

CPIM

CENTER FOR PUBLIC INVESTMENT MANAGEMENT



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TREASURER OF OHIO

Basics of Borrowing

Part 2

FIN 105

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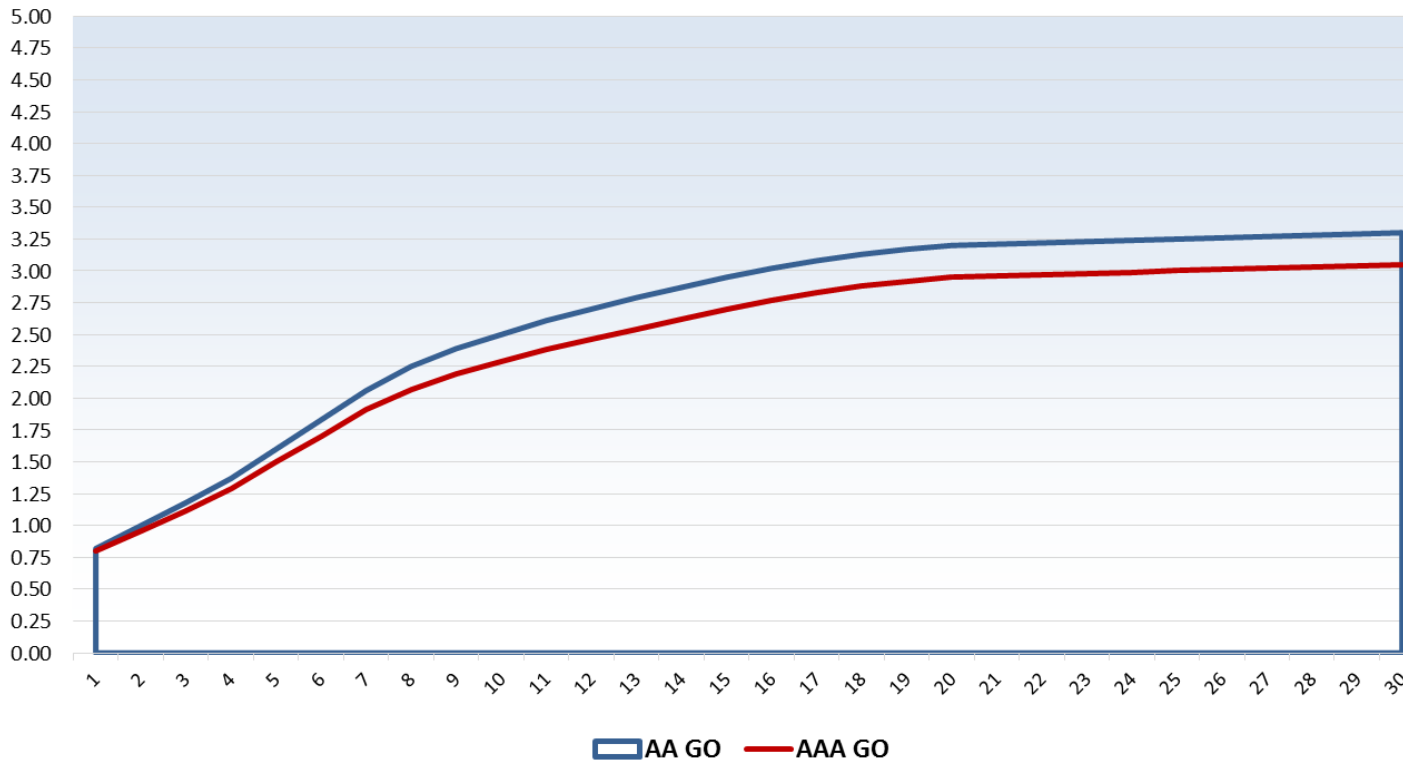
Topics To Be Discussed

- The Market
- Sale Process
- Ratings
- Federal Tax Law Issues
- Federal Securities Law Issues
- Members of the Working Group

Interest Rates & Yield Curves

AAA GO MMD vs. AA GO MMD

As of 2/27/2017
SOURCE: Thompson Reuters



Years	AAA GO	AA GO
1	0.8	0.82
2	0.96	1
3	1.12	1.18
4	1.29	1.37
5	1.5	1.6
6	1.7	1.83
7	1.91	2.06
8	2.07	2.25
9	2.19	2.39
10	2.29	2.5
11	2.38	2.61
12	2.46	2.7
13	2.54	2.79
14	2.62	2.87
15	2.7	2.95
16	2.77	3.02
17	2.83	3.08
18	2.88	3.13
19	2.92	3.17
20	2.95	3.2
21	2.96	3.21
22	2.97	3.22
23	2.98	3.23
24	2.99	3.24
25	3	3.25
26	3.01	3.26
27	3.02	3.27
28	3.03	3.28
29	3.04	3.29
30	3.05	3.3

Negotiated Sale

- Underwriting firm is selected well in advance of the proposed sale date.
- Underwriter also proposes an amount of compensation known as underwriter's discount.
- The underwriting firm takes the lead in marketing the bonds to investors.
- Underwriter proposes interest rates at which various maturities will be offered to investors.
- Upon approval by the issuer, underwriter will approach investors to determine whether bonds can be sold at the proposed rates.
- Adjustments are made to the interest rate scale until final terms are reached reflecting the supply and demand of the bonds.
- Once terms for the sale have been reached a bond purchase agreement is signed by the issuer and underwriter (purchaser) agreeing to the terms.

Negotiated Sale

- **Advantages:**
- Greater incentive for underwriter to engage in pre-sale marketing of the bonds to assess demand for certain structures and maturities.
- A negotiated sale provides the greatest amount of flexibility regarding structure and timing of the sale.
- **Disadvantages:**
- Negotiated sales require issuers to make a greater effort to remain informed of developments in the municipal market to ensure that bonds are priced at favorable rates and the underwriting spreads are reasonable.
- Utilizing a municipal advisor can mitigate this risk.

Competitive Sale

- In a competitive sale, the issuer solicits bids from underwriting firms to purchase its bonds.
- Issuer determines the size and other essential characteristics of the issue prior to soliciting bids.
- A Notice of Sale containing bid parameters and terms of the issue is distributed to underwriters.
- Each bid takes into account both the interest rate paid to investors and the amount of compensation paid to the underwriting firm for selling the bonds.
- Bonds are awarded to the firm or syndicate offering the lowest interest rate (highest price) bid.
- Final terms and underwriter who will purchase the bonds are outlined in the Certificate of Award.

Competitive Sale

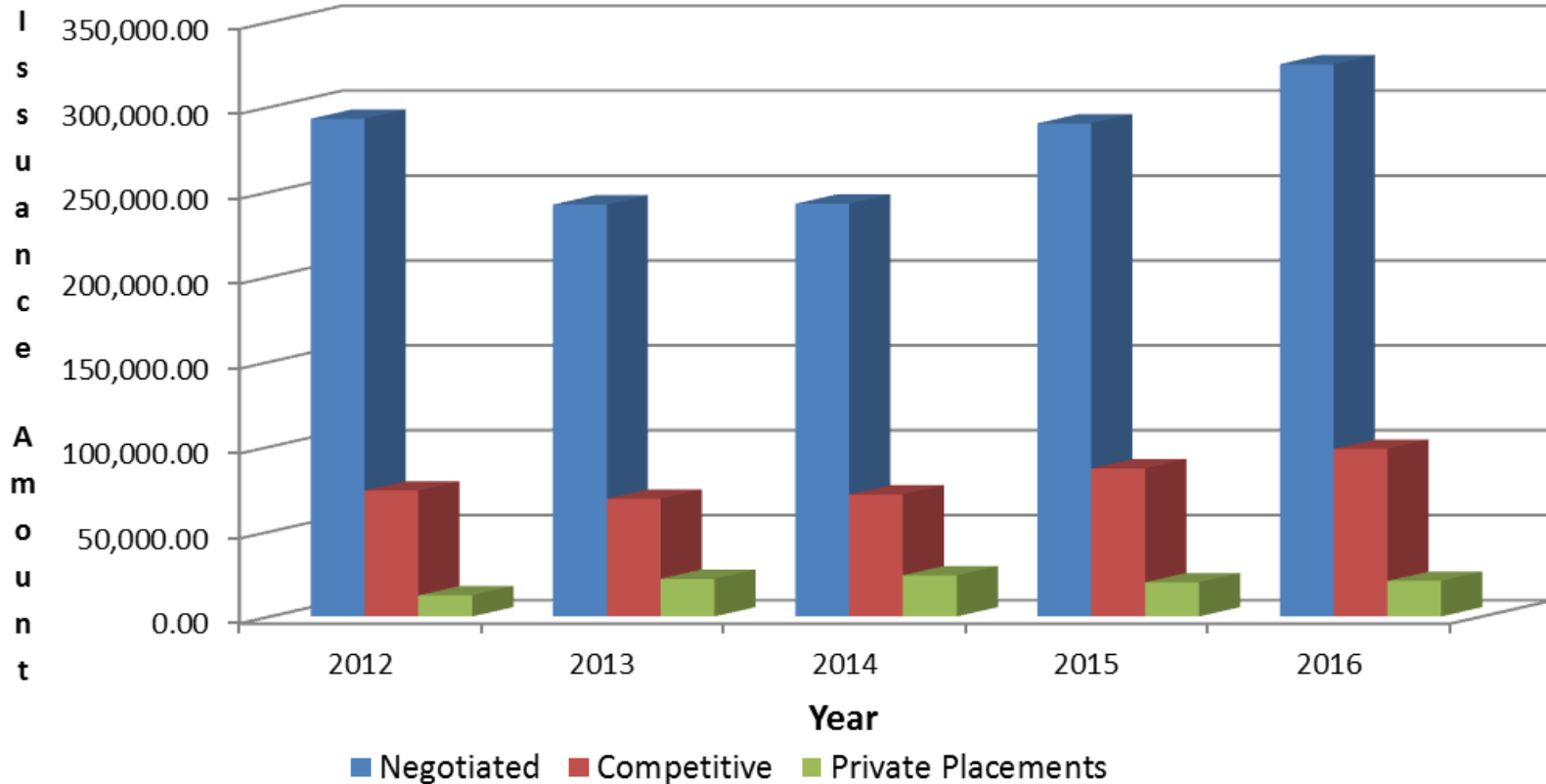
- **Advantages:**
- Provides some assurances that bonds have been sold at the lowest interest rate given market conditions.
- Competitive sales promote the appearance of an open fair process.
- **Disadvantages:**
- Issuer may have less flexibility in adjusting the structural features to respond to investor interest in certain maturities, call provisions or other characteristics.
- Underwriters may build a “risk premium” into their bids to compensate for uncertainty in being able to sell the bonds at a particular interest rate and interest rate volatility.
- Complex financings or weak or unknown credits may have difficulty attracting bids.

Private Placement or Direct Purchase

- Method of sale in which the issuer sells bonds directly to a limited number of sophisticated investors or financial institutions without a public offering.
- For governmental issues, bonds are typically sold to a bank.
- Financial institution may hold the securities in its investment portfolio until maturity.
- Bonds may also have provisions to sell or transfer the bond to another sophisticated investor.
- Common for financings with shorter terms (weighted average maturity of approximately 10 years or less)
- Typically no offering document or rating, CUSIP or DTC
- Private Placements require investor letters (big boy letters)
- Can be sold to 35 or fewer investors
- Typically exempt from continuing disclosure under Rule 15c2-12

Negotiated vs. Competitive Sale

Negotiated, Competitive & Private Placement Issuance 2012 - 2016



Source: Bond Buyer

What Is A Rating?

- Provides an analysis (and rating) of the issuer's credit quality. (i.e. ability to repay the debt obligation)
- There are three primary rating agencies:
 - Standard & Poor's (S&P)
 - Moody's
 - Fitch

S&P Global

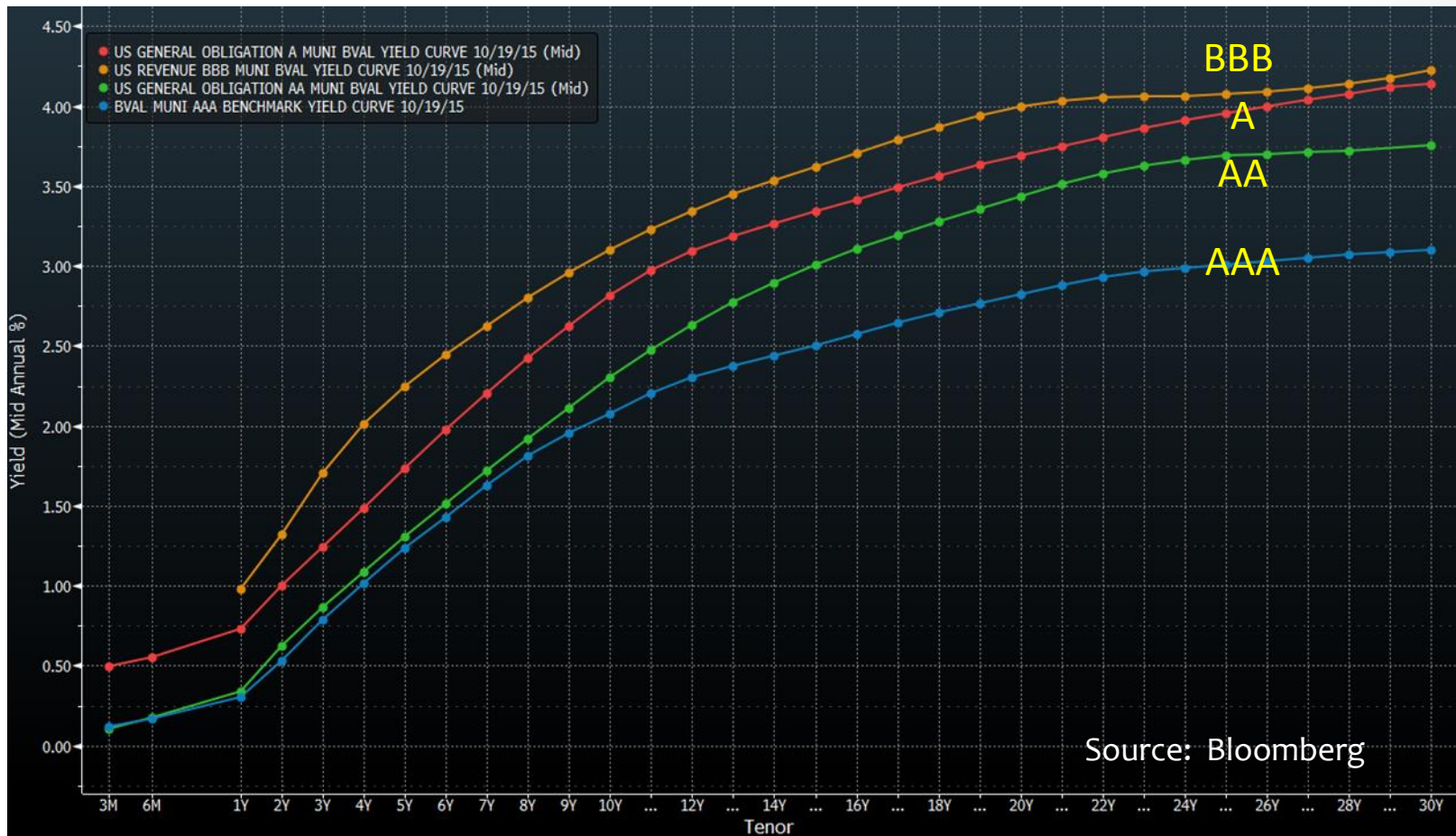
MOODY'S
INVESTORS SERVICE

FitchRatings

Credit Rating

	MOODY'S INVESTORS SERVICE	S&P Global	FitchRatings	Description
Investment Grade	Aaa	AAA	AAA	Highest Quality
	Aa1	AA+	AA+	High Quality
	Aa2	AA	AA	
	Aa3	AA-	AA-	
	A1	A+	A+	Good Quality
	A2	A	A	
	A3	A-	A-	
	Baa1	BBB+	BBB+	Below Average
	Baa2	BBB	BBB	
Baa3	BBB-	BBB-		
Below Investment Grade	Ba1, Ba2, Ba3	BB+, BB, BB-	BB+, BB, BB-	Speculative
	B, Caa	B, CCC, CC	B, CCC, CC, C	Very Speculative
	Ca, C	D	DDD, DD, D	Default

Ratings & Interest Rates



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Marketing the Bonds

Competitive and Negotiated Sales

- How does an issuer sell its bonds?
- Who assists the issuer with this process?
- A *Preliminary Official Statement* (POS) is sent to prospective investors (via hardcopy and/or electronic distribution).
- Retail Investors
- Institutional Investors

Pricing

- Interest Rates Locked in for Bonds (Serial Bonds v. Term Bonds)
- Debt Service Schedule finalized
 - Details how much principal and interest will be paid each year and at maturity.
 - At the time of issuance, the auditor or finance director can decide how many bonds to pay off each year
 - No changes once bonds price
- Purchase Agreement/Certificate of Award signed
- Final Official Statement

Closing

- Documents finalized for execution
- Closing certificates
- Tax Documents and IRS Form 8038-G
- Transcript
- Wires Sent/Bonds Close
 - Bonds to investors
 - Bond proceeds to issuer

New Money vs. Refunding

- New Money bonds issued in order to obtain the initial funding necessary for a particular project.
- Refunding involves issuing new bonds to retire existing bonds.
- Refundings are done to reduce interest expense (savings threshold), eliminate restrictive covenants or restructure existing debt
 - Current Refunding – Bonds being refunded are callable within 90 days
 - Advance Refunding – Bonds being refunded are NOT callable within 90 days
 - Escrow Fund
 - Verification Report
 - Only permitted 1x during life of bonds and any tax-exempt refunding bonds
 - Refunded bonds are considered defeased (no longer outstanding)

Legal Considerations: Bond Issuance



- Federal Tax Law – “Tax-Exempt”
 - Use of Tax-Exempt Financed Facility – Private Use
 - City finances municipal building and then leases space to restaurant/cafe
 - Payment of Debt Service – Private Payment
 - City leases space to restaurant/cafe which makes rent payments to issuer
 - Bank Qualification – QTEO
 - Arbitrage /Rebate
- Federal Securities Law
 - No Omission or Misstatement of Material Facts
 - Primary and Secondary Disclosure



SEC Disclosure: Bond Issuance

- Primary Disclosure (POS/OS) – Securities Laws
- Rule 15c2-12 – Regulates underwriters but indirectly regulates issuers
 - Annual information updates
 - Annual audited financial statements
 - Event notices
- MSRB's Electronic Municipal Market Access (EMMA) system and rating agencies

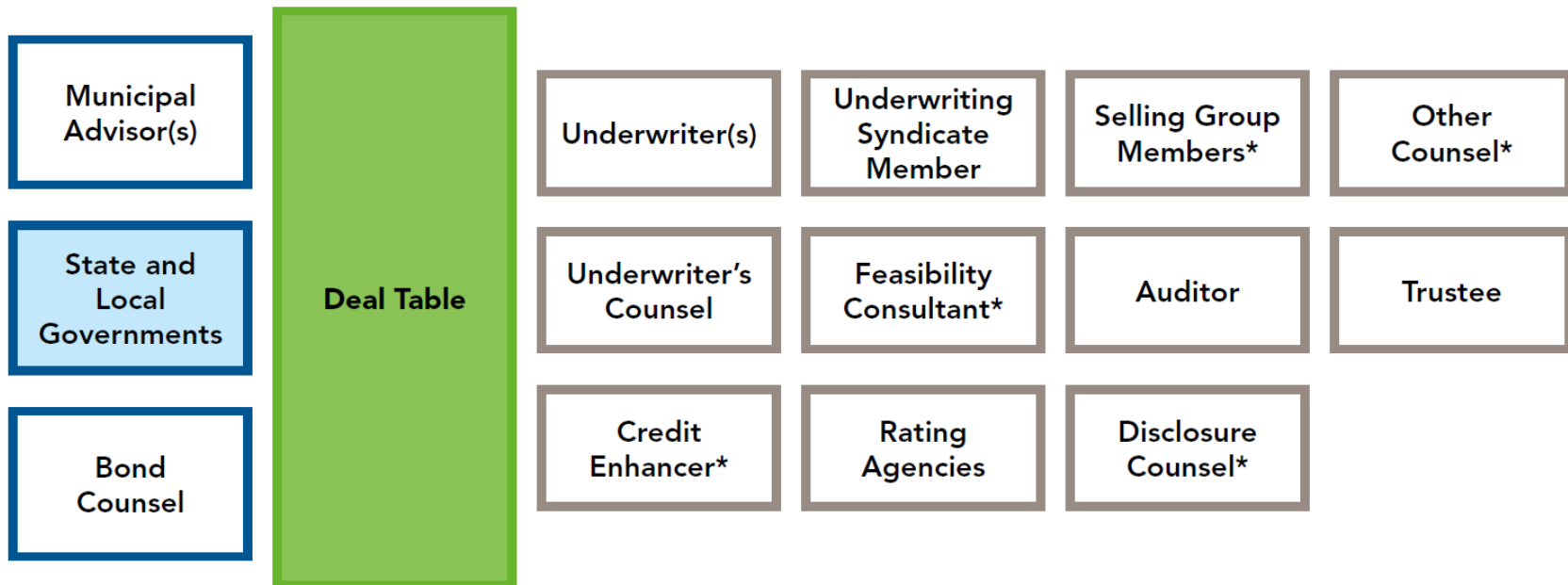
Working Group

- Issuer
- Municipal Advisor
- Bond Counsel
- Underwriter(s)
- Underwriters' Counsel
- Rating Agencies
- Bond Insurer
- Trustee, Registrar, Paying Agent
- Verification Agent
- Escrow Agent/Trustee
- Bond Printer
- Bondholders

Working Group



Professionals Involved in a Negotiated Municipal Bond Transaction



This chart illustrates the various professionals involved in a negotiated municipal bond financing transaction.

* The type, size and feature of the bond transaction will determine the participation of these professionals.

Questions?

