




Introduction to the Municipal Bond Market



Jason Hughes
Managing Director

direct 214.953.8707 toll free 800.678.3792
fax 214.953.4050
jason.hughes@hilltopsecurities.com
1201 Elm Street, Suite 3500, Dallas, TX 75270



Jeff Gulbas
Partner Attorney

direct 214.754.9260
fax 214.754.9250
jgulbas@mphlegal.com
717 N. Harwood Street, Ninth Floor, Dallas, TX 75201

Debt/Bond – Four Letter Words

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

Debt/Bond – Four Letter Words

- **Legality of Debt** – In Texas, debt is the only way to raise to capital. Texas political subdivision are constitutionally prohibited from granting equity or “lending its credit”.

- **Specificity of Texas law** – All evidences of indebtedness must be specifically authorized by statute or home rule charter.
 - This can place burdensome limitations on methods to fund projects
 - All bonds must have a “public purpose”
 - "Debt" as used in the Texas Constitution means any pecuniary obligation imposed by contract; defines "debt", however, as not including obligations payable out of either the current revenues for the year or funds expressly available and set aside for repayment of the pecuniary obligation.
 - Texas courts construe statutes authorizing debt “strictly and narrowly”

Debt Is Not a Four Letter Word

- Alternatives to issuing debt

- Use cash reserves – potential negative credit implications, cash flow concerns
- Defer purchases/improvements – potential negative implications, deters growth, may cost issuer more in long run in the form of lost assessed valuation or economic development
- Pay-as-you-go
 - Budget for excess revenues over time to use for capital projects/improvements
 - May be difficult for large projects due to inability to have funds on hand to enter into construction project
 - Does not allow you to leverage cash flow
 - Puts majority of cost on current user, not future user
 - Consider a reimbursement resolution in case you want to reimburse cash spent on project through the issuance of debt

Advantages of Issuing 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 municipal entity access to another revenue stream, the Interest & Sinking Fund tax rate

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

- Payment of capital expenditures
- Refunding (i.e., refinancing) prior debt
- Reimbursing cash spent on prior capital expenditures (with some limitations)
- Payment of working capital (with *many* limitations)
- Payment of financing costs (costs of bond issuance, capitalized interest and funding reserve funds)
- A single bond issue may combine multiple purposes

What is Unique about Munis?

- If municipal bonds are issued for a governmental or public purpose, their interest earnings are exempt from federal taxation
- In addition, some state and local governments extend state and local income tax exemptions for in-state bonds
- They are a relatively safe investment vehicle -- few governments declare bankruptcy or disappear
- There are about 70,000 state and local governments authorized to issue tax-exempt debt
- Not subject to strict regulation by the Securities and Exchange Commission

What is Unique about Munis in Texas?

- 1869 Texas Constitution was a disaster for local government issuers
 - Carpetbaggers/railroads
 - Broad defaults
- 1876 Texas Constitution vested all local government power to the Legislature
- If debt is incurred in ways other than those authorized by State law it is not enforceable
- Validation lawsuit is an option for unauthorized debt
- There is no basis in State law to refinance an illegal debt into a legal debt
- The Attorney General approves all issues as to conformance with State law; bonds become incontestable (except for unconstitutionality and fraud)

Issuance of Bonds – When, What For and How Much

- When?
 - Typically when funds are needed
 - Not uncommon to issue earlier if interest rates warrant

- What For?
 - For a municipality, a public purpose
 - Useful life of greater than 1 year
 - Can also bond for operating purposes
 - Subject to a number of restrictions

- How Much?
 - Cost of the project(s)
 - Legal constraint
 - Voter/citizen constraint

- Debt component is only one factor of the rating process

Considerations When Issuing Debt

- **Debt Structure and Timing**
 - Planning for the future
 - Does the term match the asset life?
 - Deferral of principal
 - Deferral of interest (capital appreciation bonds)
 - Call feature
 - Ability to achieve the lowest true interest cost while maintaining future flexibility

- **Credit Ratings**

- **Disclosure**
 - Timing
 - Materiality
 - Consistency and accuracy

Most Common Types of Debt in Texas

	General Obligation Bonds	Certificates of Obligation	Tax Notes	Water and Sewer Revenue Bonds
Public Approval	Bond Election	Council Approval of Notice of Intent	None Required	None Required
Security/Pledge	Taxes Only	Taxes and/or Revenues	Taxes and/or Revenues	Water and Sewer Revenues Only
Other Considerations	If the Election Fails, how does the City Address Needs?	Subject to Petition by 5% of Registered Voters	Maximum Maturity of 7 Years	Coverage Requirements, Additional Bonds Test, Debt Service Reserve Fund
Ratings	Highest Rated Credit for a City Based on Ad Valorem Tax Pledge			<u>Typically</u> 1 to 2 Notches Lower than a City's Tax Credit

General Obligation Bonds “GOs”

- For projects that are for economic development (typically stadiums, amusement venues, conference centers, etc.), such bonds must be voted in order to pledge ad valorem taxes
- Attorney General policy is that a bond election becomes “stale” after ten years; however, a determination of reasonable time must take into account "all of the surrounding facts and circumstances"
- Bond Propositions must be carefully tailored
 - Two or more separate and distinct propositions cannot be combined into one and submitted to the voters as a single question ...so as to have one expression of the voter answer all of them
 - The character, features and purposes of the proposed bond election are to be set out in sufficient detail in the proposition, so that the voters will be familiar with the proposal when they cast their ballot
 - Ex: "improving and extending City's Waterworks System" is legal and sufficient statement of purpose for the bonds
- “Full faith and credit” (generally applied to States) implies that all sources of revenue, unless specifically dedicated or forbidden to be used for debt service payments, will be available to repay the bonds

Certificates of Obligation “COs”

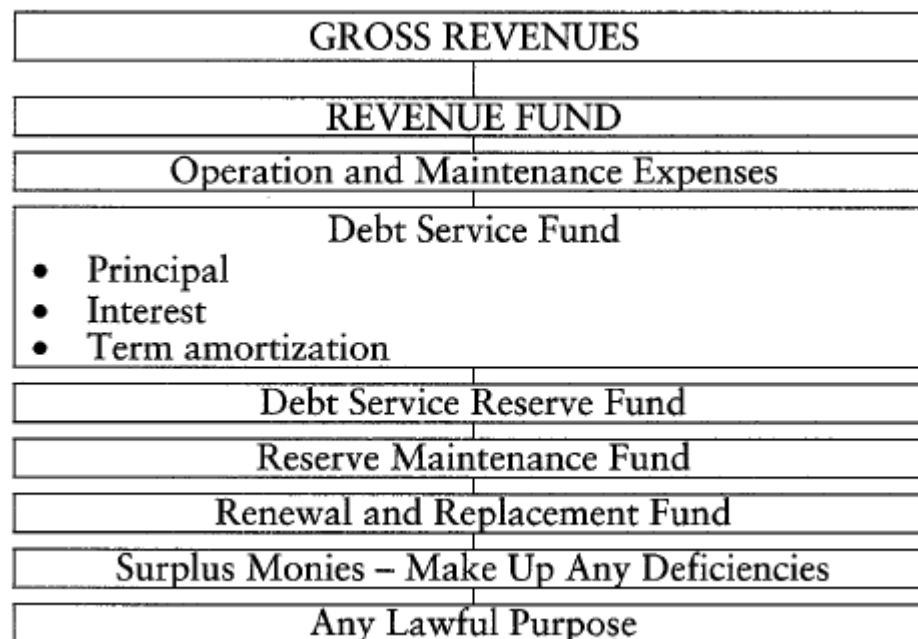
- May be issued to pay for the: (1) construction of any public work; (2) purchase of materials, supplies, equipment, machinery, buildings, land, and rights-of-way for authorized needs and purposes; or (3) payment of contractual obligations for professional services, including services provided by tax appraisers, engineers, architects, attorneys, map makers, auditors, financial advisors, and fiscal agents
- May not be issued for projects which constitute “economic development”
- Notice of Intent must identify:
 - The projects to be financed
 - The date, time and location the ordinance is scheduled to be adopted
 - The maximum principal amount of COs to be issued
 - The source of payment for the COs

Tax Notes

- Tax note proceeds may be spent for (1) construction of a public work; materials, supplies, equipment, machinery, buildings, lands, and rights-of-way for the issuer's authorized needs and purposes; a professional service, including a service by a tax appraisal engineer, engineer, architect, attorney, mapmaker, auditor, financial advisor, or fiscal agent or (2) operating or current expenses (with limitations)
- Seven year maturity limitation
 - However; refunding bonds issued under Chapter 1207, Tex. Govt. Code, to refund a tax note issued by a county, municipality, or certain special districts for purposes in clause (1) is subject to a forty year maturity limitation

Revenue Bonds

- Revenue bonds generally grant first lien on net revenues (funds remaining after normal operating costs)
- Important to understand what is an operating expense (e.g., power contract)
- May allow for subordinate liens
- Flow of Funds: set's forth the order in which funds generated by the enterprise will be allocated to various purposes; may differ depending on structure (will be “married” to this structure)



Professionals Involved in the Debt Issuance Process

<p>Financial Advisor</p>	<p>Bond Counsel</p>	<p>Underwriters</p>	<p>Underwriter's Counsel / Disclosure Counsel</p>
<ul style="list-style-type: none"> Advises the issuer on all matters regarding bond issuance Issuer's representative in and to the bond market Fiduciary duty to the issuer 	<ul style="list-style-type: none"> Counsel retained by the issuer to give legal opinions that the issuer is authorized to issue the bonds Provides tax-exempt opinion, and that bonds are legal and valid obligations Prepares bond documents with input from financing team 	<ul style="list-style-type: none"> Securities dealer which purchases municipal securities for resale; either by competitive or negotiated sale, and may purchase the securities in a group with other underwriters (an underwriting syndicate) 	<ul style="list-style-type: none"> Underwriter's Counsel represents the underwriter and works toward accurate disclosure in the offering documents Disclosure Counsel conducts independent due diligence to ensure complete and accurate disclosure in offering documents
<p>Paying Agent / Escrow Agent</p>	<p>Rating Agencies</p>	<p>Bond Insurance / Credit Enhancement</p>	<p>Trustee</p>
<ul style="list-style-type: none"> Paying Agent tracks ownership of the securities and coordinates distribution of funds for debt service payments from the issuer to the bondholders Escrow Agent holds bond proceeds in an escrow and distributes funds as described in the bond documents 	<ul style="list-style-type: none"> Rating Agencies evaluate the credit quality of a debt instrument and assign credit (bond) ratings 	<ul style="list-style-type: none"> Organizations such as banks and insurance companies that lend their higher credit quality for a fee and guarantee debt service payments to the bondholders 	<ul style="list-style-type: none"> Financial institution with trust powers that acts in a fiduciary capacity to facilitate the collection, escrow, and distribution of funds for the benefit of the bondholder

Disclosure Rules and the Official Statement

- The Official Statement (or offering memorandum or private placement memorandum) is the document used by the underwriter to sell the bonds to potential buyers
 - Counterpart of the prospectus in the corporate finance industry
- SEC has promulgated rules which govern the information necessary to be included in the Official Statement of a municipal financing; the bonds are actually sold by the issuer to potential purchasers
- Legal opinions addressing untrue statements of material facts or omissions of material facts
- Material information about the issuer
- Material information about the project (complexity and details depends on type of offering)

Disclosure Rules and the Official Statement

- Issuer focus should be SEC Rule 10b-5
- “It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
 - (a) To employ any device, scheme, or artifice to defraud,
 - (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
 - (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.”

THE BOND BUYER

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Enforcement

SEC's Ceresney Tells Muni Market Enforcement Focus is 'Here to Stay'

“Municipal market participants also shouldn't be surprised if they continue to see the SEC use new-to-the-market techniques like civil penalties for issuers, individual accountability under control person liability, and increased coordination with agencies investigating criminal conduct...”

“Since 2013, the SEC has brought enforcement actions against: 76 state or local government entities, including four states; 13 obligated persons; and 16 public officials. That compares to enforcement actions against 6 government entities, 6 obligated persons, and 12 public officials in the 10 years between 2002 and 2012.”

The Debt Issuance Process

