 628: "Enhanced Infrastructure Financing Districts" (EIFD)**
  - Expands existing IFD law, allows for military base development, low mod housing
  - Formation follows property owner "majority protest" process
  - Bond issuance requires **55% <u>voter</u> approval** (in the EIFD)
  - Revenue collection limited to <u>45 years</u> from date of bond issuance approval
- **AB 229: "Infrastructure and Revitalization Financing Districts" (IRFD)**
  - Can be used in former RDA project areas and military bases
  - Broad range of eligible uses including housing if 20% for low-mod housing
  - Formation and bond issuance both require **2/3rds <u>voter</u> approval**
  - Revenue collection limited to <u>40 years</u> from date of adoption or later specified date
- **AB2: Community Revitalization and Investment Areas (CRIA)**
  - Complex approval requirements
  - 25% affordable housing requirements
  - Requirement for annual review and potential amendment to Plan
  - Revenue collection limited to <u>45 years</u> from date of formation

Considerations for IFD Bonds

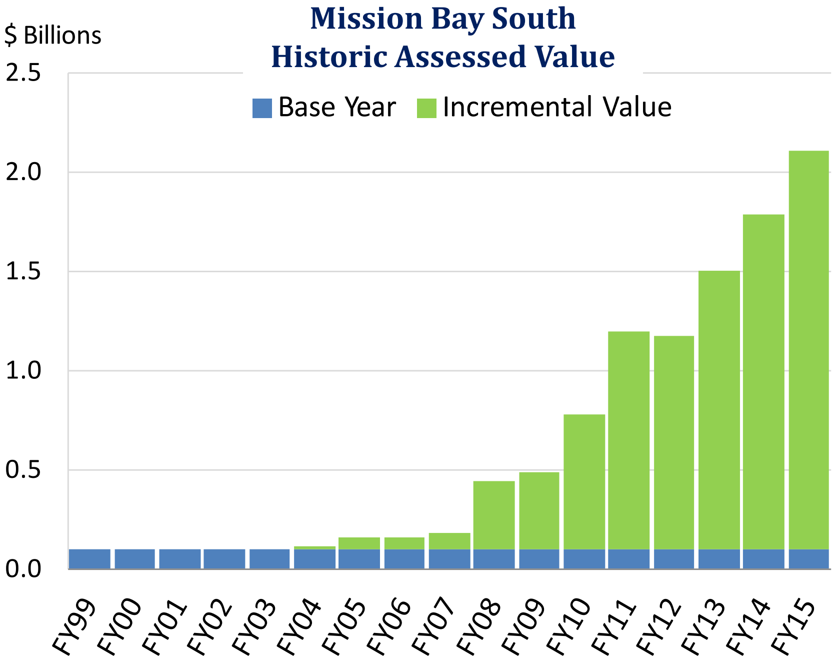
- **Issuer share of property tax rate varies**
  - San Francisco gets **65%** of base property taxes
  - West Sacramento gets **54%** of base property taxes
  - Average city gets about **20%** of 1% base rate
- **Early stage credits tend to be weak**
  - Passive revenue stream
  - Project areas likely to be smaller in size
  - Concentration of tax base
    - Geographic, land use, top taxpayers
  - Volatility of revenues
    - Depends on velocity of growth
    - Base year relative to total value
  - Development plan and developer wherewithal
- **Combination with CFD Bonds**
  - Tax increment can be used to reduce special tax or increase tax capacity

Tax Increment Credits

- Project area size and location
- Assessed valuation
  - Base year value as % of total Assessed Value
  - Growth trends and potential
- Taxpayer diversity
  - Residential, commercial, etc.
  - Concentration of revenues
  - Stability of key anchors
- Revenue collection limits
- Local economy
  - Employment and wealth
- Legal structure
  - Debt service coverage
  - Additional bonds test
  - Flow of funds

Case Study: San Francisco Mission Bay South

- **Overview**
  - Transformation of former industrial area
  - Mixed-use community anchored by a new UCSF medical campus
- **Key Takeaways**
  - Long life-cycle of a major project
  - Alignment of interests between issuer and developer
  - Combination of CFD and tax increment
  - Replicable with IFDs in lieu of RDA
- **Phasing and timing**
  - CFD Bonds
    - First issued in 2001
    - Financed backbone costs
    - Constrained by 3-to-1 values
  - Tax Allocation Bonds
    - First issued in 2009 as assessed values caught up with growth

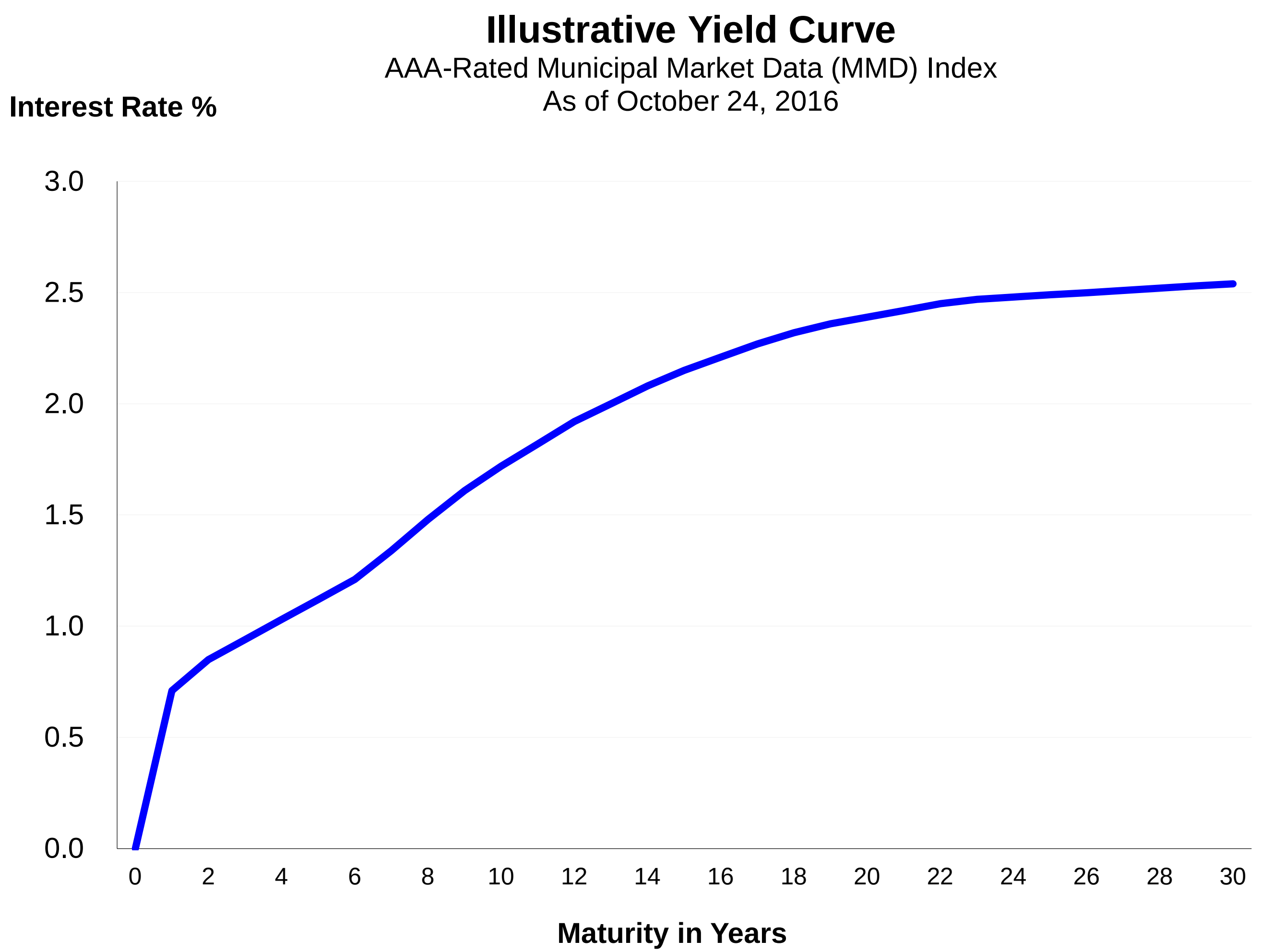


Short Term Instruments

Introduction: Short Term Financings

- **Cash flow financing**
  - Provide working capital to pay operating expenses
  - Examples: tax and revenue anticipation notes (TRANs), working capital notes
- **Bridge financings**
  - Provide interim short term financing for capital projects
  - Examples: bond anticipation notes (BANs), grant commercial paper (CP)
- **Permanent financings**
  - Provide long-term project funding at short-term interest rates
  - Examples: variable rate demand obligations (VRDOs), floating rate notes
- **Why Used?**
  - Access lower short term rates
  - Avoid locking-in long-term rates in unfavorable market conditions
  - Align assets and liabilities
  - Defer full debt service payments until project is completed
  - Postpone payments to relieve near-term financial stress
  - Retain variable rate debt compatible with an outstanding swap

Short-Term Interest Rates Tend to be Lower



Illustrative Rates by Maturity

1 year:	0.71%
2 year:	0.85%
5 year:	1.12%
10 year:	1.72%
30 year:	2.54%

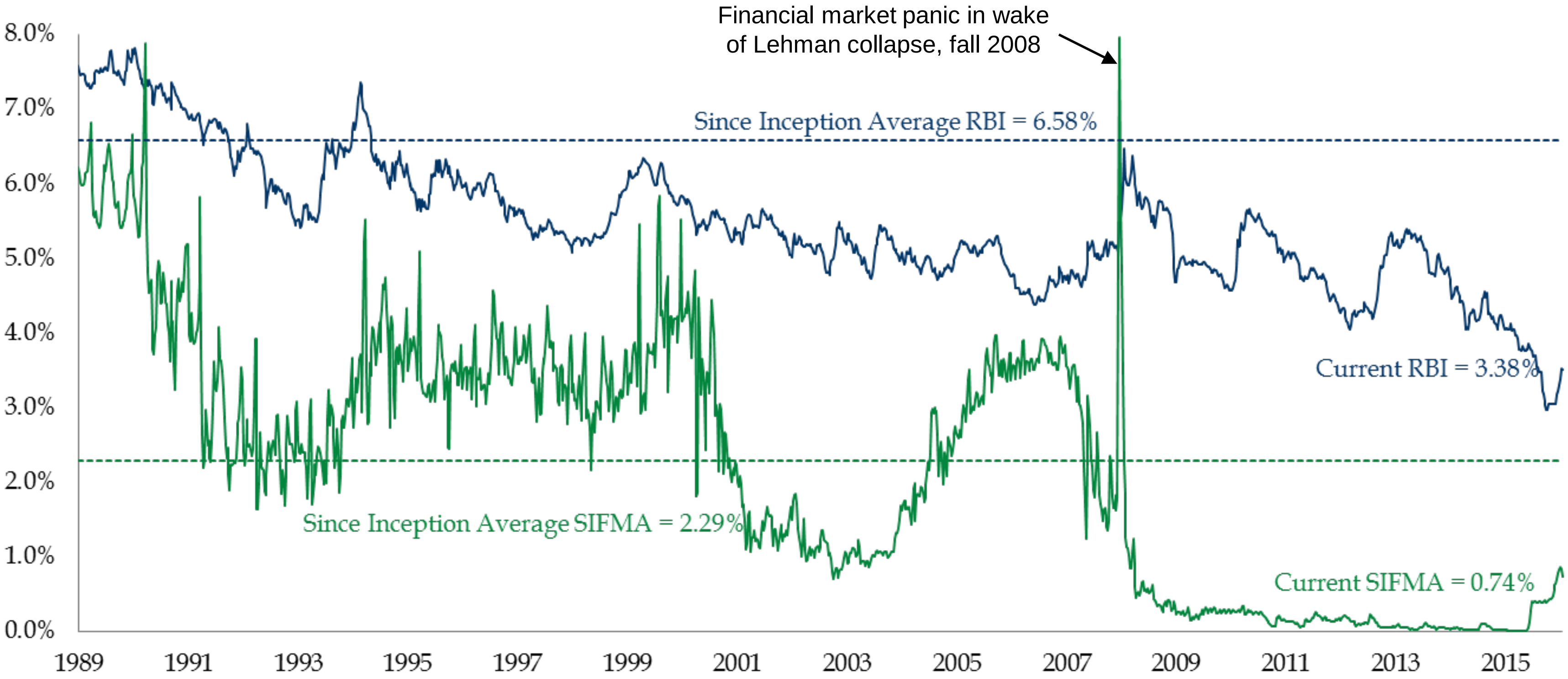
Source: Thompson

Short vs. Long Term Interest Rates Over Time

Spread between short and long maturities is wide in current market

Comparative Tax-Exempt Municipal Interest Rates

25-Bond Revenue Bond Index (RBI) vs SIFMA Index of Weekly Resets Since 1989



Source: : SIFMA, The Bond Buyer. As of 10/20/16

RBI: Long Term Tax-Exempt Bonds Maturing in 30 Years with Average Rating of A1/A+. SIFMA: All bonds in Index must be tax-exempt, non-AMT, have $10mm or more outstanding and the highest short-term rating by Moody's or S&P, and pay interest monthly with interest rate resets occurring on Wednesdays.

RANs, TRANs and GANs

- **Tax Revenue or Grant Anticipation Notes (RANs or TRANs or GANs)**
  - Purpose: used for cash flow or capital projects
  - Benefit: smooth out inconsistent revenue streams like property tax receipts or grants
  - Risks: short term and fixed repayment require careful forecasting of future cashflow
  - Interest rate: fixed at time of note sale
  - Requirements: Government Code and federal tax requirements

- ***Example:***
  - City relies heavily on property tax receipts due in December and April while expenses are fairly evenly spread throughout year
  - With diminished reserves in current economic climate, cash flow shortfall peaks after early December payroll payment
  - TRAN proceeds bolster cash position in July to cover peak deficits in fall; balances are restored and funds are set aside to repay TRANs throughout winter and spring, before June TRAN maturity
  - Credit rating is based on predictability of revenues, accuracy of projections, expected liquidity (and alternatives) at maturity and ability to withstand less favorable results

Deficit Borrowings

- **Working Capital Note ("deficit borrowing")**
  - Purpose: used for cash flow to address a deficit
  - Benefit: provides near term cash relief from cash flow pressures
  - Challenges: requires accelerated repayment from all free cash flow beyond a modest reserve; can be difficult to market to investors
  - Constraints: federal tax law limitations for tax-exempt issue

- ***Example*:**
  - City committed cash to a capital project in expectation of reimbursement from CalTrans
  - Delayed reimbursements created cash flow strain on city's operations
  - Working capital note provides financial breathing room
  - Repaying notes over 10-year horizon

Commercial Paper

- **Commercial Paper (CP or TECP)**
  - Purpose: may be used for capital projects or cash flow
  - Benefit: offers flexibility to create template for borrowing program and then draw down project funds as needed with streamlined approvals
  - Maturity: less than 270 days; a true maturity
  - Interest rate: set at time of CP draws
  - Liquidity requirements: third party (bank) liquidity or (rarely) self-liquidity

- ***Example*:**
  - Transportation authority with large capital program
  - May use CP draws to fund interim, initial project funding
  - One large, long-term financing issued to fund balance of project and pay off CP
  - Credit rating based on credit quality of liquidity bank, not borrower

Bond Anticipation Notes

- **Bond Anticipation Notes (BANs)**
  - Purpose: capital projects
  - Benefit: can provide seed financing in advance of a planned long-term financing
  - Interest rate: fixed at time of note sale
  - Requirements: statutory and tax limits

- ***Example*:**
  - Sales tax authorization approved by voters but revenue collections begin in 2 years
  - Transportation authority can issue BANs now to tap future debt capacity
  - BANs are repaid with long-term financing after collections begin
  - Credit ratings are based on expected terms of future take-out and assessment of future market access

Variable Rate Debt: VRDOs

- **Variable Rate Demand Obligations (VRDOs or VRDBs)**
  - Purpose: used for capital projects
  - Benefit: access rates on the short end of the yield curve, retain flexibility to pay off or restructure debt at any time
  - Maturity: principal amortization may be scheduled over the life of the bonds, typically 30 years, or structured as lump sum term maturity
  - Interest rates: variable rate may be reset daily, weekly, monthly or other periodic basis
    - Most debt issued is in 7-day mode
    - Assuming 7-day reset mode, interest payments are made on a monthly basis
    - Remarketing agent resets the interest rate based on market conditions on each rate reset date
  - Liquidity requirements: third party (bank) liquidity or (rarely) self-liquidity
    - Investors can “put” the bonds back to the issuer/remarketing agent at each rate re-set period; this feature makes VRDOs appealing to money market funds
    - Standby purchase agreement (SBPA)
    - Direct-pay letter of credit (LOC)

Emergence of Alternative Variable Structures

Dearth of liquidity spurred development of new approaches

- **Floating Rate Notes**
  - Benefit: can be used to create or retain variable rate debt without third-party bank liquidity
  - Interest rates: set at a fixed spread to variable weekly index (i.e. SIFMA or LIBOR)
  - Liquidity requirements: No liquidity required, essentially "self-liquidity"
  - Risks: Exposure to future short-term yields, market access and interest rate risk at maturity
  - Structuring considerations: amortization, put timing, call features, target investors
- **Fixed-Rate Notes**
  - Benefit: accesses lower short term rates, *may* retain an outstanding swap
  - Interest rates: fixed rate based on maturity
  - Liquidity requirements: None, investors evaluate prospects for take-out at maturity
  - Risks: Issuer exposed to market access and interest rate risk at take-out

Conduit Borrowings

Conduit Revenue Bonds

- **Overview**
  - Bonds issued by a governmental agency
  - Proceeds are loaned to a borrower
  - Payable solely from the loan repayments ("revenues") received by the conduit issuer from the borrower
- **Why used?**
  - To qualify for "tax-exemption" for certain types of private activity bonds
    - i.e. Housing, Health Care, Industrial Development
  - When a third-party entity is needed such as for a lease-leaseback financing
  - For efficiency, such as a pool financing program
- **Wide Variety of Borrowers**
  - Local governmental entities
  - Natural persons, for-profit corporations, partnerships
  - Nonprofit 501(c)(3) corporations

Most Common Types of Conduit Revenue Bonds

- **Economic development**
  - i.e. small issue industrial development bonds, industrial revenue bonds, or industrial development revenue bonds
- **Educational facilities**
- **Health facilities**
- **Multifamily housing**
- **Other**
  - Facilities for pollution control or abatement, particularly in connection with disposal of solid wastes—these are often referred to as pollution control revenue bonds (PCRBs)
  - Certain other narrowly defined categories, such as airport or port facilities, water furnishing facilities, mass commuting facilities, and facilities for local furnishing of electricity or gas

Considerations for Conduit Issuers

- **Obligation to pay**
  - Conduit Issuer’s credit is not on the line
  - Borrowers duty to repay
- **Reputation risk**
  - However, the Issuer’s name on the face of the bonds may expose them to some residual risk of adverse publicity or involvement in litigation if the bond issue were to default
- **Third-party credit rating?**
  - Investment-grade credit rating from a national rating agency can provide comfort
- **Credit enhancement**
  - Requires additional third-party credit review
  - May take the form of a letter of credit from a highly rated bank, a bond insurance policy, or a surety bond
  - Can mitigate risk of default/reputation risk

Case Study: Harbor Regional Center

- **Harbor Regional Center (HRC)**
  - A nonprofit that has contracted with the State since 1977 to coordinate services to people with developmental disabilities in part of LA County
- **California Municipal Finance Authority (CMFA)**
  - Joint powers authority (JPA) created by a number of cities, counties and special districts
  - Under California law, a JPA is a governmental entity with the power to issue bonds.
  - Several, including CMFA, have been created specifically for that purpose.
- **Financings**
  - In 2009, HRC borrowed $25 million through CMFA
    - Bond proceeds were used to purchase and improve buildings in Torrance for HRC's use
    - Net borrowing cost was up to 8.50%
  - In 2015, HRC refinanced the 2009 debt through CFMA
    - New borrowing cost of only 4.12% to 2039 final maturity
    - Took advantage of lower market interest rates and higher Moody's rating
    - Moody's upgraded its evaluation of HRC from a rating of Ba1 to A3
    - Bondholders are repaid from the revenues that HRC receives from operating the center
    - Additional security from a deed of trust in the land and property in the event the HRC fails to make debt service payments.

Direct Lending

Private Placement Alternative to Public Bond Sale

- **Overview**
  - A privately negotiated extension of credit from a commercial lender – or institutional investor - that does its own (regulated) diligence before making the loan
  - Sophisticated investor assesses credit on its own without the need for a separate disclosure document
  - Since 2010, dramatic increase in the use of bank loans/direct purchase as a tool to finance capital improvements as well as refund outstanding debt.
- **Considerations**
  - Interest rates can be higher or lower than available in public markets
  - Lower issuance costs may offer a compelling alternative to a public sale
  - Benefits may include limited documentation, quick completion time and lower costs of issuance by eliminating need for bond ratings, Official Statement, and debt service reserve fund
  - Credit parameters and purchasing interests vary
    - Term may be limited to 10 years or shorter, but some lenders willing to go longer
    - Less aggressive interest in transactions paid from general fund appropriation

Hot Topic: Bank Loan Disclosure

- **Disclosure of Bank Loans**
  - Currently not required under Rule 15c2-12, though this may change
  - No Ratings, Offering Document or Continuing Disclosure
- **Why Should the Issuer Disclose?**
- **The bank loan/direct purchase may:**
  - Increase the issuer's outstanding debt
  - Have different covenants and events of default
  - Be secured by assets previously available to secure bonds
  - Be structured with a balloon payment (e.g., a put prior to final maturity at the end of the bank's stated holding period)

Case Study: Concord 2015 General Fund Lease

- **Secured by lease payments from annual general fund appropriations**
  - Lease of Civic Center, public library, parking garage and senior center
- **Goal of raising $22.4 million for road repairs**
  - Leverage $2.5 million of annual ½ cent sales tax revenues
  - 10 year borrowing term and semi-annual amortization
  - No reserve fund and 5-year par call
- **9 banks active in the muni market were solicited**
  - Six bids were received ranging from 1.91% to 3.25%
- **Transaction closed in less than 6 weeks from solicitation**
- **Financing team members**
  - Municipal advisor, private placement agent, bond counsel, purchasing bank and bank's counsel

Concord

Private Placement Bid Results	
Bank of the West	1.91%
Capital One	2.64%
BBVA/Compass	2.69%
City National	2.97%
Umpqua	3.09%
Western Alliance	3.25%

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