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

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**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

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

* 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 **excluded**
  - 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

<table>
<thead>
<tr>
<th>District Property Value</th>
<th>Market Value</th>
<th>Current AV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Potential revenues = participating entity’s share of 1% of incremental value</td>
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</tbody>
</table>

Development activity over time:

- **Base Year Value**
- **Incremental Value**
- **Current AV**
### Two Primary Statutory Options

<table>
<thead>
<tr>
<th>Governance</th>
<th>Infrastructure and Revitalization Financing District (IRFD)</th>
<th>Enhanced Infrastructure Financing Districts (EIFD)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Legislative body of sponsor</td>
<td>3 from legislative body, 2 from public</td>
</tr>
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</table>

<table>
<thead>
<tr>
<th>Boundaries</th>
<th>Flexible. Sub-project areas can have distinct limits. May annex territory at any time</th>
<th>Flexible</th>
</tr>
</thead>
</table>

| 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 |
|--------------------|-------------------------------------------------------------------------------------------------------------------------------------|----------|

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<tr>
<th>Other</th>
<th>City or county can also allocate its motor vehicle in-lieu revenues corresponding to incremental value</th>
</tr>
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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
    o Geographic, land use, top taxpayers
  – Volatility of revenues
    o Depends on velocity of growth
    o 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

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<thead>
<tr>
<th>Year</th>
<th>Base Year</th>
<th>Incremental Value</th>
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<tr>
<td>FY09</td>
<td>0.0</td>
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<td>FY10</td>
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<tr>
<td>FY11</td>
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<td>FY12</td>
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<td>FY13</td>
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<td>FY14</td>
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<td>0.0</td>
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<td>FY15</td>
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<td>0.0</td>
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<td>2001</td>
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<td>2015</td>
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<tr>
<td>2016</td>
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**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 Yield Curve
AAA-Rated Municipal Market Data (MMD) Index
As of January 31, 2019

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
Spread between short and long maturities is fairly narrow in current market.
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
    o 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
    o Term may be limited to 10 years or shorter, but some lenders willing to go longer
    o Less aggressive interest in transactions paid from general fund appropriation
    o 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
    o Does not apply to existing undertakings
  – Issuers need to file notice on EMMA, within 10 business days, two new listed events:
    o (1) incurrence of “financial obligations”, if material
    o (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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