

Structuring & Financial Aspects of a Municipal Bond Transaction

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The Essentials

APRIL 19–21, 2023

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Why Are We Here?

To understand the basic elements, financial aspects, and law relating to the issuance of municipal securities

What is a Municipal Bond?

A security

A debt
instrument

An obligation

Debt Instruments Typically Specify -

- An obligation to pay
- A stated amount (the “principal”)
- At a given time (the “maturity”)
- With interest at a stated rate or formula

Securities Law

1933/1934

Tax Law

1913

State Law

1783

Law of Contracts

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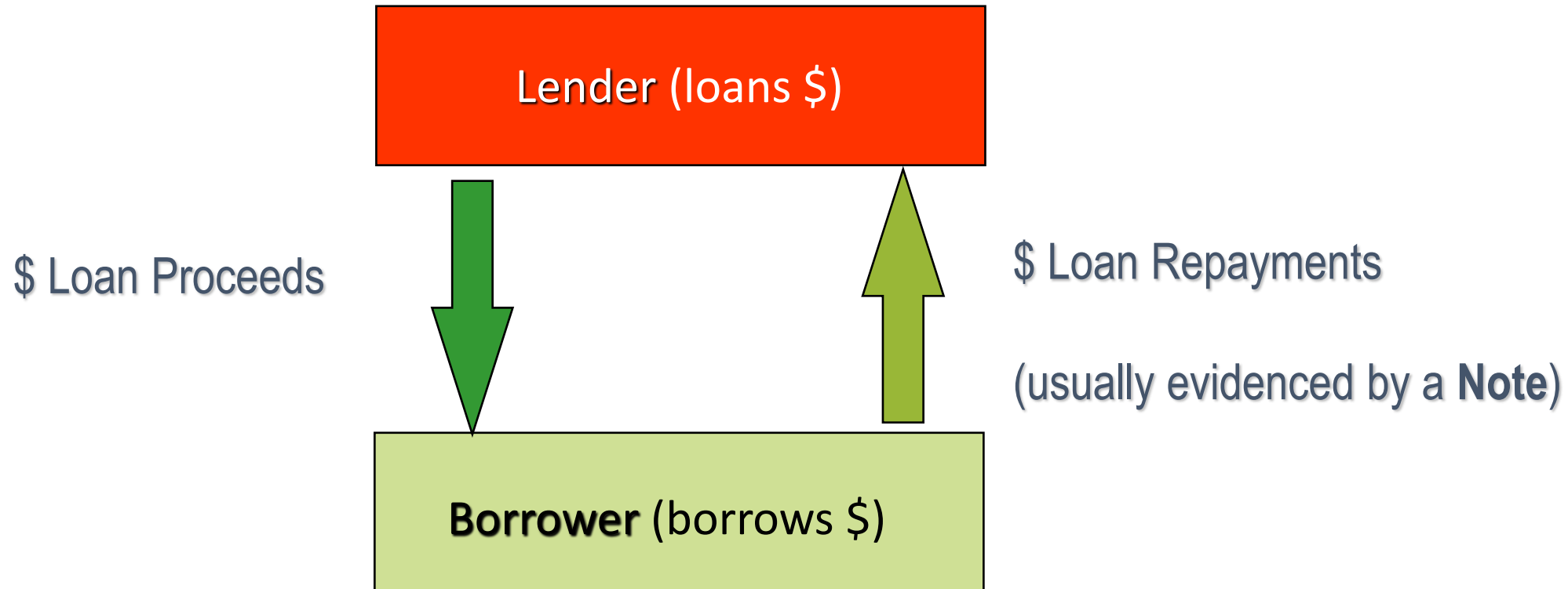
Four Key Questions

These questions are key considerations in rendering the bond opinion, which is essential to the issuance of a municipal security.

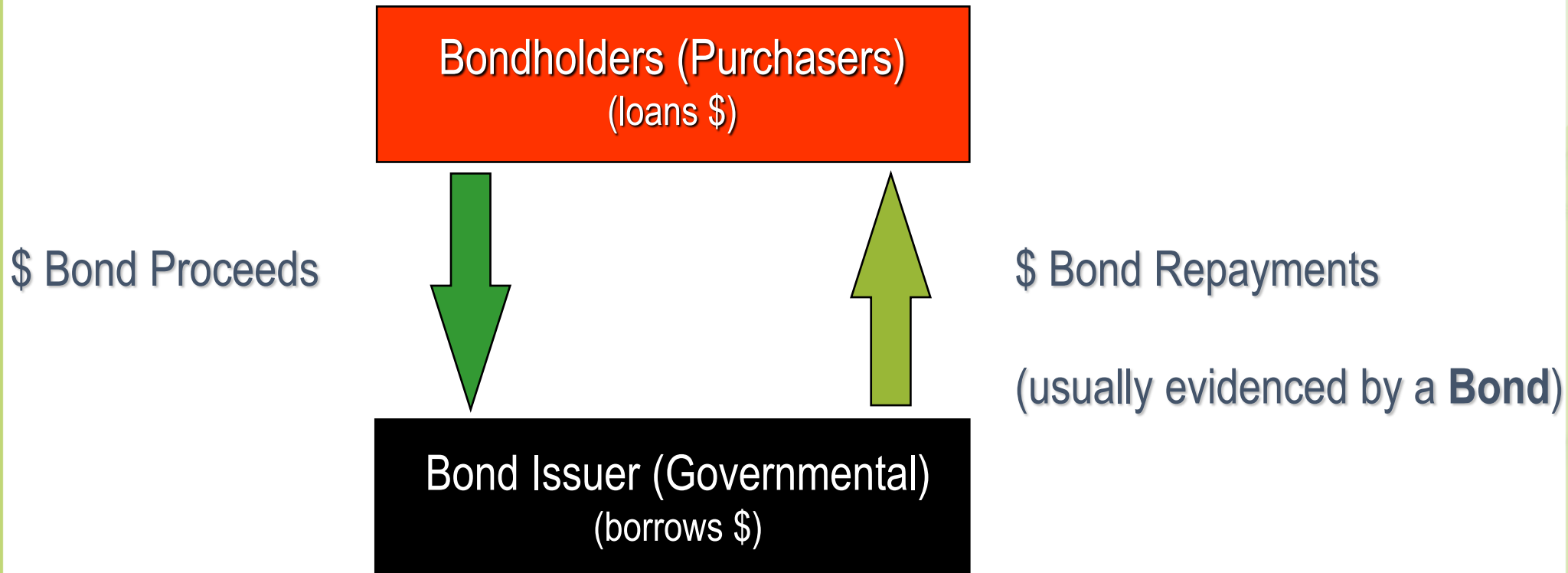
Bond Counsel bases its bond opinion on an examination of all material legal and factual sources regarding the subject addressed therein.

1. What is the agreement?
2. Is it valid under state law?
3. Is it tax-exempt?
4. What are the securities law implications?

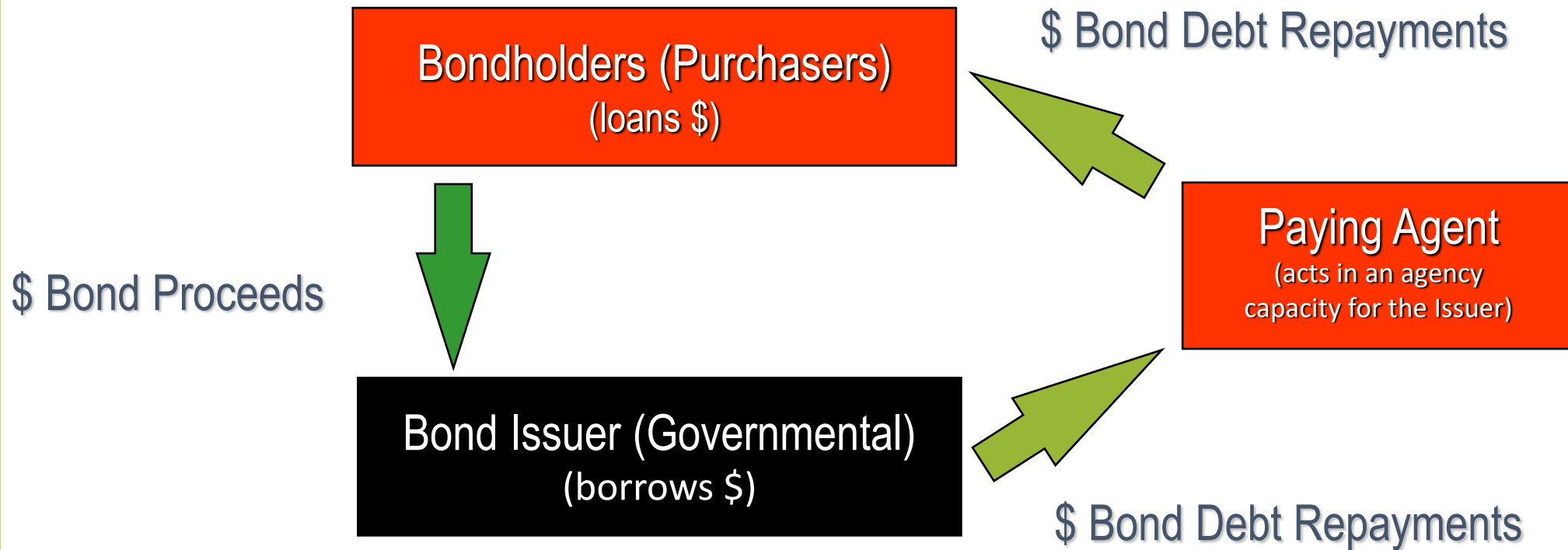
Basic Debt Transaction



Basic Municipal Bond Transaction



Basic Municipal Bond Transaction



Why An Issuer Issues/Sells Tax-Exempt Bonds

Taxable Rate	7.00%
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Multiply by 1 minus marginal tax rate (assume 33%)	<u>x .67</u>
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Tax-exempt Rate	4.69%
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Annual Interest Example

Taxable: $\$10,000,000 \times 7.00\% = \$700,000$

Tax-Exempt: $\$10,000,000 \times 4.69\% = \$469,000$

On a \$10,000,000 bond, interest savings would be \$231,000 in the first year alone

Why An Investor Buys Tax-Exempt Bonds

Taxable Bond Rate	7.00%
<i>Tax-exempt Rate</i>	4.69%
<i>Investor's Assumed Tax Rate</i>	33%

\$10,000,000 Bond Example

	<u>Interest Income</u>	<u>Tax Liability</u>	<u>Net Interest Income</u>
Taxable:	\$700,000	(\$231,000)	\$469,000
Tax-Exempt:	\$469,000	N/A	\$469,000

Anatomy of a Transaction



Initial Communications and Analysis



Bond Documents



Bond Sale



Closing

Initial Communications and Analysis

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Initial Communications & Analysis

What is the deal being proposed?

What is the security/source of payment?

Initial Due Diligence – tax and state law disclosure

Timeline of required actions & hearings

Ethical obligations

- Who is your client?
- Engagement letter
- Conflicts to clear

The Project

State Law Concerns

- Is the Project within the issuer's jurisdiction/scope of authority?
- Are there limitations on the client's ability to purchase/finance the Project?
- What approvals are required?

The Project (continued)

Initial Tax Inquiry

- Who will own/use/manage the Project?
- What is the anticipated timing of expenditures (use of bond proceeds)?
- Is there any expectation to reimburse prior expenditures?

The Project (continued)

What is the security for the debt and/or Project?

- Will the Project produce sufficient net revenue?
- What limitations exist on the pledge/use of such revenues?
- Is another source of funding readily available?

Types of Security

General Obligation

Special Taxes or Assessments

Revenues

- Utilities
- Airports
- Hospitals

Leases or Installment Payments

Payments from Conduit Borrowers

Additional Security

- Mortgage/Security interest in specific assets
- Credit enhancement

General Obligation Bonds

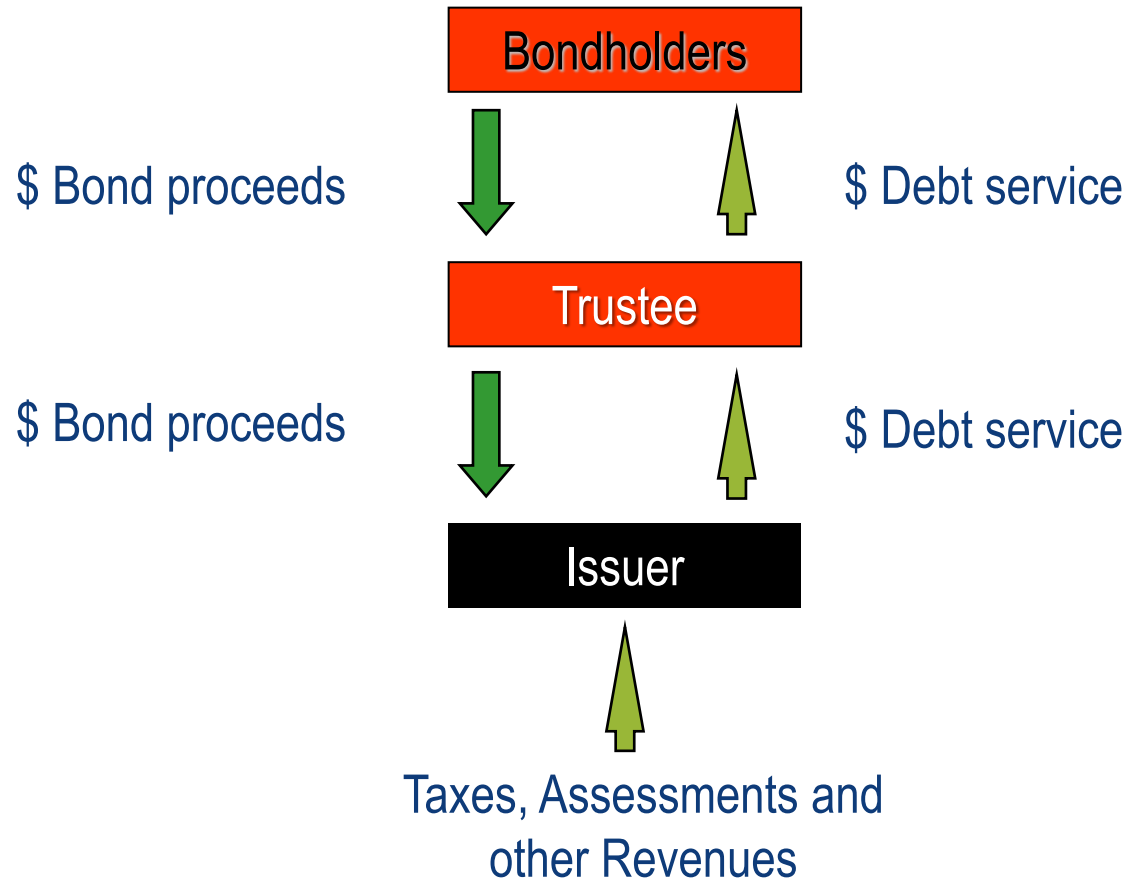
Know the requirements of your state / local laws

Backed by the full faith and credit of the issuer

Often supported by the ability of issuer to levy taxes
(particularly ad valorem taxes)

Sometimes requires voter approval

General Obligation Bonds (Continued)



- General obligation to pay
- Parties - Issuer and Trustee, on behalf of Bondholders

Revenue Bonds



Generally, not a tax pledge ... but there are exceptions

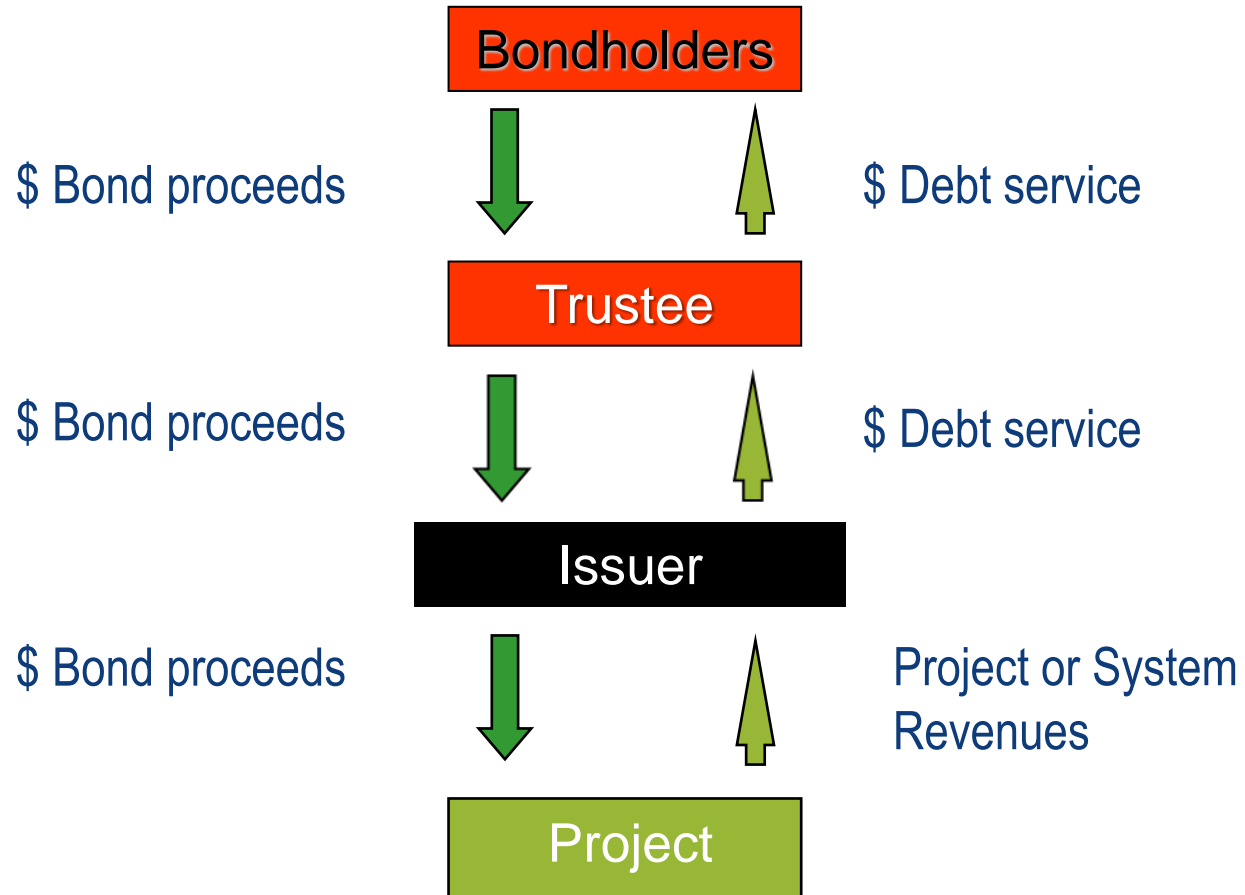


Supported by revenues of the facility/enterprise/system being financed (can be rents, tuition, revenues, etc.)



Collateral may include the Project itself or rights to the Project

Revenue Bonds (continued)



- Project/System and Revenue Pledge
- Covenants
- Parties - Issuer and Trustee, on behalf of Bondholders

Conduit Bonds



GOVERNMENTAL ENTITY
(I.E. “CONDUIT ISSUER”)
ISSUES BONDS TO BENEFIT
CONDUIT BORROWER



CONDUIT BORROWER: THE
ENTITY BORROWING THE
BOND PROCEEDS AND
RESPONSIBLE FOR PAYING
DEBT SERVICE



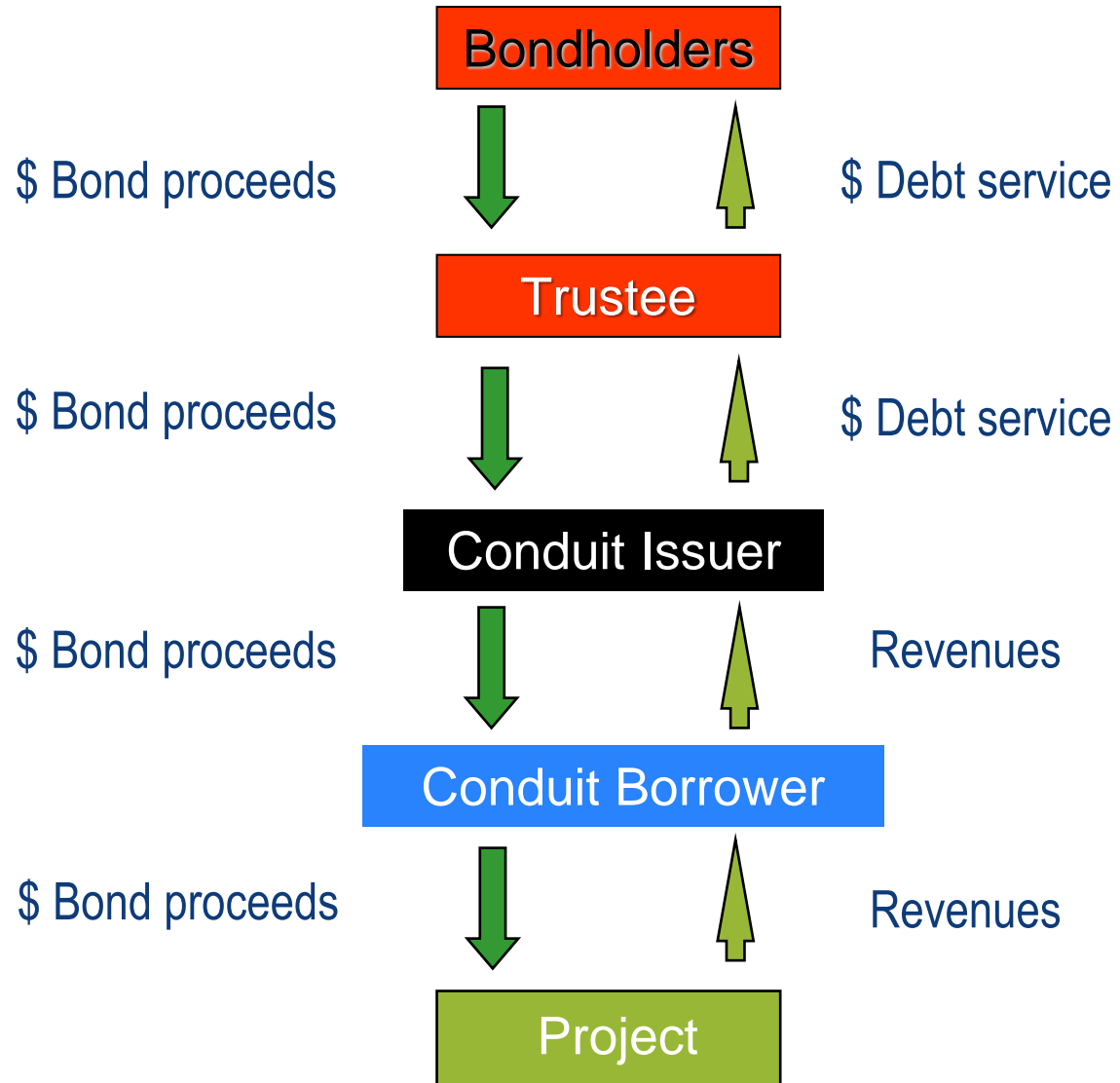
EXAMPLES: SMALL ISSUE
MANUFACTURING FACILITY
(OR “INDUSTRIAL
DEVELOPMENT”) BONDS,
501(C)(3) BONDS, VARIOUS
“EXEMPT FACILITY” BONDS

Conduit Bonds

The Conduit Issuer

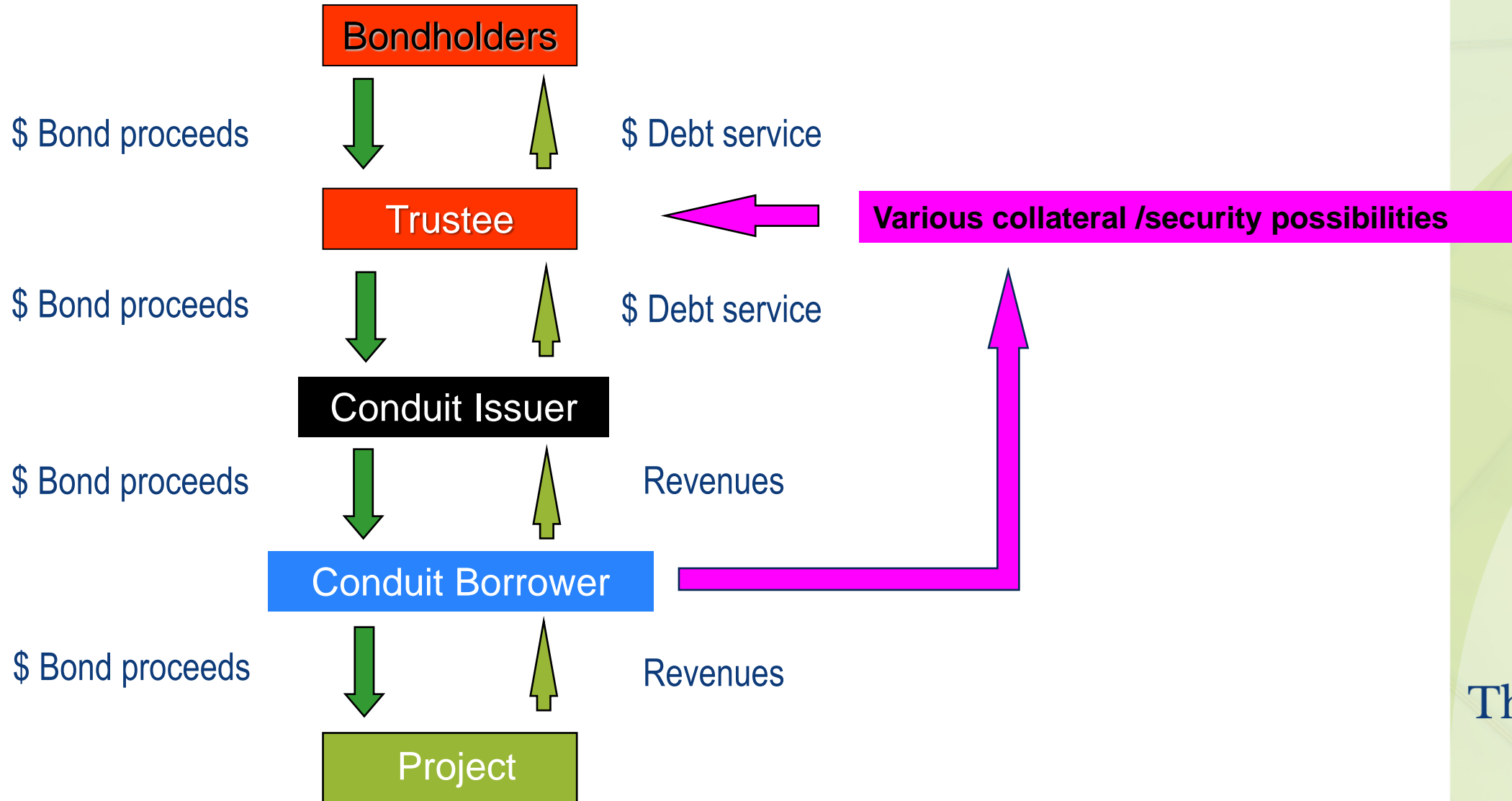
- Political subdivision can act directly as the Conduit Issuer
- Typically formed by a political subdivision (e.g., a city or a county) to act a “on-behalf of” issuer
- Formed so debt can be federally tax-exempt
- Often retain little to no liability in the transaction after issuance of bonds

Conduit Bonds (continued)



- Project/System and Revenue Pledge
- Covenants
- Parties – Issuer, Conduit Borrower and Trustee, on behalf of Bondholders

Conduit Bonds (continued)



Refunding Bonds

Refundings:

- Bond proceeds pay debt service on outstanding bonds
- Current – Bonds paid off within 90 days of closing
- Advance – Bonds paid off more than 90 days of closing (on a taxable basis)

Refunding Bonds (continued)

Current Refunding

- Refunding Bonds issued January 2, 2024 or after (i.e., within 90 days before April 1, 2024 or later)

The Bonds maturing on or after April 1, 2025 are callable for redemption at the option of the Issuer, in whole or in part, on any date on or after April 1, 2024, at a price of par plus accrued interest to the date fixed for redemption.

Refunding Bonds (continued)

Advance refunding

- Outstanding bonds to be refunded are called and paid off more than 90 days of the date of issuance of the refunding bonds
- Must refund tax-exempt bonds on a taxable basis
- Requires an escrow and verification report

Refunding Bonds (continued)

Defeasance:

- Gross – fully funded at amount needed to pay debt service to redemption (without investment)
- Net – invested in obligations (like SLGs) sufficient to pay principal, interest and premium to redemption

Key Considerations of a Refunding

Debt Service Savings

- Usually, the higher the interest rate and the earlier the call date on the refunded bonds, the greater the potential savings

Restructuring

- Restructuring debt service or to pay off an issue with overly restrictive covenants

Redemption Provisions

- Call provisions with respect to the bonds being refunded will govern whether you can do a current refunding

Escrow Investment Yield and Other Factors

Debt Service Savings

Usually, the higher the interest rate on the refunded bonds relative to current market rates, the greater the savings potential

The earlier the call date, the greater the potential savings

Bond Documents

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The Basic Bond Document

“Contract” between Issuer and Bondholders

Two basic types (lots of different names):

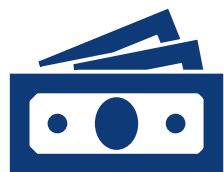
- Indenture/Loan Agreement
- Bond Ordinance or Resolution

General or Master Document for Parity Bonds

Typical Document Provisions



Typical Document Provisions (continued)



Reimbursement



Tax covenants &
designations



Use of
proceeds/construction
of project

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Typical G.O. Bond Covenants



Pledge of full faith
and credit



Maintenance of
revenue



Priority/exclusivity
of payment

Typical Revenue Bond Covenants



Limitations on Additional Debt



Rate Covenant



Flow of Funds



Maintenance Covenants



Limitations on Asset Dispositions

Official Statement

Primary Market Disclosure Laws:

- Section 17(a) of Securities Act of 1933
- Section 10(b) of Securities Exchange Act of 1934
- Rule 10b-5 Promulgated under Securities Exchange Act of 1934

Official Statement (continued)

Rule 10b-5:



“unlawful for any person...to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statement made, in the light of the circumstances under which they were made, not misleading...”

Official Statement (continued)

Contains material information on subjects like:

- Issuer and obligated persons
- Bonds being offered
- Security for the bonds
- Risks (enterprise financings) of investing in the bonds
- Litigation
- Past compliance with continuing disclosure undertakings
- Tax status of the debt

Official Statement (continued)

Secondary Market Disclosure:

- Rule 15c2-12
- Continuing Disclosure Agreement
 - Listed Events
 - Annual Financial and Statistical Information

Role of Credit Enhancement in Structuring Transaction

Who provides
credit
enhancement for
municipal bonds?

What is important
to them?

Bond Sale

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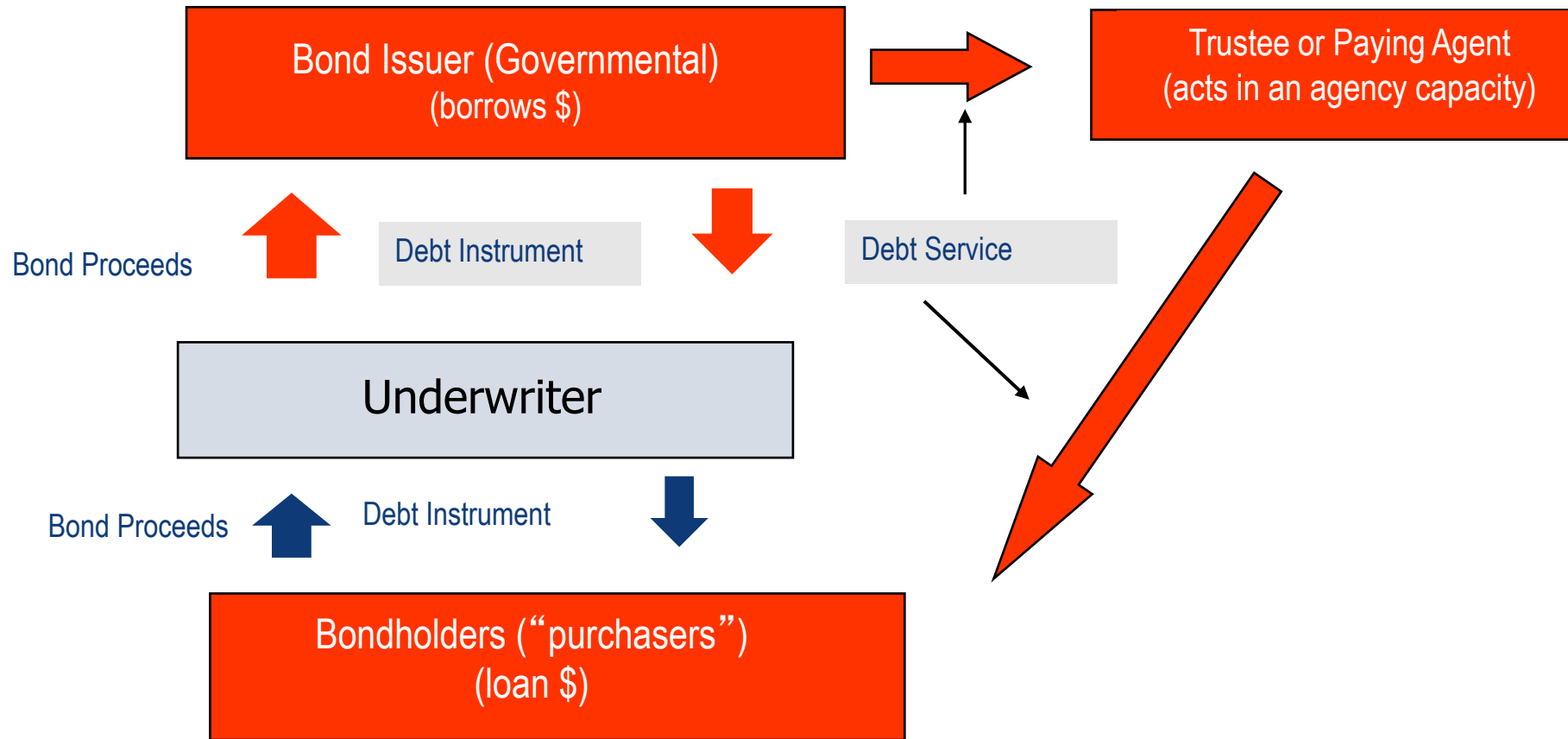
Methods of Sale

Private Placement vs. Underwritten Transaction

Competitive vs. Negotiated

Fixed Rate vs. Variable Rates

Underwritten Transaction



Debt Service Structure

New Money Issues

- Often reflects useful life or revenues of assets being financed
- Possible capitalization of interest during construction

Refundings

- Up front vs. level savings

Wrap Around of Existing Debt

Principal payments are typically made annually; interest payments are typically made semiannually (fixed rate) or monthly (variable rate)

Fixed Rate Bonds

Interest rate is fixed for term of bonds, but typically have different interest rates for each maturity (especially in a public offering)

Principal matures in stated amounts at stated intervals (generally annually)

Issuer knows exact amount of principal and interest payments at closing

Variable Rate Demand Bonds (VRDBs)

Interest rate adjusted periodically (typically weekly)

Typically offered in minimum denominations of \$100,000 and sold mostly to institutional investors

Typical put feature that provides option of bondholder to put bond back to tender agent with seven days' notice

Remarketing agent sets weekly rates (generally based on an index) and remarkets bonds tendered by bondholders

Interest typically paid monthly with annual or semiannual principal or mandatory sinking fund redemption payments

Bonds typically secured by letter of credit or liquidity facility arrangement (credit rating requirements)

Typical structure for conduit borrowings but also used for governmental bonds

Direct Bank Placement (DP)

Interest rate may be fixed or adjusted periodically

Generally structured as a single bond with principal installments

Interest typically paid monthly with annual or semiannual principal installment payments

Sold directly to and held by a single financial institution

Limited transfer provisions

Subject to additional terms, provisions and covenants set forth in separate credit agreement

No built-in remarketing features, but may have ability to convert to other variable rate modes

Often have long-term amortization with earlier bullet or mandatory tender feature

Bondholder Risks

- Interest Rate Risk
- Default Risk (Credit Risk)
- Reinvestment Rate Risk
- Inflation Risk
- Call Risk
- Maturity Risk
- Liquidity Risk
- Tax Risk
- Change in Law Risk
- Other Risk

Bondholder Risks

Interest Rate
Risk

Default Risk
(Credit Risk)

Reinvestment
Rate Risk

Inflation Risk

Call Risk

Maturity Risk

Liquidity Risk

Tax Risk

Change in
Law Risk

Other Risk

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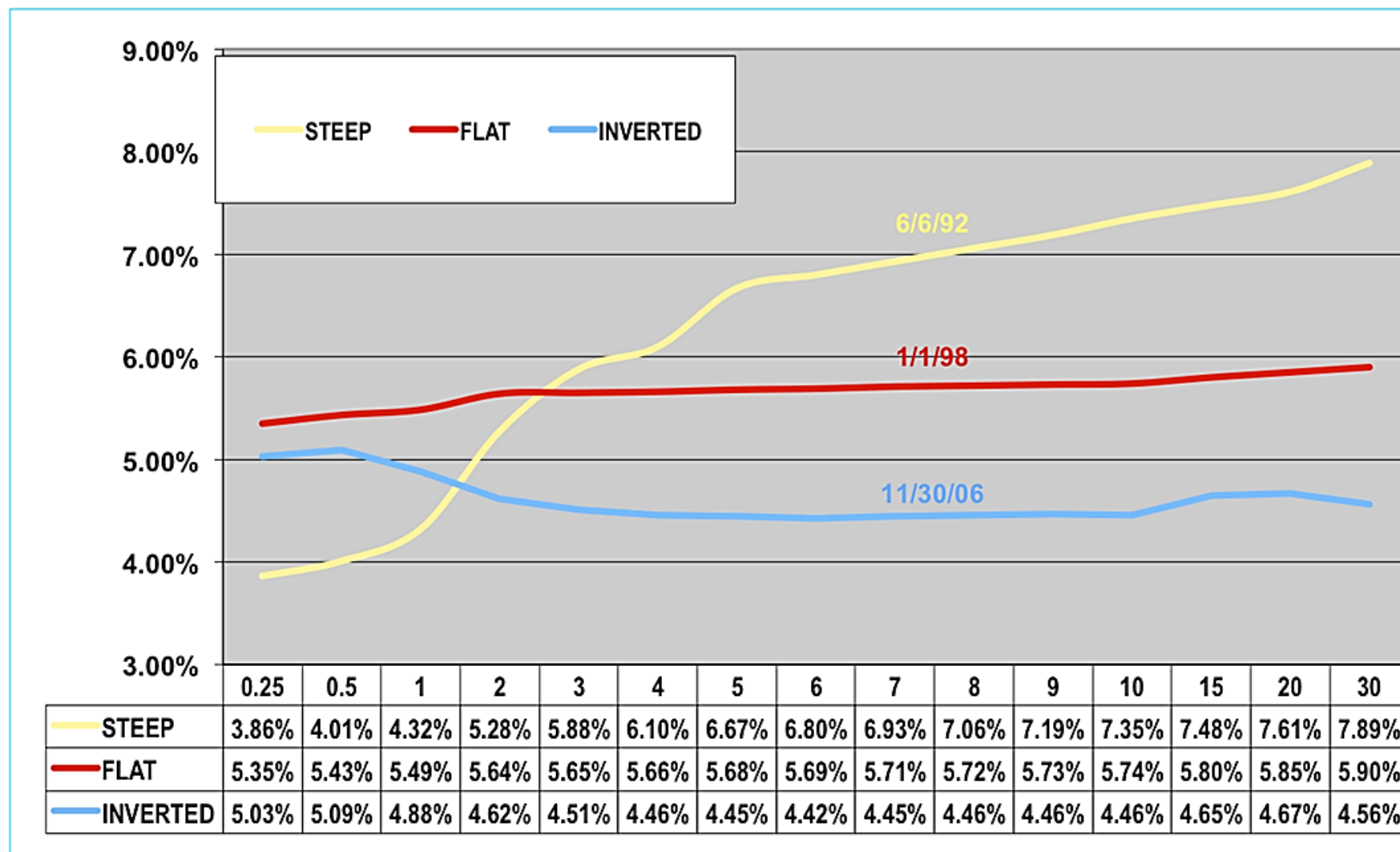
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Yield Curve

Graphical representation of yield and maturity
(the term structure of interest rates)

Yield Curves



Bond Yields

Simple Formula for Yield = interest paid/price

Current Yield

Yield calculated using coupon rate and current price

Yield to Maturity

Yield calculated to maturity date, equates present value of cash flows to current market price

Yield to Call

Yield calculated to a particular call date rather than maturity using the call price as opposed to the face value

Yield vs. Interest Rate

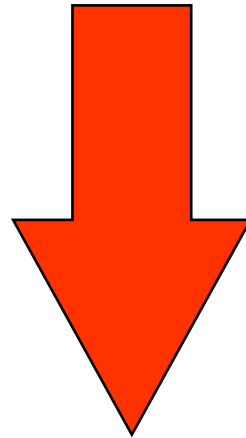
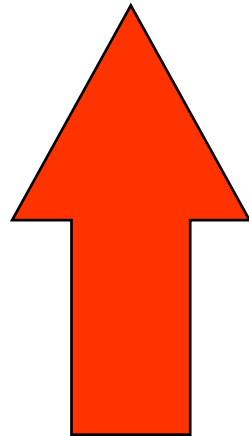
• April 1, 2021	• Dated Date
• \$5,000	• Principal Amount
• 6%	• Coupon Rate
• April 1 & October 1	• Compounding interval (interest payment dates)
• April 1, 2031	• Maturity Date

Interest Payments: $(\$5,000 \times 6\% \times 1/2 \text{ yr.}) = \150 on every interest payment date

Yield vs. Price

- Bond Yields & Bond Prices Move in Opposite Directions




Yield



Price

Par, Discount and Premium Bonds

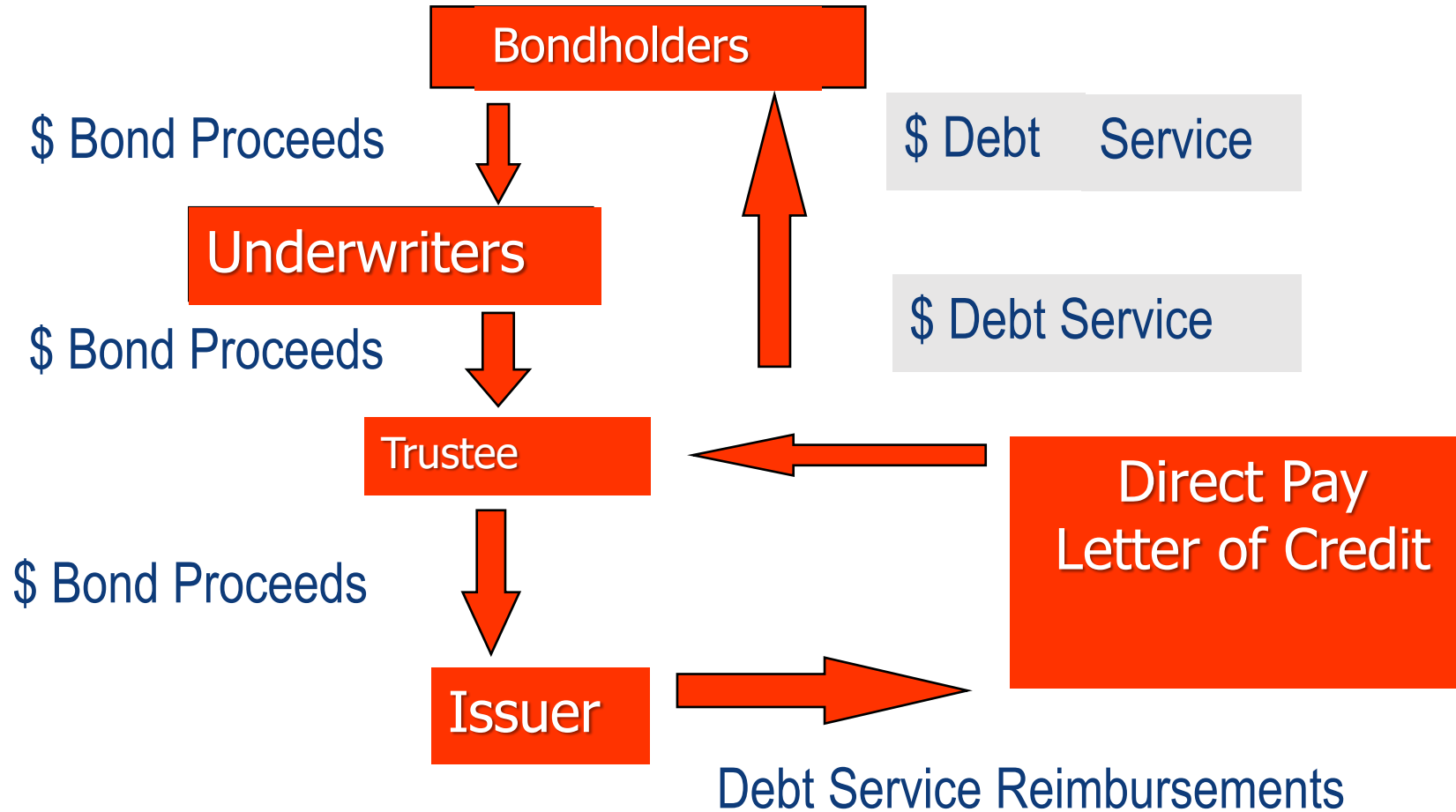
- Par = Stated Principal Amount or Face Value
- Discount/Premium = Changes price, not principal amount
- Importance of price in yield calculations
- Example Bond (6.00% coupon; 10-year maturity)

	Price 98%	Yield of 6.27%
	Price 100%	Yield of 6.00%
	Price 102%	Yield of 5.73%

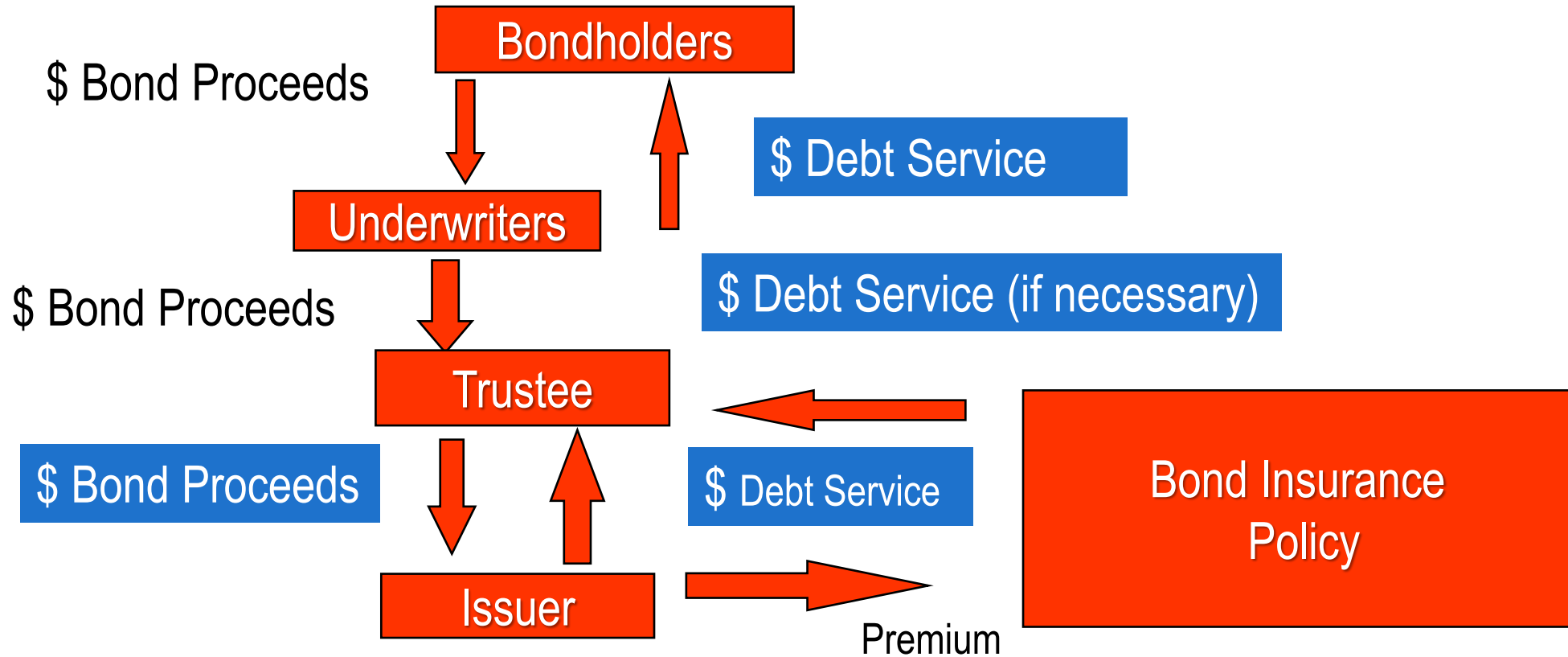
Example – Bond Pricing

Bond Component	Maturity Date	Amount	Rate	Yield	Price	Yield to Maturity	Call Date	Call Price	Premium (-Discount)	Takedown
Serial Bonds:										
	04/01/2016	1,325,000	4000%	0.300%	103.824				50,668.00	2.500
	04/01/2017	1,380,000	4000%	0.590%	106.891				95,095.80	2.500
	04/01/2018	1,070,000	5.000%	0.910%	112.219				130,743.30	3.750
	04/01/2019	1,955,000	5.000%	1.140%	115.183				296,827.65	3.750
	04/01/2020	2,065,000	5.000%	1.410%	117.392				359,144.80	3.750
	04/01/2021	2,165,000	5.000%	1.640%	119.234				416,416.10	3.750
	04/01/2022	2,305,000	5.000%	1.920%	120.180				465,149.00	3.750
	04/01/2023	2,460,000	5.000%	2.140%	121.011				516,870.60	3.750
	04/01/2024	2,615,000	5.000%	2.340%	121.550				563,532.50	3.750
	04/01/2025	2,775,000	5.000%	2.500%	122.068				612,387.00	3.750
	04/01/2026	2,840,000	5.000%	2.670%	120.393 C	2.835%	04/01/2025	100.000	579,161.20	3.750
	04/01/2027	3,015,000	5.000%	2.780%	119.324 C	3.068%	04/01/2025	100.000	582,618.60	3.750
	04/01/2028	1,600,000	3.000%	3.120%	98.721				-20,464.00	3.750
	04/01/2029	1,580,000	3.000%	3.180%	97.973				-32,026.60	3.750
	04/01/2030	1,555,000	3.000%	3.230%	97.276				-42,358.20	3.750
	04/01/2031	1,535,000	3.000%	3.310%	96.165				-58,867.25	3.750
	04/01/2032	1,515,000	3.125%	3.360%	96.969				-45,919.65	3.750
		33,755,000							4,468,978.85	
Serial Bonds 2:										
	04/01/2028	1,380,000	5.000%	2.870%	118.458 C	3.251%	04/01/2025	100.000	254,720.40	3.750
		35,135,000							4,723,699.25	

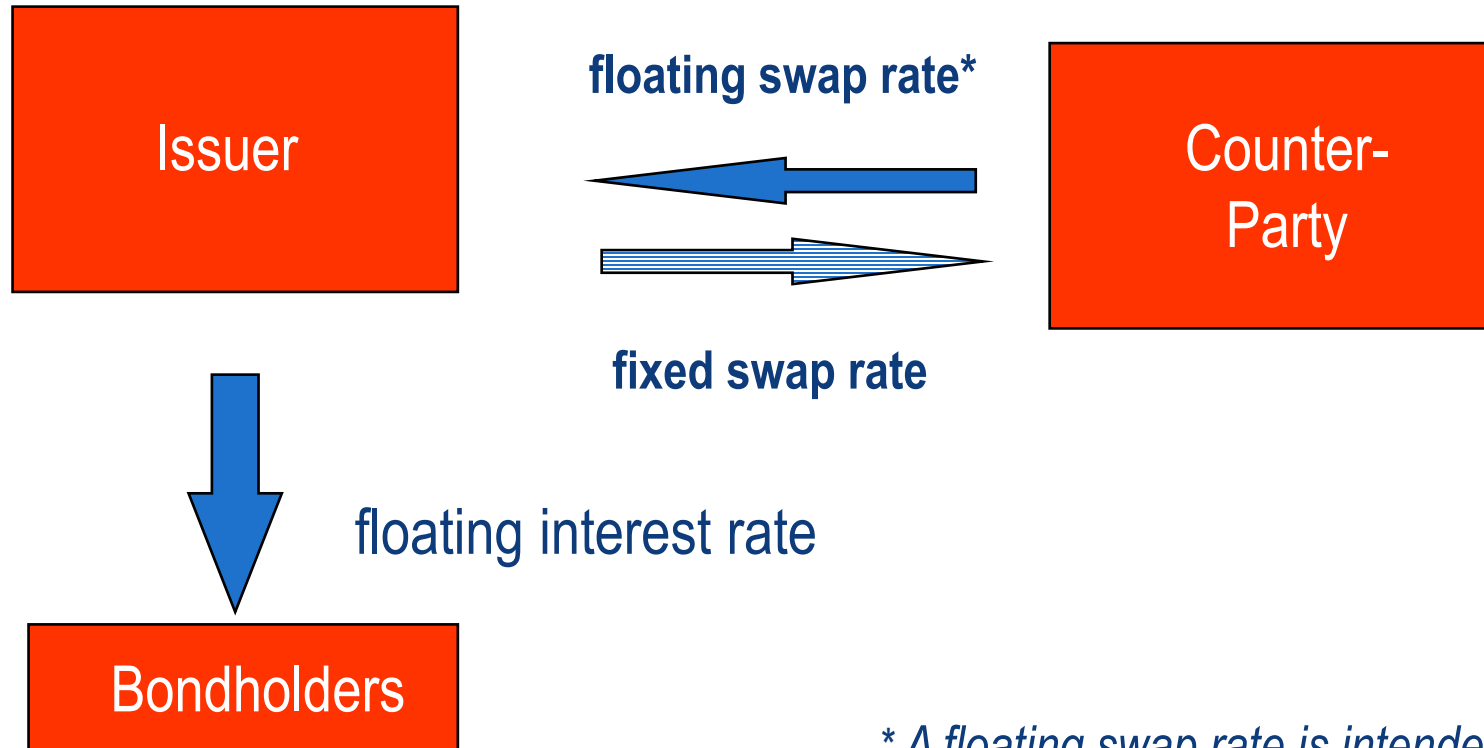
Credit Enhancement-Letter of Credit



Credit Enhancement-Bond Insurance



“Vanilla” Interest Rate Swap



** A floating swap rate is intended to mirror or closely correlate with floating interest rate on the bonds, resulting in a synthetic fixed rate issue.*

Closing

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The Closing Documents

The certificates executed at closing support the opinions rendered by counsel:

- General/Incumbency Certificate
- Tax Compliance/Non-Arbitrage Certificate
- Registration Certificate
- Parity Certificate
- Official Statement/10b-5 Certificates

The Closing Documents (continued)

Other documents delivered at closing memorialize promises made to Bondholders:

- Continuing Disclosure Agreement
- Escrow Agreement
- Ratings Reports
- Deed of Trust/Mortgage
- Feasibility Study/Engineer's Report

Common Tax Documents



Tax Certificate



Underwriter's
Certificate
(a.k.a. Issue Price
Certificate)



IRS Forms 8038



Written Policies
and Procedures

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Common Disclosure Documents

- **POS/OS**
- **Continuing Disclosure Agreement**
- **Disclosure Policies and Procedures**
- **Opinions**
 - Underwriter's Counsel Opinion
 - ☐ 10b-5 (further explored in subsequent slides)
 - ☐ Enforcement of BPA
 - ☐ Continuing Disclosure
 - Bond Counsel Supplemental Opinion to Underwriter(s)
 - ☐ 10b-5 (good luck...)
 - ☐ Negative Assurance
 - ☐ Fair Summary
- **Blue Sky Letter**

Opinions

“Good Delivery” under MSRB Rules requires delivery of the bond opinion at closing

The Bond Opinion is addressed to the issuer

Primary focus of the Bond Opinion is validity/enforceability and tax exemption of the Bonds

Supplemental opinions address other topics (securities law, specific documents, reliance)

The Bond Opinion

Bonds duly authorized and executed

Bonds valid and binding obligations (enforceability opinion given for revenue bonds)

Lien on revenues

Federal tax opinion (includes AMT/ACE opinion)

State tax opinion

The Bond Opinion (continued)

Underwriter's Counsel Opinion

- Effect of continuing disclosure agreement
- Exemption from securities laws
- 10b-5 opinion vs. 10b-5 comfort letter

Disclosure Counsel Opinion

- 10b-5 opinion

Trustee's Counsel Opinion

- Valid, binding and enforceable
- Due authorization and execution
- No conflict

Credit Provider's Counsel Opinion

Common Limitations on Opinions

Limited to federal law and law of 1 state

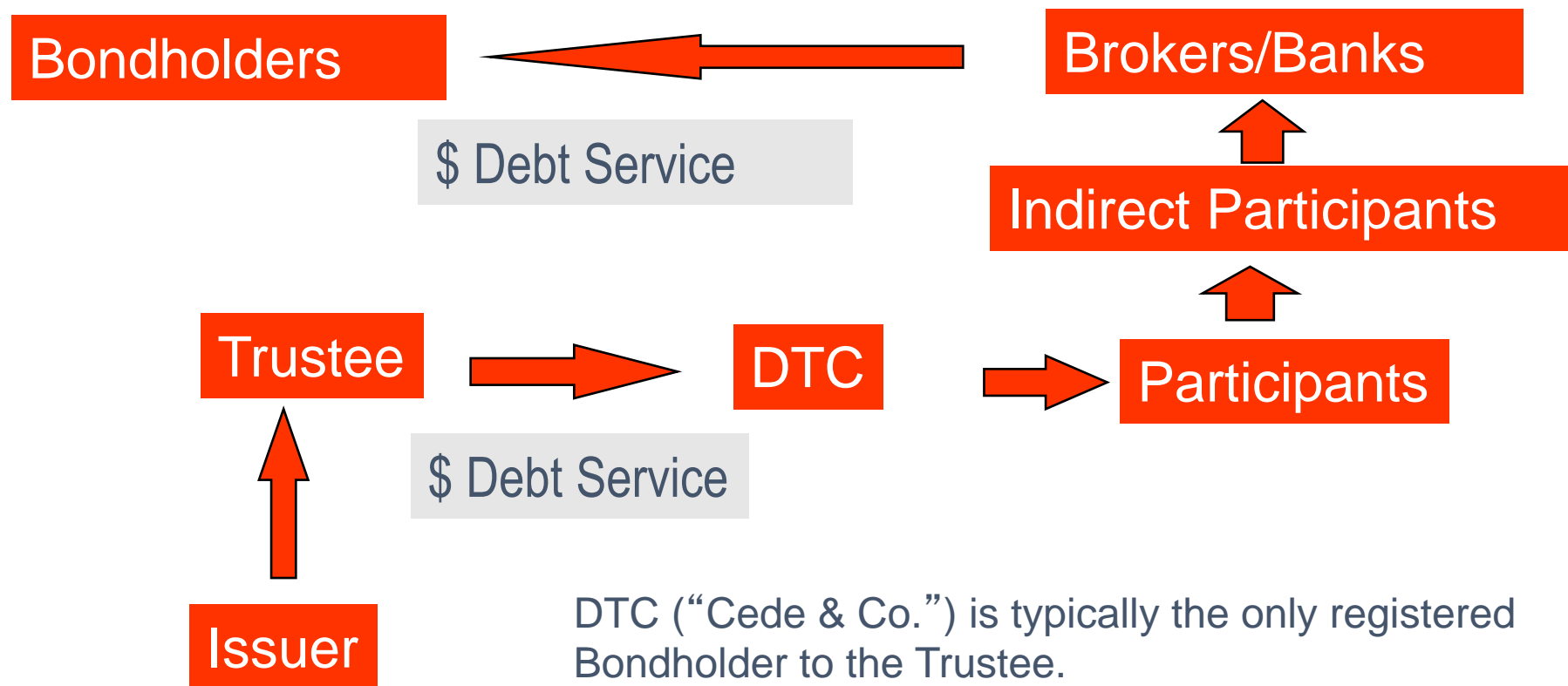
Speaks only as of its date

No obligation to update

Not a guaranty or warranty

May only be relied upon by addressee

The Depository Trust Company / DTC



DTC (“Cede & Co.”) is typically the only registered Bondholder to the Trustee.

DTC Participants are registered and typically are known underwriting and investment firms.

Questions

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