Jason Hughes

Senior Managing Director

717 N. Harwood

Suite 3400

Dallas, Texas 75201

214.953.8707

jason.hughes@hilltopsecurities.com

GFOAT Fall Conference

October 2024

Warts & All – Debt Issuance & the CGFO Test

What is a Bond?

- **Bond (aka Debt)** – An amount owed to a person or organization for funds borrowed. Debt can be represented by a loan, note, bond, mortgage or other form stating repayment terms and, if applicable, interest requirements. These different forms all imply intent to pay back an amount owed by a specific date, which is set forth in the repayment terms.

- **Municipal Bond** – Debt issued by or on behalf of a state or political subdivision, or an agency of such.

- Debt is a means of using anticipated income and future purchasing power before it is actually earned.

Why Issue Bonds?

- Finance projects over their useful lives with a variety of repayment options
- Can finance larger projects on a more timely basis
- Helps minimize impact on property tax and/or user rates
- Future beneficiaries pay their “fair share” for public improvements/services
- Tax-exempt feature provides low cost, long-term financing
- Allows a city access to another revenue stream, the Interest & Sinking Fund tax rate

Tax-Exempt versus Taxable Bonds

- Tax-Exempt
  - Interest exempt from federal income tax for individuals and some corporations
  - Proceeds must be used for state and local governmental purposes; Federal government treated the same as private parties (taxable)
  - Subject to arbitrage rebate requirements (cannot “earn” more than you “pay”)
  - No longer able to advance refund on a tax-exempt basis

- Reciprocal Immunity
  - Immunity of any level of government from taxation by another

- Taxable
  - Carry higher interest rates
  - Flexibility for private use or payment, tempered by State law
  - No arbitrage rebate compliance – can keep all investment earnings
  - Can advance refund more than once

Lawful Purposes of Tax-Exempt Bonds (Internal Revenue Code)

- Payment of capital expenditures
- Reimbursing cash spent on prior capital expenditures (with some limitations)
- Payment of working capital (with *many* limitations)
- Refunding (i.e., refinancing) prior debt
  - Tax Cut and Jobs Act of 2017 eliminated <u>tax-exempt</u> advance refundings
- Payment of financing costs (costs of bond issuance, capitalized interest and funding reserve funds)
- A single bond issue may combine multiple purposes

Regulatory Bodies and Compliance

- **Municipal Securities Rulemaking Board ("MSRB")**
  - Created in 1975
  - Coordinates federal regulation of finance professionals in the municipal bond market
  - Writes and adopts rules specific to the municipal bond market
- **Electronic Municipal Market Access ("EMMA")**
  - Repository for disclosure filings made by municipalities and related entities
- **Securities and Exchange Commission ("SEC")**
  - Does not directly regulate the municipal issuers; instead, regulates the broker/dealers

Types of Bonds

Types of Debt – General Obligation Bonds ("GOs")

- Secured debt
  - Secured by a direct and continuing ad valorem tax levied on a city's tax base
- Bond election subject to a vote by citizens
  - Bond election held in May or November
  - Simple majority for approval; once approved by voters, governing body can generally issue bonds any time after the contest period ends
  - Separate propositions if projects are not related and/or similar
  - If the election fails, city cannot issue Certificates of Obligation for the same projects for a period of 3 years
- Generally, attracts the lowest interest rates based on the tax pledge

Types of Debt – Certificates of Obligation ("COs")

- Secured debt
  - Secured by a 1) direct and continuing ad valorem tax levied on a city's tax base and 2) a pledge of certain revenues, typically from a city's water and sewer system

- No voter authorization required, but does require a Notice of Intent ("NOI")
  - NOI contains 1) not-to-exceed amount of the CO issue, 2) general description of projects to be financed with CO proceeds and 3) the date in which a council will meet to approve the sale

- COs can be petitioned
  - If 5% or more of the issuing entity's registered voters petition, forces the COs to a vote

Types of Debt – Tax Notes

- Secured debt
  - Secured by a direct and continuing ad valorem tax levied on a city's tax base
- No voter authorization required, nor is a Notice of Intent required
  - Only required approval is from the governing body
- Limited to a 7 year maximum maturity
- Typically used to finance emergency needs, smaller capital items and/or assets with shorter useful lives

Types of Debt – Revenue Bonds

- Unsecured debt
  - Pledge of revenues from the respective system
    - Water and sewer system, drainage system
    - Electric system, gas system
    - Sales tax
    - Special assessments
    - Special projects
  - May be a gross pledge (sales taxes) or net pledge (water & sewer system)
- No voter authorization or Notice of Intent is required
  - Only required approval is from the governing body
- Generally, will sell at slightly higher rates than GOs or COs

Types of City/Corporation Debt

	General Obligation Bonds	Certificates of Obligation	Tax Notes	Enterprise System and Sales Tax Revenue Bonds	PID Special Assessment Revenue Bonds
Public Approval	Bond Election (simple majority)	Council Approval of Notice of Intent	None Required	None Required	None Required
Security / Pledge	Taxes Only	Taxes and/or Revenues	Taxes and/or Revenues	Revenues Only	Assessment Revenues Only
***Typical* Projects**	Large Scale, City Halls, Quality of Life, Streets	Water, Sewer, Drainage, Streets	Emergency Needs, Smaller Projects	Water, Sewer, Drainage, Electric, Sales Tax	Public Infrastructure, Purchase of ROW
Ratings	Highest Rated Credit for a City Based on Ad Valorem Tax Pledge			May Be 1 to 2 Notches Lower than a Tax Credit	Non-Rated for New PIDs

Types of Debt - Considerations

	General Obligation Bonds	Certificates of Obligation	Tax Notes	Revenue Bonds
Considerations	1. Economic development projects must be voted in order to pledge ad valorem taxes 2. Separate and distinct propositions cannot be combined into one 3. AG typically likes to see issuance of bond election authority w/in 10 years 4. If election fails, no CO's for 3 years for same project(s)	1. May not be issued for projects which constitute "economic development" 2. Notice of Intent: projects to be financed, maximum principal amount of CO's to be issued, date/time of Council meeting to approve CO sale. First publication at least 45 days prior to sale. 3. May be petitioned by 5% of registered voters; if successful, forces CO's to a vote.	1. Maximum maturity of 7 years 2. If sold to finance a project that Council believes will not be approved by voters (GO Bonds) or may be petitioned (CO's), what are the ramifications?	1. Security is typically a first lien on net revenues 2. Flow of funds: sets forth the order in which funds generated by the enterprise will be allocated to various purposes 3. Coverage requirements, debt service reserve fund, additional bonds test 4. May allow for subordinate liens

Creative Financing Techniques

	Public Improvement District ("PID")	Tax Increment Reinvestment Zone ("TIRZ" or "TIF")
Creation	City Council, after receiving petition from landowner; NOT a separate governmental entity	City Council; NOT a separate governmental entity
Revenue Stream	Assessments (not a tax)	Property Taxes and/or Sales Taxes on Incremental Value
Funding	Public Infrastructure (capital), services (maintenance and operations)	Public Infrastructure, Reimbursement to Developer, Offset to PID Assessments, Economic Development Grant
Ability to Debt Finance	Yes - Typically Special Obligation of the City	Yes - Typically Direct Obligation of the City
Termination	Earlier of Specified Date or Collection of All Assessments	Earlier of Specified Date or Collection of Full TIRZ Revenue Amount
Additional Cost to Owner	Yes	No

Debt Issuance Process

Financing Team

- Financial Advisor/Municipal Advisor
  - City's representative in the municipal bond market
  - In Texas, generally the FA puts together the Official Statement
  - Has a fiduciary responsibility to the issuer (result of Dodd-Frank legislation)
  - FA/MA cannot serve as both financial advisor and underwriter

- Bond Counsel
  - Ensures that a bond issuance meets State law requirements
  - Renders an opinion on the tax status of the bonds
  - Prepares various bond documents

Financing Team

- Underwriter (aka Broker-Dealer)
  - Bank or investment bank charged with marketing and selling a city's bonds
    - Occurs through a process whereby the broker-dealer purchases and then resells the bonds to end investors
  - For certain underwritings, a group of underwriters may be appointed as an underwriting syndicate
  - The Underwriter(s) do <u>not</u> work directly for the issuer

- Underwriter compensation (gross spread)
  - Takedown – sales commission for selling the bonds
  - Expenses – reimbursable costs associated with the bond sale
  - Management Fee – compensation to the underwriter banking team
  - Risk – fee paid to an underwriter, typically in a negotiated sale, to compensate for potential adverse market movements when an underwriter is 'taking down' bonds

Bond Ratings

- Third party evaluation of an issuer's ability to repay its debt
- Ratings are independent from one rating agency to another
- General obligation credit factors
  - Economic and Demographic
  - Financial
  - Debt and Liabilities
  - Administrative/Management
  - Institutional Framework

S&P/Fitch Ratings	Moody's Ratings
AAA	Aaa
AA+	Aa1
AA	Aa2
AA-	Aa3
A+	A1
A	A2
A-	A3
BBB+	Baa1
BBB	Baa2
BBB-	Baa3

Establishing Debt Policies

- Typically will take into account process, use and limitations
- A comprehensive debt policy is looked upon favorably by all 3 rating agencies
- Debt policy should be approved by the entity's governing body and subject to annual review
- Common to include a floor amount that can be financed, as well as a minimum useful life for an asset to be financed
- Debt may be limited to a percentage of assessed property value or operating revenue
  - Many policies also now address the split between the M&O tax rate and the I&S tax rate

Type of Bond Sales

- **Competitive Sales**
  - A sale that is conducted using sealed bids
  - Basic terms and conditions are set by issuer
  - Bids are submitted in accordance with those terms
  - Bid resulting in the lowest effective cost for the issuer is chosen
  - Modern technology and communications have allowed the ability to adjust the provisions of sale in order to respond to market needs, structuring needs, or others factors otherwise limited by the nature of the bidding parameters

- **Negotiated Sales**
  - Issuer selects the underwriter(s) prior to the bond sale
  - Interest rates, underwriter compensation, and expenses are determined through negotiation with the underwriter

- **Private Placements**
  - Interest rates are determined through negotiation with one or more investors
  - These are usually banks or other institutional market participants
  - “Committed lending period” is often limited, as is the bank’s investment horizon

Competitive vs. Negotiated Sale

Negotiated Sale

- Pre-selected syndicate negotiates the rates and terms with oversight by the issuer and the financial advisor
- Pricing *may* occur 1 to 2 days prior to the award date
- Size and structure can be changed during pricing, sometimes significantly
- Underwriting spreads may be lower since there is less uncertainty during volatile markets
- Significant market data provides comparable transactions for pricing evaluation
- *May* be better for lower rated credits

Pros	Cons
▪ Flexibility in timing of sale to take advantage of market conditions ▪ Effective pre-sale education and marketing ▪ Reduced need to compensate for risk ▪ Ability to reprice with strong order flow ▪ Issuer involvement with allocations	▪ Potential criticism of underwriting syndicate selection ▪ Need to find market comparisons for price evaluation

Competitive Sale

- Bids received at a certain date and time
- Less flexibility could be mitigated with the ability to modify the bid specs/bond structure before and after the sale
- Underwriter's discount is imputed in the interest rate
- Underwriting spreads may be higher during volatile market and/or with more complex credits
- Numerous bids result in fair comparison

Pros	Cons
▪ Competitive posture ▪ Simplification of marketing process ▪ Objectivity related to underwriter selection	▪ Underwriting risk built into rate ▪ Generally, less flexibility than a negotiated sale

Credit Enhancement

- Backing from State government
  - Example: Permanent School Fund ("PSF") Guarantee
- Bank letter of credit ("LOC")
  - Typically provided by a commercial bank or commercial arm of an investment bank
  - Promise to repay principal and interest if the issuing entity cannot
  - Commonly associated with variable rate debt
- Municipal bond insurance
  - Third party that will guarantee the timely payment of principal and interest on a municipality's bonds
  - Higher credit rating of the municipal bond insurer will help lower the yields on a bond pricing

Interest Rates and Curves

- Basis Point
  - Equal to 1/100 of a percent
  - For example, 5.00% is 500 basis points
- Net Interest Cost
  - One method of calculating interest cost; does <u>not</u> take into account the time value of money
- True Interest Cost
  - Another method of calculating interest cost that <u>does</u> take into account the time value of money
  - Generally, this is the industry standard for quoting an overall municipal bond rate
- Yield Curves
  - Normal, Inverted, Flat, Humped

Structuring and Marketing of the Bond Issue

- Bond denomination
  - Most municipal bonds are issued in $5,000 denominations
- Bond maturity
  - Date that principal is due to an investor
- Serial bonds
  - Bonds that mature in each year and have an individual stated coupon and yield for each maturity date
- Term bonds
  - Structure whereby individual maturities are grouped together and have one coupon and yield
  - Typically a term bond will have sinking fund payments where principal is repaid in each individual year

Structuring and Marketing of the Bond Issue (cont.)

- Call provisions
  - Allows the *issuer* the ability to take away the bonds from investors based on a specific point in time or any time thereafter
  - Gives the issuer the ability to refinance the bonds for debt service savings in the future if rates are lower or pay off the bonds outright

- Put provisions
  - Gives the *bondholder* the right to require payments on the bonds at a specified time
  - Typically associated with variable rate bonds

Ongoing Compliance

- City is typically required to update certain financial and operating data annually after the issuance of bonds
  - Known as SEC Rule 15c2-12 or Continuing Disclosure
- City is also required to notify the market of material events
  - Most common are rating changes and redemption/defeasance of existing debt
- City should track earnings on project proceeds (arbitrage rebate)
- City should monitor proceeds from tax-exempt bonds
  - Proceeds must be used for intended purposes
  - May be necessary to defease debt if there is a change in use or ownership of a project