New Frontiers in Public Finance:
A Return to Direct Lending

CALIFORNIA DEBT AND INVESTMENT ADVISORY COMMISSION

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A RETURN TO DIRECT LENDING

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Overview

- What is a direct purchase/private placement financing?
- Why the resurgence over the last few years?
- Considerations for the borrower when evaluating a direct purchase
- Direct Purchase vs Public Offering
- Participating Banks

- Legal Structure
- Disclosure
- Common legal considerations

- Future of direct purchases?
- Questions
What is direct purchase/private placement financing?

- **Definition**
  - Tax-exempt financing (fixed or variable) that is privately-placed or directly purchased by an investor or bank
  - Also known as Direct Purchase, Direct Placement, Private Placement, Funded Loan, or Direct loan

- **Tax Treatment**
  - Common form of tax-exempt financing prior to the Tax Reform Act of 1986
  - Bank Qualified
  - Non-Bank Qualified
  - Taxable

- **Types of Credits**
  - General Obligation Bonds
  - Appropriation Bonds
  - Revenue Bonds
  - Lease Revenue Bonds
  - Private Activity Bonds
What is direct purchase/private placement financing?

(Cont’d)

- **Use of Proceeds**
  - Equipment purchases
  - Real estate or project development

- **General Characteristics**
  - Principally purchased by one investor or bank
  - With or without a placement agent
  - Executed as a loan or as a security
  - Exempt from SEC 15c2-12, but may not be exempt from underwriter obligations under MSRB rules
  - Highly adaptable structures with the ability to customize to existing industry standards and bond documentation
  - Pricing can be either fixed rate or variable rate (spread over an index) for a defined commitment period
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Why the resurgence over the last few years?

Market Factors

- For 2009 and 2010, the American Reinvestment and Recovery Act’s ("ARRA") "de minimis provision" suspended the cost of carry disallowance for banks, thereby increasing the value of certain tax-exempt holdings.

- Downgrades to insurers and liquidity/credit/swap providers (domestic & foreign banks) forced market participants to seek alternative structures.

- High volume of expiring credit/liquidity facilities.

- Favorable taxable/tax-exempt ratios (relationship between Libor and SIFMA).
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Why the resurgence over the last few years? (cont’d)

Issuer Factors

- Restructuring/conversion of existing variable rate transactions
- Elimination of bank downgrade risk
- Elimination of “put risk” due to credit or market events
- Elimination of trading risk volatility
- Opportunity to avoid basis risk (alignment of indices between financing and swap)
- Ease of execution (reduced costs and limited public disclosure requirement)
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Why the resurgence over the last few years? (cont’d)

Bank Factors

- Lower-rated banks are able to participate as a lender / investor
- Basel III regulatory changes have encouraged Banks to pursue funded loans vs. contingent liabilities
- Reduced opportunities for traditional lending
- Banks are able to recognize tax-exempt income vs taxable income
- Positive correlation between bank profits and municipal holdings
- Commercial banks have become the third largest holder of municipal securities behind only households and mutual funds and ahead of money market funds. Commercial banks hold $327.4 billion in municipal securities as of June 30, 2012.¹

¹ Source: Bond Buyer and Federal Reserve Flow of Funds, Includes Direct Purchases structured as securities only
Considerations for the borrower when evaluating a direct purchase

- Compare economic terms
  - can be fixed rate or variable
  - can be new money, refunding, or a variable rate conversion
  - how do costs and interest rates compare?

- Compare legal covenants
  - make primary covenants non-negotiable
  - request specific terms (prepayment options, no debt service reserve)
  - conform to existing covenants in parity issues

- Compare financial structure
  - maturities beyond 10-12 years not always available

- Seek several proposals
  - bank preferences and appetites vary
  - request alternative quotes for callable, non-callable

- Arrive at an informed choice on performance and any potential risk
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Direct Purchase vs Public Offering – fixed rate

- Fixed rate financings
  - competitive pricing available from several purchasers (subject to credit and tenor)
  - seek similar terms to refunded or parity issues
    • optional redemption may be more flexible
    • seek amortization based on issuer objectives
  - direct purchases often do not require a debt service reserve fund
  - credit ratings typically unnecessary when entering into a direct purchase
  - direct purchases have a lower costs of issuance
    • no underwriter’s discount
    • no rating fees
Direct Purchase vs Public Offering – variable rate

- Variable rate financings
  - publicly offered
    - variable rate demand obligations (“VRDOs”)
      - typically remarketed daily or weekly; paid monthly
      - remarketing rates (interest) on VRDOs are based on the credit strength of the underlying letter of credit bank
    - floating rate notes (“FRNs”)
      - reset weekly; paid monthly
      - interest is based on a published index
        - SIFMA (+ a spread)
        - % of 1M LIBOR (+ a spread)
  - private placement
    - direct purchase
      - reset weekly; paid monthly
      - interest is based on a published index
        - SIFMA (+ a spread)
        - % of 1M LIBOR (+ a spread)
Direct Purchase vs Public Offering – variable rate (cont’d)

- Direct purchase/FRNs vs VRDOs
  - competitive pricing
  - similar terms
    - long-term variable rate financings
    - amortization
    - lends to hedging alternatives
  - renewal risk
    - will the institution (lender) renew the direct purchase or letter of credit?
- direct purchases and FRNs eliminate LOC bank counterparty risk
  - Allied Irish Bank
  - Bank of America
## A Return to Direct Lending

### Direct Purchase vs Public Offering – variable rate (cont’d)

<table>
<thead>
<tr>
<th></th>
<th>LOC Backed VRDBs</th>
<th>Direct Purchase</th>
<th>LIBOR/ SIFMA Index Bonds (FRNs)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Commitment Period:</strong></td>
<td>1 to 3 years</td>
<td>1 to 7 years</td>
<td>1 to 7 years</td>
</tr>
<tr>
<td><strong>Failed Remarketing:</strong></td>
<td>Put to bank; Subject to bank rate/ acceleration</td>
<td>Soft put: Generally subject to penalty rate/ acceleration</td>
<td>Hard put/ Maturity: Default Soft put: Penalty rate None</td>
</tr>
<tr>
<td><strong>Bank Exposure:</strong></td>
<td>Ongoing exposure</td>
<td>Limited exposure</td>
<td>No cost impact in event of downgrade</td>
</tr>
<tr>
<td><strong>Issuer’s Credit:</strong></td>
<td>Cost increases in event of downgrade</td>
<td>Cost increases in event of downgrade</td>
<td>Resets weekly, paid monthly</td>
</tr>
<tr>
<td><strong>Interest:</strong></td>
<td>Resets weekly, paid monthly</td>
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<td>resets weekly, paid monthly</td>
</tr>
<tr>
<td><strong>Primary Investors:</strong></td>
<td>Money market funds</td>
<td>Held by bank</td>
<td>&lt; 13 months: Money market funds</td>
</tr>
<tr>
<td><strong>Call Option:</strong></td>
<td>At any time; potentially subject to breakage fees</td>
<td>Any time; potentially subject to breakage fees</td>
<td>&gt; 13 months: Intermediate funds Generally 3 to 6 months prior to maturity</td>
</tr>
<tr>
<td><strong>Considerations:</strong></td>
<td>- Long-term variable rate financing alternative</td>
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<tr>
<td></td>
<td>- Quick execution. Easiest option to implement</td>
<td>- Bank liquidity facility not required</td>
<td>- Diversifies investor base</td>
</tr>
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<td>- Eliminates bank counterparty risk (credit and remarketing) and costs</td>
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</table>
# A Return to Direct Lending

## Variable Rate Direct Purchase vs FRNs

<table>
<thead>
<tr>
<th>Structure:</th>
<th>Floating Rate Notes</th>
<th>Direct Purchase</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Market</strong></td>
<td>Public</td>
<td>Private</td>
</tr>
<tr>
<td><strong>Investor Base</strong></td>
<td>Money market funds, short bond funds, SMAs, insurance companies</td>
<td>Commercial and investment banks</td>
</tr>
<tr>
<td><strong>Index</strong></td>
<td>Predominantly SIFMA, but also % of LIBOR</td>
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</tr>
<tr>
<td><strong>Term</strong></td>
<td>Up to 7 years</td>
<td>1-7 year initial maturity</td>
</tr>
<tr>
<td><strong>Maturity/Put</strong></td>
<td>Maturity and hard put less costly</td>
<td>Maturity with soft put</td>
</tr>
<tr>
<td><strong>Credit enhancement and Remarketing</strong></td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td><strong>Trading Risk Volatility</strong></td>
<td>None</td>
<td>None</td>
</tr>
<tr>
<td><strong>Matching Versus Swap Terms</strong></td>
<td>Some ability to match terms to swap receipts</td>
<td>Greater ability to structure terms to match swap receipts</td>
</tr>
</tbody>
</table>
Participating Banks

- Banks active in California include:
  - Bank of America
  - Bank of the West
  - BBVA Compass Bank
  - Citibank
  - Comerica Bank
  - First Republic Bank
  - J.P. Morgan Chase
  - Northern Trust
  - RBC
  - Union Bank
  - US Bank
  - Wells Fargo
  - Zions First National Bank
Legal Structure

- Common Types of Direct Lending Financings
  - general fund lease revenue financings
  - general obligation
  - water/sewer/electric revenue
  - land secured
  - 501(c)(3)

- Need Legal Authority for the Transaction
  - same constitutional and statutory debt limit restrictions apply
Legal Structure (cont’d)

- Typically Direct Purchases use the same form of legal documentation as public offering
- Same sources of security and pledge or lien on revenues or assets as in public offering
- Typically same or similar covenants as in public offering
- Sometimes these covenants will be set forth in a Continuing Covenants Agreement
Legal Structure (cont’d)

- Bonds are either sold directly to the Purchaser or the Purchaser is a party to the Lease, Installment Purchase Agreement, or Loan Agreement and directly receives Lease Payments, Installment Payments, or Loan Payments.

- Depending on structure sometimes no Trustee and payments made directly to Purchaser.

- Swaps – Sometimes Banks want to spread revenues to different arms of the bank and will propose a floating rate based on an index and a spread and a swap where the Issuer makes a fixed rate payment and receives back a floating rate and spread identical to what they pay on the underlying security.

- Typically same closing documents, certifications and opinions as public sale.
Disclosure

- Usually structured to avoid Rule 15c2-12 requirements
  - no official statement required
  - no requirement to provide/file continuing disclosure with EMMA, however, continuing disclosure is often required to be provided directly to the Purchaser

- Still subject to the Anti-Fraud provisions of Section 17 of the Securities Act of 1933 which make it unlawful to obtain money in interstate commerce by means of an untrue statement of a material fact in the offer or sale of securities, or by omission of material facts
  - direct purchaser’s might require 10b5 types of representation as to information provided to them
  - direct purchasers do conduct due diligence and will require budgets, audits, operating data, projections, etc.

- Investor Letter (“Big Boy Letter”)
  - representation that purchaser is an “accredited investor” or a “qualified institutional buyer”
  - purchaser is purchasing for its own account and not with a view to resell
  - purchaser has done its own due diligence
  - sometimes transfer restrictions or “traveling” letter
Common legal considerations

- Authority to do direct lending
- Covenant Negotiation
  - abatement risk/substitution of asset provisions in lease transactions
  - set off
  - cross default
  - liquidity tests
- Assignment/Transfer
- Default Rates/Terms Outs
- Consent Rights
Future of direct purchases?

Market Factors
- Regulatory uncertainty (MSRB & SEC evolving views on disclosure)
- Legislative uncertainty (status of tax exemption and tax policy)
- Interest rate environment and corresponding taxable/tax-exempt ratios
- Emergence of alternative structures or re-emergence of traditional structures

Issuer Considerations
- Competitive pricing vs market alternatives
- Cost of issuance
- Disclosure requirements
- Renewal / restructuring risk at end of term
- Debt Policy guidelines
Bank Considerations

- Basel III uncertainty (2015 implementation date)
- Recovery of bank ratings
- Assessment of tax risk by banks (micro/macro level)
- Uncertainty of Renewal Cycle
- Corporate earnings (i.e., return of traditional or new lending opportunities) will have some impact on banks appetite and capacity for direct purchases
Questions