

# DEBT 101: FUNDAMENTALS OF DEBT ISSUANCE

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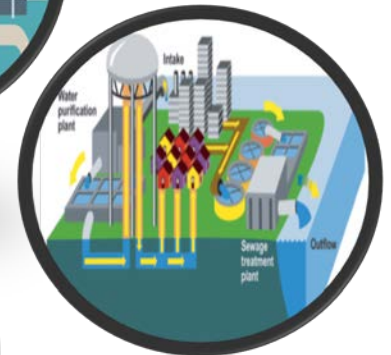
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# WE HAVE A PROJECT THAT NEEDS TO BE FINANCED

- Project type will dictate approach to financing
- Long lived infrastructure capital assets have different financing suitability vs. shorter term assets
- Where to go for financing?
- Internal Financing – inter-fund loans, cash/reserves
- External Financing – municipal bonds and/or other indebtedness to third-party creditors

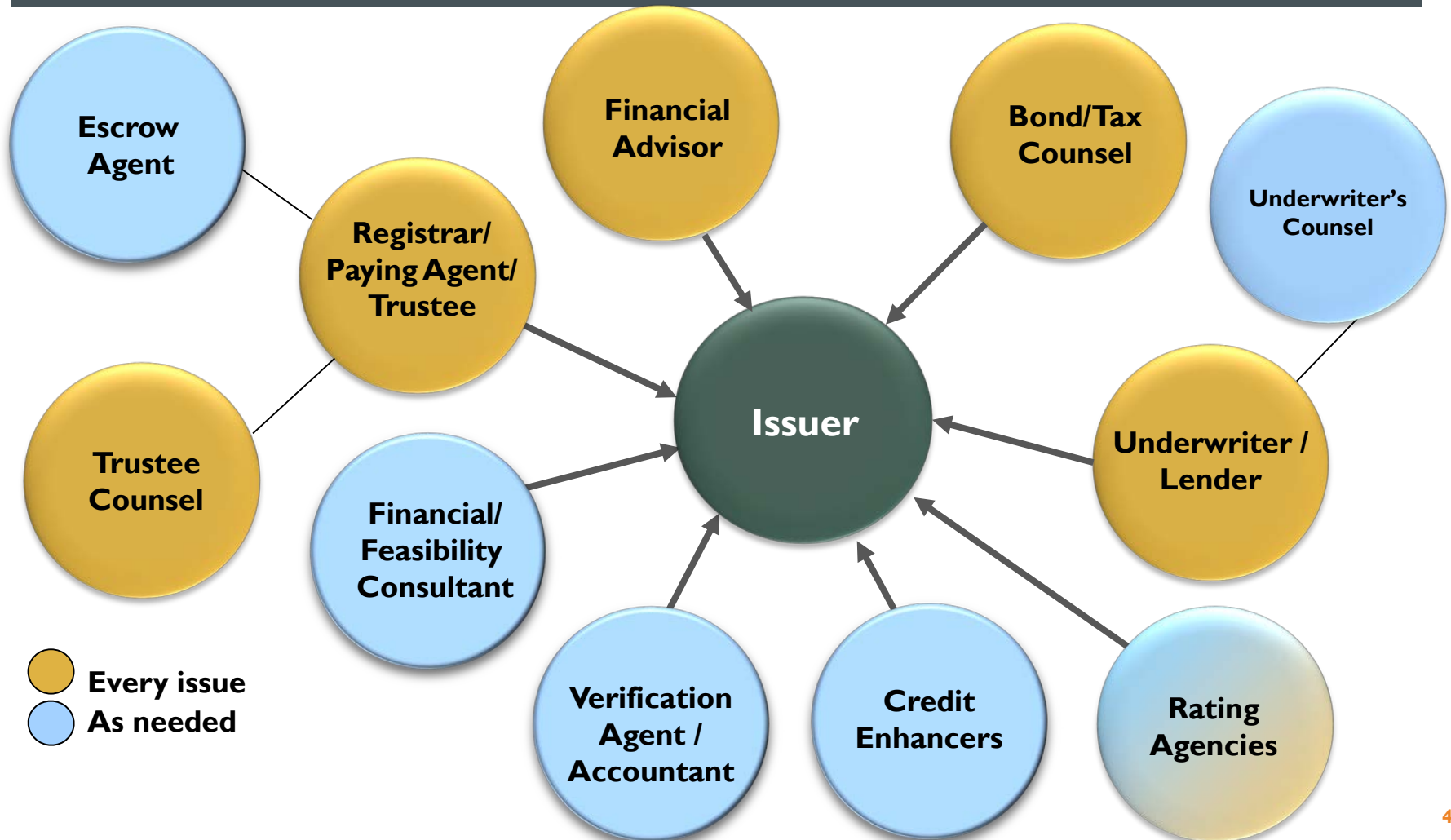


# LOOKS LIKE WE NEED EXTERNAL FINANCING

- Capital planning process has identified a project well suited for external financing
- What borrowing options do I have available to my organization?
  - Publicly issued municipal bonds
  - Bank loans and/or lines of credit
  - Direct purchases
  - Private placements
- What is a municipal bond?
- What are the benefits of issuing bonds?
  - Typically lower cost vs. taxable debt
  - Intergenerational equity
  - Part of my organization's overall capital structure objectives



# DEBT ISSUANCE REQUIRES WORKING WITH A NUMBER OF PARTNERS



# ASSEMBLING THE TEAM — PART I

- Bond Counsel on all public and many direct placement transactions; legal and tax opinions critical to market acceptance of bond
- Advises on authority to issue debt (resolution; election)
- Advises on repayment structure (drafts legal documents obligating issuer to repay and reviews documents prepared by other parties)
- Advises on projects to be financed (tax exemption generally available only for capital improvements or to refund previously issued tax exempt bonds)



## ASSEMBLING THE TEAM — PART II

- Municipal Advisor (“MA”) on most public and direct placement transactions
- MAs work for the issuer and must give fiduciary care in advising issuer by putting the issuer’s interest above their own
- MAs provide advice on many aspects of a municipal bond issue – structure, credit strategy, pricing, etc.
- 2014 SEC Municipal Advisor Rule requires MAs to be registered with the SEC and limits broker-dealer communications with issuers



*"Do you really know what you're doing, or do you Google-search know?"*

## ASSEMBLING THE TEAM — PART III

- Public issuance of municipal bonds will require services of one or more municipal securities broker-dealers (i.e. underwriters)
- Deciding between competitive and negotiated methods of selling bonds
  - Competitive bid process – Bonds awarded to lowest bidder meeting the issuer's bid parameters
  - Negotiated sale process – Underwriter is selected by the issuer prior to selling the bonds and will have input in structuring and completing the sale
- Other considerations in selecting an underwriter

# ASSEMBLING THE TEAM — PART IV

- A bond issue may require additional specialized consultants
  - Examples may include: special tax, engineering, feasibility, tax rate, economic consultants and appraisers
- Type of project being financed and the repayment source will dictate the need for additional consultants and the associated expert work products
  - Examples may include: appraisals, asset valuations, market absorption study, special tax revenue projections, assessment revenue projections, financial feasibility reports, financial projections, etc.





# MITIGATING RISKS WITH CONSULTANT ENGAGEMENT

- The issuer is ultimately in charge and responsible for consultants providing expert work products
- Consultants should be independent: hired, overseen and paid by the issuer
- Consultant contracts competitively bid on a regular and recurring basis
- Consultant contracts include insurance requirements; indemnification clause protecting issuer from errors related to work product
- Expert work products are incorporated into the public record – included in staff reports and approval of the financing by governing board

# WHAT IS AN OFFICIAL STATEMENT

- In order to sell bonds to the public, a disclosure document (called an Official Statement) is required
- **The SEC is concerned that issuers are committing securities fraud through inaccurate and incomplete disclosures in Official Statements**
- The Official Statement must not contain “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” (SEC Rule 10b-5)
- Materiality:
  - Is there a substantial likelihood that a reasonable investor or prospective investor would consider the information important in deciding whether or not to invest.
  - Materiality is determined in context of all of the facts and circumstances, but usually on a retroactive basis
  - Guidance comes primarily from court decisions and SEC enforcement cases

# HOW IS AN OFFICIAL STATEMENT PREPARED

- Unlike corporate securities, there is no “line item” set of rules for what goes into an Official Statement
- Provide important disclosures up front, but don’t overwhelm readers with details in the back
- It is critical to obtain input about the issuer and its finances from all departments – have the right people in the room
- Empower staff to comment on and raise concerns about the disclosure
- In the end, the issuer must use its best judgment. The issuer is responsible for the content, although consultants can help

# TYPES OF MATERIAL INFORMATION

- Typically bond/disclosure counsel will take the lead
- Telling your story to the market
- Summarize legal structure/payment and redemption terms
- Disclose risks of nonpayment
- Disclose past continuing disclosure noncompliance
- Accuracy is paramount – but readability is important, too
- Subject to SEC antifraud rules (Rule 10b-5)

# BOND STRUCTURING

- What drives structuring decisions?
- Fixed vs. variable rate
- Term (attention to life of improvements being financed)
- Level debt service vs. alternative
- Call provisions in a world without advance refundings
- Additional parity debt test
- Rate covenant/foreclosure covenant
- Debt service reserve fund
- Amendment provisions
- Defaults and remedies (can debt be accelerated?)

# WHAT IS A CREDIT RATING?

- Rating agencies rate municipal bond issuers in order to categorize the creditworthiness of the security pledge and likelihood of default by an issuer
- While many sophisticated investors do their own credit research, ratings play a critical role in the minds of most market participants and are perceived by the market as a guide of an Issuer's creditworthiness
- Rating agencies view the same credit structure differently – understand differences in methodologies
- Inaugural credit and/or “story” credit requires a tailored approach (in person/visit/etc.)

**S&P Global**  
Ratings

**MOODY'S**

**Fitch**Ratings

**KBRA** **KROLL BOND  
RATING AGENCY**

# WHAT IS A CREDIT RATING – PART II

- Credit ratings play a role in broadening the investor base for an issuer
- Usually a stronger rating = lower cost of capital
- During the credit crisis, single-A credits in California were ~150bps higher than AAA, while BBB tax-exempt credits priced ~300bps (3%) higher than AAA credits
- Cost differential in normal credit conditions approximately 5-10 basis points per “notch” in AA and A categories

	Moody's	S&P	Fitch
Investment Grade	Aaa	AAA	AAA
	Aa1	AA+	AA+
	Aa2	AA	AA
	Aa3	AA-	AA-
	A1	A+	A+
	A2	A	A
	A3	A-	A-
	Baa1	BBB+	BBB+
	Baa2	BBB	BBB
	Baa3	BBB-	BBB-
Junk	Ba1	BB+	BB+
	Ba2	BB	BB
	Ba3	BB-	BB-
	B1	B+	B+
	B2	B	B
	B3	B-	B-
	Caa1	CCC+	CCC+
	Caa2	CCC	CCC
	Caa3	CCC-	CCC-
	Ca	CC	CC+
		C	CC
			CC-
	D	D	DDD

# WAIT, HAVE I MET MY STATUTORY REQUIREMENTS?

- **SB 1029** – Issuers must have an adopted debt management policy
  - Purpose for which debt proceeds may be used
  - Types of debt that may be issued
  - Relationship of debt to issuer's CIP
  - Policy objectives for issuing debt
  - Internal control procedures regarding expenditure of proceeds
- **SB 450** – New disclosures either in resolution or staff report; good faith estimates for:
  - True interest cost
  - All third-party fees
  - Net bond proceeds received by the issuer
  - Total debt service



# FINALIZING DISCLOSURES AND SELLING BONDS — PART I

- Ensure all necessary approvals are in place (board, city council, etc.)
- Mail preliminary official statement (POS)
- Marketing
  - Underwrite is the primary “marketer” of the bonds – but issuers and their MA should be actively involved in the process
  - Is the underwriter marketing to the right investor base?
  - Issuers may carefully dialogue with investors directly
- Price bonds – process is different for competitive and negotiated sales
  - Oversubscription/undersubscription, yield curve integrity, diversity of participating investors all key to determining the final yield in a negotiated sale process
  - Restructure bond terms (e.g. coupon, call provisions, etc.) to further lower borrowing cost to issuer

# FINALIZING DISCLOSURES AND SELLING BONDS — PART II, MY BONDS ARE SOLD

- Sign Bond Purchase Agreement – includes representations and warranties of the issuer, underwriter “outs” and itemization of closing deliverables
- Prepare final Official Statement (including bond pricing)
- Sign closing documents
- Close bonds (receive \$\$)



# MY BONDS ARE SOLD, NOW WHAT?

- Detailed records of expenditure/investment of bond proceeds – tax compliance
- Book the transaction
- Budget for repayment
- Continuing disclosure obligations – policies, responsibilities and accountability
- Compliance with covenants: debt service coverage ratio, rate covenants

# EXPENDITURE OF BOND PROCEEDS

- Hot topic right now in California (SB 1029)
- Tax compliance
  - Use of financed assets
  - Investment of bond proceeds
  - Expenditure of bond proceeds
- Written policies are a must – and now a statutory requirement – responsibility and accountability are critical

# CONTINUING DISCLOSURE

- Know your CDA obligations (only what you agree to in the agreement)
- Typical “listed events” include:
  - Principal & interest payment delinquencies
  - Unscheduled draws on DSRF
  - Unscheduled draws on any credit enhancement (bond insurance)
  - Rating changes (this includes ratings of bond insurers)
  - Bankruptcy
  - IRS determination of taxability
- Designate a responsible person
- Most common missed event is ratings; set up ticklers for rating changes
- Dissemination agent or in-house responsibility

# DO I NEED AN INVESTOR RELATIONS/OUTREACH STRATEGY?

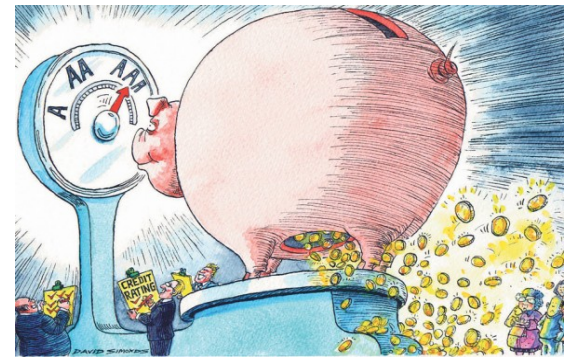
- Maybe; it depends on the size and scope of planned future bond issuance
- EMMA is a good resource for investors
- Helpful to have a page on your entity's website that has relevant investor info (links to budget, CAFR, policies, Municipal Advisor – IRMA, ratings, EMMA documents, etc.)

The screenshot shows the EMWD website with a navigation bar at the top containing links like 'Español', 'News', 'Job Openings', 'Water Outages', 'Home', 'View / Pay My Bill', 'Contact Us', and 'Site Map'. The main navigation menu includes 'About EMWD', 'Services', 'Education', 'Use Water Wisely', 'Customers', 'Development', 'Construction' (highlighted), 'Vendors', and 'How C'. The left sidebar lists various categories such as 'Board of Directors', 'Board and Committee Meetings', 'Career Opportunities', 'EMWD Administrative Code', 'EMWD Calendar', 'EMWD Mission, Vision, and Guiding Principles', 'EMWD Construction Projects', 'EMWD Service Area', 'Executive Management', 'Financial Information' (with sub-links for Budget, Financial Reports, and Investor Relations), 'Investor Relations' (highlighted), 'Community Facilities District (CFD) Bonds', 'Policies and Rating Reports', 'Rates and Fees', 'Unclaimed Monies', 'Grant Projects', 'History', 'Maximizing Resources Programs', 'News & Information', 'Organizational Chart', 'Public Notices', 'Transparency Information', 'Tell Us How We Are Doing', and 'Water Leaders Academy'. The main content area is titled 'INVESTOR RELATIONS' and includes sections for 'Municipal Advisor', 'Budget', 'Financial Reports', 'Community Facilities District Bonds', 'Assessment District Bonds', 'Policies and Rating Report', and 'Disclosure Reports'. A table at the bottom provides a summary of bond disclosures.

Bond	Official Statement	Continuing Disclosure	MSRB EMMA website link
<b>Revenue Bonds</b>			
2011A Refunding	<a href="#">2011A RB Official Statement</a>	<a href="#">Continuing Disclosure</a>	<a href="#">Refunding Water and Wastewater Revenue Bonds, Series 2011A</a>
2015A Refunding	<a href="#">2015A Official Statement</a>	<a href="#">Continuing Disclosure</a>	<a href="#">Refunding Water and Wastewater Revenue Bonds, Series 2015A</a>
2015B New	<a href="#">2015B Official Statement</a>	<a href="#">Continuing Disclosure</a>	<a href="#">Water and Wastewater Revenue Bonds, Series 2015B</a>

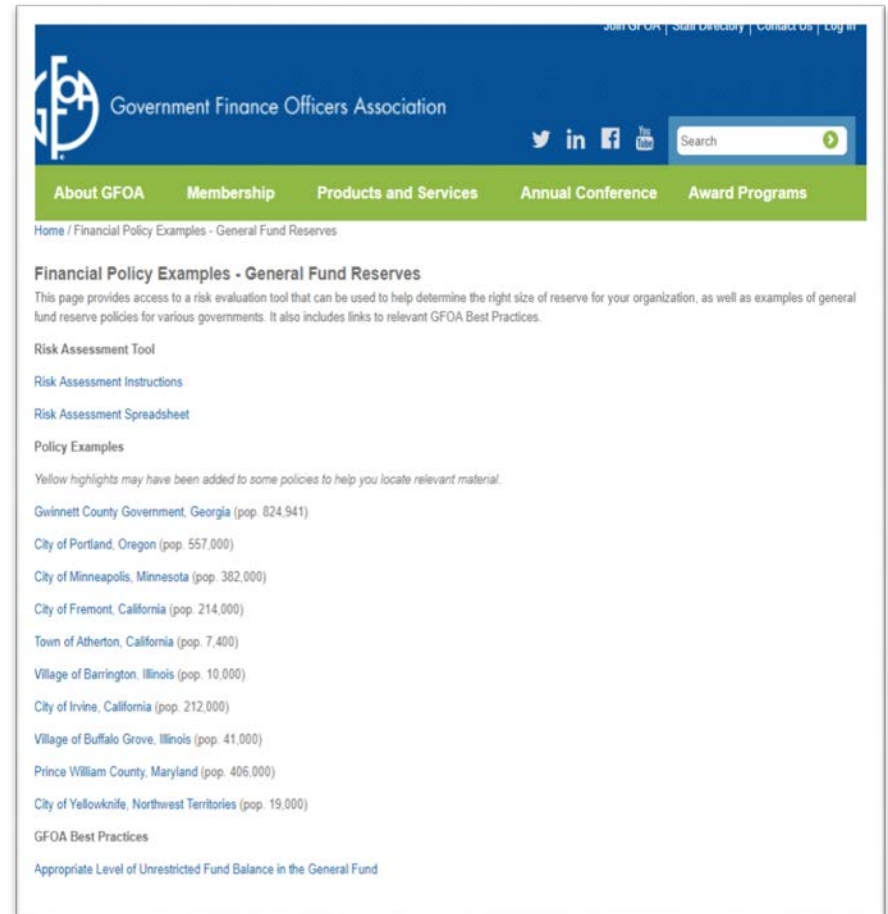
# WHAT ABOUT THE RATING AGENCIES — DO I NEED TO STAY IN CONTACT WITH THEM, TOO?

- Rating agencies are obligated to perform surveillance on a regular basis
- Be proactive if there is a material event — positive or negative — nobody likes surprises
  - Passage or failure of a forecast rate package
  - Material change in tax base or service area demographics
- Change in rating criteria — RAs provide notice and request for comments on significant criteria changes



# ADDITIONAL RESOURCES

- GFOA provides numerous free resources with respect to best practices
  - <http://www.gfoa.org/best-practices/>
- CDIAC hosts ongoing educational seminars and provides an excellent debt primer tailored to California issuers, as well as SBI029 compliance guidance
  - <http://www.treasurer.ca.gov/cdiac/>





# CONCLUSION & CONTACT INFORMATION

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