Public Finance Overview

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David Drown Associates, Inc.

Why bother with bonds?

• State law requires a County to borrow money only using bonds or notes -- It is illegal to take out a conventional loan at the local bank. (but you can place bonds at the local bank)
• Most local government bonds feature tax-exempt interest benefits -- this lowers the interest rate on borrowing by approximately 1% - 1.5% (depending on term)

What is a bond?

• A bond is a written promise to repay borrowed money at a future date, and to pay interest in the meantime.
• Bonds are evidenced by Certificates
  – With Bearer Bonds the certificate itself is evidence of ownership, and attached “coupons” were cashed-in to collect interest payments.
  – With Registered Bonds, actual ownership records are maintained by a third party. The certificate has no actual value. Likewise, interest is paid automatically to the registered owner.

General Obligation Bonds

• General Obligation means that the bonds are guaranteed by the full, faith and credit of the County.
• G.O. Bonds are not necessarily paid with taxes (G.O. Revs) but...
• If pledged revenues fail to materialize, the County must levy taxes to cover bond payments (and if the County refuses, the County Auditor will be compelled to levy them)
• G.O. bonds are very secure -- generally very easy to sell at competitive interest rates.
“Pure” Revenue Bonds

- Revenue bonds are paid with a **specific source of revenue**
- The full faith and credit of the issuer is **NOT pledged** to guarantee bond payments. Revenue bonds can (and do) default.
- Revenue bonds are often harder to sell, and have **higher** costs and interest rates.

Serial Bonds

- Most municipal bonds are structured as **serial bonds**
- Each principal payment acts like a separate loan with a unique interest rate
- Interest rates increase with term

Bond Pay Schedule

Bonds are really a lot different than loans.

- Think of this issue as 10 **separate** little bonds.
- Each principal payment has **its own** separate interest rate.
- Lots of flexibility in determining when principal is paid.
- Serial bonds **can** be designed to produce increasing or decreasing payments.
- 30 day month 360 day year convention

<table>
<thead>
<tr>
<th>Payment Schedule &amp; Cashflow</th>
<th>Rate</th>
<th>Interest</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>2/1/2005 to 2/1/2006</td>
<td>2.25%</td>
<td>16,575</td>
<td>61,575</td>
</tr>
<tr>
<td>2/1/2007 to 2/1/2008</td>
<td>2.50%</td>
<td>15,563</td>
<td>60,563</td>
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<tr>
<td>2/1/2009 to 2/1/2010</td>
<td>3.00%</td>
<td>13,200</td>
<td>58,200</td>
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<tr>
<td>2/1/2011 to 2/1/2012</td>
<td>3.20%</td>
<td>11,850</td>
<td>61,850</td>
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<tr>
<td>2/1/2013 to 2/1/2014</td>
<td>3.40%</td>
<td>10,250</td>
<td>60,250</td>
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<td>2/1/2015 to 2/1/2016</td>
<td>3.60%</td>
<td>8,550</td>
<td>58,550</td>
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<tr>
<td>2/1/2017 to 2/1/2018</td>
<td>3.80%</td>
<td>6,750</td>
<td>61,750</td>
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<tr>
<td>2/1/2019 to 2/1/2020</td>
<td>4.00%</td>
<td>4,660</td>
<td>59,660</td>
</tr>
<tr>
<td>2/1/2021 to 2/1/2022</td>
<td>4.10%</td>
<td>2,460</td>
<td>62,460</td>
</tr>
</tbody>
</table>

500,000 104,295 604,295

Bond Details & Structure

Call Protection

- **Call Protection** -- a promise **not** to pay off bonds ahead of schedule until the **call date**.
  - Investors prefer **long** call protection so they have certainty in future bond payments.
  - Counties prefer **short or no** call protection so you can prepay or refund (refinance) bonds without limitation, such as penalties and/or restricted prepayment dates.
  - “Normal” call protection is 7 to 8 years.
  - Understanding terms of call is important.
**Bond Details & Structure**

**Capitalized Interest**

- Additional proceeds added to the bond issue for the purpose of making initial interest payments until identified revenue sources begin to kick in (property taxes, assessments).
- Principal can be deferred for a maximum of 3 years on General Obligation bonds (with exceptions – you can “blend” GO debt to soften this rule).

**Net Effective Interest Rate**

- **Net Effective Interest Rate (NEI)**
  - Is a calculation of total interest paid and the underwriter’s discount.
  - Sometimes referred to as Net Interest Cost (NIC)
  - Higher discount = higher NEI
  - Longer term = higher NEI
  - “Back-ending” principal = higher NEI
- **Competitive sales award based on lowest NEI (or NIC)**

**Payment Schedule & Cashflow**

<table>
<thead>
<tr>
<th>Period Ending</th>
<th>Principal</th>
<th>Rate</th>
<th>Interest</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>9/1/2002</td>
<td></td>
<td></td>
<td></td>
<td>0.00%</td>
</tr>
<tr>
<td>2/1/2003</td>
<td></td>
<td>7,701</td>
<td>7,701</td>
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<tr>
<td>2/1/2004</td>
<td></td>
<td>18,481</td>
<td>18,481</td>
<td>18,481</td>
</tr>
<tr>
<td>2/1/2005</td>
<td></td>
<td>18,481</td>
<td>18,481</td>
<td>19,405</td>
</tr>
<tr>
<td>2/1/2006</td>
<td>30,000</td>
<td>3.000%</td>
<td>18,481</td>
<td>48,481</td>
</tr>
<tr>
<td>2/1/2007</td>
<td>35,000</td>
<td>3.125%</td>
<td>17,581</td>
<td>52,581</td>
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<tr>
<td>2/1/2008</td>
<td>35,000</td>
<td>3.250%</td>
<td>16,488</td>
<td>51,488</td>
</tr>
<tr>
<td>2/1/2009</td>
<td>35,000</td>
<td>3.500%</td>
<td>15,350</td>
<td>50,350</td>
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<tr>
<td>2/1/2010</td>
<td>35,000</td>
<td>3.625%</td>
<td>14,125</td>
<td>49,125</td>
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<tr>
<td>2/1/2011</td>
<td>40,000</td>
<td>3.750%</td>
<td>12,856</td>
<td>52,856</td>
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<tr>
<td>2/1/2012</td>
<td>40,000</td>
<td>3.875%</td>
<td>11,356</td>
<td>51,356</td>
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<tr>
<td>2/1/2013</td>
<td>40,000</td>
<td>4.000%</td>
<td>9,806</td>
<td>49,806</td>
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<tr>
<td>2/1/2014</td>
<td>45,000</td>
<td>4.125%</td>
<td>8,206</td>
<td>53,206</td>
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<tr>
<td>2/1/2015</td>
<td>45,000</td>
<td>4.250%</td>
<td>6,350</td>
<td>51,350</td>
</tr>
<tr>
<td>2/1/2016</td>
<td>50,000</td>
<td>4.375%</td>
<td>4,438</td>
<td>54,438</td>
</tr>
<tr>
<td>2/1/2017</td>
<td>50,000</td>
<td>4.500%</td>
<td>2,250</td>
<td>52,250</td>
</tr>
<tr>
<td>2/1/2018</td>
<td>60,000</td>
<td>4.750%</td>
<td>1,050</td>
<td>61,050</td>
</tr>
<tr>
<td>2/1/2019</td>
<td>70,000</td>
<td>5.000%</td>
<td>1,050</td>
<td>71,050</td>
</tr>
<tr>
<td>2/1/2020</td>
<td>80,000</td>
<td>5.250%</td>
<td>1,050</td>
<td>81,050</td>
</tr>
<tr>
<td>2/1/2021</td>
<td>90,000</td>
<td>5.500%</td>
<td>1,050</td>
<td>91,050</td>
</tr>
<tr>
<td>2/1/2022</td>
<td>100,000</td>
<td>5.750%</td>
<td>1,050</td>
<td>101,050</td>
</tr>
</tbody>
</table>

**Design Issues**

- **Principal Payment Structure (GO)**
  - 3 year deferral limitation
  - Largest principal payment may not exceed smallest by more than five times
  - Both of these rules can be **softened** by “combining” new debt with existing debt
  - Each maturity is to be in increments of $1,000, but industry standard is $5,000 for conventional open market sales
**Revenue Streams**

- Payments should be designed to coincide with designated revenue streams.
- Tax levies, tax increments, tax abatements, and assessments are collected semi-annually.

**Official Statement**

- **Official Statement** -- the disclosure document
  - Describes the debt and issuer in detail.
  - Used by investors to evaluate risk and credit-worthiness.
  - Not always necessary, sometimes an Offering Memorandum is sufficient.

**Bond Issuance Process**

- **Competitive Sale**
  - Solicit bids for the purchase of a County’s bonds, and award to the lowest cost bidder (NEI or NIC).
  - Let market competition select the underwriter to work with.
- **Negotiated Sales**
  - First, select a bank or underwriter to work with;
  - Then negotiate the terms and rates for the issue.

**Issuance Process: Competitive Sale**

- Competitive sales work best when:
  - General Obligation issues (easy for bidders to quickly understand)
  - Rated issues
  - Issue size is fairly large
  - Timing is not critical
- You are confident of getting the lowest cost financing.
### Competitive Sale:

**Competitive Sale Process**

- Select financial advisor and bond counsel.
- Design the bond issue.
  - Term, payments, call, revenue sources
- Pass resolution setting date to receive bids
- Prepare and distribute an *Official Statement*
- Apply for Moody’s or S&P rating (optional)
- Receive bids and pass resolution awarding to low bidder.
- Close and wire funds

Process usually takes about **45 days**

### Issuance Process:

**Negotiated Sales/Local Placements**

- Negotiated sales work best when:
  - Bond issue is complicated or involves additional credit risk
  - Revenue Bonds
  - IDBs, Lease deals
  - Very small issues -- need to control issuance costs (i.e. Offering Memorandum vs. Official Statement).
  - Very LARGE issues -- need to work closely with the underwriters to find enough buyers.
  - You want to control who buys the bonds and where they are sold.
  - Timing is critical -- some refundings

### Negotiated Sale:

**Negotiated Sale Process**

- Select a banker or underwriter.
  - Interview process to select banker
  - Work with local banks to “keep business in town.” There are rules that complicate this process.
- Design the bond issue.
- Negotiate final rates and terms.
- Pass resolution and close

Process usually takes **2 to 6 weeks**

### Other items

- Bonds are governed by many different statutes. I call them “pockets” of authority (described later).
- Some General Rules:
  - Bonds payable *solely* from property taxes cannot exceed 3.0% of the estimated market value of a County - *the statutory net debt limit*
  - Most bonds paid primarily by property taxes are usually subject to referendum vote or reverse referendum criteria.
  - Bonds over $1.2 million must be sold competitively, unless the city is represented by independent financial advisor.
Other items

- **General Obligation** bonds must have revenue sources sufficient to cover 105% of actual payments, and in a very few cases the coverage must be 110%.
- **Continuing Disclosure**
  - “Full” required if all outstanding debt exceeds $10 million
  - “Full” disclosure means that a disclosure statement will be prepared annually and attached to a copy of the most recent audit for the County and sent to all nationally recognized municipal securities information repositories (NRMSIR).
  - “Limited” disclosure, which is much more common requires that the County simply notify the NRMSIR of a major event, such as defaulting on payments. Uploading audits electronically each year is still required.

Other items

- Bonds can be **tax-exempt** if:
  - Project is **County owned** and operated -- highways, parks, buildings, etc; or
  - If a project is privately owned, the County must have sole responsibility for bond payments -- **no developer guarantees**.
  - Tax exempt status equates to an interest rate approximately 1 - 1 ½ percent lower than a taxable deal.
- **Arbitrage** -- investing bond money at a higher rate than the bonds.
  - **Generally Not Legal**.
  - Feds limit yields on bond funds.
  - Proceeds must be spent within a certain time frame.
  - Can’t reimburse prior cash purchases with tax-exempt bonds unless you **declare beforehand** via a Reimbursement Resolution.

The Bond Industry

**Matching Investors with Issuers...**

Industry Participants:

- Investors
- Underwriters
- Financial Advisors
- Bond Attorneys
- Rating Agencies
- Pay Agents/ Registrars

Industry Participants:

- Investors like Minnesota municipal bonds because of:
  - Low risk
  - Tax Exemption -- no tax on interest earnings
- **Individuals** buy over half of all muni bonds
- **Institutions** are also big buyers
  - Mutual funds, insurance companies -- tend to buy “investment grade” rated debt.
  - Commercial banks often buy **unrated** bonds
- Most investors buy bonds through an intermediary brokerage firm (underwriter).
Industry Participants: The Underwriter - (Investment Banker)

- Underwriters are the “wholesale buyers” of the bond industry.
  - They bid or negotiate to buy bonds in bulk
  - Their brokers then resell them to their customers.

Industry Participants: The Underwriter (continued)

- Underwriters are able to receive compensation through two sources.
  
  Source 1 – Underwriters Discount

City of St. Peter, Minnesota Miller Johnson Steichen Kinnard

$805,000 General Obligation Water & Sewer Revenue Bonds, Series 2004C

<table>
<thead>
<tr>
<th>Uses of Funds</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Construction &amp; Engineering - Sanitary</td>
<td>121,470</td>
</tr>
<tr>
<td>Construction &amp; Engineering - Water</td>
<td>360,130</td>
</tr>
<tr>
<td>Construction &amp; Engineering - Storm</td>
<td>285,330</td>
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<tr>
<td>Contingency</td>
<td>8,000</td>
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<tr>
<td>Total Project Costs (snow &amp; ice age)</td>
<td>777,420</td>
</tr>
<tr>
<td>Construction &amp; Engineering - Storm</td>
<td>806,345</td>
</tr>
<tr>
<td>Final Fee</td>
<td>6,000</td>
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<tr>
<td>Bond Counselor</td>
<td>4,000</td>
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<tr>
<td>Pay Agent/Registrar</td>
<td>1,000</td>
</tr>
<tr>
<td>Federal Revenue Tax</td>
<td>3,500</td>
</tr>
<tr>
<td>Capitalized Interest</td>
<td>7,560</td>
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</table>

City of St. Peter, Minnesota Miller Johnson Steichen Kinnard

<table>
<thead>
<tr>
<th>Uses of Funds</th>
<th>Amount</th>
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</thead>
<tbody>
<tr>
<td>Bond Details</td>
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<tr>
<td>Sale Date</td>
<td>6/27/2004</td>
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<tr>
<td>Dated Date</td>
<td>9/27/2004</td>
</tr>
<tr>
<td>Closing Date</td>
<td>10/25/2004</td>
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<tr>
<td>Issued Payment</td>
<td>11/1/2004</td>
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<tr>
<td>Proceeds Used by</td>
<td>11/10/2004</td>
</tr>
<tr>
<td>Purchase Price</td>
<td>706,936.38</td>
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<tr>
<td>Issued Date</td>
<td>10/25/2004</td>
</tr>
<tr>
<td>Issued Interest</td>
<td>3.466%</td>
</tr>
<tr>
<td>Average Life</td>
<td>5.4550</td>
</tr>
<tr>
<td>Call Option</td>
<td>2/1/2011</td>
</tr>
</tbody>
</table>

Sources of Funds

- Cash (City Utility Funds) - Miller Johnson Steichen Kinnard
- Construction Fund Earnings (Excess Proceeds) - Miller Johnson Steichen Kinnard
- Capitalized Interest - Miller Johnson Steichen Kinnard

Industry Participants: The Underwriter (continued)

- Underwriters are paid from the Discount or “spread”;
  - They buy from issuers at a discount -- the underwriters discount is typically 1/2 to 2% of the issue.
  - They resell bonds to customers at a price that is sometimes at par (face amount of bonds); or
Industry Participants: The Underwriter (continued)

Source 2: Reoffering Price, Selling at a Premium:

- The reoffering price is a second source of income for underwriters that most people are not aware of. Often times it will be listed at the bottom of a sales results tabulation.
- The reoffering price that can generate a significant amount of revenue for the underwriter.

Industry Participants: The Underwriter (continued)

- Underwriters usually resell bonds to investors for a price near par (face amount); however, they are able to re-offer the bonds to an investor at premium.
- This sales premium can serve as a significant second source of income for the underwriter.

Industry Participants: The Underwriter (continued)

- Underwriters want higher rates and low prices - you want the opposite.
- A competitive sale process is the best way to ensure that everyone is charging a fair price and the County is receiving the lowest overall cost of borrowing.

Industry Participants: The Underwriter (continued)

- **Syndicates** – are used when bond issues are too large for one firm to handle alone.
  - One firm “runs the books” -- others just sell bonds
  - Local banks often participate in syndicates to secure a portion of a bond issue.
  - Syndicates are often issuer-specific -- the same firms bid together each time a certain issuer goes to market.
  - Issuers typically don’t get involved in syndication, except to ensure a local bank/underwriter gets some of the bonds.
Industry Participants: The Financial Advisor

- The Issuer’s finance expert and advisor. They represent YOU.
- Job duties include:
  - Help develop a strategy for project financing
  - Design the details of the bond issue – amount, term, payment requirements, revenue sources, etc.
  - Prepare the Official Statement

Job duties (continued):
- Negotiate price and rate, or administer the competitive bidding process.
- Make an award recommendation
- Coordinate closing and transfer of funds
- Assist after the sale with accounting, arbitrage compliance, etc.

Fiscal Advisors are your Financial “Engineers”

- Feasibility Studies
- Street and Utility Design
- Plans and Specs
- Advertise for Bids
- Tabulate sealed bids
- Award to lowest qualified bidder

- Plan of Finance / CIP
- Bond Issue Design
- Official Statement
- Solicit Bids
- Tabulate sealed bids
- Award to lowest qualified bidder

What to look for in a good financial advisor...

- Commitment to long-term financial Strength
  - Long term vs. transaction orientation.
  - Capital financial planning.
  - Goal to preserve financial strength.
- Willingness to help you avoid and control the issuance of new debt.
- Willingness to tailor the process to your needs.
  - Negotiated sales & competitive sales as appropriate.
  - Use of non-market debt (state & federal funding sources, etc.) despite the fact those deals typically don’t involve fees for the advisor
Industry Participants: 
The Bond Attorney *(Bond counsel)*

- Specialist attorneys -- perhaps a dozen firms in Minnesota recognized as experts.
- Bond attorneys duties are to:
  - Interpret federal, state, local, and *securities laws* and make sure the County complies with them.
  - Prepare bond documents, resolutions, agreements and other related legal documents.

Industry Participants: 
The Bond Attorney *(continued)*

- and perhaps most importantly….
  - Issue a written *legal opinion*  
    - certifies the County has the *authority* to issue the bonds
    - certifies that interest on the bonds will be *exempt* from federal and/or state taxation.

Industry Participants: 
The Rating Agencies

- Major agencies are Moody’s, S & P and Fitch
- What they do:
  - For a *fee*, rating agencies will issue a “credit rating” for a specific bond issue.
    - AAA, AA, A, Baa (investment quality)
    - Ba and lower (non-investment quality)
  - Ratings give investors an *independent opinion* about risk and credit quality.

Industry Participants: 
What is a credit rating worth?

- Depending on market conditions, one grade means 5 to 15 basis points.
- The difference in interest rate between a rated and unrated bond issue can be significant
- For a $1 million bond issue with a longer term, a $9,500 credit rating could save an issuer up to ten times that amount in interest paid over the life of the deal.
Industry Participants: The Pay Agent/Registrar

- Bonds of an issue may be owned by dozens of investors scattered throughout Minnesota.
- Pay Agent/Registrars make your job easier in future years by:
  - Keeping the official “register” of bond owners -- update when bonds trade owners
  - Sending invoices to County staff for upcoming payments
  - Receiving County payments and distributing them in the right amounts to the investors.

Bonds are heavily regulated

- General rules found in M.S. Chapter 475 govern all types of bond issues.
- Special rules are scattered throughout State Statutes -- each has unique requirements and exceptions to general rules.
- When bonds are issued, a specific statute is cited as the “Authority” for the bonds.
- Challenge is to match each project’s needs with the proper Authority.
- Some forms of authority have capacity limitations.

General G.O. Bond Rules

- **Statutory Net Debt Limit** – Bonds payable solely from property taxes cannot exceed 3.0% of the estimated market value of a jurisdiction.
- **Competitive Sales** – required for GO Bonds over $1.2 million, unless the jurisdiction is represented by independent financial advisor.
- **3-year Rule** – requires some principal payment within 3 years
- **5 times Rule** – max and min. principal payments cannot differ by more than 5 times
- **105% Coverage** – pledged revenues must exceed bond payments by 5%.

General G.O. Bond Rules

- Minnesota law allows most bonds to carry a **G.O. pledge**, even when paid from non-tax sources.
- Common revenue bonds (non GO):
  - Housing Revenue Bonds (affordable or senior housing)
  - Lease Revenue Bonds – public facilities
  - Tax Increment Revenue Bonds
Courthouse Bonds

Authority: • Chapter 375.18 Sub. 3
Typical Projects: • Courthouse (erect, furnish, maintain)
Special rules or limits: • Amount limited to a levy of .04030% of market value
• Not subject to referendum vote if below that threshold.

Jail Bonds

Authority: • Chapter 641.23
Typical Projects: • County Jail, Sheriff's Residence
Special rules or limits: • No election (referendum) required if the annual payment on all bonds issued for this purpose is less than .09671% of the estimated market value of taxable property within the County.

Capital Improvement Plan Bonds

Authority: • Chapter 373.40
Typical Projects: • Acquisition or betterment of public lands, buildings for the purpose of a courthouse, admin building, health or social service building, jail, law enforcement center, hospital, morgue, library, park, roads & bridges, public works, fairgrounds, data storage, conservation easements.
Special rules or limitations: • Must have useful life of at least 5 years.
• Requires 5 yr. capital improvement plan which is subject to reverse referendum (5% petition).
• Three-fifths board approval
• Annual P&I limited to .12% of taxable market value.
**Capital Notes**

**Authority:** • Chapter 373.01 Subd. 3
**Typical Projects:** • Equipment with a useful life at least equal to the term of the notes.

**Special rules or limits:** • Term limited to 10 yrs.  
• Pledge of tax levy  
• Subject to County Debt Limit

**Drainage Bonds**

**Authority:** • Chapter 103E.635
**Typical Projects:** • Drainage Improvements

**Special rules or limits:** • Must be 100% assessed  
• Maximum term of 23-years  
• General Obligation Pledge  
• Temporary bonds can be issued

**Lease Purchase Deals**

One alternative to a referendum vote

- Often used when referendum vote or debt limit is a problem.
- **Typical Structure:**
  - EDA/HRA issues a *revenue* bond (not subject to G.O rules)
  - EDA/HRA signs an *annual appropriation lease* with County -- uses lease payments to cover bond payments.
  - County Board *must* be able to cancel lease in any year.
- Works best for *essential-purpose* structures where a County is unlikely to cancel the lease.
- Interest usually win .25% to .5% of G.O. rates

**G.O. TIF Bonds**

**Authority:** • Chapter 469
**Typical Projects:** • Development Subsidies Related Public Improvements

**Special rules or limits:** • Tax Increments must fund at least 20% of principal payments any source for balance  
• Bonds and expenditures must be authorized in a TIF Plan.  
• Not subject to net debt or referendum.
Essential Function Bonds
Corporate Purpose Bonds

Authority:
• Chapter 469.034

Typical Projects:
• Low Income Housing
  Elderly Housing

Special rules or limits:
• Can carry G.O Pledge if:
  – Project revenues projected to cover 110% of bond payments
  • Amount limited to one-half of 1% of the estimated market value for all projects within jurisdiction.
  • Projects subject to payment in lieu of taxes.

A few others…

• Tax Abatement Bonds – tax abatements must cover 100% of principal.
• Tax Anticipation Notes – issued for cash flow purposes in anticipation of levy receipts.

Finish Line

Questions?

Thank you for attending this presentation.