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# Municipal Bond Basics and the Municipal Market

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# Today's Discussion Objectives

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- I. Municipal Bond Basics
- II. The Financial Crisis
- III. Current Market Drivers
- IV. Logistics of a Bond Deal
  - Players and Timing
  - Marketing
  - Pricing

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# Municipal Bond Basics

# What is a Municipal Bond?

- A **municipal bond** is a debt security issued by a public entity to finance (new money) or refinance (refunding) capital expenditures.
  - States
  - State Authorities
  - Counties
  - Cities
  - School Districts
  - 501-c-3 Organizations



# Tax-Exemption

- Typically, the federal government allows the interest income on municipal bonds to be federally tax-exempt.
- Sometimes, states and local governments also allow the interest income on municipal bonds to be exempt from state and local income taxes.
- What's the benefit of tax-exemption?
  - Investor – it depends
    - 15% tax bracket: a 5% tax-exempt bond is equivalent to a 5.9% taxable bond
    - 28% tax bracket: a 5% tax-exempt bond is equivalent to a 6.9% taxable bond
    - 35% tax bracket: a 5% tax-exempt bond is equivalent to a 7.7% taxable bond
  - Issuer – lower cost of capital

# Types of Municipal Bonds

- General Obligation (“G.O.”) Bonds
  - Full Faith and Credit
  - Ad Valorem Taxes
- Revenue Bonds
  - Utility (Water & Sewer, Public Power)
  - Non Ad-Valorem Taxes (Gas, Franchise)
  - Transportation (Tolls, Airports)
  - Public Education (K-12)
  - Healthcare (Assisted Living, Hospitals)
  - Higher Education (Dorms)
- Hybrid – Double Barreled

# Structures of Municipal Bonds

- Fixed rate
  - Serial vs. Term
  - Current Interest vs. Capital Appreciation
  - Premium vs. Discount
- Floating rate
  - Variable rate demand bonds/Commercial Paper
  - Short term Notes (BANs, TANs, RANs)

# Redemption (Call) Provisions

- Optional Redemption
  - Issuer may redeem the bonds before maturity
  - Standard Municipal redemption provision is the 10-year call
  - Some issues contain a schedule of call prices with premiums:

Date	Call Price
5/1/2016 – 4/30/2017	102%
5/1/2017 – 4/30/2018	101%
5/1/2018 and thereafter	100%

- Possible restrictions:
  - Inverse order call
  - Callable only on interest payment dates
- Mandatory Redemption
  - Issuer must redeem the bonds before maturity
  - Normally applicable to sinking fund payments of term bonds

# Sales Methods of Municipal Bonds

- Competitive
  - Put deal out to market for firms to bid
  - Lowest interest rate is winning bid
- Negotiated
  - Choose underwriter(s) prior to marketing and pricing
  - Based on relationships, experience, capabilities, service
  - Ability to assess environment, pre-market bonds and optimize structure
  - Public Finance – focused on obtaining negotiated municipal bond business

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# The Financial Crisis

## Prior to Financial Crisis

- Less market volatility
- Muni's viewed as the safe investment
- Number of buyer categories
- Use of bond insurance prevalent
- Investor not too focused on underlying credit
- Real Estate related transactions more prevalent
- Ability to sell bonds "based on a spreadsheet"
- Bank liquidity was relatively inexpensive (risk vs return)

# What Happened?

- Sub-prime mortgage crisis hit
  - Players involved in various areas of credit markets
  - Muni market players became more corporate like
- Fallout has resonated throughout the credit markets
  - Investors and Institutions have reevaluated their deployment and commitment of capital
    - Has resulted in wider credit spreads
    - Market access limited for all credits in late 2008
    - Increased regulatory scrutiny
  - Rating agency process more time consuming
  - Credit enhancement options have diminished

# Downfall of “AAA” Bond Insurers

- In January 2008, there were 7 “AAA” rated bond insurers, today there are none.

January 2008

Insurer	Moody's	S&P	Fitch
Ambac	Aaa	AAA	AAA
Assured Guaranty	Aaa	AAA	AAA
Berkshire Hathaway	-	-	-
CIFG	Aaa	AAA	AAA
FGIC	Aaa	AAA	AAA
FSA	Aaa	AAA	AAA
NPFGC (formerly MBIA)	Aaa	AAA	AAA
Syncora (formerly XLCA)	Aaa	AAA	AAA

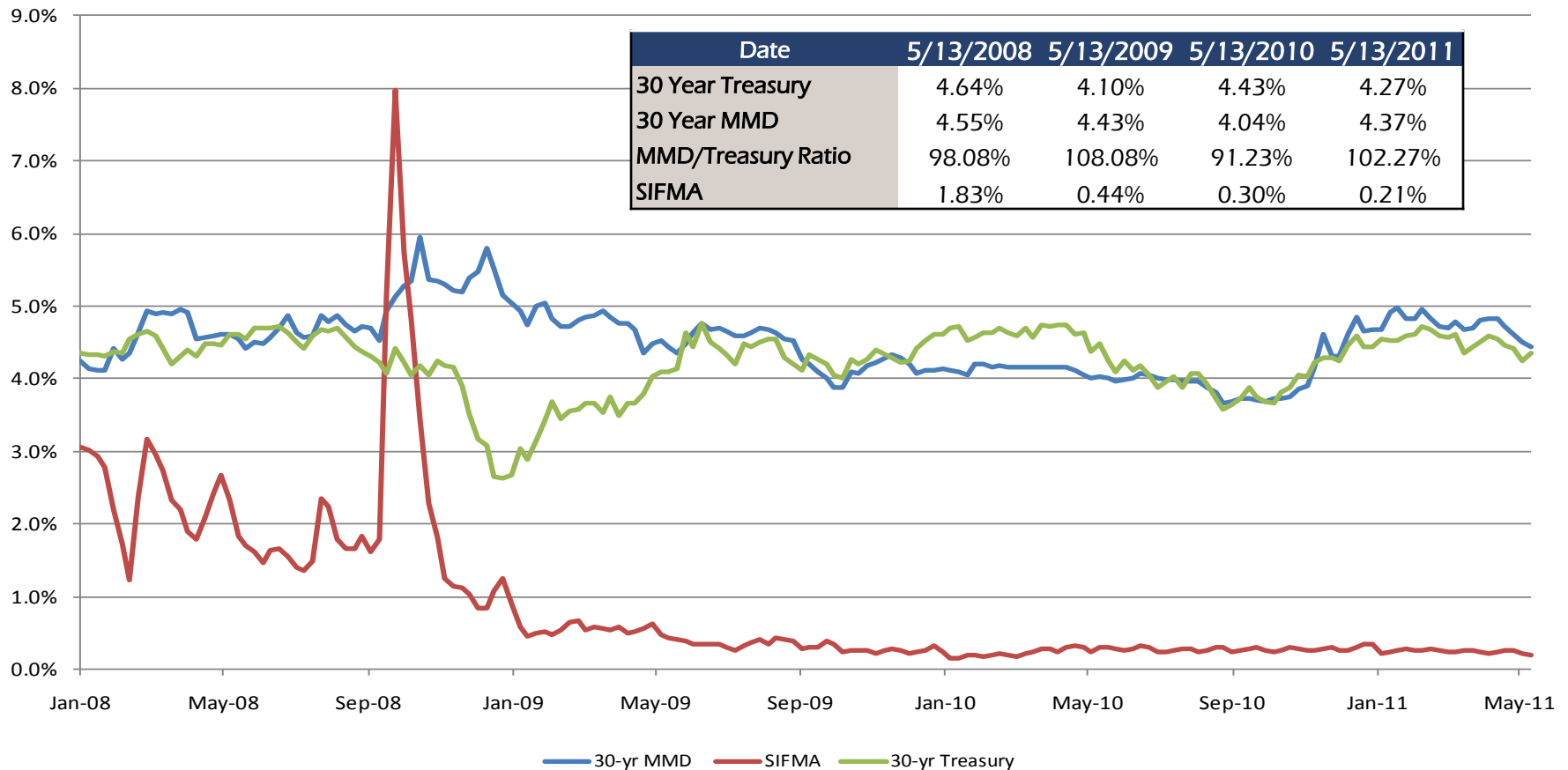


Today

Insurer	Moody's	S&P	Fitch
Ambac	Caa2	R	-
Assured Guaranty	Aa3	AA+	-
Berkshire Hathaway	Aa1	AA+	-
CIFG	-	-	-
FGIC	-	-	-
FSA (now AGM)	Aa3	AA+	-
NPFGC (formerly MBIA)	Baa1	A	-
Syncora (formerly XLCA)	Ca	R	-

# Current Market Characteristics

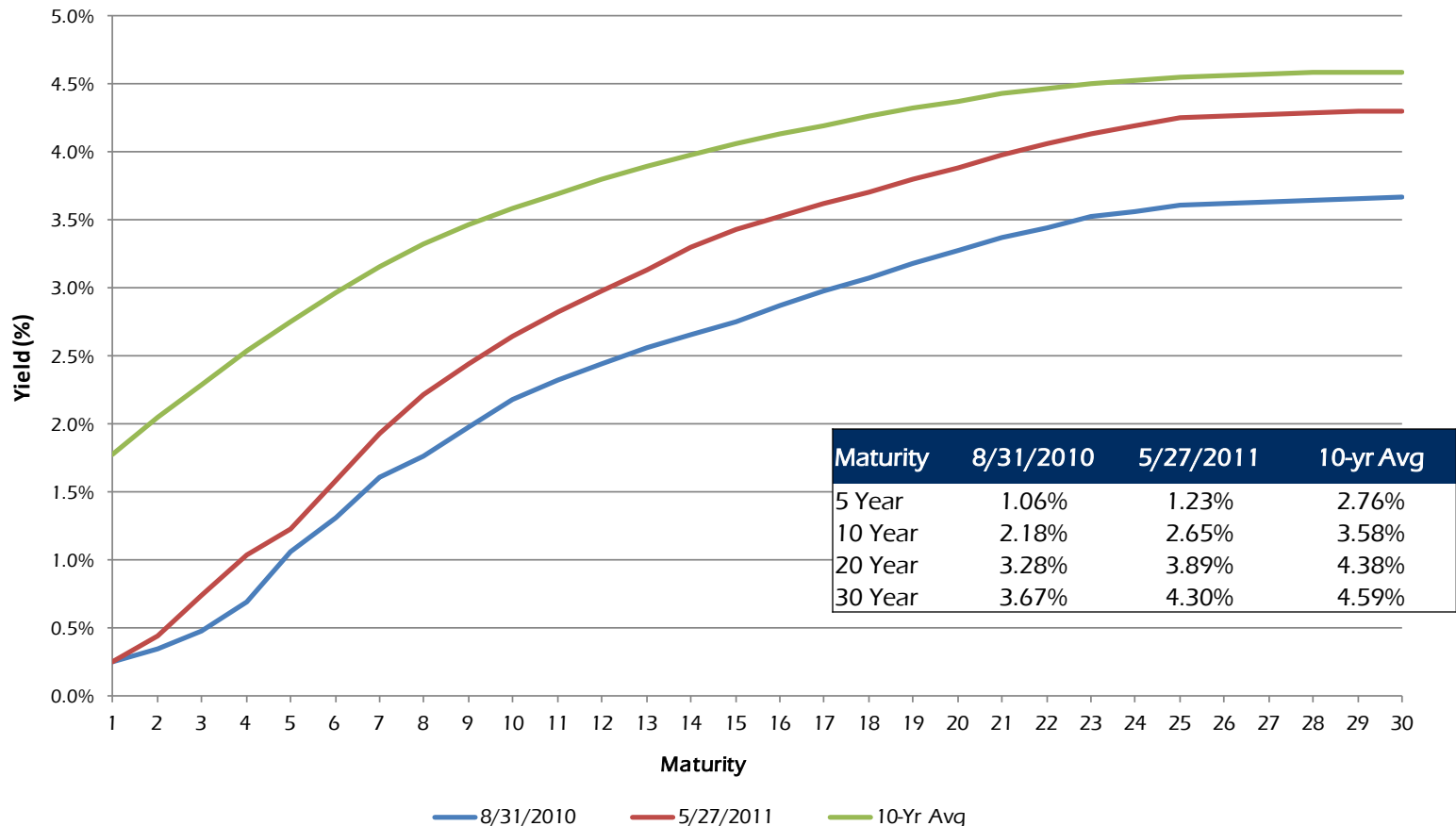
- Continued uncertainty characterized by volatility and steep yield curve:
  - Headline risk driving market sensitivity
  - Limited investor participation due to supply
  - Heightened focus on underlying credit
  - Investor communication and education is essential



# Current Market Overview

- Current MMD levels are remain below the 10-year averages by significant margins
- The yield curve has flattened out slightly with long term rates decreasing at a faster pace than short term rates over the month of May

MMD Yield Curves



# Looking Ahead

- Credit focus
  - Heightened market sensitivity and negative market bias due to headline risk
  - Provides for market illiquidity and limits investor participation
  - All credits are in price discovery mode as municipals are under continuous pressure
- Supply Changes
  - Impact on both new issue and secondary market supply
  - Yields have hit a low last seen in December due to strong demand and limited supply
  - Lowest first quarter issuance in almost a decade
- Investor Base
  - Signs of economic recovery and higher equity returns are altering investments
  - Retail investors remain cautious with focused interest on specific maturity ranges
  - Bond funds are still seeing redemptions but net cash and reinvestment are prompting purchases
  - Insurance companies are net sellers of tax-exempt munis, with many moving to taxable securities



	<u>Interest Rate Forecast - Period Ending</u>				
	2Q11	3Q11	4Q11	1Q12	2Q12
<b>Fed Funds Target</b>	0.25%	0.25%	0.25%	0.50%	0.75%
<b>3 Month LIBOR</b>	0.31%	0.35%	0.45%	0.75%	1.09%
<b>2 Year Note</b>	0.76%	0.90%	1.20%	1.50%	1.75%
<b>10 Year Note</b>	3.50%	3.65%	3.80%	4.00%	4.10%
<b>30 Year Bond</b>	4.52%	4.70%	4.85%	4.95%	5.05%

*As surveyed by Bloomberg between May 13, 2011 and May 23, 2011*

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## Current Market Drivers

# Headline Risk

- Global Headlines  Flight to Quality
  - Japan disaster
  - Mideast tension
  - Sovereign credit downgrades
- Municipal Headlines  Less Demand, Higher Spreads
  - Municipal Defaults (Meredith Whitney)
  - State Budget Gaps
  - Tax Reform

**“Misery Continues  
for Muni’s”**

**“No Relief Likely for  
Muni Bonds”**

**“State Budget  
Deficits Continue  
to Widen”**

**“Muni Market’s  
Drought Goes On”**

# Credit Ratings

- Three major Rating agencies provide ratings on municipal debt:



- Two types of ratings exist for bond issues:
  - Insured Rating
  - Underlying Rating
- Most long-term ratings carry on “outlook”
  - Positive
  - Negative
  - Stable

# Ratings Criteria

Each rating agency produces criteria books describing their rating methodology in each sector

AUGUST 25, 2010 U.S. PUBLIC FINANCE

**Moody's**  
INVESTORS SERVICE

**RATING METHODOLOGY U.S. Municipal Pool Program Debt**

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**Summary Opinion**

This rating methodology provides a detailed explanation of how Moody's evaluates the quality of municipal pool programs. Pool programs are generally established with the providing loans to municipalities and enterprise systems to fund capital improvement lower cost of borrowing than other forms of financing. Pool program ratings are assess of relative creditworthiness, based on our analysis of four broad rating factors:

- » Underlying Credit Quality and Default Tolerance
- » Pool Size and Diversity
- » Debt Structure and Legal Covenants
- » Management and Governance

This report includes a rating grid that weights factors relevant to municipal pool program debt. The purpose of the rating grid is to provide a reference tool that can be used to approximate credit profiles within the pool program sector. A rating level will be assign each factor and the results will be added together according to the weights outlined for factor. The resulting rating can be adjusted by a rating committee if it determines that certain strengths or weaknesses of a particular program that are not captured in the methodology.

**Delineating Moody's Rated Municipal Pool Programs:**

Moody's groups U.S. municipal pools into two categories - pool financings and pool programs. Much like pool financings, pool programs vary widely in their security features and structural elements and are typically secured by general obligation and revenue pit of their borrowers and support essential government projects. However, unlike small financings, which typically have less than 10 participants and limited structural elements pool programs tend to be characterized by a larger evolving pool of participants, active management teams independent of the participants, and more robust structural enhancements. For additional information regarding our approach to rating municipal financings please reference "Moody's Approach to Rating U.S. Municipal and Not-For-Profit Pool Financings", published in May 2010.

**STANDARD & POOR'S**

**Global Credit Portal**  
RatingsDirect®

September 15, 2010

**Criteria | Governments | U.S. Public Finance:**  
Standard & Poor's Revises Criteria For Rating Water, Sewer, And Drainage Utility Revenue Bonds

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Rationale For Revision

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Factors Supporting The 2008 Criteria Revision

Related Articles

Secondary Credit Analysts:

[www.standardandpoors.com/ratingsdirect](http://www.standardandpoors.com/ratingsdirect)

07/29/2010

**FitchRatings**  
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**Public Finance**

**Tax Supported Sector-Specific Criteria**

**U.S. State Government Tax-Supported Rating Criteria**

September 15, 2010

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**Related Research**

• Tax-Supported Rating Criteria, Dec. 21, 2009

**Summary**

This report fully incorporates and expands upon tax-supported rating criteria, with a focus on U.S. state government debt, and updates and replaces Fitch Research on "U.S. State General Obligation Bond Rating Criteria," dated April 25, 2008. This report identifies rating factors considered by Fitch in assigning ratings to a particular entity or debt instrument within the scope of the criteria. Not all rating factors in this report may apply to each individual rating or rating action. Each specific rating action commentary or rating report will discuss those factors most relevant to the individual rating action.

To determine the rating for a tax-supported bond issued by a U.S. state government, Fitch first evaluates the nature of the legal security and then analyzes the following four major factors to establish the general credit quality of the state:

- Debt and other long-term liabilities.
- Economy.
- Finances.
- Management and administration.

Fitch's rating process involves analyzing trends in these areas. Actual and potential future obligations and exposures are identified. The major rating factors are interactive. For example, while a state may have a vibrant and wealthy economy, weak fiscal management may offset positive credit factors, resulting in a reduced ability to meet obligations. In turn, a weak economy may be offset by other strengths, such as proactive management or a very low debt burden. The emphasis on specific factors may be influenced by the nature of the rated security, with the analysis of bonds backed by a specific revenue stream focusing more on economic drivers of that revenue and less on management and administrative factors.

**Rated Security**

Prior to an analysis of the state government's general credit quality, Fitch details the nature of the security being rated and evaluates the relationship between the credit quality of the security and the general credit quality of the state.

**Legal Pledge**

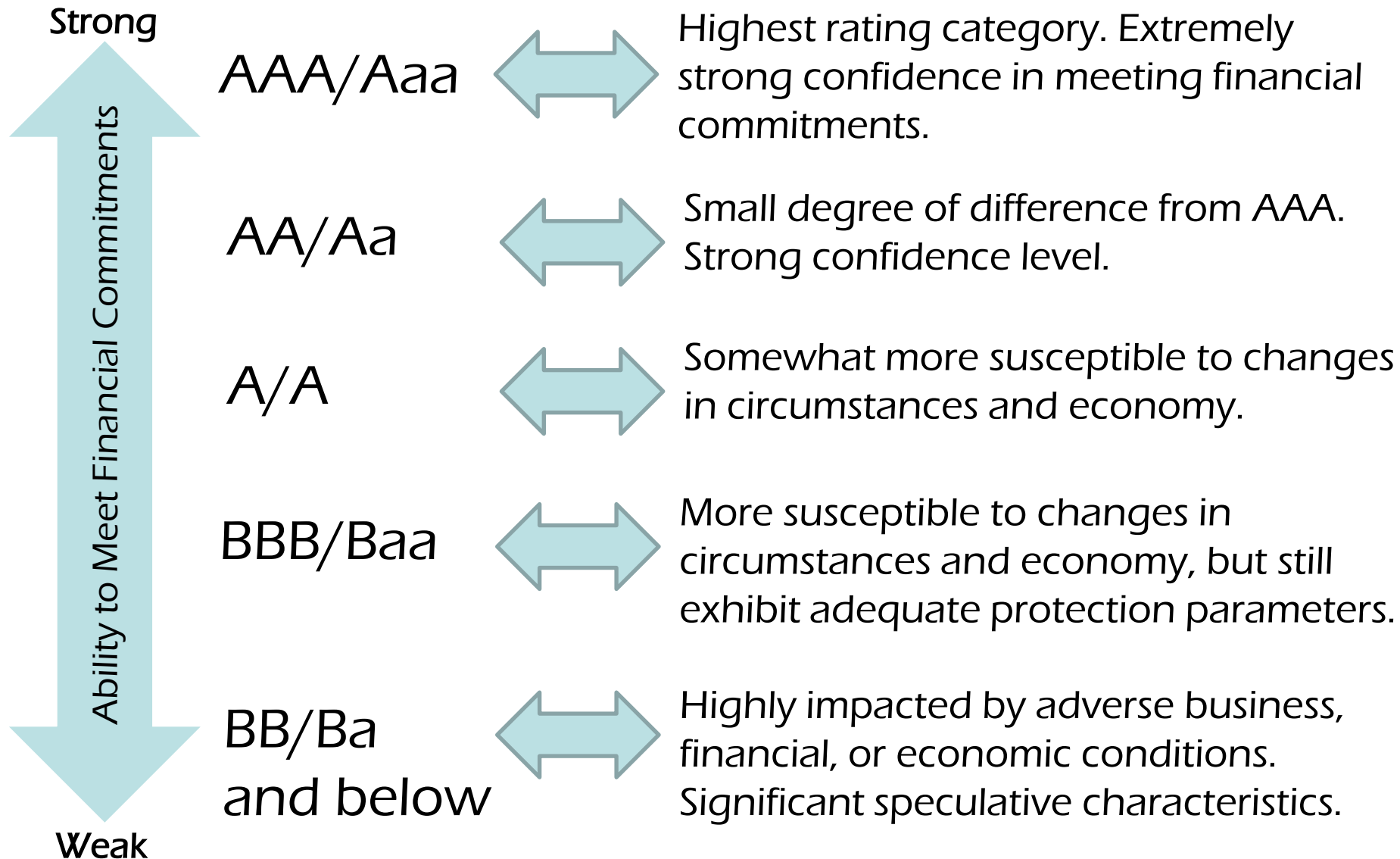
A security's rating takes into account the strength of the legal pledge. If a debt obligation carries two pledges, such as a special tax pledge backed by a general obligation (GO), Fitch takes note of the "double-barreled" feature but does not consider the two pledges to be additive. Instead, Fitch will rate the issue based on the stronger of the two pledges.

The GO full faith and credit pledge is the broadest security a U.S. state government can provide to the repayment of its long-term debt, and the rating on this type of obligation reflects the general credit quality of the issuer.

In cases where bond payment requires annual or biennial legislative appropriation, this lesser long-term commitment to repayment generally is reflected in a lower rating than

[www.fitchratings.com](http://www.fitchratings.com) **December 28, 2009**

# Rating Categories

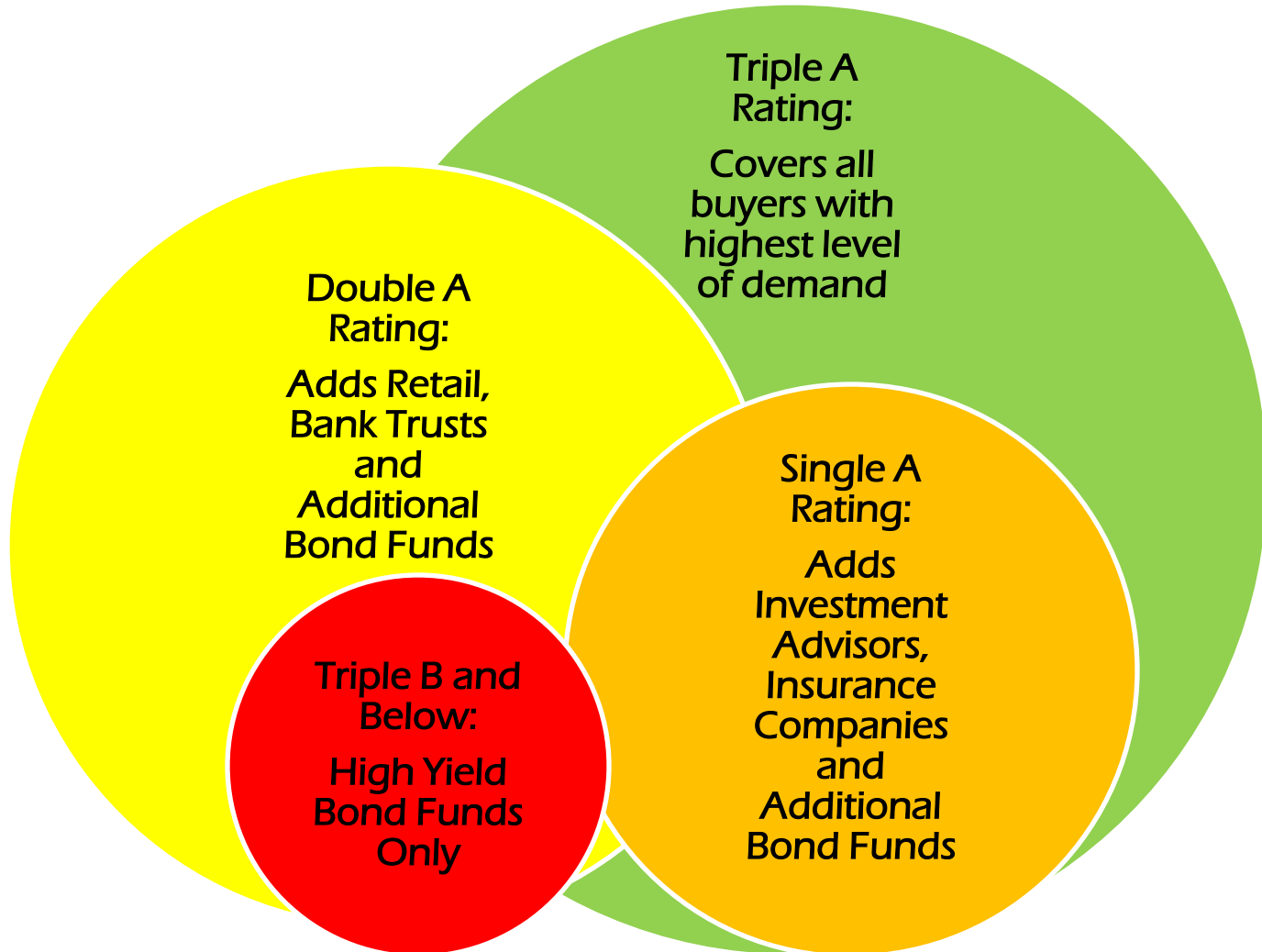


# Credit Ratings in Today's Marketplace

- The world related to credit ratings and credit enhancement has changed dramatically:
  - Downgrades of bond insurers led to less market participants and shifts in perception of credit enhancement
  - Underlying credit ratings are essential to investors
  - Investors are digging in and doing their own due diligence
  - Tighter credit requirements and need for long-term plan

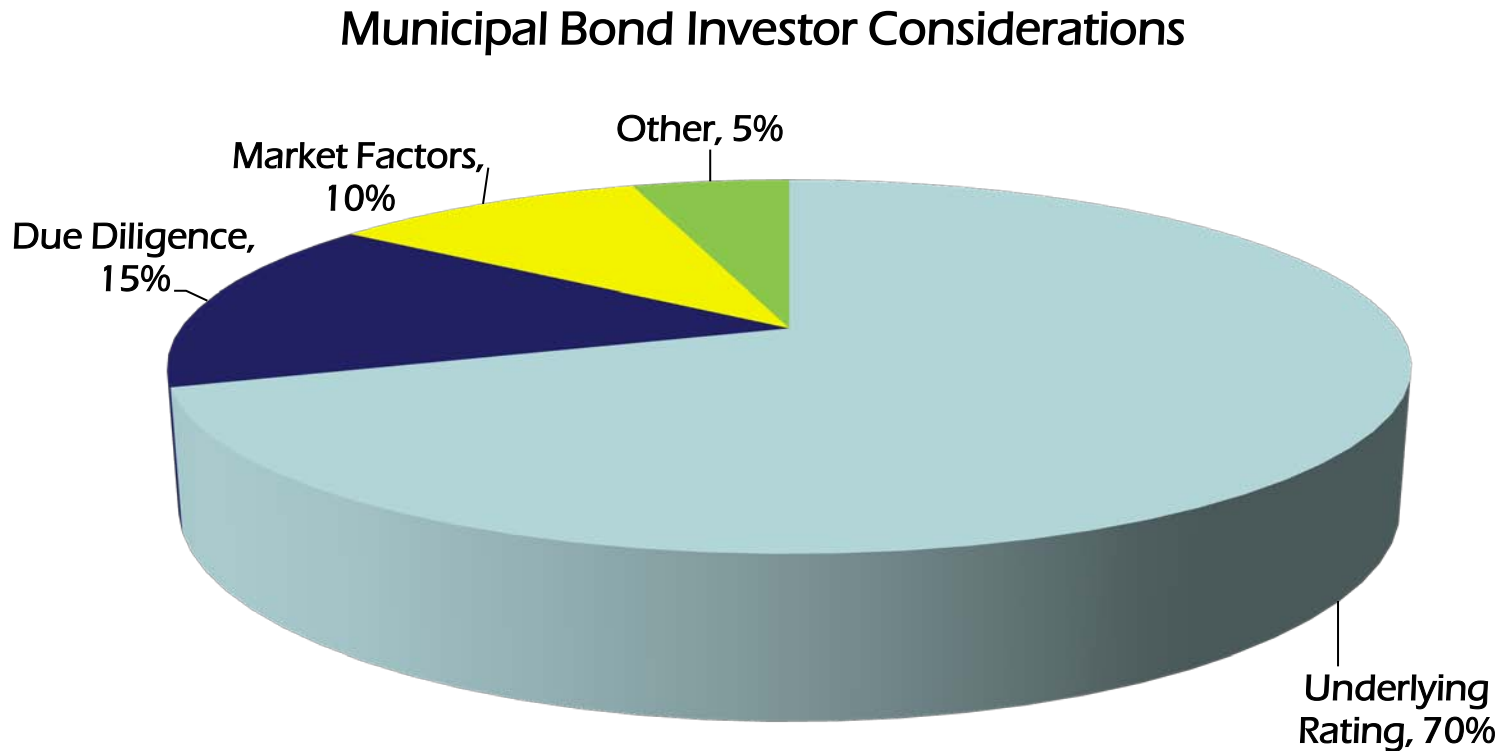
# Credit Ratings and Investors

- The universe of buyers is expanded at higher credit ratings:



# Key Investor Considerations

- Underlying rating(s) are the key decision point for investors reviewing investment alternatives.



# Market Demand (Investor Side)

- Signs of economic recovery and higher equity returns are altering investment decisions by buyers
- Retail investors are reallocating their investment portfolios; recently some retail investors returning to the municipal market
- Bond funds continue to be net sellers versus the largest buyer category in 2010
- Insurance companies and other institutional accounts are focused on credit factors and yield

# Market Supply (Issuer Side)

- 1Q11 – lowest issuance quarter in a decade (\$47 billion)
- 4Q10 – largest issuance quarter historically (\$133 billion)
- Given market supply, unique or different deal provisions result in significantly reduced investor interest.
- Since the beginning of the year:
  - Municipal interest rates in the middle part of the yield curve (10-20 years) have shown the most dramatic increases of up to 25 basis points
  - Rates in the long end of the curve (30 years) have remained relatively flat.
- Market is expecting significant issuance increases over the next quarter, which may put upward pressure on rates.

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## Logistics of a Bond Deal

# Where Do I Start?

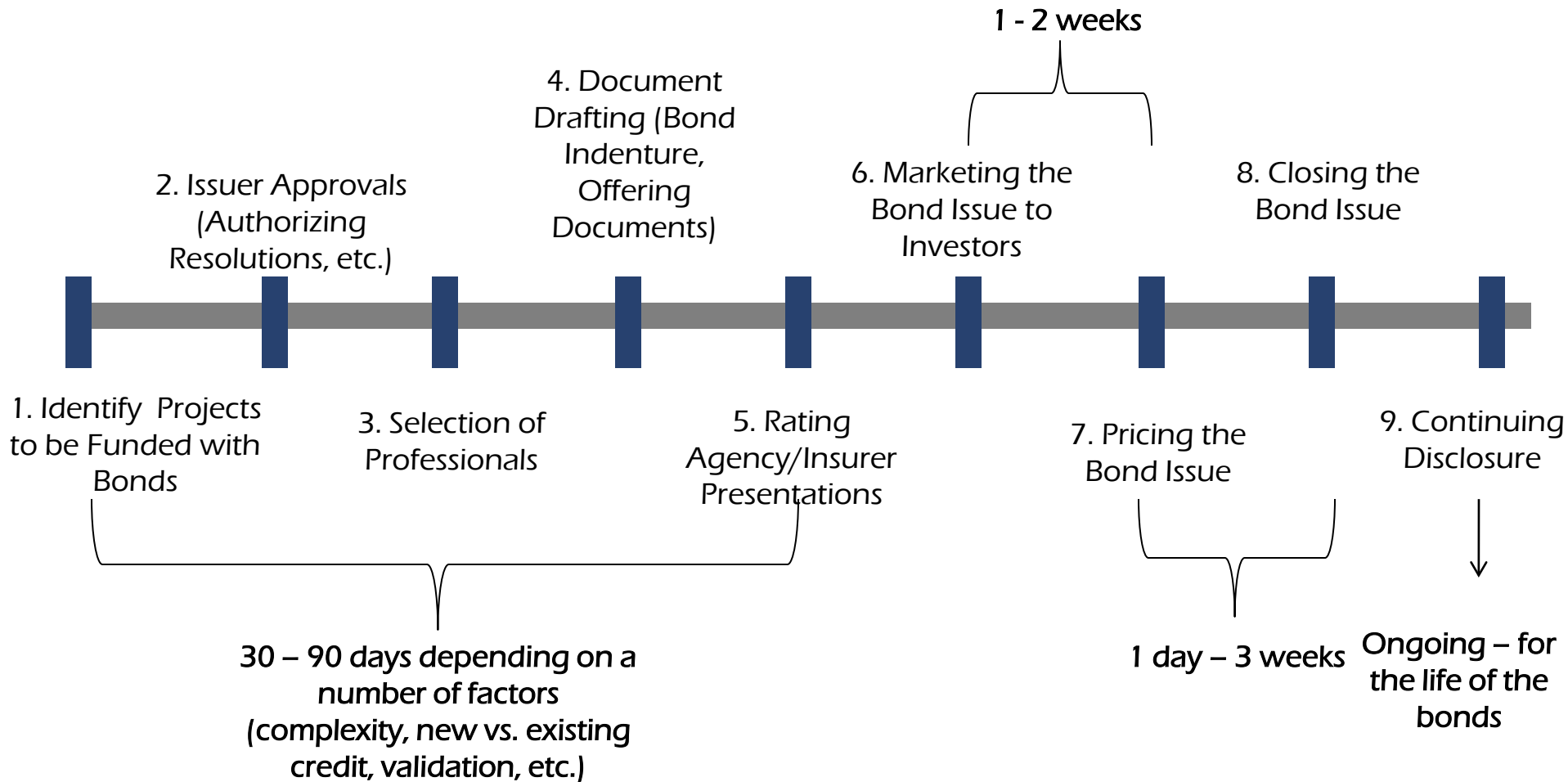
## Your (The Issuer's) Goal: Lowest Cost of Capital

- How?
  - Utilize top tier professionals to assist you in accessing the capital markets
    - ✓ A premier investment banking firm to underwrite your bonds
    - ✓ Reliable Financial Advisor
    - ✓ Highly regarded Bond Counsel to issue the bond opinion
    - ✓ Cogent offering documents (increasing in importance)
    - ✓ Comprehensive marketing/pre-marketing effort.
  - Allocate sufficient staff time and resources
    - ✓ Disclosure process may seem obnoxious at times
    - ✓ We're on the same team
  - Remain as flexible as possible
    - ✓ Education of elected officials

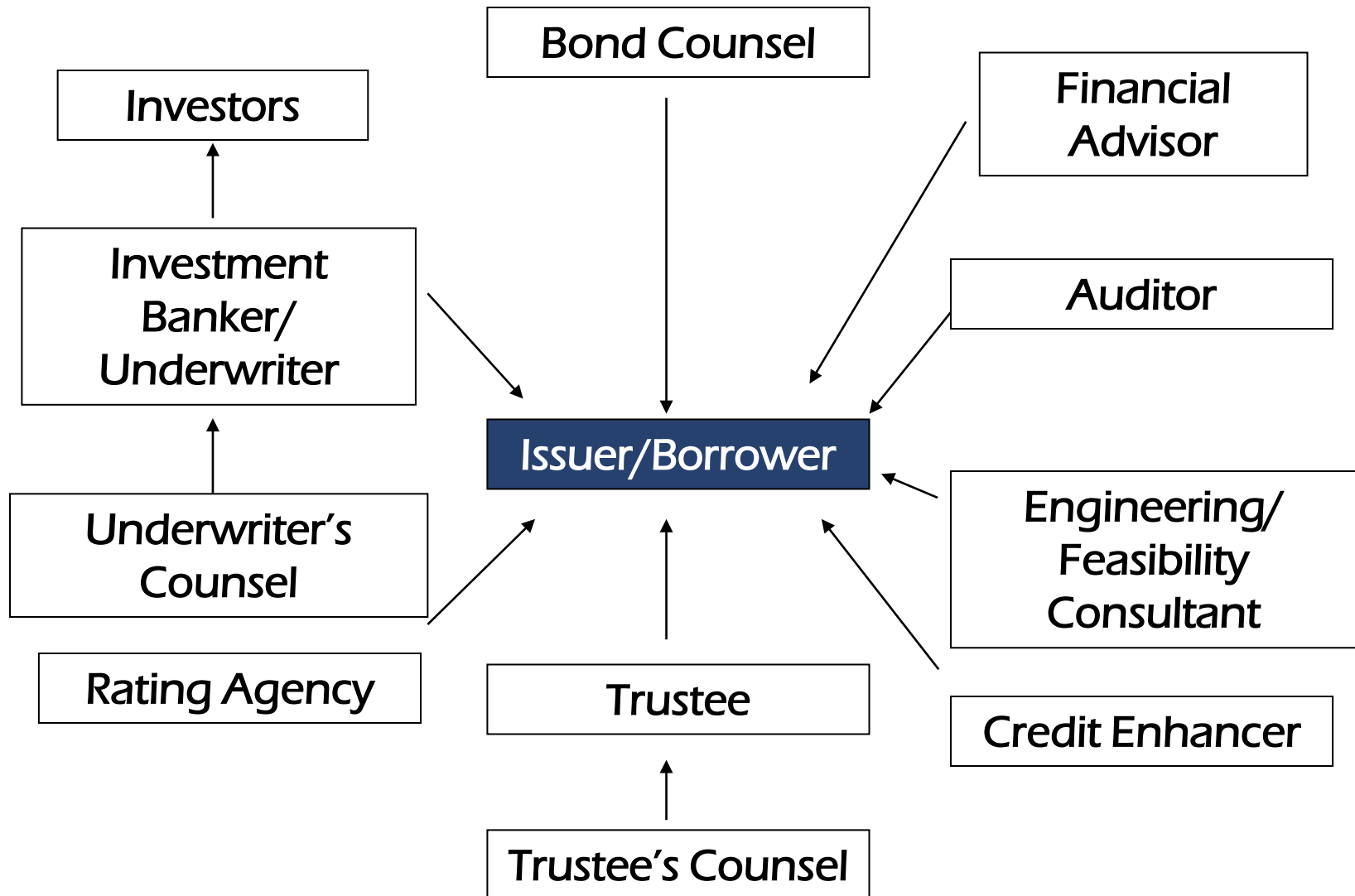
# What's the Big Deal?

- It's a big deal because it's your deal
  - The interest rate is the most significant part of borrowing cost
  - The PV01 (the value of one basis point) on a \$50 million, level 30-year issue is approximately \$64,000
- The professionals are in the market when you are not
  - Getting the best value from that experience
- A borrower should have the tools to make an informed judgment:
  - Relative pricing value of selected credit enhancers - and break-even analysis
  - How to structure an issue for the optimal price that is available
    - ✓ Coupon structuring
    - ✓ Marketing Strategy
    - ✓ Attracting investor segments
  - Pricing results relative to “peer” market
    - ✓ Defining the peer market

# Timing



# Financing Team



# Roles of Issuer Staff

- Develop capital improvement plan
- Identify, quantify, and prioritize project needs
- Develop debt management policy
- Develop criteria for issuing debt
- Set parameters for debt limitations, refunding issues, variable rate debt, derivative/swap agreements
- Develop investment policy
- Set goals and parameters for investing funds including bond proceeds
- Provide historical and projected revenue, expense, operational, and statistical information
- Liaison with Issuer Board Members
- Responsible for ongoing reporting/disclosure requirements

# Roles of Financial Advisor

- Work with Issuer to develop financing strategies
- Analyze benefits, risks, opportunity costs, timing, and effects on the Issuer's overall debt position and financial condition.
- Help Issuer draft CIP, debt management policy, and investment policy
- Legal considerations that require consultation with bond counsel
- Help evaluate types and structures for debt / economic feasibility of refunding candidates
- Document review
- Advise on fairness of pricing, terms, and bond ratings

# Roles of Bond Counsel

- Help develop legal structure of debt
- Prepare legal documents and resolutions required for the bond financing and closing
- Opine on validity of bonds
- Opine on tax-exemption

# Roles of Disclosure Counsel

- Prepares Preliminary and Final Official Statements
- Provides knowledge of disclosure requirements, including continuing disclosure
- particularly relevant in light of recently stepped up filing requirements
- Assists Issuer with material events filings

# Roles of the Underwriter (Negotiated Sale)

- Helps develop structure of financing
- Provides analysis of various options, based on changing market conditions
- Monitors outstanding debt for refunding opportunities
- Document review
- Maintains relationships with investors
- Purchases Issuer's bonds for resale to investors
- Provides a secondary market for the bonds
- Underwrites or "takes down" bonds, as necessary

# Roles of Underwriter's Counsel

- Prepares Bond Purchase Agreement
- Document review
- Provides counsel to Underwriter, with a focus on protecting the Underwriter's interests

# Roles of Rating Agency

- Provides objective evaluation of Issuer's credit
- Provide Credit Ratings
- Insured – based on the credit of the bond insurer (if applicable)
- Underlying – based on credit of the Issuer and source of repayment for bonds
- Improve efficiency of marketing process
- Additional source of information for investors on credit quality of investment

# Roles of Paying Agent/ Escrow Agent

- Invoices Issuer when debt payments are due
- Makes payments to DTC
- Holds refunding escrow on behalf of bondholders
- Sends redemption notice to bondholders

# Roles of Consulting Engineer/ Rate Consultant

- Necessary for certain utility projects
- Provides information on construction cost and rate implications
- Projects revenues available to support debt
- Enhances credibility of project
- Helps develop structure of debt

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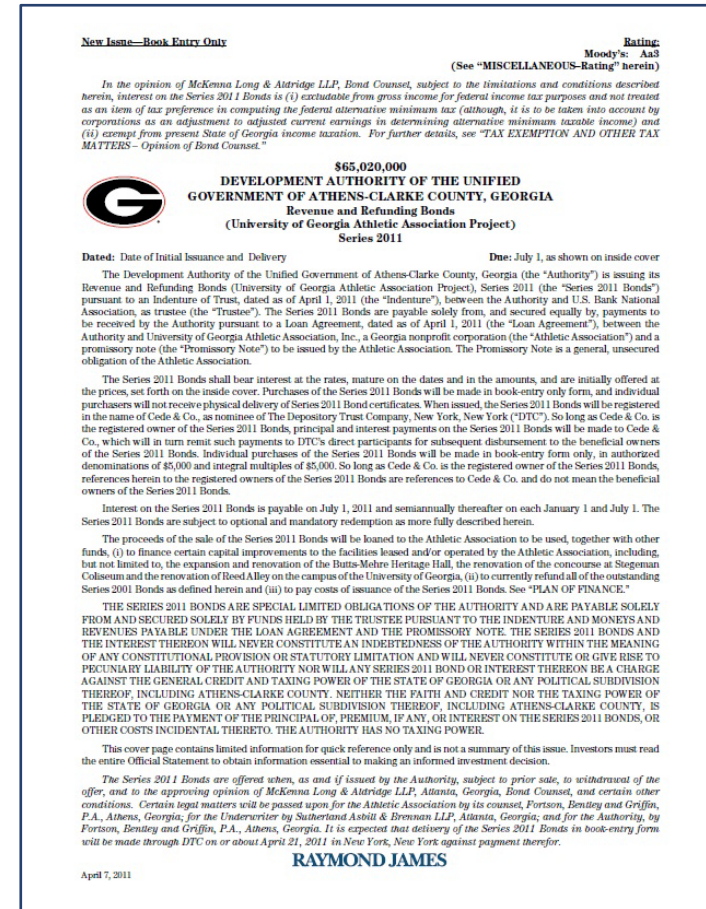
Marketing

# The Marketing Process: Pre-marketing

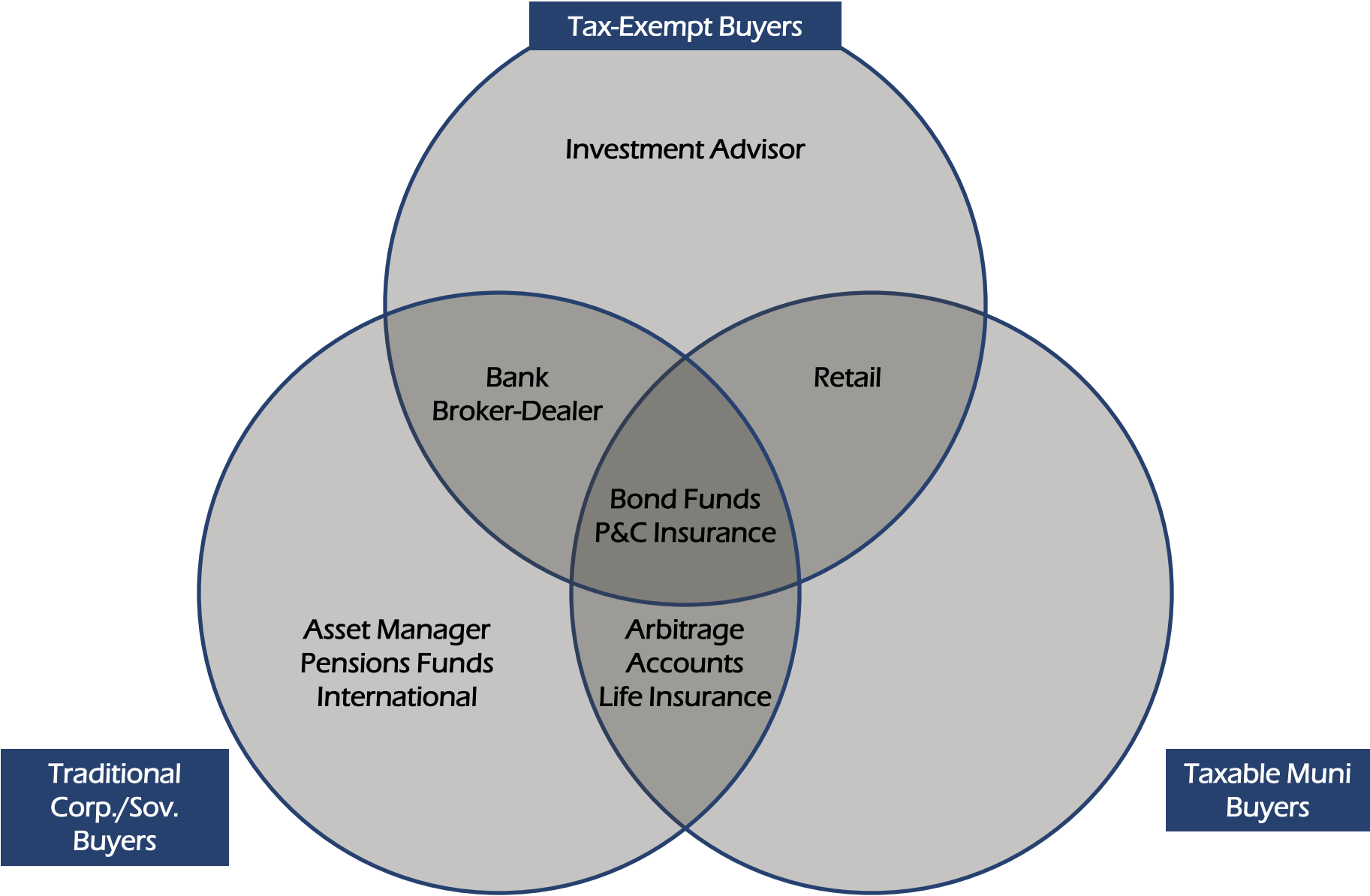
- Occurs between the distribution of the POS and pricing day
- Bond issuance is introduced to investors and preliminary indications of investor demand are noted
- Includes interactions between the issuer and investors in cases of particularly large or complex transactions
  - Investor Teleconferences
  - Internet-based Presentations
  - Road Shows
  - Preliminary offering statement
- May include local promotion efforts
  - Issuer website
  - Tombstone newspaper ads
  - Local meetings
  - Drive time radio spots
- All members of the underwriting syndicate involved in this process

# The Official Statement

- Official Statement contains:
  - Information about the issuer and/or project
  - Terms of the bonds
  - Security for the bonds
  - Credit Ratings
- Official Statement vs. Preliminary Official Statement
  - POS is distributed before pricing
    - Details such as maturity amounts, coupons, yields, and call provisions might be blank
  - Official statement is distributed after pricing
    - Contains the final terms



# Types of Investors



# Tiers of Investors

- **1<sup>st</sup> Tier Accounts** – typically buy blocks of \$5 million and more; 20 years and longer
  - Tier 1 Accounts includes:
    - ✓ Bond Mutual Funds (e.g., Franklin, Oppenheimer, Pimco)
    - ✓ Asset Managers (e.g., Merrill Lynch Asset Management, Cap Research)
    - ✓ Insurance Companies (e.g., MetLife, Allstate, State Farm)
  - Major purchasing consideration is liquidity
- **2<sup>nd</sup> Tier Accounts** – typically buy in blocks of \$500,000 to \$5 million throughout the entire yield curve
  - Tier 2 Accounts includes:
    - 1) Bank Trust Departments (e.g., Northern Trust, US Trust)
    - 2) Investment Advisors (e.g., Blackrock Advisors)
    - 3) Small Insurance Companies (e.g., Southern Farm Bureau)
  - Less Price Sensitive/More Coupon Sensitive
- **3<sup>rd</sup> Tier Accounts** – typically buy blocks of \$100,000 to \$250,000 throughout the entire yield curve
  - Tier 3 Accounts are similar to 2<sup>nd</sup> tier accounts, but on a smaller scale.
  - Major concern is structure (i.e. buyer looks for specific rating, maturity, and coupon)

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## Pricing the Bonds

# Economic Factors Impacting Pricing

## Economic Indicators

- Federal Reserve Board Policy
- Calendar of Economic Releases
  - Daily/Weekly/Monthly

## Key Economic Statistics

- Employment Report
- Producer Price Index
- Consumer Price Index

# Municipal Market Factors Impacting a Pricing

## Market Technicals

- Comparable Offerings
  - Primary market
  - Secondary market
- Market Supply
  - Weekly new issue calendar
  - New issue syndicate balances
  - 30 Day Visible supply
  - Secondary market offerings
  - Institutional bid wanted lists
- Governmental and Corporate Bond Market Movement
- Federal and State Income Taxes
- Coupon Reinvestment/Bond Maturity Date

# Internal Factors Impacting a Pricing

- Credit Ratings/ Enhancement
  - Underlying issuer ratings
  - Bond Insurance (if any)
- Structuring Products
  - Serials and term bonds
  - Premiums and discounts
  - Capital appreciation bonds
  - Call features
  - Bifurcated maturities
- Legal/Security (may be constrained by outstanding debt)
  - Additional Bonds Test/Lien Status
  - Debt Service Reserve Fund
  - Bondholder Consent to Changes
  - Flow of Funds (open vs. closed)

# Pricing Process

## First Steps

- Get hired as lead manager
- Assemble Working Group
- Perform financial, structuring, and cash flow analysis
- Present the issuer's credit to rating agencies and insurance providers

## Pre-sale of Bonds

- Begin drafting official statement
- Monitor market movements and effects on the financing
- Examine investment strategies for bond proceeds
- Receive ratings
- Complete preliminary official statement
- Pre-market the sale

## Sale of Bonds

- Determine final structure
- Discuss pricing levels with issuer, financial advisor, and underwriting team
- Hold order period
- Discuss results and reprice maturities where necessary

## Post-sale of Bonds

- Complete official statement and delivery bonds
- File regulatory documentation
- Assist in continuous financial updates

# Day of Pricing

## The Order Period

- Typically a 60-90 minute timeframe
- Investors (retail/institutional) enter all orders
- Investors may request change to structure, coupon and/or yield

## The Order Period Results

- Order Status Review
  - Orders by maturity
  - Unsold balances
  - Allotments
- Re-pricing/Re-structuring Subject to:
  - Investor demand per maturity
  - Number and type of investors
  - Volatility in the market
  - Comparable transactions

# Post Pricing

## Award

- Issuer and underwriter agree to pricing levels
- Both verbal and written award

## Bond Closing

- Typically 1-2 weeks after pricing
- Documents finalized and signed
- Funds wired to appropriate parties

## Continuing Disclosure/ Ratings Surveillance

- Issuer must abide by Continuing Disclosure Agreement
  - Agree to provide annual financials and other relevant information to the market in a timely manner
  - Rating agencies will monitor the Issuer annually for any significant changes in financial or credit situation