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# CDIAC/CASBO Workshop

## The ABC's of School Debt Financing

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### Session I

## Basic Considerations Before Assuming Debt

*Prepared By Ruth Alabydoian, December 12, 2007*



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# Why Are We Here?

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- Purpose of today's workshop:
  - Understand basics of school district debt
    - Terminology
    - Options
  - Understand obligations and responsibilities
  - Know what questions to ask
  - Resources for future reference
  
- Like a home mortgage, taking on debt has long-term implications for a school district.



# ABC's of Debt Financing

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- What do we mean by “debt”?
  - Borrow now, pay back later with interest
  
- What do we mean by “financing”?
  - The technical side of borrowing
    - the legal documentation
    - the interest rates & amortization
    - the on-going obligations
  - Must be in place for someone to give you the money



# Constitutional Debt Limit

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- California Constitution, Article 16, Section 18a:
  - *No county, city, town, township, board of education, or school district, shall incur any indebtedness or liability in any manner or for any purpose exceeding in any year the income and revenue provided for such year, without the assent of two-thirds [now 55% for schools] of the voters of the public entity voting at an election to be held for that purpose [...]*
  - In other words, public agencies can't go into debt without voter approval.
  - TRANs are not debt because they are short-term.
  - Leases are not debt because they are contingent on use of equipment or property



# Why Borrow?

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- Economics of debt & time value of money
- Future students / homeowners will benefit, they should pay for some of the costs.
- Reduce one-time burden and match repayment to useful life of project
- Bridge financing



# Do You Really Need To Issue Debt?

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- Just because you can, or just because it is easy, is not a good reason:
  - TRAN's – cash flow needs should be #1, not arbitrage opportunity
  - GO Bonds – large bond just because it will pass
- Already explored your other funding options, i.e. State funds/match, grant \$, sale of surplus sites
- Cost shifting opportunities – General Fund expenses to GO bond program
  - Energy savings projects: Solar, fuel cell technology
  - Water & maintenance savings: All-weather fields & tracks



# Match Repayment Term to Use

<b>Useful Life Table (Partial)</b> (from SACS & ASBO)	
<b>Capital Asset</b>	<b># of Years</b>
School Buildings	50
Portable Buildings	25
Site Improvements	20
HVAC Systems	20
Roofing	20
Kitchen Equipment	15
Vehicles (Buses)	8
Copiers	5
Computer Software (Instructional)	10 - 20
Computer Software (Administrative)	5 - 10
Computer Hardware	5



# State Match Requirements

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- State School Facilities Program requires local match.
  - 50% local / 50% State for new construction
  - 40% local / 60% State for modernization
  
- State funds usually insufficient
  - Local community preferences may cost more
  - Some projects outside scope of State program





# Determining Need

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- First Question:
  - What is the District's financing need?
- Only possible answers for which money can be borrowed:
  - Cash flow deficit
  - Capital Project (real property or equipment)



# Capital Projects

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- If a capital project, what type of capital project is it?
  - District-wide facilities projects
  - Specific to a school or neighborhood
  - New construction or modernization
  - Equipment



# How Much?

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- Second Question:
  - How much will need to be borrowed?
  
- Considerations:
  - Cost of project
  - Offsetting interest earnings
  - Offsetting matching funds
  - Costs of issuance
  - For some financings, cost of a debt service reserve fund and/or capitalized interest



# Who Pays for It?

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- Third Question:
  - Who will pay for this?
  
- Possible Answers:
  - District (General Fund)
  - Designated revenue (e.g., developer fees)
  - Taxpayers
  - State
  - Specific neighborhood benefiting from project



# Other Considerations

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- Length of repayment
  - Must match useful life of project
  - For cash-flow borrowings, generally must be repaid within one year
  
- Board & community support
  
- Staff time/capabilities



# Sources/Types of Financing

Type of Financing	Voter-Approved	Not Voter-Approved	Who's responsible for repayment?
General Obligation Bonds (GOB)	X		All Taxpayers
School Facility Improvement District (SFID)	X		Taxpayers within specific SFID
Mello-Roos (Community Facility District (CFD))	X		Property owners within CFD
Direct Lease (under \$3 million)		X	District
Certificates of Participation (COPs) (over \$3 million)		X	District
Tax and Revenue Anticipation Notes (TRAN)		X	District



# Features

Type of Financing	Uses	Amount	Term
General Obligation Bonds (GOB)	Capital Projects on Voter List	\$500,000+	Up to 40 years
School Facility Improvement District (SFID)	Capital Projects on Voter List	\$500,000+	Up to 40 years
Mello-Roos (Community Facility District (CFD))	Capital Projects	\$500,000+	Up to 40 years
Direct Lease (under \$3 million)	Capital Projects, may include equipment	\$50,000-\$3M	2-10 years
Certificates of Participation (COPs) (over \$3 million)	Capital Projects, may include equipment	\$3M+	Up to 30 years
Tax and Revenue Anticipation Notes (TRAN)	Cash flow deficit or working capital	\$50,000+	1 year



# Choosing Among Options

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- Key features used to determine best financing option:
  - Interest rates (short/long term + costs)
  - Type of interest (variable/fixed)
  - Cost of issuance (one time costs)
  - Prepayment penalty
  - Need for credit rating or bond insurance
  - Paperwork
  - Approximate processing time





# Debt Management Policy

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- Sets guidelines for debt issuance decisions
  - Caps on General Fund Debt
  - Parameters for technical terms and conditions of debt
- Provides opportunity to educate Board and staff on roles and responsibilities
- Look to CDIAC and other advisors for help developing policy.



# Managing the Financing Process

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- Bring in the experts
- Check references
- Interest rates are big part of picture; but also look at other up-front costs
- Compare net funds to district to the net payment(s) by district
- Is disclosure complete, accurate, and not misleading?
- How complicated is the ongoing management? Who is going to do it?



# Pre-Financing Process: Laying the Proper Groundwork

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- Find out what all of your needs are
  - Even if you have no idea how you are going to pay for them
- Repeatedly lay out the facts, and let other people connect the dots
- Start your PR campaign – how you are doing things well
- Assemble information on where you are and what you have done already – lean toward the expectation that you will need more money
  - ‘If you are faithful with taking care of the small things entrusted to you, then you will be given even more to oversee’
  - ‘You trusted us before, now trust us again’



# Pre-Financing Process: Laying the Proper Groundwork

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- Get some help and advice from a Financial Advisor
  - What are taxpayers paying now?
    - \$?? / \$100,000 of AV
  - Get an education on the rules, regulations, and critical dates on various types of debt
  - Firm up your bond rating
    - Visit Moody's and S&P off-cycle
  
- Explore other funding opportunities, i.e. State bond and grant monies



# Pre-Financing Process: Laying the Proper Groundwork

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- Go very slow with your Superintendent and Board
  - Let them take the lead
  - Commission a community poll of voter sentiment
    - What projects & wording rings the bell or sounds alarms?
    - What \$ / \$100,000 of AV that garners a passing vote?
  - Wait for them to ask for your advice
  - Let them make the decisions
  
- Firm up needs list and project cost estimates
  - Build in soft costs and healthy cost increases
  - Financial advisor to analyze: \$?? / \$100,000 of AV
  
- Continue your PR campaign
  - Employees, parent groups, community groups
    - Create a core group of supporters



# Overview of the Financing Process

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## 1. Determine need

- Project description
- Timeline
- Cost/Expenditure schedule

## 2. Identify repayment source

- Are funds available “internally”?
- Will community support a tax, and how much?

## 3. Identify “team” to coordinate financing

- Retain Financial Advisor and/or Underwriter
- Retain Bond Counsel



# Process Overview, continued

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## 4. Legal Framework

- Voter approval
- District Board approval
- County Board approval

## 5. Disclosure & Credit Review

Information provided to investors must be:

- Accurate
- Thorough
- Up-to-Date



# Process Overview, continued

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## 6. Pricing

- Can be done competitively or negotiated
- Interest rates are determined
- Repayment schedule is set

## 7. Closing

- Paperwork is signed
- Money changes hands

## 8. Ongoing responsibilities

- Repayments
- Investing proceeds
- Other obligations





# Parties to a Securities Transaction



**Bond Counsel**



**Financial  
Advisor**



(Wants lowest cost)



**County  
Treasurer/  
Auditor**

**Seller of Bonds (Borrower)**

**Buyer of Bonds (Lender)**



**Rating Agency**



**Underwriter**



**Bond Trustee/  
Registrar/  
Paying Agent**



**Disclosure  
Counsel**



**Investors  
(Wants highest return)**



**Underwriter's  
Counsel**



# CDIAC/CASBO Workshop The ABC's of School Debt Financing

## Session I Role of the Professionals

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## Role of the Professionals

 Importance of Financing Team

 Issuer Internal Team

 Issuer Consultants

- ◆ Financial Advisor
- ◆ Bond Counsel
- ◆ Disclosure Counsel
- ◆ Trustee
- ◆ Dissemination Agent

 Third Parties

- ◆ County Treasurer/Auditor
- ◆ Underwriter
- ◆ Underwriter's Counsel
- ◆ Rating



## OVERVIEW

### IMPORTANCE OF FINANCING TEAM

- ◆ Optimal structuring to accomplish goals
- ◆ Protection from potential legal liability
- ◆ Better market acceptance of debt being sold



## PARTICIPANTS

### ISSUER INTERNAL TEAM

- ◆ General Counsel
- ◆ Finance Director & Chief Business Official (if different)
- ◆ Project Staff
- ◆ Risk Manager



## PARTICIPANTS

### ISSUER CONSULTANTS

- ◆ Financial Advisor
- ◆ Bond Counsel
- ◆ Disclosure Counsel
- ◆ Trustee
- ◆ Dissemination Agent
- ◆ Appraiser (Mello-Roos only)
- ◆ Market Absorption Consultant (Mello-Roos only)

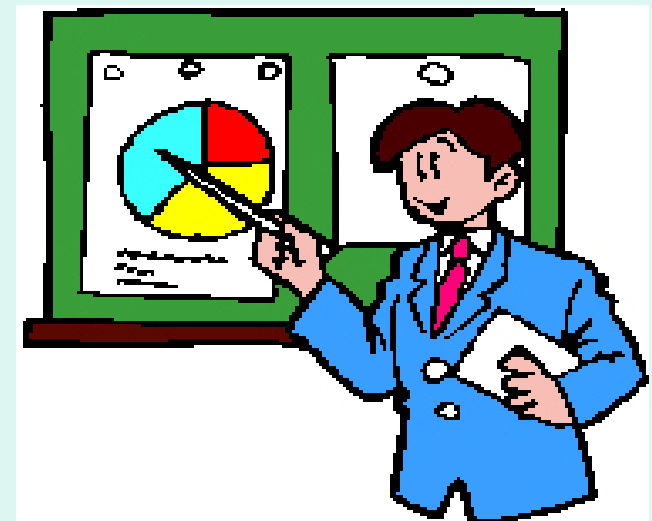


## Financial Advisor

**Financial Advisor:** An independent consultant who advises the issuer on matters related to the bond financing including structure, method of sale, timing, marketing, fairness of pricing, terms and bond ratings. Represents only the interests of the issuer.

### Duties:

- Develop overall plan of finance
- Assist with debt authorization
- Explore financing alternatives
- Construct financial model
- Assemble financing team
- Develop issuance timeline
- Evaluate and recommend method of sale
- Prepare bond specifications and terms
- Prepare district personnel and presentation materials for bond rating
- Manage bond sale
- Provide compliance



**Financial Advisor**

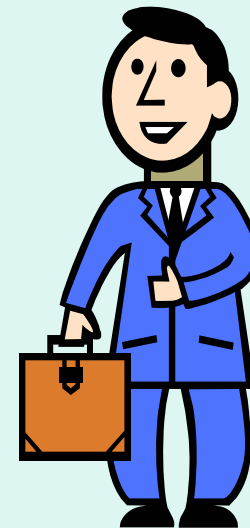


## Bond Counsel

**Bond Counsel:** An attorney who reviews/prepares the legal documents and writes an opinion on the authority to issue bonds, that legal requirements have been met, and the tax-exempt status of interest paid on the bonds.

### Duties:

- Issues valid obligation opinion
- Issues tax-exempt opinion
- Prepares legal documents including:
  - Resolution calling for election
  - Ballot proposition
  - Bond issuance resolution
- Advises:
  - State legal constraints
  - Federal tax law
- Prepares transcript of legal proceedings



**Bond Counsel**





## Disclosure Counsel

### **Disclosure Counsel:**

**An attorney or law firm retained to ensure that District has fairly disclosed all pertinent facts relating to the offering.**

### **Duties:**

- **Provide advice on disclosure obligations**
- **Prepare Official Statement**
- **Prepare Continuing Disclosure Agreement**



**Disclosure Counsel**



## Bond Trustee/Registrar/Paying Agent

**Bond Trustee:** Usually a bank with trust power which acts in a fiduciary capacity for the benefit of the bondholders in enforcing the terms of the bond contract.

**Duties:**

- Collects payments from Issuer
- Distributes payments to Investors



Bond Trustee/  
Registrar/  
Paying Agent

**Registrar:**

The person or entity responsible for maintaining records on behalf of the issuer for the purpose of notifying the owners of registered bonds. The paying agent frequently performs this function.

**Paying Agent:**

The entity responsible for the payment of interest and principal on municipal bonds on behalf of the issuer. The paying agent is usually a bank or trust company, but may be a county treasurer.

**Duties:**

- Invests Funds
- Disburses Funds



## Dissemination Agent

### **Dissemination Agent:**

**The Dissemination Agent takes responsibility for filing the Annual Report under the Continuing Disclosure Agreement and filing notices of material events.**

### **Duties:**

- **Provides notice to Issuer if report not filed**
- **Files Annual Report**
- **Distributes material event notices**



**Dissemination Agent**



## PARTICIPANTS

### THIRD PARTIES

- ◆ County Treasurer/Auditor
- ◆ Underwriter
- ◆ Underwriter's Counsel
- ◆ Rating Agencies
- ◆ Credit Enhancer
- ◆ Land Developer



## County Treasurer/Auditor

### **County Treasurer/Auditor:**

The principal duties include the management and investment of County, Schools, and Special District funds, Bond Administration, and the collection of taxes and revenues.

### **Duties:**

- **Holds proceeds of sale of bonds**
  - ❑ **Disburses funds upon Board authorization**
- **Invests bond proceeds**
- **Determines Tax Rates**
  - ❑ **Uses debt service information provided by Issuer (Official Statement)**
- **Prepares Tax Bill and collects taxes**
- **Sends money to Trustee/Paying Agent for payment of bonds**



**County  
Treasurer/ Auditor**



# Underwriter

**Underwriter:** Key function is to buy the new issue of securities from the issuer and resell the bonds to investors.

## Duties:

- Offers to buy the bonds from the issuer at specific interest rates
  - ❑ Sells bonds to investors (institutional/retail)
  - ❑ Fee earned is called Underwriter's Spread (Reoffering Price – Purchase Price)
  - ❑ Can advise on structure/terms of financing (negotiated sale)
- Divisions:
  - ❑ Public Finance/Investment Banking
    - Liaison between underwriter and public officials
  - ❑ Underwriting/Trading
    - Prices bonds
    - Syndicate formation
    - Settlement/Clearing
  - ❑ Sales
    - Retail/Institutional



**Underwriter**



## Underwriter's Counsel

**Underwriter's Counsel:** A law firm retained by the Underwriter to represent the Underwriter's interests.

### Duties:

- Drafts Bond Purchase Agreement
- Reviews and comments on Official Statement
- Reviews and comments on Continuing Disclosure Agreement
- Prepares Blue Sky and Legal Investment Memoranda





## Rating Agency

**Rating Agency:** An independent service that provides a credit quality evaluation of bonds and notes. Standard & Poor's and Moody's are common for school district credit ratings.

### Duties:

- Reviews four broad factors to determine rating:
  - The financial strength of the Issuer
  - The economic health of the community (commercial, industrial, residential)
  - Managerial and governance practices
  - Debt position – direct and overlapping debt, overall debt to wealth position
- Interviews Issuer, others
- Assigns a letter rating to bonds



**Rating Analyst**






## Ratings

### Purpose of Ratings:

- ◆ To help investors assess the issuer's ability to repay the bonds
- ◆ Provide independent, trusted, consistent and comparable information/evaluation
- ◆ Allows comparison among credits

 NOT a substitute for full disclosure by the Issuer, or due diligence by the investor



## What are they looking for?

 Repayment source

 ABILITY TO REPAY

- ◆ GOBs – Taxbase, economics of region
- ◆ COPs – Identified source? GF of District?
- ◆ TRANs – Tax revenues, coverage

 Debt Structure:

- ◆ Legally sound
- ◆ Reasonable repayment structure

 Other Debt:

- ◆ Debt ratios
- ◆ Other “overlapping” debt



## Differentiating among similar credits

### District Finances

- ◆ Flexibility – class sizes, other funds
- ◆ Fund Balances
- ◆ Budget management

### Projects to be Financed

- ◆ Essentiality
- ◆ Ability to complete projects

### District management

- ◆ Community relations
- ◆ Labor relations
- ◆ Stability & Experience of Administration, Board



## Credit Review Process

### Credit Strategy

#### **Historical Ratings**

**Which rating agencies**

**Underlying Ratings**

**Will you seek credit enhancement**

**Credit Profile/Story**

### Credit Presentation

**The Road Show or Tour  
(Show/See & Tell)**

**Credit Strengths**

**The Presentation Team**

**The Presentation Book**

### Credit Result

**Negotiating for the best possible rating**

**The legal structure –where are you flexible and where can you give**

**Getting your rating**

**Do you like it and want to use it**

**What lessons have you learned**



# Description of Bond Ratings

Moody's	Standard & Poor's	Description
<b><u>High Grade</u></b>		
Aaa	AAA	The highest rating assigned to a debt instrument, indicating an extremely strong capacity to pay principal and interest. Bonds in this category are often referred to as "gilt-edge" securities.
Aa1	AA+	High-quality bonds by all standards with strong capacity to pay principal and interest and are judged to be of high quality by all standards. These bonds are rated lower primarily because the margins of protection are less strong than those for Aaa and AAA.
Aa2	AA	
Aa3	AA-	
<b><u>Medium Investment Grade</u></b>		
A1	A+	These bonds possess many favorable investment attributes, but elements that suggest a susceptibility to impairment given adverse economic changes may be present.
A2	A	
A3	A-	
Baa1	BBB+	Bonds are regarded as having adequate capacity to pay principal and interest, but certain protective elements may be lacking in the event of adverse economic conditions that could lead to a weakened capacity for payment.
Baa2	BBB	
Baa3	BBB-	
<b><u>Speculative</u></b>		
Ba1	BB+	Bonds regarded as having only moderate protection of principal and interest payments during both good and bad times.
Ba2	BB	
Ba3	BB-	
B1	B+	Bonds that generally lack characteristics of other desirable investments and have greater vulnerability to default. Assurance of interest and principal payments over any long period of time may be small.
B2	B	
B3	B-	







## Rating Agency Presentations

- ⚡ Be proactive
  - Get an off-cycle ratings update with Moody's, S&P
  
- ⚡ A better rating saves taxpayers dollars down the road
  
- ⚡ Your Board and Superintendent will be happy
  
- ⚡ Present “The Good, The Bad, & The Ugly”
  - Get the negatives out of the way first
  - Then present the good news and plans for the future
  
- ⚡ Work with your Financial Advisor, but the CBO or the Superintendent needs to take the lead



## Fremont High: The Bad & Ugly

*Get it out of the way first*

-  2.1% General Fund reserve previous year
-  Staff endured a 4.9% salary roll-back
-  Superintendent recently terminated
-  Modernization out of cash;  
promised projects remain;  
community not happy



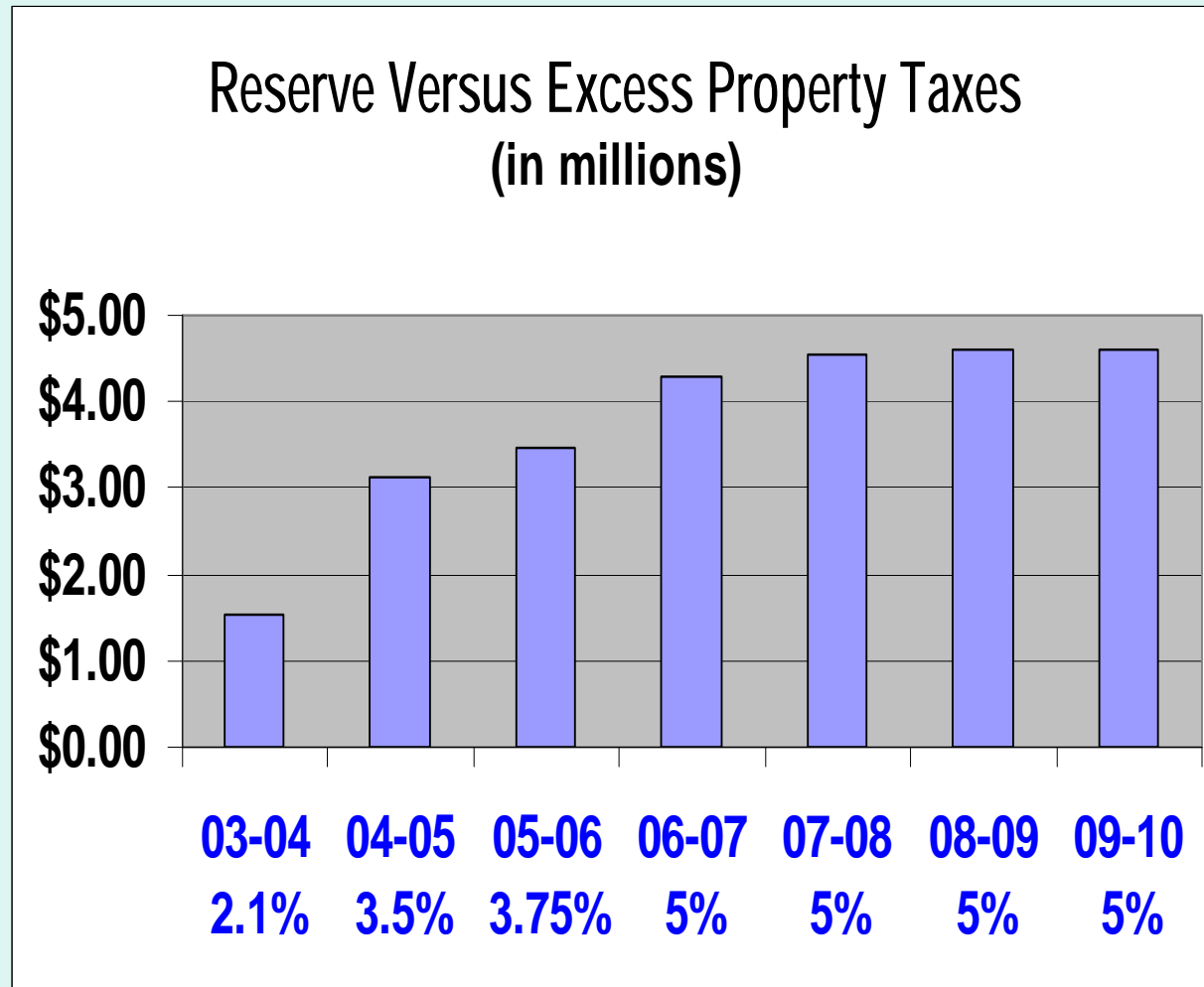
## Fremont High: The Good Making Our Own Good News

- ⚡ Saving millions of dollars every year:
  - ⚡ Tightening up on student loading in sections
  - ⚡ Residency verification process
  - ⚡ Revamping Revenue Sharing Process with unions to share organizational cost increases “off-the-top”
  
- ⚡ Eliminating dependency upon lease revenue \$
  
- ⚡ Salary increases between 11% and 12.35%
  
- ⚡ 3.75% Reserve with a plan to go to 5%
  
- ⚡ Plan to establish Board Reserve Policy
  
- ⚡ Adopted GASB 45 OPEB requirements 3 years ahead of schedule and funded an irrevocable trust





## Fremont High: Promises Kept → Superior Bond Rating



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### Session I

### Competitive vs. Negotiated

*Prepared By Ruth Alabydoian, December 12, 2007*



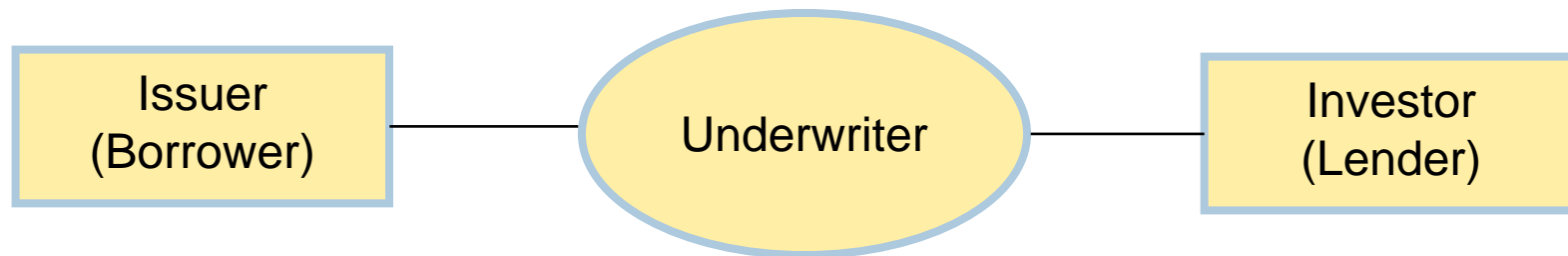
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# Key Players in A Bond Sale

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- Underwriter intermediates between borrower and lender
  - Buys bonds at wholesale price from issuer
  - Resells to investor at profit
  - In negotiated sale, also serves as investment banker in assisting to structure transactions



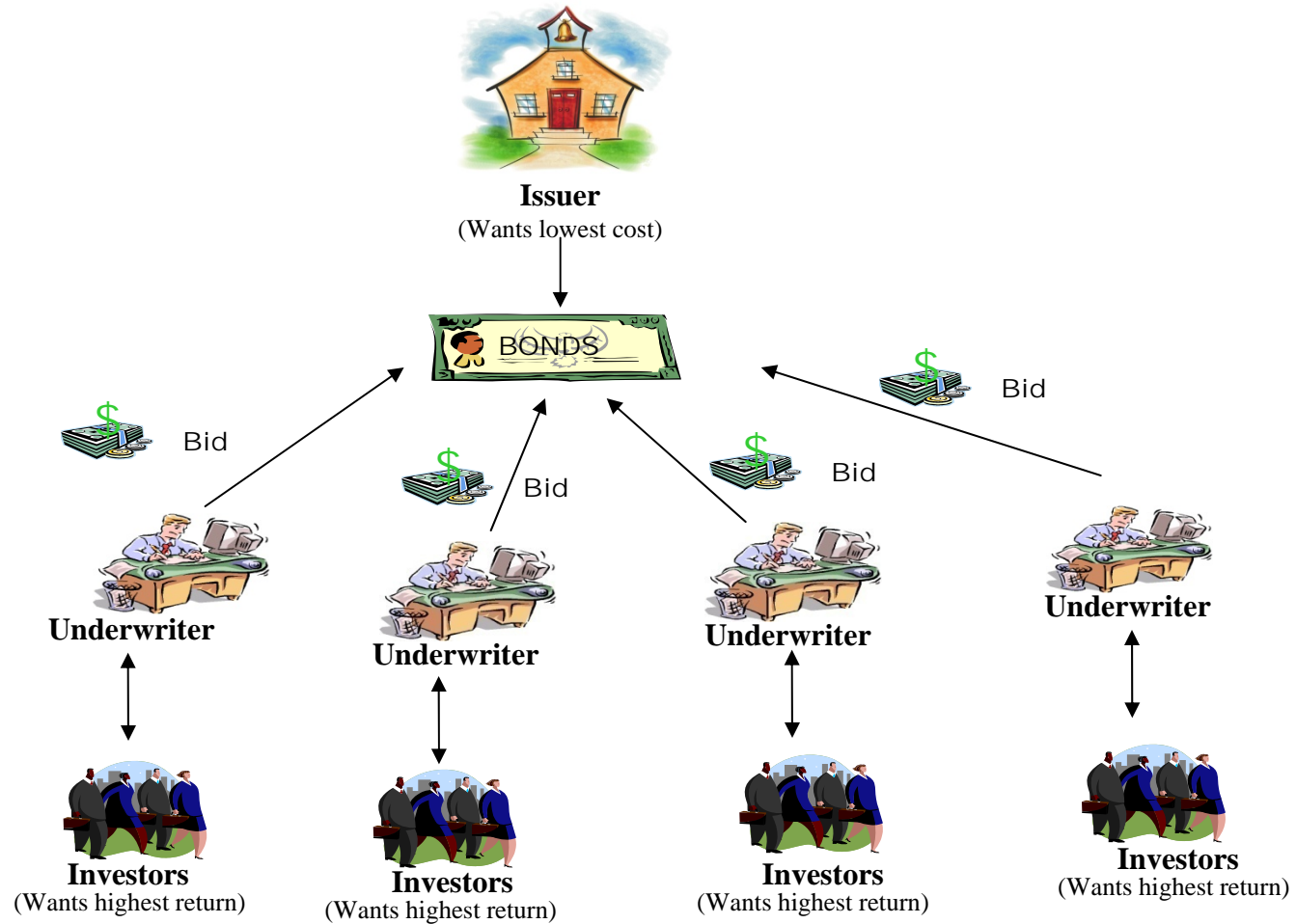
# Competitive Sale

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- Deal is structured by financial advisor
- Request for bids advertised
- Bids accepted at a specific date and time
  - Most commonly via electronic platform
- Bonds sold to bidder with lowest “true interest cost”
- Best when:
  - Market is familiar with issuer
  - Active secondary market, broad investor base
  - Unenhanced credit rating of “A” or above
  - Issue is neither too large nor too small
  - Not complex, easily understood revenue stream



# Bond Sale - Competitive



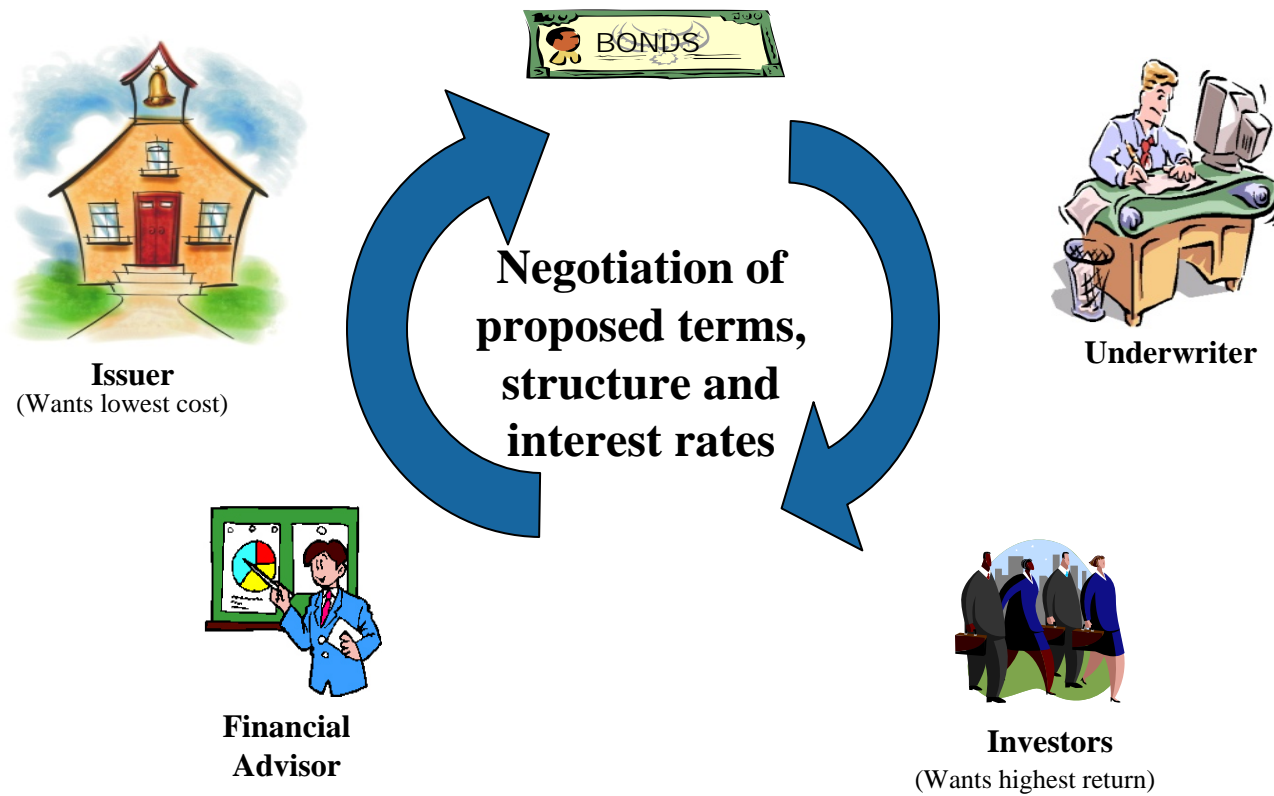
# Negotiated Sale

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- Underwriter selected up-front
- Underwriter participates in structuring
- Interest rate established through collaboration
- Adjusted based on actual investor interest and orders
  - Individual maturities will be repriced based on order flow
- Best when:
  - Underwriter selection process ensures multiple proposals are considered
  - Knowledgeable employee or outside professional (other than underwriter) assist in structuring, pricing, and monitoring sales activities



# Bond Sale - Negotiated



# Advantages of Each Method of Sale

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## Negotiated Sale

- Best suited for “story bonds” and very large transactions
- Allows underwriter to pre-market bonds
- Transaction can be re-structured to meet specific investor demand
- More flexibility in timing

## Competitive Sale

- Emphasizes “commodity” nature of bonds
- Satisfies public policy preference for competitive procurement
- Sometimes legally required
- Generally the best way to get the lowest interest rate





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### Session I

#### Debt-Related Issues: Oversight Committees Investment Options

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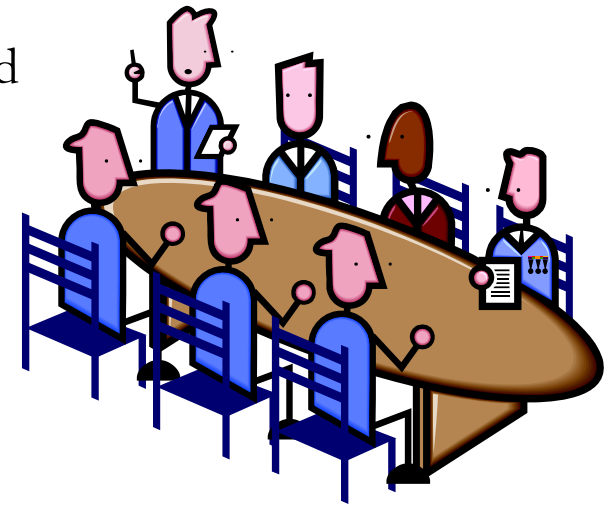
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# Oversight Committees

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- Citizens Oversight Committee required for 55% (Prop. 39) elections
- Committee oversees bond program expenditures and construction progress
- Role is limited – oversight and review only, no decision-making powers
- Make-up of committee specified in law



# Expert Committees

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- Community members often can provide expert advice on construction matters
- Builds community support for District
- Need to balance with demands on staff



# Investing in the Interim

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- While funds are waiting to be spent, consider interest earnings
- Interest earnings stay with the funds that earn it
- Arbitrage considerations



# Investment Options

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- County Pool
  - Default for District Funds
- Direct investment in government security
- Local Agencies Investment Fund (LAIF)
  - Requires Board Approval
- Guaranteed Investment Contract (“GIC”) or Investment Agreement
  - Requires board approval
- Sweep or Other Trustee-Held Account



# Additional Resources

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- **CDIAC** — <http://www.treasurer.ca.gov/cdiac>
  - Debt Primer
  - Debt issuance seminars
  - Debt Line and special publications
  
- **CASBO** — <http://www.casbo.org>
  - Library and Bookstore
  - Conferences and Seminars
  
- **GFOA** — <http://www.gfoa.org>
  - Recommended practices
  - Digital Finance Library
  
- **NFMA** — <http://www.nfma.org>
  - Good links page
  - Best practices in disclosure
  
- **Rating Agencies**
  - Selected articles published on public sites
  - Call your analyst if you want something specific

