



DEBT ISSUANCE AND ADMINISTRATION SERIES FOR ELECTED OFFICIALS' TRANSCRIPT

Marketing and Structuring Strategies for a Win-Win Debt Issuance | Part 1.0

Module 6 provides an overview of the market for municipal debt and discusses the alignment of debt marketing and structuring strategies with market preferences to achieve desired financing objectives. Other topics include the effects of agency governance practices on marketability and investor preferences.

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Narrator: Comprehensive strategic, capital improvement, and financial planning will yield well-formed objectives for your agency's use of debt financing. Your decisions regarding authority, amounts, timing, repayment, and structure influence the achievement of these objectives, but the goals and objectives of the investors buying your agency's debt also have a strong influence. When the goals of investors and issuers are not well-aligned, an issuer is faced with either compromising its objectives or accepting a higher borrowing cost. This module will discuss important marketing and structuring strategies that issuers can use to meet their financing objectives and how issuers may either be penalized or rewarded with higher or lower borrowing costs by the market.

Generally, when debt is structured more simply, borrowing costs are lower, but meeting your objectives through debt is not simple and involves thorough consideration of the risks and rewards, costs and benefits, of this significant long-term commitment by your agency.

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Narrator: The US municipal securities market is about \$4 trillion in size. In comparison, the corporate bond market is about 2.5 times larger. There are about one million different municipal securities, while the corporate bond market has less than 50,000. In spite of the number of securities, daily trade volume of municipal bonds is one-third that of corporate bonds. On average, a municipal bond will trade less than once per month. Perhaps the most interesting contrast is the default rate on municipal bonds is less than 5% of the default rate of corporate bonds.

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Narrator: Understanding investors is key to understanding the municipal market. About 40% of the municipal securities market is held by individuals, called "retail investors." About 28% are held by managed funds that buy securities on behalf of others, largely retail investors. Banks and insurance companies own about 27%. Managed funds and these large financial institutions are commonly called "institutional investors."



Institutional and retail investors have different preferences and objectives that must be considered when structuring and marketing your agency's debt. Retail investors are attracted to municipal securities because of the tax exemption, date certainty of interest and principal payments, and very low default rates. Retail investors do not actively trade their bonds—they are called "buy-and-hold" investors. The buy-and-hold strategy generally causes the whole market to be less "liquid"—at any point in time there are not as many buyers and sellers and few opportunities to convert a bond to cash.

Institutional and retail investors share many investment preferences, but there are notable differences. Institutional investors buy and sell bonds more frequently and the dollar amounts of their transactions are much larger. As a result, institutional investors tend to prefer structures that enhance the bond's liquidity.



DEBT ISSUANCE AND ADMINISTRATION SERIES FOR ELECTED OFFICIALS' TRANSCRIPT

Marketing and Structuring Strategies for a Win-Win Debt Issuance | Part 1.1

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Narrator: Investor preferences are driven by their assessment of the reward against the variety of risks. As the issuer of the debt, carefully consider how the range of investors will view and value the risk profile, either real or perceived, of your debt structure.

Generally, the greater the risks, the higher the interest cost to your agency. The best indication of how investors are feeling about risk in the bond market is the yield curve. The yield curve is a graphical representation of the current interest rates investors are willing to accept for bonds of the same credit quality that mature over a range of future dates.

When an investor buys a bond, they are assuming a variety of risks. The longer the maturity, the greater the chance the risks materialize and erode the value of their investment. Investors want to be compensated for this future uncertainty, so generally, the longer the maturity of the debt, the higher the yield the investor will demand. This is why the yield curve normally slopes upward. However, the yield curve is dynamic and the current and forecasted shape will have a significant influence on how your debt, given the credit quality and structural features, will price in the market.



DEBT ISSUANCE AND ADMINISTRATION SERIES FOR ELECTED OFFICIALS' TRANSCRIPT

Marketing and Structuring Strategies for a Win-Win Debt Issuance | Part 1.2

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Narrator: While the yield curve is a predictor of general financing costs, achieving your lowest cost will depend on striking a balance between your agency's financing objectives and the investment objectives of the targeted investors. Achieving this balance will be significantly influenced by your choice of sales method. Each method presents advantages and disadvantages.

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Narrator: In a competitive sale, underwriters bid on the bonds, as structured, on a prescribed date. The underwriter that offers the price with the lowest interest cost is awarded the bonds. A competitive sale method communicates the agency's values of transparency and fairness, but the main objective is to use competition to push the interest cost as low as possible.

Competitive sales are most effective in generating lower costs when agencies are recognizable, issue regularly, and have a steady financial condition. Their debt issues are generally larger with more conventional structures, strong repayment security, and high credit ratings. The fixed timing of the bids limits the issuer's ability to alter course if market conditions change so the best interest cost outcomes are achieved in stable interest rate environments.

A disadvantage with the competitive method is that policy objectives may be compromised because the "arms-length" nature of the bidding process limits issuers' influence over the marketing and distribution of bonds to investors. An agency's participation goals aimed at using veteran-owned underwriting firms, for instance, or selling to specific retail investors, would not be attainable.

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Narrator: Under the negotiated method, the underwriter is selected in advance of the offering of the bonds and is very involved with the financing team to structure the issue to meet the market demand. They bring to bear their knowledge of specific investor preferences for particular structures amid current market conditions and are also able to assess demand through pre-sale marketing. Assessing demand and tailoring the bonds to meet it can



lower the cost of the financing, but ultimately the terms of the purchase are subject to negotiation between the issuer and the underwriter.

The municipal bond market's general lack of liquidity and related price ambiguity negatively impacts demand, especially among retail investors, the largest segment of the market. The negotiated method allows issuers to stimulate awareness and demand from retail investors by establishing a retail order period. During this period, lasting a day or two, only retail investors may order bonds under criteria established by the issuer which can include limiting order size or prioritizing investors living within the agency's jurisdiction.

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Narrator: Privately placed debt is sold to a small group of accredited investors or directly to a bank. Selling directly to an investor group or bank who is responsible for their own due diligence can simplify the borrowing process and reduce official disclosure responsibilities. The private placement method can also allow for customized structures not normally available in the public market. While the private placement method can offer process efficiencies borne of more direct investor access, private placements frequently require shorter terms, more restrictive covenants, and higher interest costs versus debt issued in the mainstream municipal market. However, for small or complex financings that challenge the public market's conventions or risk tolerance, a private placement may be the only reasonable method to secure needed debt.



DEBT ISSUANCE AND ADMINISTRATION SERIES FOR ELECTED OFFICIALS' TRANSCRIPT

Marketing and Structuring Strategies for a Win-Win Debt Issuance | Part 1.3

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Narrator: Many agencies are pursuing projects that focus on a form of environmental stewardship, climate resilience, or positive social impact; and there is increased interest from a broad range of investors in bonds that can be directly linked to these projects. This has given rise to “labeled debt,” a marketing strategy in which issuers segregate the debt used to finance or refinance socially responsible projects and label the issuance with the category of impact. Three of the most frequently used labels in the market are “Green,” “Social Impact,” and “Sustainability.”

The most successful marketing of labeled debt devotes ample attention to identification and measurement of the project’s intended impact. Labeled debt also requires a commitment to provide post-issuance impact reporting to the market. Issuers that can deliver positive, quantifiable impact consistent with the label generate the greatest increase in investor demand from this marketing strategy.

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Narrator: The cost of financing is a strong indication of how well your agency’s financing objectives are balanced with the objectives of investors. It is customary to include the interest paid to investors and the agency’s transaction costs in the cost of financing. However, there are different calculation methods that produce different results.

The “true interest cost,” or TIC, is the cost of the financing expressed as an interest rate that equates the timing and amount of all future principal and interest payments to the amount the agency receives from the sale. TIC is an insightful measurement of cost because it accounts for the time value of money, the concept that a dollar today is worth more than a dollar in the future. The TIC rate also includes the underwriter’s spread: the compensation paid to the underwriter. It is important to note that in a competitive sale the underwriter’s bids are expressed in terms of true interest cost.



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Narrator: A municipal issuance typically includes a host of different costs of issuance in addition to the underwriter's spread, including the expenses of the remaining financing team members, credit enhancement, and credit rating.

The "all-inclusive cost," or AIC, is calculated the same way as the TIC except that it includes all of the costs associated with the issuance. For this reason, the AIC provides a more complete and accurate measure of the total cost of the financing to the agency.

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Narrator: The marketing strategy is key to the pursuit of your agency's financing objectives but, to be effective, it must be paired with a debt issuance that is structured to meet the demands of your targeted investors. The next section will discuss some common debt structures used to meet strategic objectives, investor preferences for the structures, and the potential effect on an agency's financing cost.



DEBT ISSUANCE AND ADMINISTRATION SERIES FOR ELECTED OFFICIALS' TRANSCRIPT

Marketing and Structuring Strategies for a Win-Win Debt Issuance | Part 1.4

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Narrator: The price that your agency receives for its bonds, and thus the interest cost of your financing, is directly related to the market's assessment of the risks associated with the purchase of your debt. Chief among the variety of risks evaluated by investors is "default risk": the probability that your agency will willingly pay principal and interest to investors on time, as scheduled, for the entire term of the debt.

The primary predictor of default risk is the reliability of the revenues that the agency will use to repay the debt. Debt that is repaid with revenues that are derived from the agency's authority to tax is assigned relatively lower default risk. Debt that is structured to be repaid with revenues dependent on market forces is viewed as having higher default risk. A review of the spectrum of credit risk shows general obligation bonds on the lowest risk end and ranges up to Mello-Roos financing with its repayment sources dependent largely on the housing market.

As an elected official it is important that you understand where your proposed debt fits on the spectrum. You may have structural options that are lower on the spectrum of credit risk and present benefits to your agency, including the opportunity to lower your cost of financing.

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Narrator: Understanding where your project will fit on the spectrum of credit risk and how to optimally structure your debt service requires a comprehensive review, analysis, and forecast of the projected revenue stream during the term of the debt. Careful revenue analysis, including worst case scenarios, will allow you to prepare contingency strategies to mitigate heightened default risk.

While the reliability of revenues and default risk is a primary consideration of investors, your financing team will consider a variety of other structuring decisions that seek to match your financing strategy with the preferences of the market.



DEBT ISSUANCE AND ADMINISTRATION SERIES FOR ELECTED OFFICIALS' TRANSCRIPT

Marketing and Structuring Strategies for a Win-Win Debt Issuance | Part 2.1

Module 6 Provides an overview of the market for municipal debt and discusses the alignment of debt marketing and structuring strategies with market preferences to achieve desired financing objectives. Other topics include the effects of agency governance practices on marketability and investor preferences.

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Narrator: Borrowing money only when it is needed is optimal—it lowers your agency's interest costs—but the municipal debt market is not an ATM from which you can draw out money only when needed. Your agency must select the timing and amount of debt to issue. The size of the issue is tied to the timing and amount of the revenue stream, but it is also dependent on the timing and amounts of the project's expenditures.

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Narrator: Agencies may have a project and revenue schedule that optimally align with several smaller issues of debt over months or years in a series. Other schedules align better with fewer issues or perhaps even a single issuance. Small issues do not draw as much attention from investors, particularly institutions seeking to place larger amounts of capital. Underwriters may need to increase their marketing efforts which may increase issuance costs. Also, the many other issuance costs, including internal costs, will be especially high per dollar raised in the financing. In some cases, agencies may elect a private placement or a direct bank borrowing.

Generally, a larger issue will be less costly per dollar to issue and may enjoy increased investor demand, but the amount should be driven by the project expenditure schedule to avoid additional interest costs and complications presented by IRS requirements for timely expenditure of proceeds.

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Narrator: An issuance of debt can be structured with serial or term bonds, or both. Serial bonds generally have short to medium terms and mature in a "series," on consecutive principal payment dates. Term bonds are larger and have longer-term final maturities out to 15, 20, or 30 years. With term bonds, a portion of the principal is repaid prior to maturity. Sinking fund payments are made on consecutive principal payment dates a few years leading up to the bond's maturity date. The individual bonds to be repaid by the sinking fund are selected by lottery and are not predetermined.

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An agency can use serial bonds to issue a portion of their debt at lower, short-term interest rates. Serial bonds also allow an agency to match the bond maturities with the timing of revenues and lower the cost of the financing by repaying a portion of the principal over the entire term of the debt. This is known as "amortization."



Serial amortization looks a bit like your home mortgage: in total more interest than principal is paid in the early years, gradually becoming more principal than interest as time goes by. The long-dated maturities of term bonds will distribute principal repayment toward the end of the asset's useful life or when future revenue growth is projected, while preserving a form of serial amortization through the sinking fund payments.

Unless these are the overriding financing objectives, issuances are not typically comprised solely of term bonds. Instead, term bonds are more often combined with serial bonds and used to target market demand for the term structure.

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Serial bonds are generally preferred by retail investors because they favor shorter terms and value the date-certain maturity which lowers their reinvestment risk: the risk of reinvesting repaid principal, early, at lower market rates. Institutional investors tend to be the buyers of term bonds because they prefer to buy in larger-sized lots which are more easily resold in the secondary market. The secondary market liquidity offsets the reinvestment risk associated with early sinking fund repayment of the term bonds. If the range of investor preferences can be met by offering a selection of serial and term maturities, an issuer is likely to achieve a lower cost of financing when compared to the cost of a single, long-term maturity. The challenge for the financing team is to structure the blend of maturities to match the amount and timing of the revenues for repayment.



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Narrator: The amount of interest that must be paid to investors on the interest payment date is calculated by using the coupon rate. When bonds are sold with a coupon rate equal to the prevailing market rate, or yield, the bond is said to be priced at par, or face value. It is common that bonds are sold with a coupon that does not match the yield. When the coupon rate is set higher than the yield, investors will pay a premium for the bond. When the coupon rate is lower than the yield, the issuer will discount the price of the bond to the investor.

Investors generally prefer premium bonds over par or discount bonds. Premium bonds return cash to investors sooner through higher coupon payments, which is particularly attractive in periods when market interest rates are expected to rise. The extra interest income from the premium bond can be reinvested at higher rates. Premium bonds exhibit lower price volatility in the secondary market. Conversely, discount bonds have higher price volatility.

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Narrator: Issuers may elect to structure certain bonds at a discount to reduce interest payments in specific years of revenue uncertainty or to take advantage of the shape of the yield curve. However, given investor demand, the best value per dollar borrowed may be through issuing premium bonds.

It is important to recognize that structuring the issuance to generate greater issuance premium than discount is effectively borrowing more money than the stated principal amount of your bonds. It is common for issuers to pay the costs of issuance from premium which allows them to direct 100% of the principal amount to projects. School districts face statutory limitations on this practice but, regardless of how premium is used, consideration should be given to the costs of the additional borrowing and the viewpoint of constituents when the issuance amount is established by voter authorization.

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Narrator: Agencies must decide on issuing their debt as taxable or tax-exempt. Tax-exempt bonds pay interest to investors that is not subject to taxation, so investors will accept significantly lower interest rates than they will on taxable bonds. Agencies will almost always have lower borrowing costs with tax-exempt debt. However, tax



exemption compels agencies to meet IRS requirements for the investment and timely expenditure of proceeds and limitations on the private use of the financed facilities for the life of the debt. The market for taxable municipal bonds is only a small portion of the total municipal bond market, but if an agency is unable to meet the limitations of the tax-exempt market, a taxable issuance may provide a viable alternative.

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Narrator: Variable rate bonds are attractive to issuers when short-term interest rates are low relative to long-term rates. A variable rate can reduce the overall interest cost of the debt since, under normal market conditions, short-term interest rates are lower than long-term rates, but the issuer must be willing to accept the risk of interest rate fluctuation.

There is a segment of the municipal market that targets variable rate debt, particularly institutions that purchase large lots and do not require the certainty of fixed-interest payments preferred by retail investors. However, variable rate debt adds complexities for issuers beyond interest rate risk. Given the variability of interest, and even principal payments, the market typically requires an issuer post an instrument, like a letter of credit, to mitigate the liquidity risk of the agency's repayment source. The liquidity instrument adds costs and risk to the transaction. Variable rate bonds are complex, require continuous active monitoring, and should be avoided by agencies without the expertise and administrative capacity to manage the inherent risks.

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Narrator: Capital appreciation bonds, also known as CABs, are a type of bond that does not pay interest semi-annually like most bonds. Instead, interest accretes to the par value of the bond and is paid when the bond is redeemed. As a result, the bond is sold at a substantial discount. The difference between the sale price and redemption value represents the interest to be earned over the term of the debt. Issuers use this type of debt when they lack current revenues to satisfy the debt service but assume large increases in revenues in the future.

Effectively, issuers delay interest payments by borrowing the interest from the investors over the term of the bond. This is called "compounding" and can lead to very high interest costs. In addition, investors typically require higher interest rates for CABs than they do for bonds that pay interest periodically. Given the inherent risks and questions of taxpayer and intergenerational equity, California statutes have placed limitations on the issuance of CABs by school districts, but all agencies should carefully consider the implications of CAB issuance and establish use limitations in their debt management policy.

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Narrator: In the municipal bond market, the option to prepay the principal amount of the bonds is called "optional redemption" or a "call option." Bonds issued with this feature can be redeemed, at the agency's election, on or after a specific date prior to maturity at a specified price—often face value. The option allows the agency to reduce or restructure debt, release security pledges, and achieve debt service savings during periods of declining interest rates by refinancing.

While call options are a very common feature, investors require compensation to include them and accept the reinvestment risk of redemption prior to maturity. This compensation comes in the form of a higher interest rate or a redemption price for the bond higher than the par value, or sometimes both. The unpredictability of interest



rates and the flexibility provided issuers makes the call option a sensible risk mitigation measure, but electing to not exercise the option represents an inherent cost to the agency.



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Narrator: An agency should include a review of the current market environment as part of the ongoing administration of its debt. If market interest rates have declined relative to the rates due on outstanding bonds of comparable remaining maturity, debt service costs can be reduced by refinancing the outstanding bonds with new, lower-interest, refunding bonds.

Significant savings may be achieved by exercising the call option and simply replacing longer term bonds with shorter term bonds. Statute allows the issuance of refunding bonds without voter approval, even if the original issuance of the bonds being refunded required it. However, refunding bonds are subject to the same federal tax and security laws and on-going administrative responsibilities as the original debt. While there is general market acceptance of refunding bonds, a thorough assessment of a refunding opportunity, including issuance costs, will be aided by incorporating structuring criteria and savings thresholds for refunding into the agency's debt management policy.

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Narrator: Many structural factors contribute to how the municipal market views and values your agency's debt, but there is no single characteristic that contributes more to the market's opinion of the value of your debt issue than its credit rating. A credit rating is an opinion that provides an independent and systematic evaluation of the credit risk associated with a debt issue. It grades the probability that the investors' principal and interest payments will be made in full and on time.

The rating assigned to your debt issue directly impacts the cost of your financing: the higher the rating, the lower the total interest costs. While a credit rating is not required to issue debt, it generates greater market acceptance in comparison to unrated debt. Rated securities have greater liquidity in the secondary market: it is easier to find buyers, an advantage to both retail and institutional investors that translates to lower initial interest rates.

Credit rating agencies use their own proprietary models to generate a rating, but generally the rating is built from an evaluation of the type and amount of the debt, security of the repayment source, financial condition of the agency, area economics and demographics, and agency management practices.



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Narrator: Agency management practices are given substantial weight in the rating decision and warrant active leadership and policy oversight by elected officials. Rating agencies will look for thorough and far-sighted strategic planning, long-term financial planning, and capital improvement planning. Better scores are given to agencies that integrate these planning disciplines to produce conservative, multi-year budgets, based on reasonable assumptions, that position the agency to thrive through economic cycles.

Agency management policies and planning are also evaluated for the strength of internal controls, operational contingencies, cybersecurity, and the agency's capacity to produce complete and timely disclosure of financial reports and material events. The importance of disclosure cannot be overstated with respect to regulatory compliance, but it also increases general market receptivity of your agency's debt and instills confidence among your constituents.

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Narrator: The initial decisions you will make regarding the marketing and structuring of debt and your agency's policy and procedural preparation will affect the likelihood of achieving and sustaining the critical objectives of your financing. Along with serving your agency's goals, your debt is a product that you need to sell to investors who have their own market-driven objectives. Finding the point of intersection between your agency's objectives and those of investors is the key to a win-win debt issuance.

In addition to legal and regulatory constraints, the market imparts a level of control over your methods and structure by virtue of its preference for risk avoidance and the corresponding price signals it will send. The market will help reveal risky or complex structures, but it will not keep you from making ill-conceived decisions that negatively impact your agency and constituents.

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A current and thorough debt management policy, an experienced and aligned financing team, and your ability as an elected official to thoughtfully question "why are we doing it that way?" will ultimately put your agency in the best position to avoid the pitfalls of imprudent structures and methods. A steadfast management approach is highly valued by investors and constituents, leads to lower financing costs, and helps achieve long-term project goals.