Kern County Superintendent of Schools

Demystifying School Debt Finance

presented by

Kern County Office of Education

and

California Debt and Investment Advisory Commission

California Debt and Investment Advisory Commission

FRA113995

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- 31 years school bond experience
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- Principal, Fieldman, Rolapp & Associates
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- Expertise in general obligation bonds, certificates of participation, land secured financings, developer negotiations and school facilities
- Co-chair of the CASH Fiscal Management Strand, member of CSBA, and CASBO

Reasons Why School Districts Use Financing

- Acquire land
- Construct/improve buildings
- Install improvements and facilities
- Acquire equipment
- Fund working capital
- Refinance existing obligations / leases

Finance Mechanisms & Tools

- General Obligation Bonds (GO Bonds)
  - Education Code
    (Maturities to 25 yrs)
  - Government Code
    (Maturities to 40 yrs)
- Bond Anticipation Notes (BANs)
- Certificates of Participation (COPs)
- Tax and Revenue Anticipation Notes (TRANs)

GO Bonds

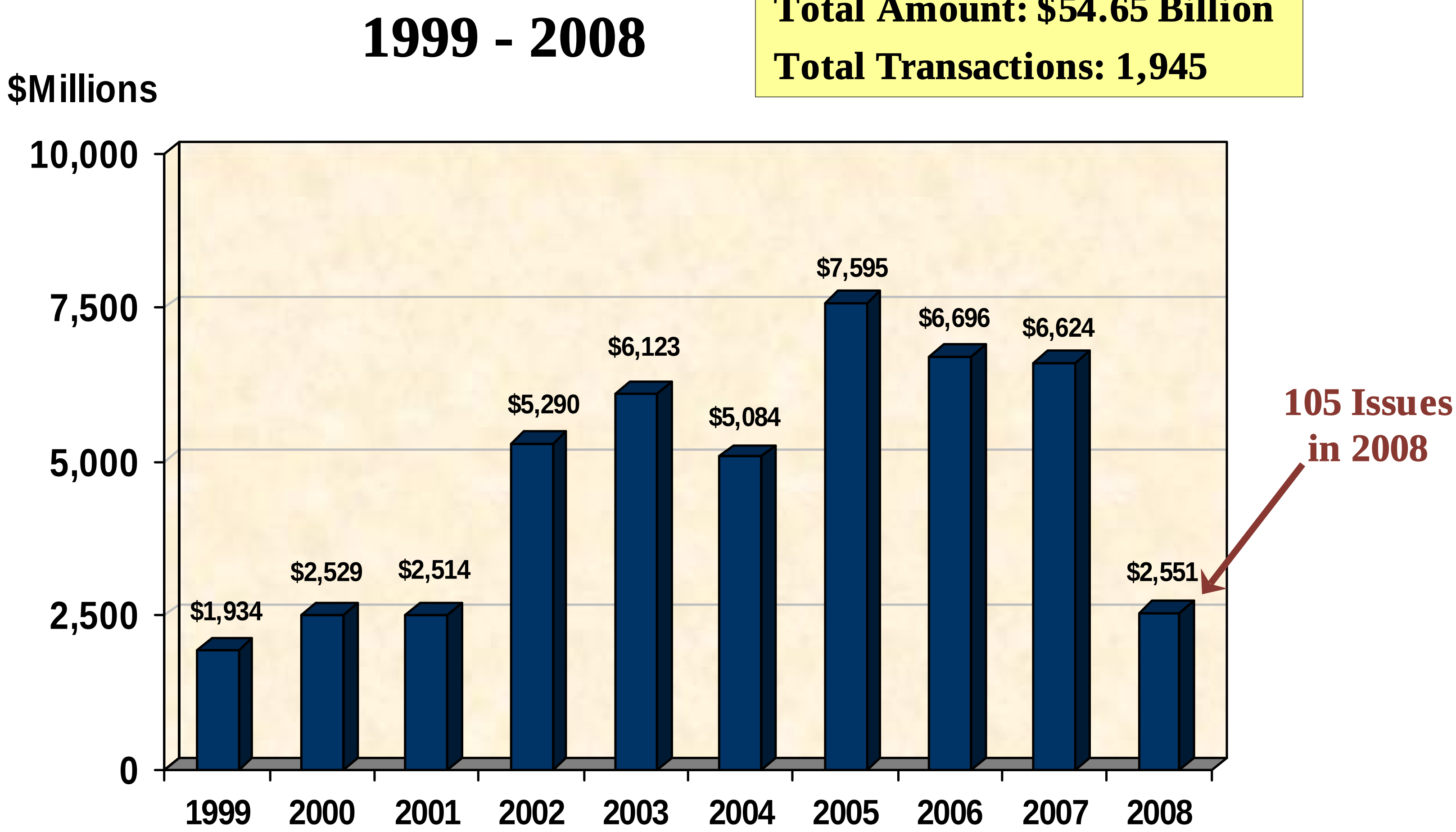
- Assessed Valuation Drives Access
  - Voter Approved Authorization ≠ Cash Available Now
  - Higher growth allows earlier issuance
  - Lower growth/decline hinders issuance
  - Tax Rate Caps – Legal vs Political Restriction?

Assessed Value Trends

- The State of California had seen double-digit growth in assessed valuation for many local governments, including school districts, from 2003-2007
- Recently, this trend has slowed or reduced to high single digit and double digit reductions in assessed valuations in 2008 and 2009
- What does this mean for K-12 school districts?
  - Lower assessed valuations mean lower 1.25% or 2.50% statutory bonding capacity
  - Limited or no access to proposition approved Proposition 39 $30 or $60 per $100,000 tax rate limitations GO Bond elections due to assessed valuation reductions
  - Political implications due to lack of access to funds may lead to other more expensive financing options for K-12 school districts

Annual K-12 GO Bond Volume

Total Amount: $54.65 Billion
Total Transactions: 1,945



Source: California Debt and Investment Advisory Commission (CDIAC)

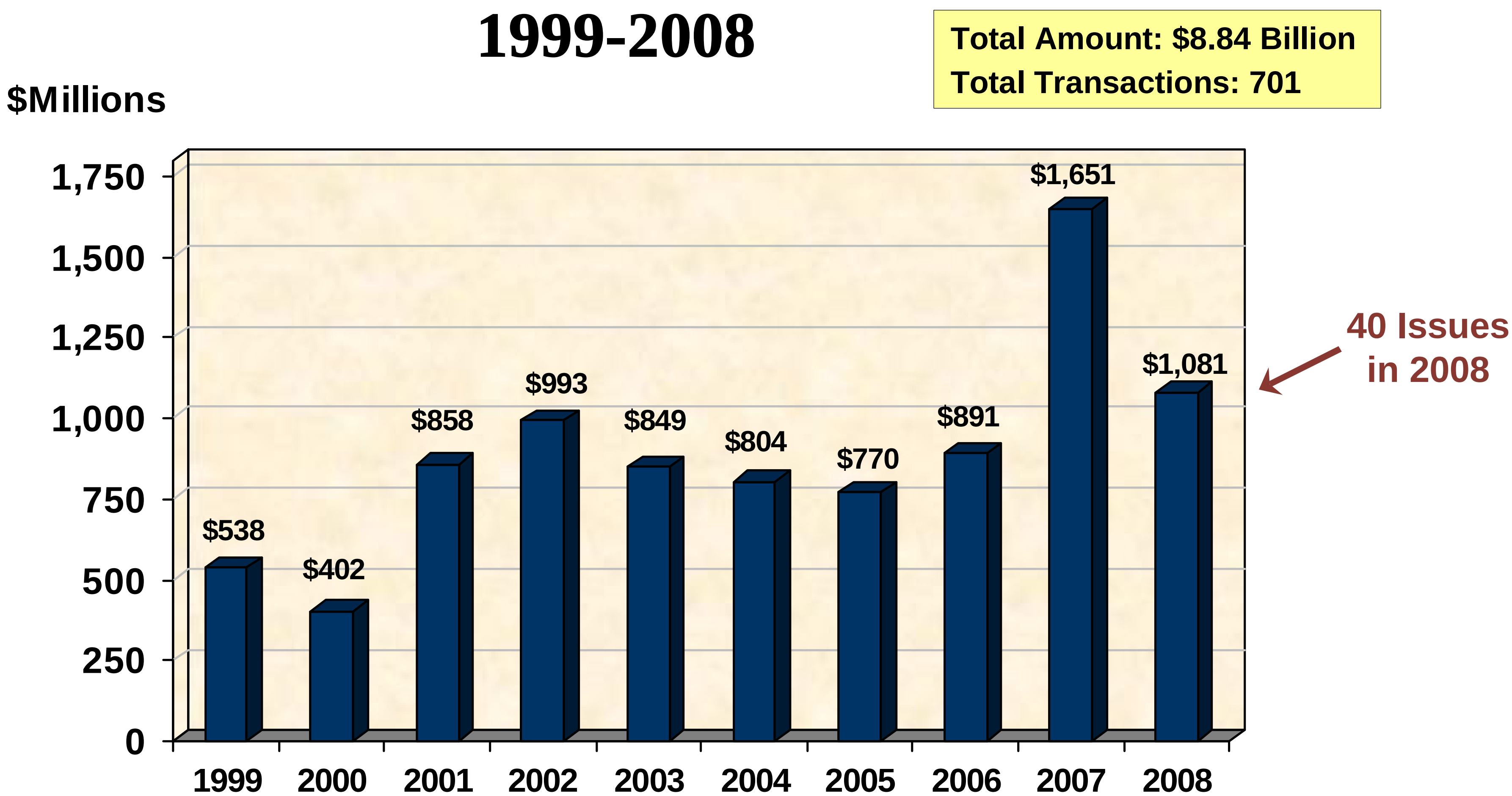
BANs

- Bond Anticipation Notes can be used to give districts access to cash sooner than bonds
- Notes and renewals thereof must be payable not more than five years from the date of the original issuance of the first Notes
- Total amount of Notes or renewals thereof issued and outstanding may not exceed the total amount of unsold (authorized) bonds
- The proceeds from the sale of the Notes must be used only for authorized purposes of the bonds or to repay outstanding notes previously issued

COPs

- Issue Certificates of Participation
  - Advance/finance bond authorization to undertake immediate facility needs
  - Pay-off w/GO Bonds in future when assessed value has grown
  - Drawback: COPs pay interest that is a current drain on General Fund

Annual K-12 COPs Volume



Source: California Debt and Investment Advisory Commission (CDIAC)

TRANs

- Short term borrowing
  - Maximum 13 months
  - May be tax-exempt or taxable
  - Must be repaid from revenues of the same fiscal year; repayment set-asides made during or after the fiscal year
- Provide working capital and ease cash flow fluctuations during the year
  - Sized to cover maximum cash flow deficit
  - May be used for current expenses, capital expenditures and investment and reimbursement
  - May be able to keep arbitrage earnings

TRANs

- No voter approval required
- Require school board and county board approval, ratings (or credit enhancements) and disclosure
- Alternative: Borrow from the County Office or County Treasurer in negative months

Build America Bonds (BABs)

- Taxable bonds with a 35% interest subsidy
  - Expands market to investors who prefer taxable returns
  - Bonds that could otherwise be issued as tax-exempt
  - Government purpose bonds only
    - No Private Activity Bonds, e.g. affordable housing, student loans, IDBs, 501(c)3 bonds
  - No volume limitation for bonds issued in 2009 and 2010
  - Program expires December 31, 2010
  - District choice: Direct Payment BAB or Tax Credit BAB

Direct Payment BABs

- District receives subsidy of 35% of interest payment – federally guaranteed revenue stream
  - Payments can go directly to bond trustee or
  - Payments may go directly to district for other expenditures
- Limit of 2% for costs of issuance
- No refundings permitted
- Arbitrage calculations based upon net payment by district

Tax Credit BABs

- Bondholder receives 35% tax credit
  - Tax credit payment is taxable
  - Paid quarterly
- May strip the tax credits and sell them separately
- Same rules for capitalized interest & issuance costs as apply to tax-exempt bonds
- Tax credits do *not* count in arbitrage calculations
- Refundings are permitted
- May be helpful to soften Prop 39 tax levy by removing the interest component

California K12 School District ARRA Issues

Build America Bonds (BABs)

Issuer	Issue Date	Total Issue Size	Taxable Portion
Oakland USD	8/12/2009	$158.7M	$70.8M
West Contra Costa USD	9/3/2009	$162.8M	$52.8M
Santa Monica - Malibu USD	8/5/2009	$60.0M	$48.1M
Napa Valley USD	8/4/2009	$30.0M	$21.5M
Total			**$193.2M**

Tax Credit Bonds

Issuer	Issue Date	Total Issue Size	Tax Credit Portion
San Diego USD	5/7/2009	$38.8M	$38.8M
Oakland USD	8/12/2009	$26.3M	$26.3M
Total			**$65.1M**

Qualified School Construction Bonds (QSCBs)

What are QSCBs?

- A new form of tax credit bond to promote the construction and improvement of public schools
  - U.S. Treasury Department initially allocated QSCBs to large urban districts in California
  - State has established regulations for allocating volume cap to other districts
- Bonds are sold with a tax credit to investors that substantially replaces interest payments on the bonds
- Fewer restrictions for eligibility compared with other tax credit bonds such as Qualified Zone Academy Bonds ("QZABs")
- Debt repayment period of 14-16 years
- Not free money to school districts, but rather interest free loans
- Principal amount can be repaid with annual installments or sinking fund deposits over specified years
- QSCBs may be repaid using almost any revenue source available to a school district

California QSCB Allocations and Use of Proceeds

California Allocations

- In 2009, the State will allocate $773.5 million to local school districts after August 25, 2009, and $582.0 million directly to 11 large districts (see chart below)

Local Education Agency	2009 Allocation	Local Education Agency	2009 Allocation
Bakersfield City ESD	$15,720,000	Oakland USD	$26,326,000
Compton USD	18,559,000	Sacramento City USD	21,251,000
Fresno USD	41,398,000	San Bernardino City USD	27,790,000
Long Beach USD	37,905,000	San Diego USD	38,877,000
Los Angeles USD	318,816,000	Santa Ana USD	19,269,000
		Stockton City USD	16,055,000

- In 2010, the State will allocate $1.36 billion total to school districts which will be available for allocation beginning January 1, 2010

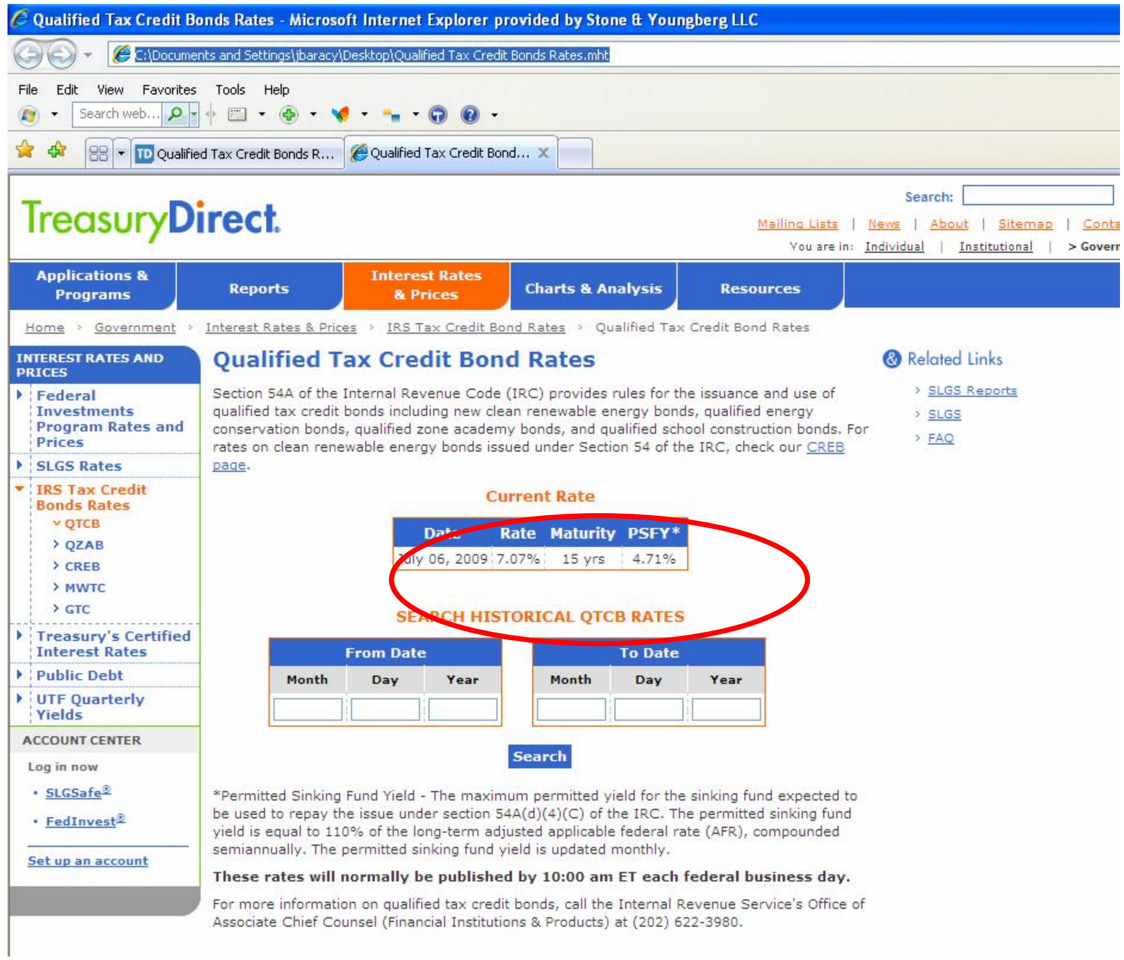
Use of Proceeds

- Public school construction, rehabilitation and repair
- Acquisition of land for facility funded with QSCBs
- Equipment for use in facility funded with QSCBs (or portion thereof)

How Interest Rates are Determined for QSCBs

The tax credit rate for the life of the QSCB bond is set by the U.S. Treasury daily (7.07% on 7/6/2009) and can be found at the following website:

https://www.treasurydirect.gov/govt/rates/irs/rates_qtcb.htm



Lessons Learned: SDUSD QSCB

- SDUSD did first QSCB in the nation - $38.7 million of GO Bonds
- Special Challenges:
  - Redemptions <u>required</u>
  - "Make Whole" <u>penalty</u>
  - <u>2% limit</u> on COI
- Tax Credit "Strips"
- Taxable bonds still subject to arbitrage rebate and audit

Identifying the Need

- Student enrollment growth
  - Updated enrollment projections
  - Available facilities
  - Demonstrated facility needs (Project)
    - New Facilities
    - Modernization

Building the Support

- Voter research poll
  - Voter profile
  - Project and Measure Support
- Campaign Advice
  - Campaign Consultant
  - Campaign steering committee
- District Activities to build support of the Measure
  - Financial Activities in order (Clean House)
  - Clear and Consistent Message
  - Supportive community leaders
  - Supportive school district staff
  - Engage the taxpayer early in the process
- Campaign
  - Funding
  - Media Promotions
  - Phone Bank
  - Speakers Bureau
  - Endorsement

Financing Team Members and Roles

Role of the Professionals:

- **Issuer Internal Team:**
  - Superintendent
  - Chief Business Official
  - Facilities Director
  - District Counsel
- **Issuer Consultants:**
  - Bond Counsel
  - Disclosure Counsel
  - Dissemination Agent
  - Campaign Consultant
  - Financial Advisor
  - Trustee
  - Underwriter
- **Third Parties:**
  - County Treasurer/Auditor
  - Rating Agency
  - Credit Enhancer

Financing Team Members and Roles *(cont'd)*

Their Collective Role:

- Optimal structuring to accomplish goals
- Minimize potential for legal liability
- Better market acceptance of debt being sold

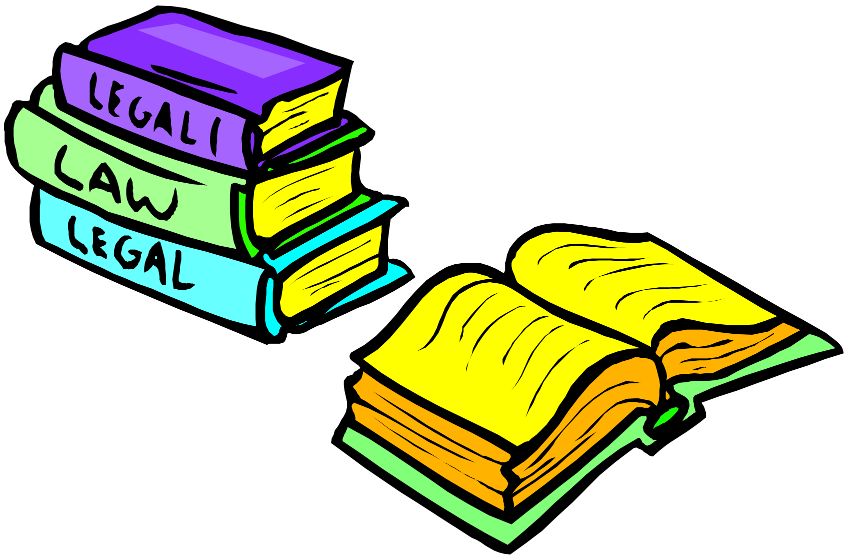
Financing Team Members and Roles *(cont'd)*

Bond Counsel:

- Provides legal parameters and guidelines to School District and Financing Team
- Drafts legal documents pursuant to which debt is issued/secured
- Provides the legal opinion stating that debt is *exempt* from federal and state income taxes (California)

  or

  That QSCBs and BABs are valid obligations and exempt from California income taxes *only*



Financing Team Members and Roles *(cont'd)*

Financial Advisor:

- Advises and assists in the formulation/ execution of financing plans
- Does not purchase or underwrite debt
- Role of financial advisor depends on:
  1. the needs of the School District
  2. the method of sale chosen and/or
  3. the complexity of the financing

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Financing Team Members and Roles *(cont'd)*

Underwriter:

- Purchases debt with the intent to resell to investors
- In a negotiated sale the underwriter is hired early in the process and assists the School District and other members of the financing team
- In a competitive sale, the Underwriter simply delivers a sealed bid on the date of sale offering to purchase the debt at fixed interest rates and prices

Campaign Consultant:

- Hired by the district to conduct marketing campaign for election
- Works directly with district staff, legal and financial team to determine most successful strategy to win bond election

Financing Team Members and Roles *(cont'd)*

Disclosure Counsel:

- A law firm retained to assist the District in fairly disclosing all pertinent facts relating to the debt offering

Bond Trustee / Registrar / Paying Agent:

- Usually a bank with trust power which acts in a fiduciary capacity for the benefit of the bondholders in enforcing the terms of the bond documents
- Maintains records on behalf of the issuer for the purpose of notifying the owners of registered bonds
- Pays interest and principal on bonds on behalf of the issuer

Financing Team Members and Roles *(cont'd)*

Dissemination Agent:

- The Dissemination Agent takes responsibility for filing the Annual Report under the Continuing Disclosure Agreement and filing notices of material events

County Treasurer / Auditor:

- The principal duties include the management and investment of County, School and Special District funds
- Bond Administration (general obligation bonds)
- Collection of taxes and revenues

Financing Team Members and Roles *(cont'd)*

Underwriter's Counsel:

- A law firm retained by the Underwriter to represent the Underwriter's interests

Rating Agency:

- An independent service that provides a credit quality evaluation of bonds and notes. Standard & Poor's, Moody's and Fitch are common for school district credit ratings

Credit Provider:

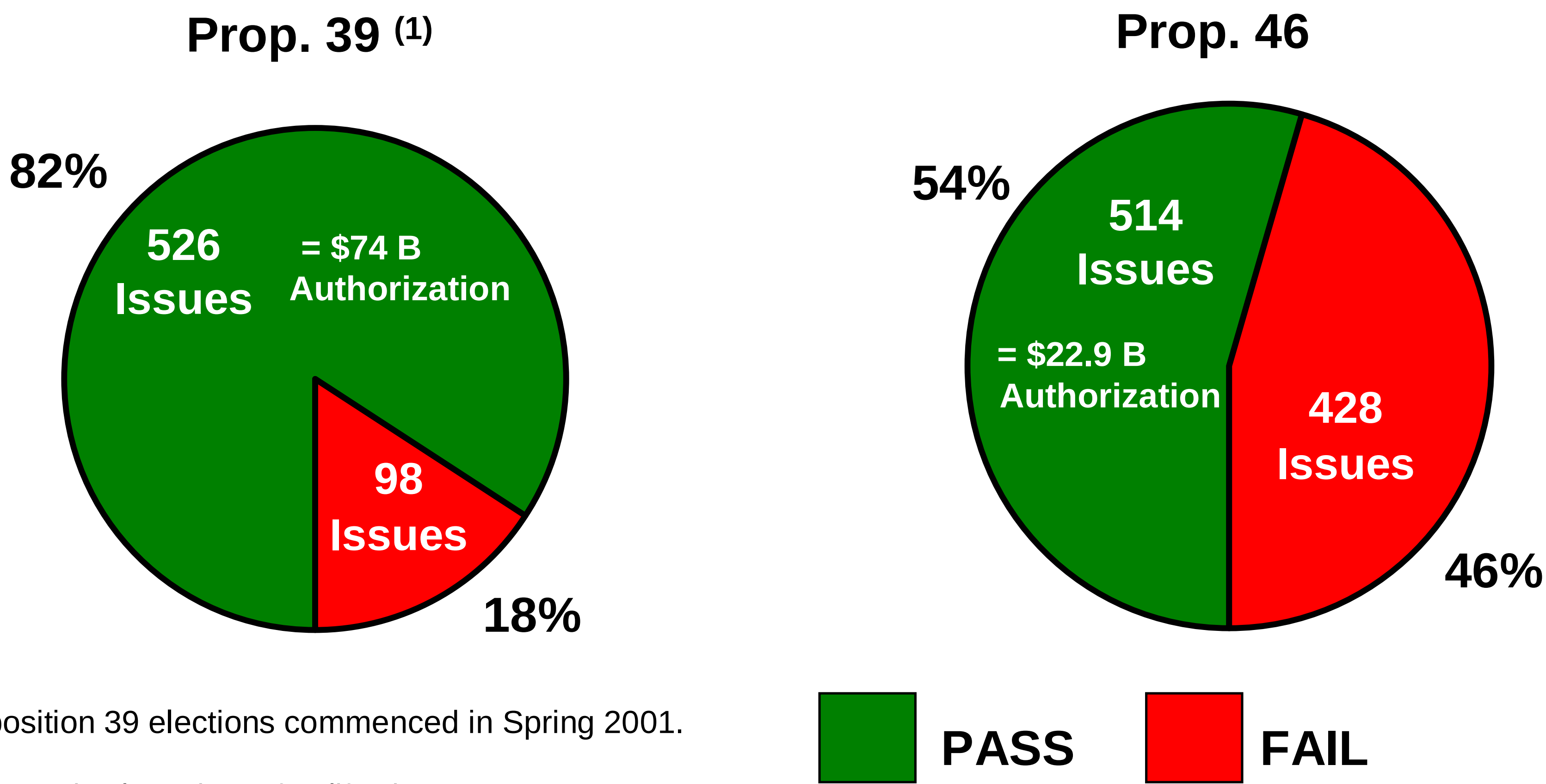
- An institution that lends its credit for a cost to provide a school district the opportunity for a lower cost of borrowing (i.e., Bond Insurance, Liquidity Facility or Letter of Credit)

Upcoming Prop. 39 Election Dates

- June 8, 2010 – Primary Election
- November 2, 2010 – General Election
- Other dates only if coincide with regularly scheduled district-wide election
  - School Board election
  - County election
  - Special District election
  - Community College election

Historical Results

School District GO Election Results: January 1986 – November 2008



(1) Proposition 39 elections commenced in Spring 2001.

Source: School Services of California

Tax Rates

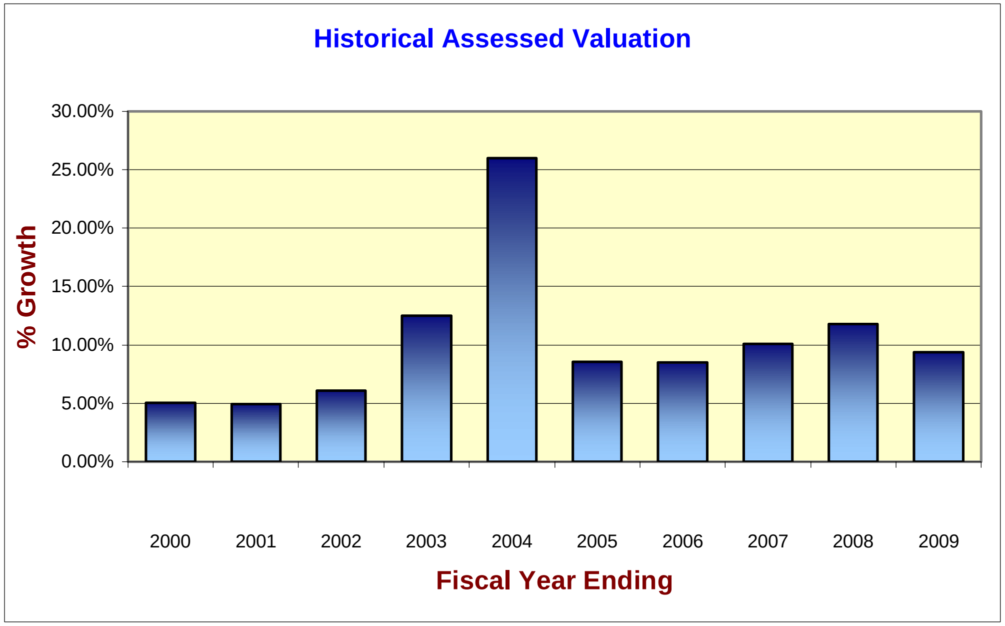
$$\text{Tax Rate} = \frac{\text{Annual Debt Service}}{\text{Assessed Valuation}}$$

- Therefore, bonding capacity at a given tax rate is a function of the following variables:
  - Beginning Assessed Valuation of Taxable Property
  - Assumed Growth Rate of Assessed Valuation
  - Number of Years Tax to Levied
  - Assumed Interest Rates on Bonds
  - Timing and Amount of Individual Bond Sales
  - Shape of Debt Service Profile

History of Assessed Valuation

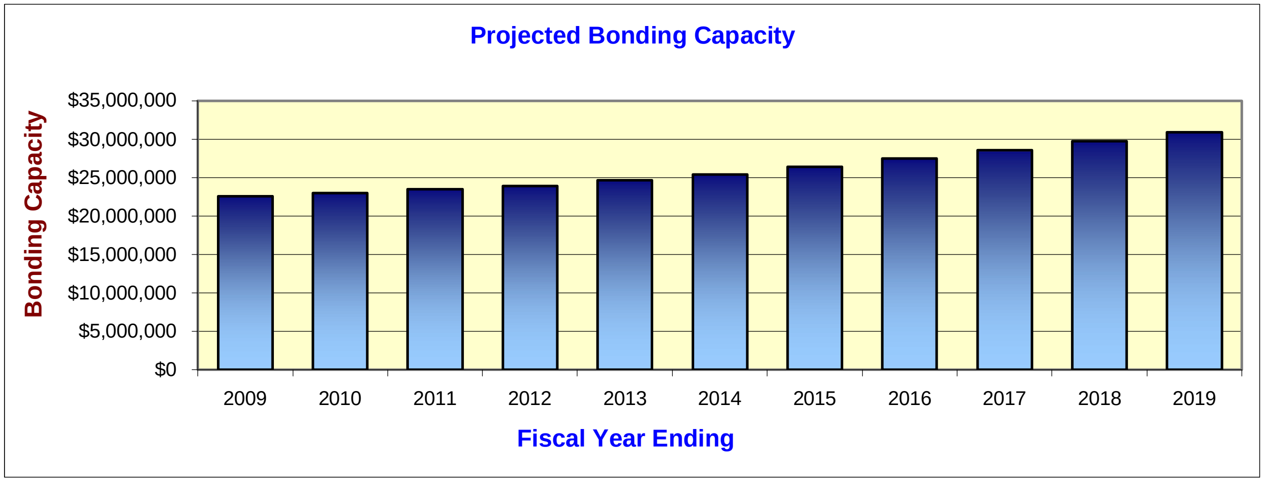
FY Ending	Assessed Valuation	AV Growth
1999	$687,055,994	-
2000	721,695,404	5.04%
2001	757,220,988	4.92%
2002	803,428,129	6.10%
2003	903,745,727	12.49%
2004	1,138,476,772	25.97%
2005	1,235,918,619	8.56%
2006	1,340,791,145	8.49%
2007	1,476,442,534	10.12%
2008	1,650,373,253	11.78%
2009	1,804,850,737	9.36%

Average Growth Rate: 10.28%



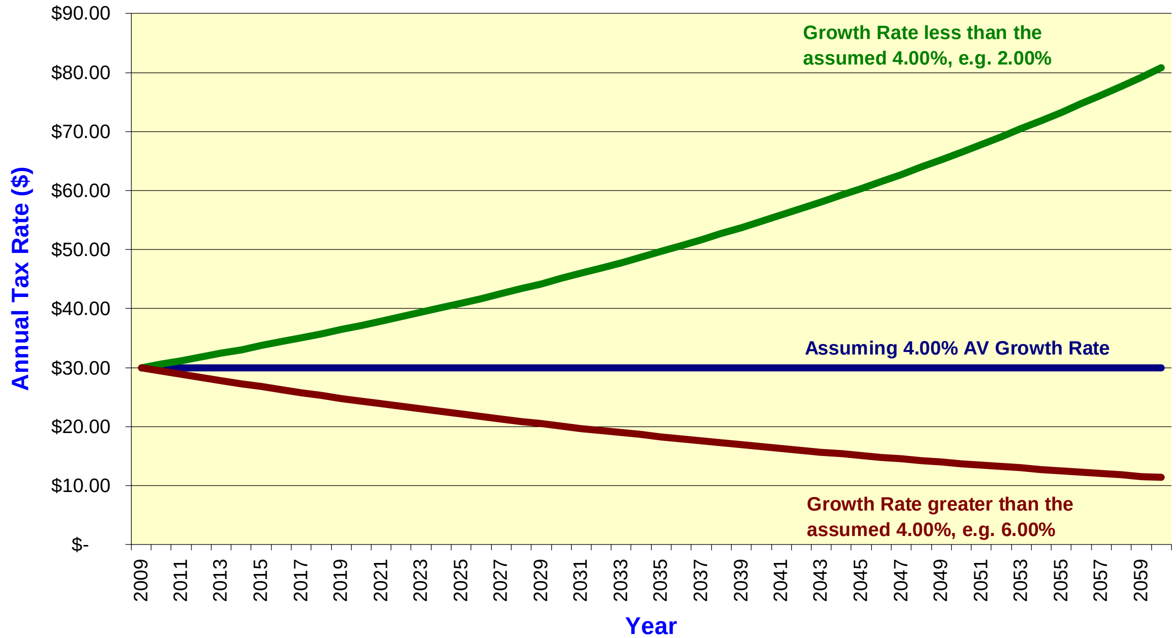
Statutory Bonding Capacity (Waiver)

FY Ending	Assessed Valuation[1]	Assumed % of AV Growth[2]	Bonding Capacity
2009	$1,804,850,737	-	$22,560,634
2010	1,840,947,752	2.00%	23,011,847
2011	1,877,766,707	2.00%	23,472,084
2012	1,915,322,041	2.00%	23,941,526
2013	1,972,781,702	3.00%	24,659,771
2014	2,031,965,153	3.00%	25,399,564
2015	2,113,243,759	4.00%	26,415,547
2016	2,197,773,510	4.00%	27,472,169
2017	2,285,684,450	4.00%	28,571,056
2018	2,377,111,828	4.00%	29,713,898
2019	2,472,196,301	4.00%	30,902,454



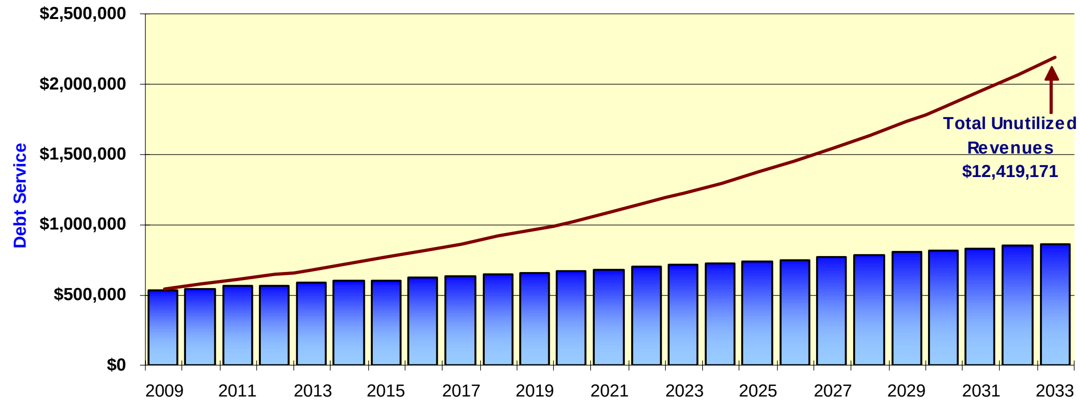
(1) Estimates based on Historical Assessed Value Growth.
(2) Estimates must be reviewed and discussed with School District.

Impact of AV Growth Rate on Tax Rates

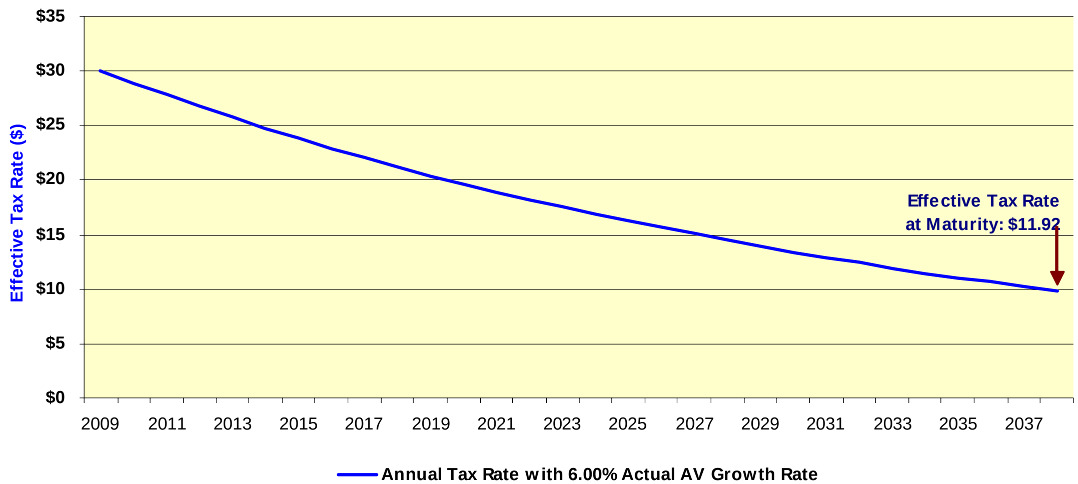


	Year 1	Year 5	Year 10	Year 25	Year 50
Tax Rate if AV Grows at Assumed Rate (e.g., 4.00%)	**$ 30.00**	**$ 30.00**	**$ 30.00**	**$ 30.00**	**$ 30.00**
Tax Rate if AV Grows at Slower Than Assumed Rate (e.g., 2.00%)	**$ 33.71**	**$ 37.14**	**$ 37.14**	**$ 49.70**	**$ 80.76**
Tax Rate if AV Grows at Faster Than Assumed Rate (e.g., 6.00%)	**$ 26.76**	**$ 24.33**	**$ 24.33**	**$ 18.28**	**$ 11.36**

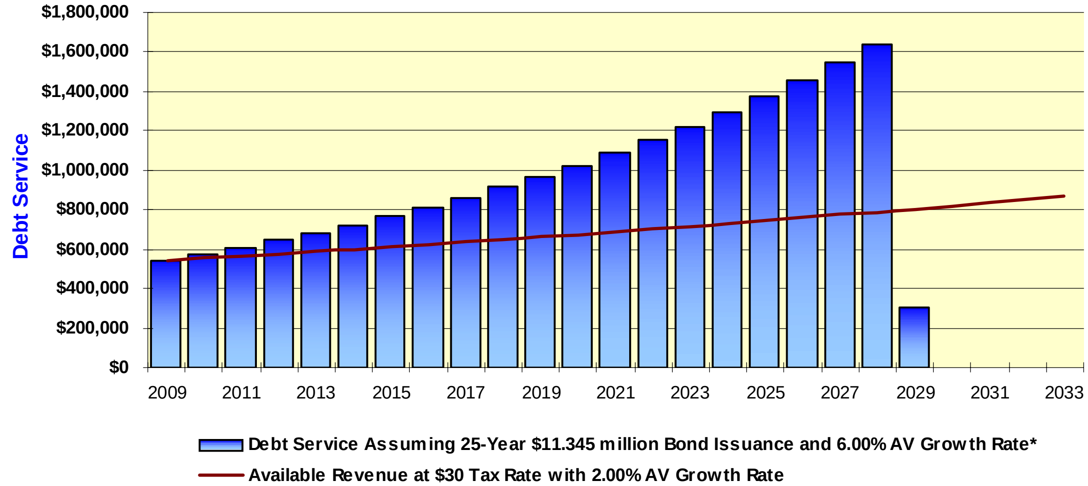
Conservative Planning



* Debt Service uses 12/4/2008 Index 94 Delphis Hanover Corporation interest rates. Interest rates are subject to change based on market conditions.



Aggressive Planning



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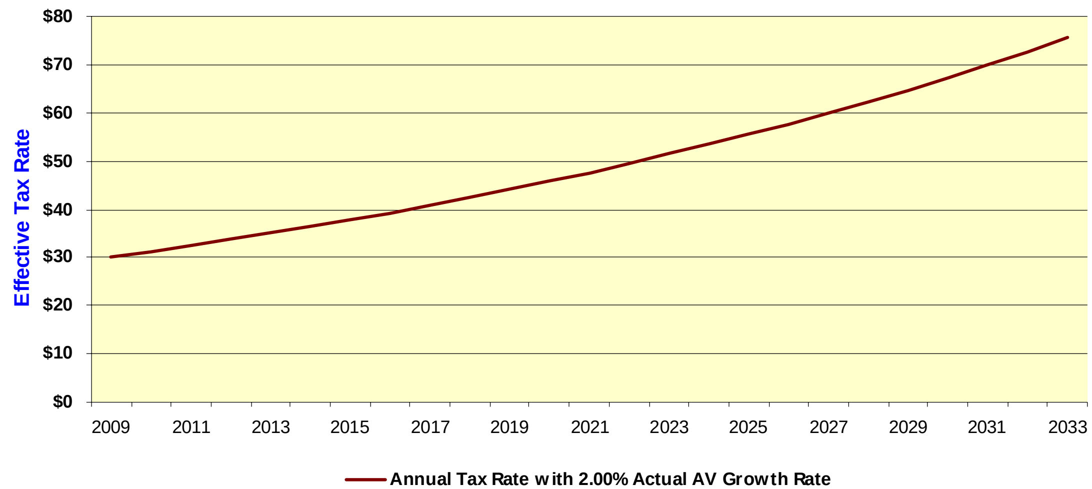
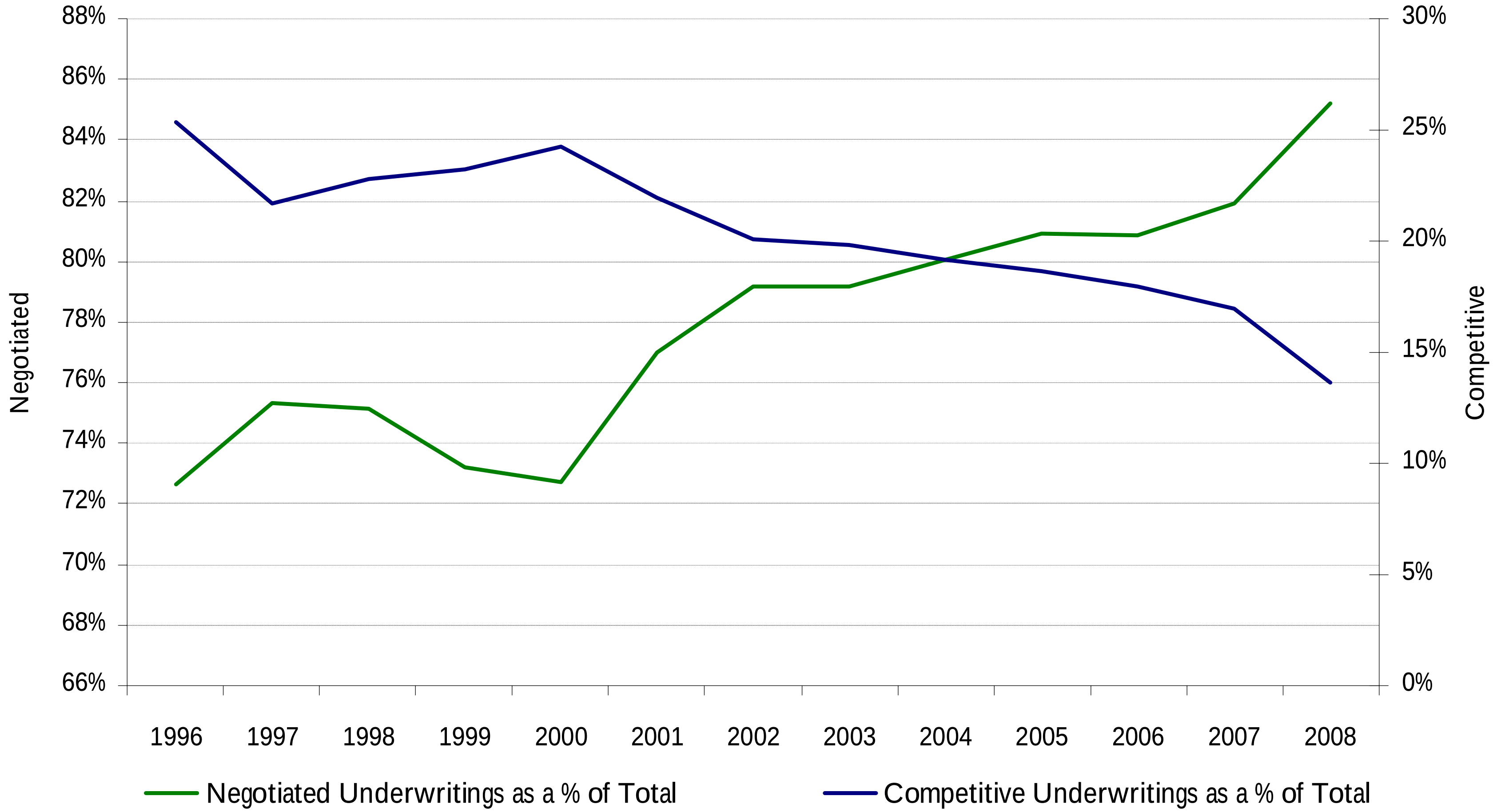


Two Types of Bond Sales

- Competitive Sale
  - Underwriter is selected on day of pricing by submitting lowest bid for the bonds
  - Underwriter does not participate in financing
  - Rates of borrowing based on bids submitted on day of pricing
- Negotiated Sale
  - Underwriter selected prior to sale date
  - Underwriter participates in structuring
  - Rates of borrowing based on collaboration with Financial Advisor and Issuer

Negotiated vs. Competitive

Negotiated & Competitive Underwritings as a % of Total Issuance (1996 – 2008)



Source: CDIAC and SIFMA. Includes issues with maturity greater than 13 months.

Arguments for Both Types of Sale

- Competitive
  - Sometimes legally required
  - Treats bond transactions as commodities
  - Issuer able to say they got the best rate available that day at that time
- Negotiated
  - More expertise at the table
  - Allows underwriter to premarket or tell a credit story to potential investors
  - Changes can be made during pricing to react to a changing market

School District Role

- Fiduciary responsibility
  - Analyze needs and estimate their cost and timing
  - Optimize leverage (not too big or too small)
  - Minimize credit cost
- Selecting team members
  - Plan ahead to allow time for an RFP
  - Develop a scoring rubric to minimize subjectivity
    - Don’t underestimate your “gut”
- Provide data for Offering Statement and review all documents to make sure they
  - Represent the School District’s Goals and Objectives
  - Fairly portray the financial position and ability of the District and its taxpayers

Getting the Best Deal

- Assume competitive sale will be used
- Use a negotiated sale only if a better result is indicated
  - Complex issues
  - Need for flexibility
  - Timing constraints
  - Rates
  - Be prepared to make your case
- Secure the best rating possible
- Test the rates
  - Do comparables within a few days of your sale
- Don't commit to any sale that costs more than you can afford

Administering the Debt

- Continuing Disclosure Obligations
  - Provide updated data
- Be sure payments are timely and correct
  - Trustee
  - Auditor-Controller

Tax Code Compliance

- Most District deals require compliance with the Internal Revenue code – even “taxable” QSCBs and BABs
- Projects must be for public use
- Proceeds must/should be spent in 3 years
- No early issuance
- No over issuance
- No deliberate arbitrage (profit) on investment

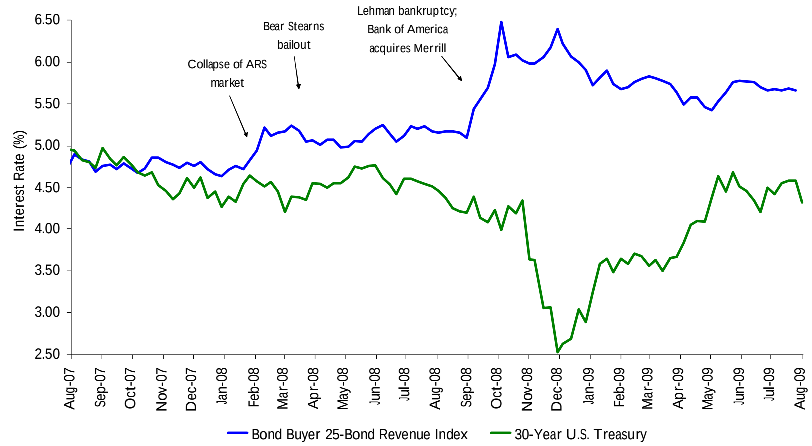
Tax Code Compliance – *con't*

- Reporting to IRS (8038G)
- Post- issuance compliance
  - Allocation
  - Record-keeping
  - Arbitrage payment
- Audits
  - May not result in penalties ("random")
  - Require assistance of tax lawyer
  - Worst case: "Going Taxable"

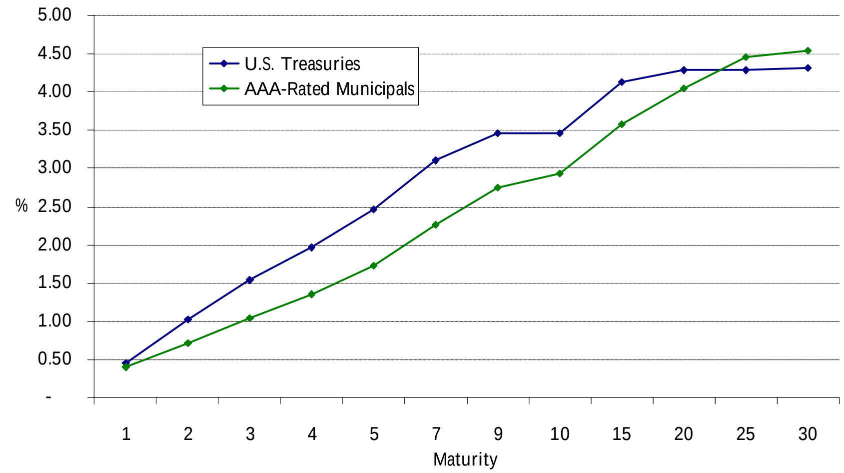
Municipal Market Landscape Redefined in 2008

- Decoupling of Markets
  - “Flight to Quality” in Treasuries
  - Away from other sectors
  - Long-dated munis still trading at historically high percentages of their Treasury counterparts
- Collapse of Enhancement Market
  - Demise of most AAA bond insurers
  - Letter of Credit/Liquidity market upheaval
- Strained Variable Rate Sector
  - Auction rate market collapse
  - Limited access to liquidity
- Retreat of Wall Street Firms
  - Departure of Bear Stearns, Lehman Brothers, Merrill Lynch, UBS, Wachovia
  - Constrained capital positions

Bond Buyer 25-Bond Revenue Index v. 30-Year US Treasury (August 2007 - Present)



Treasury vs. AAA-Rated Tax-Exempt Municipal Yield Curves (8/19/2009)

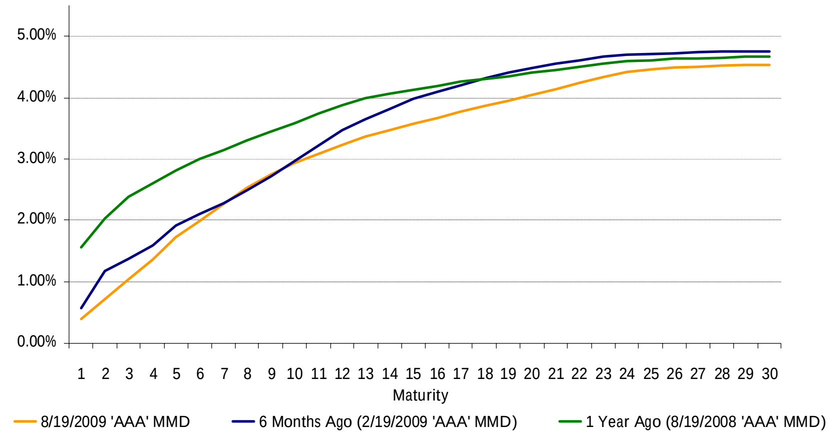


Source: Bloomberg & Thomson Financial

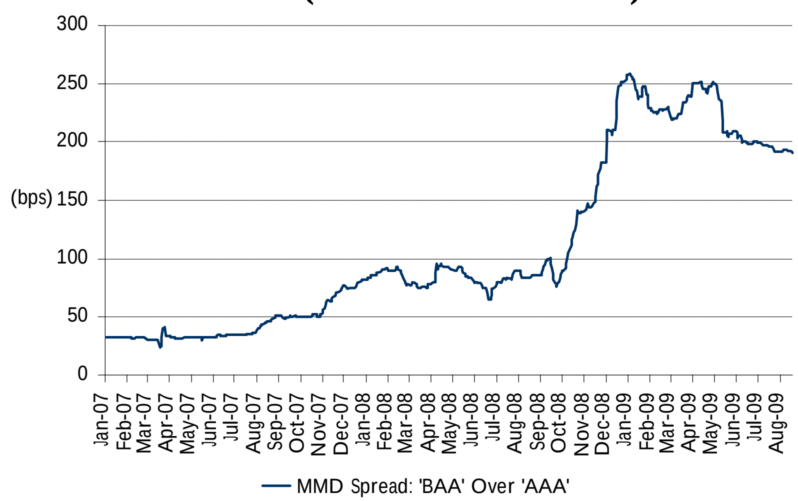
Functioning Municipal Market

- Market Response
  - Steeper yield curve
  - Wider credit spreads
- Focus on Highest Quality Credits
  - GO or essential service credits
  - AA as the "new AAA"
  - Insurance still has value for some credits
- Uncertain 2009 Issuance Volume
  - Many borrowings postponed in Q4 2008 and Q1 2009
  - Volume-to-date lighter than expected
  - Continuing variable rate restructurings

Comparative 'AAA' MMD Yield Curves

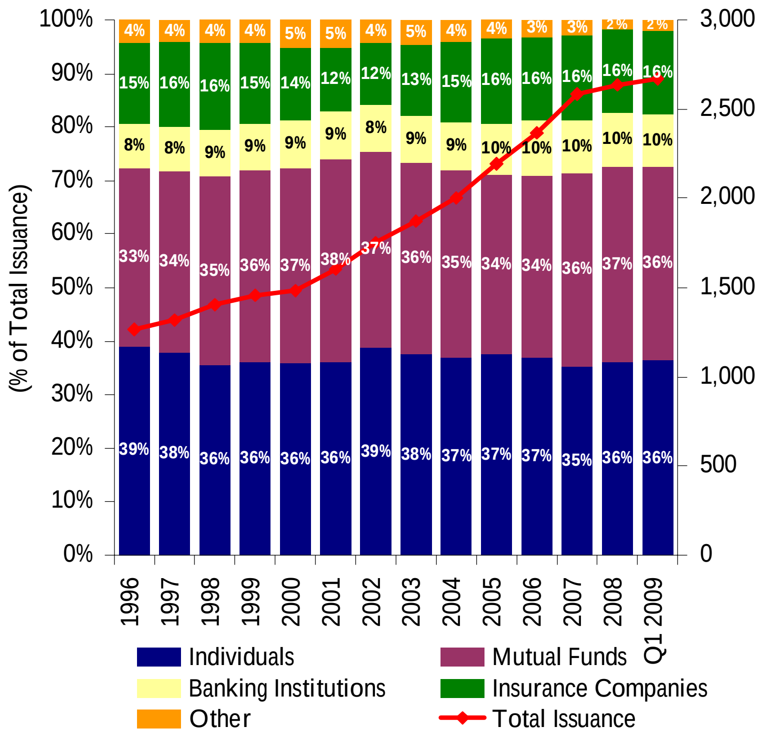


Spread between 'BAA' MMD and 'AAA' MMD (1/2/2007 – 8/19/2009)

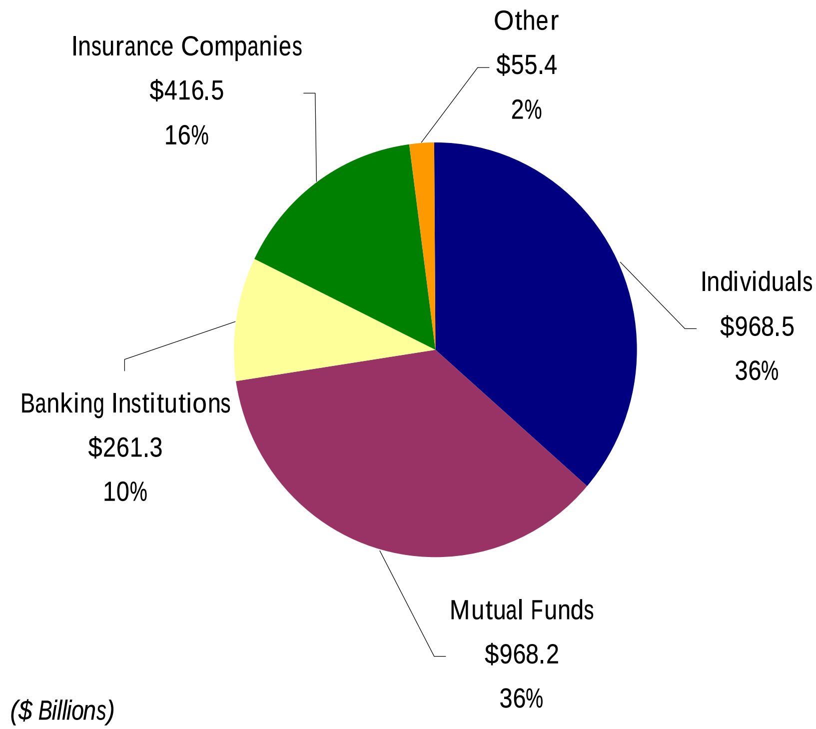


Municipal Securities Have Had a Very Consistent Buyer Base

Municipal Securities Holders as a % of Total Issuance (1996 – Q1 2009)



Municipal Securities Holders
(Q1 2009 Snapshot - $2.67 Trillion Outstanding)



Note: **'Mutual Funds' includes money market funds and closed-end funds;**
'Banking Institutions' means commercial banks, savings institutions and broker / dealers;
'Insurance Companies' means property / casualty and life insurance companies; and
'Other' means non-financial corporate business, nonfarm non-corporate business, state and local governments and retirement funds and GSEs.

***Source:* SIFMA**

Questions & Discussion