CDIAC Debt Essentials Workshop

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

February 12, 2019

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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 to fund certain facilities
- **Bond financing**
  - Bonds generate up-front funds for capital projects
  - Repaid with special taxes or assessments levied annually on property tax bill
  - Issuer promises to foreclose on delinquent parcels
  - In the event of a foreclosure, land value serves as ultimate collateral securing repayment
- **Advantages**
  - New revenue stream created for projects
  - No payment obligation for public agency
- **Disadvantages**
  - Development projects can be risky in early stages
  - Assessment spreads vulnerable to legal challenge

Two Types of Districts

Community Facilities District

Mello-Roos Act

2/3rds approval

Flexible tax spread

⇒ Most frequently used option

Assessment District

1915 Act

50+% support

Proportional allocation of "special benefit"

⇒ Burden of proof on issuer results in potential litigation risk

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
- ***Tax Levy***: 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

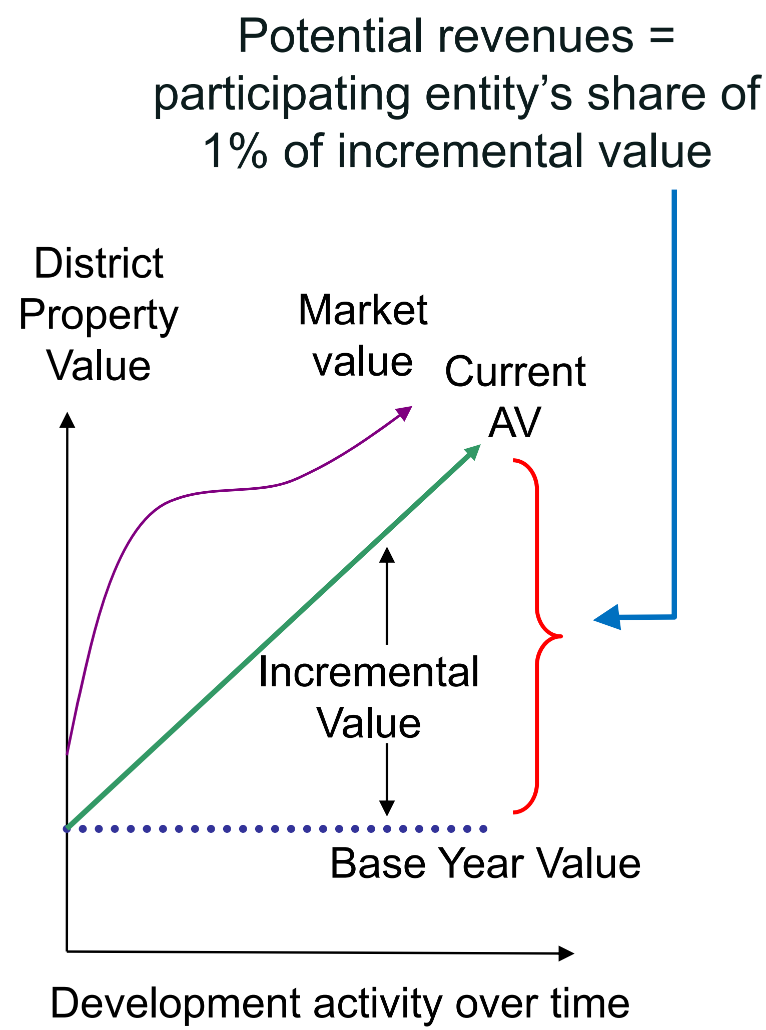
	<u>**Community Facilities District (CFD)**</u>	<u>**Assessment District (AD)**</u>
Statute:	Mello-Roos Act	1915 Act/1913 Act
Security:	Annual special tax on property tax roll	Annual assessment on property tax roll
Vote:	2/3rds vote *	50%+ weighted by assessment
Scope:	Capital projects and maintenance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

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

Infrastructure Financing Districts

Infrastructure Financing Districts (IFDs)

- **Conceptually similar to redevelopment**
  - Capture portion of property value increases within a defined area
  - Statutory authority since 1990; more recent legislation extended revenue collection period
- **Limited revenue stream**
  - Share of 1% property tax revenues for participating entity(ies) who ***opt in***
  - Schools are specifically <u>excluded</u>
  - No revenue until *after* growth occurs
- **Most likely applicability**
  - In combination with other tools, like a CFD
  - By issuers with a large share of 1% property tax rate
  - For projects with regional benefits and multiple participating entities



Two Primary Statutory Options

	Infrastructure and Revitalization Financing District (IRFD)	Enhanced Infrastructure Financing Districts (EIFD)
Governance	Legislative body of sponsor	3 from legislative body, 2 from public
Boundaries	Flexible. Sub-project areas can have distinct limits. May annex territory at any time	Flexible
Formation	• Legislative body adopts Resolution • Infrastructure Finance Plan • Public hearing and election like a CFD	• Legislative body adopts Resolution and establishes Authority • Infrastructure Finance Plan • Public hearing requirement
Election *	• Formation: 2/3rds voter approval • Bonds: 2/3rds voter approval	• Formation: none • Bonds: 55% voter approval
Revenue Collection	• 40 years from the date of adoption or a later specified date • Can set threshold to start clock and create separate thresholds for sub-areas	• 45 years from the date of bond issuance approval
Other		City or county can also allocate its motor vehicle in-lieu revenues corresponding to incremental value

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

Considerations for IFD Bonds

- **Issuer share of 1% property tax rate varies**
  - San Francisco gets **65%**
  - West Sacramento gets **54%**
  - Average city gets about **10%** to **20%**
- **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 debt capacity later on

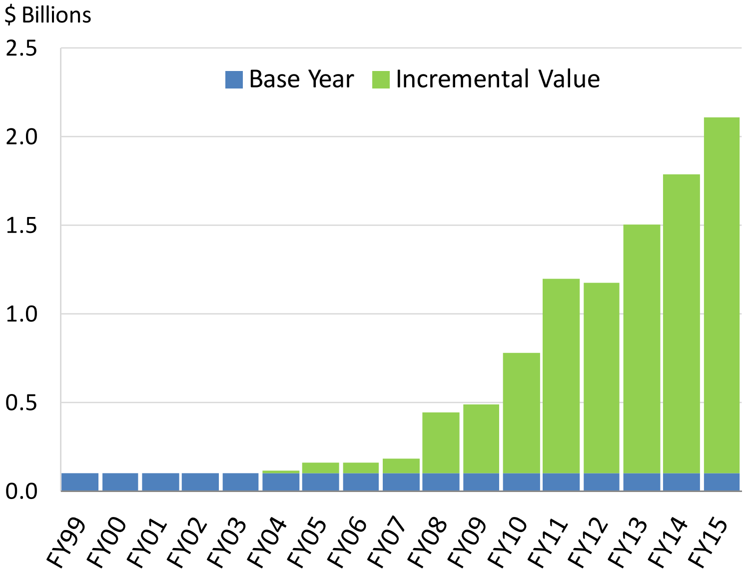
Tax Increment Credits

- 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
  - Used CFD to jump start development
- **CFD Bonds**
  - Financed backbone infrastructure
  - Bond issuance phased over time, constrained by 3-to-1 value-to-lien
  - First issued in ***2001***
- **Tax Allocation Bonds**
  - "Passive" tax increment revenue
  - Based on assessed values (AV) which can lag development by 18+ months
  - Bond issuance constrained by debt service coverage
  - First issued in ***2009***

Mission Bay South Historic Assessed Value



New Money Issuance

2001: $54 million CFD

2002: $39 million CFD

2005: $21 million CFD

2009: $50 million TAB

2011: $36 million TAB

2013: $41 million CFD

2014: $56 million TAB

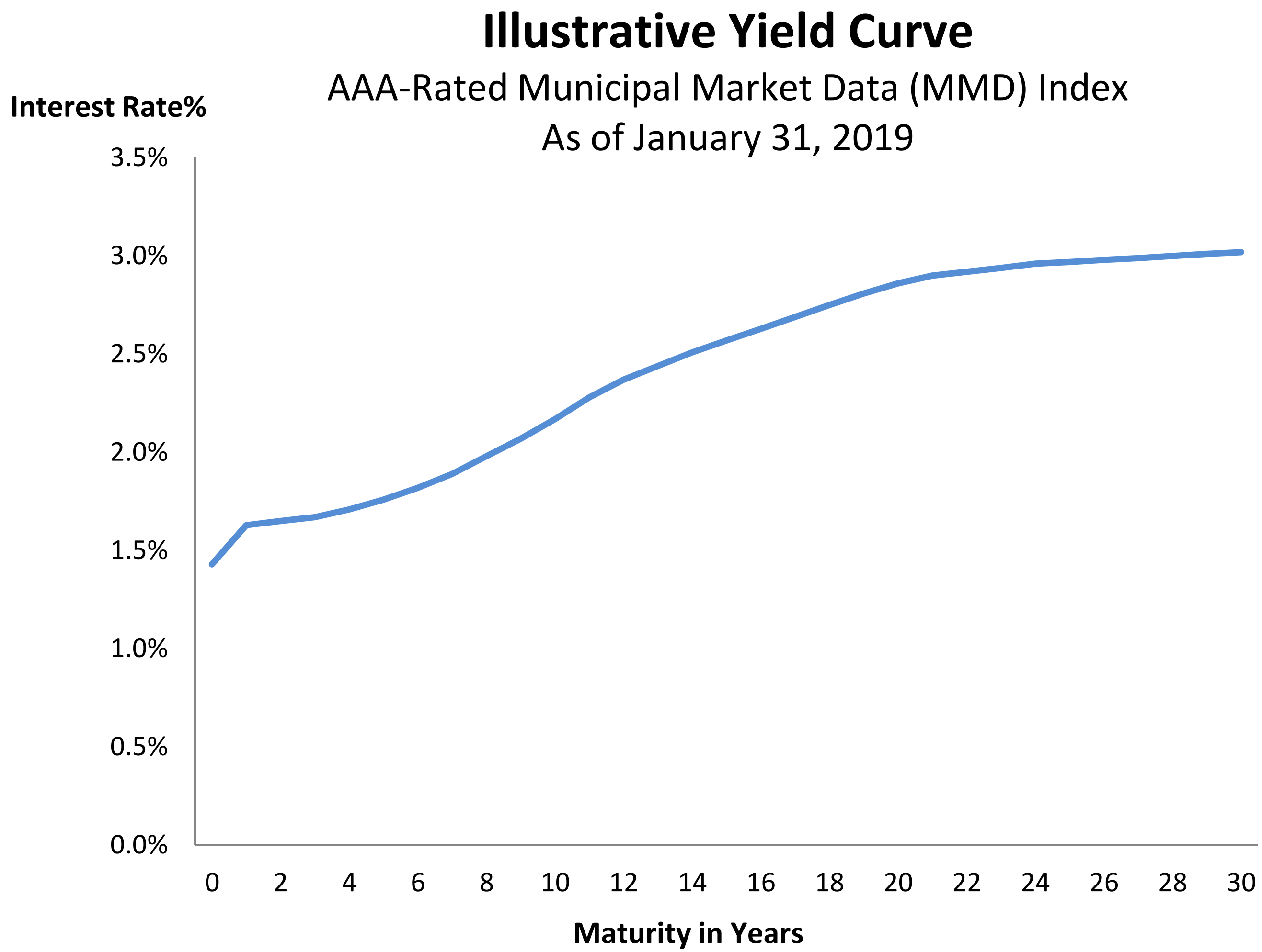
2016: $45 million TAB

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 or grant anticipation notes (BANs or GANs), 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



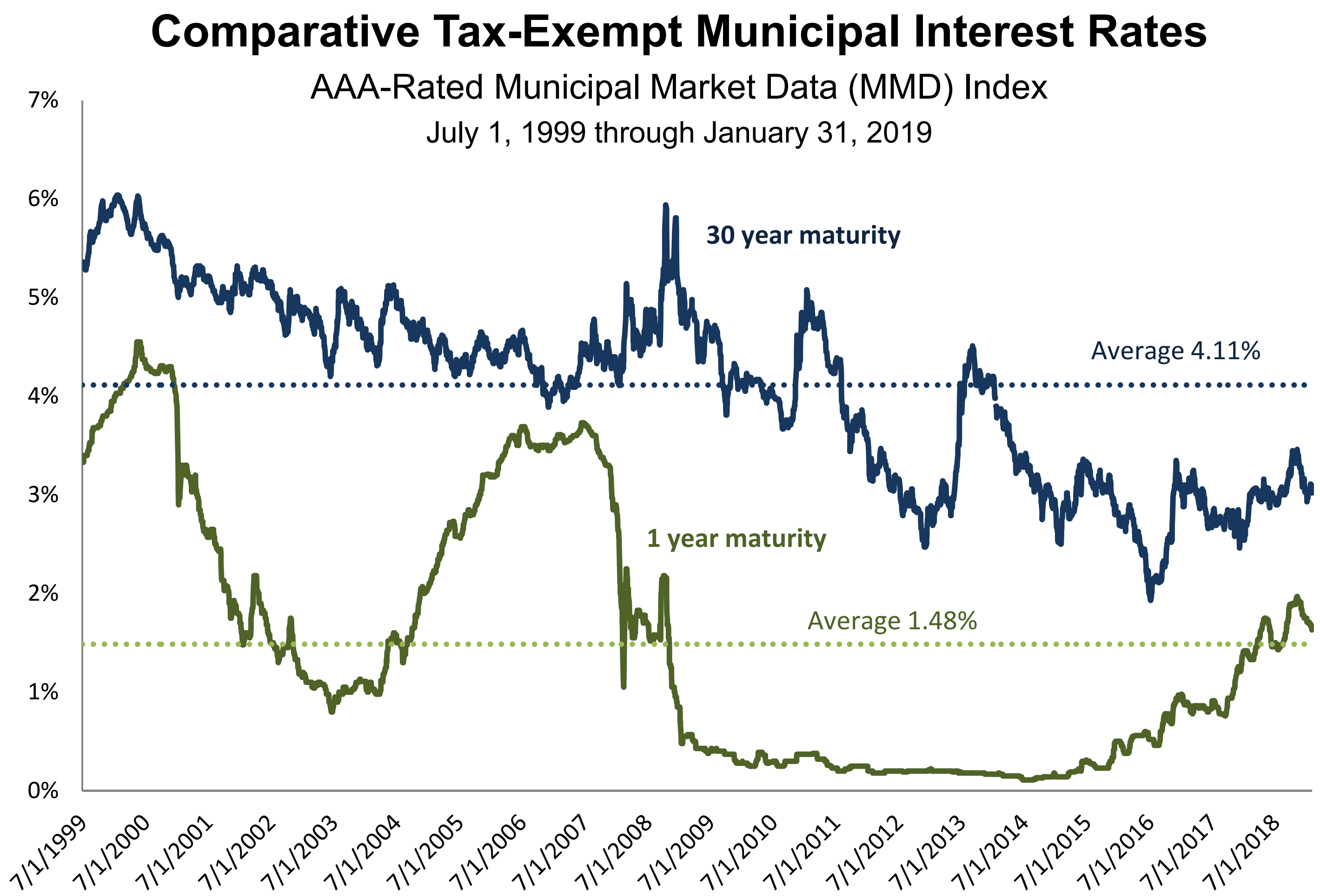
Illustrative Rates by Maturity

1 week:	1.43%
1 year:	1.63%
2 year:	1.65%
5 year:	1.76%
10 year:	2.17%
30 year:	3.02%

Source: Thompson

Short vs. Long Term Interest Rates Over Time

Spread between short and long maturities is fairly narrow in current market



Source: : Thompson

RANs, TRANs and GANs

- **Tax Revenue or Grant Anticipation Notes (TRANs, RANs 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 cash flow
  - Interest rate: fixed at time of note sale
  - Requirements: statutory and tax limits

- ***Example:***
  - City relies heavily on property tax receipts due in December and April while expenses are fairly evenly spread throughout year
  - Without sufficient reserves, 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)

Alternative Variable Structures

Dearth of liquidity after recession 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, LIBOR, SOFR)
  - 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
- **Discontinuation of LIBOR (London Interbank Offered Rate) beyond 2021**
  - May affect some existing indexed notes and swaps
  - Emergence of Secured Overnight Financing Rate (SOFR) as alternative index

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
  - Borrower may be another governmental entity, a non-profit or a private entity
- **Why used?**
  - To qualify for “tax-exemption” for certain types of private activity bonds
    - i.e. affordable housing, health care, industrial development
  - When a third-party entity is needed such as for a lease-leaseback financing
  - For efficiency, such as a pooled financing program
- **Common examples**
  - Multifamily housing, economic development (such as industrial development bonds), educational facilities (such as private schools, student housing), health facilities

Considerations for Conduit Issuers

- **Obligation to pay**
  - Borrower has duty to repay the debt
  - Conduit Issuer's credit is not on the line but may make certain covenants to investors
- **Reputation risk**
  - Conduit 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

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
  - Benefits may include limited documentation, quick completion time and lower costs of issuance
    - May eliminate need for bond ratings, Official Statement, and/or debt service reserve fund
  - Issuer may take on additional risks, such as tax risk
  - Investor 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
    - Lower corporate tax rate has reduced value of tax free income for some lenders

Recent Changes Regarding Disclosure of Placements

- **Private placements historically required only limited disclosure**
  - No ratings, offering document or ongoing continuing disclosure
  - SEC and GASB rules did not require disclosure of all material information
  - Investors were concerned about potential for detrimental private placement terms, covenants and/or remedies affecting their bond security
- **New GASB Statement 88**
  - Requires disclosure of private placements and terms specified in debt agreements related to defaults, termination events, etc., effective June 15, 2018
- **New Amendments to Rule 15c2-12**
  - Applicable to any new continuing disclosure undertaking after Feb. 27, 2019
    - Does not apply to existing undertakings
  - Issuers need to file notice on EMMA, within 10 business days, two new listed events :
    - (1) incurrence of "financial obligations", if material
    - (2) default, termination and similar event under a "financial obligation" reflecting financial difficulties
  - "Financial obligation" does not include bonds with a final OS posted to EMMA

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