Alternatives for Advanced Refundings

Maryland GFOA – Spring Conference

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General Overview of Refundings

What is a Refunding?

- Refunding means refinancing outstanding debt at a lower rate of interest and is most commonly used to achieve savings on interest costs.

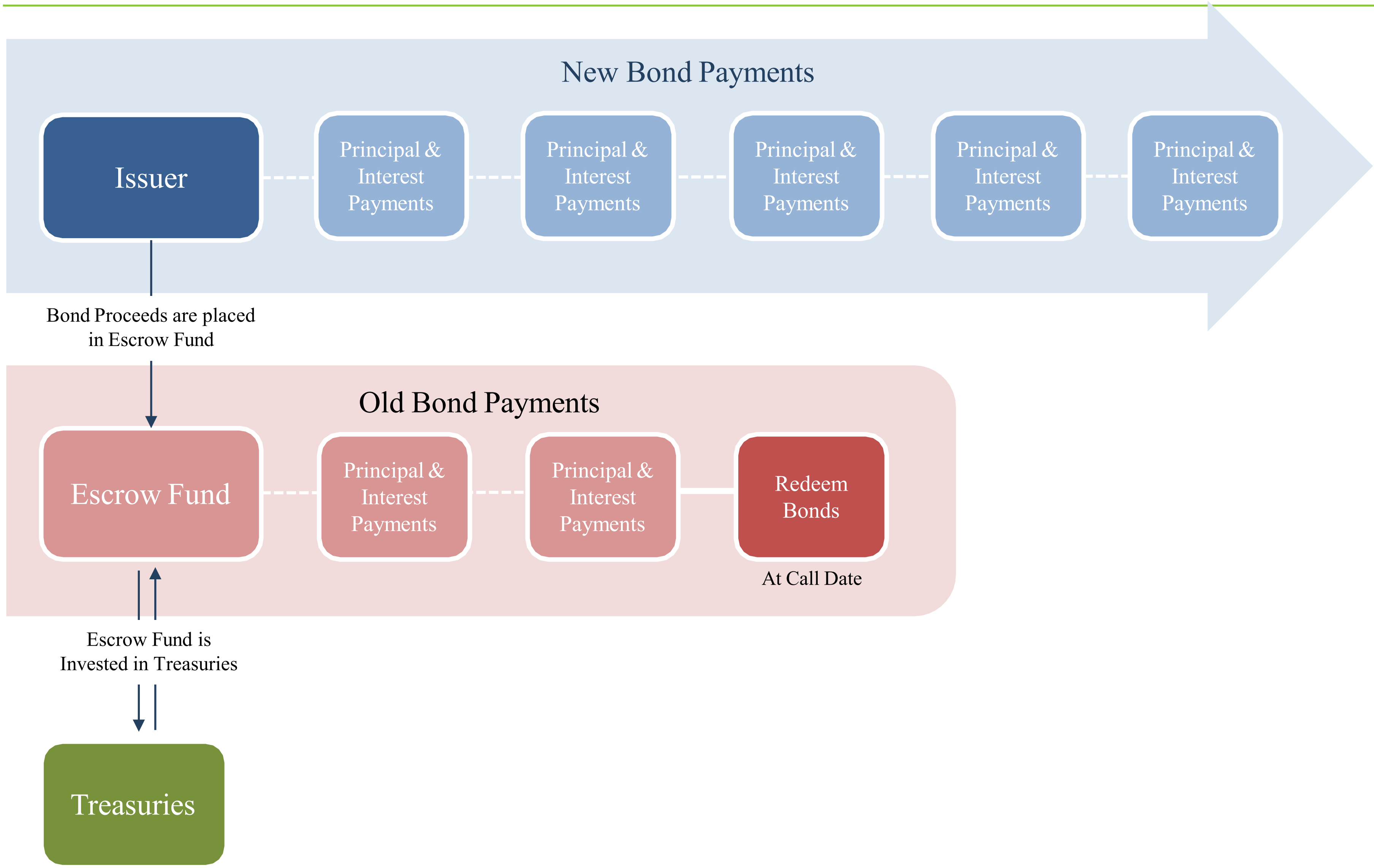
- Current Refunding
  - Outstanding bonds are redeemed within 90 days from the date the refunding bonds are issued.

- Advance Refunding
  - Refunded bonds remain outstanding for a period of more than 90 days from the date the refunding bonds are issued.
  - Since the passage of the tax reform in 2017, advance refundings may not be done on a tax-exempt basis. However, there is the potential that tax-exempt advanced refundings could be reinstated as part of an upcoming Infrastructure Bill.

Assumes the annual principal payments	Original 20-year 6% bonds	Refunding issue 4.5% maturing in 8 years
Annual Principal Payment	4,500,000	6,500,000
Annual Interest Payment	6,300,000	2,860,000
Total Annual Payment	10,800,000	9,360,000

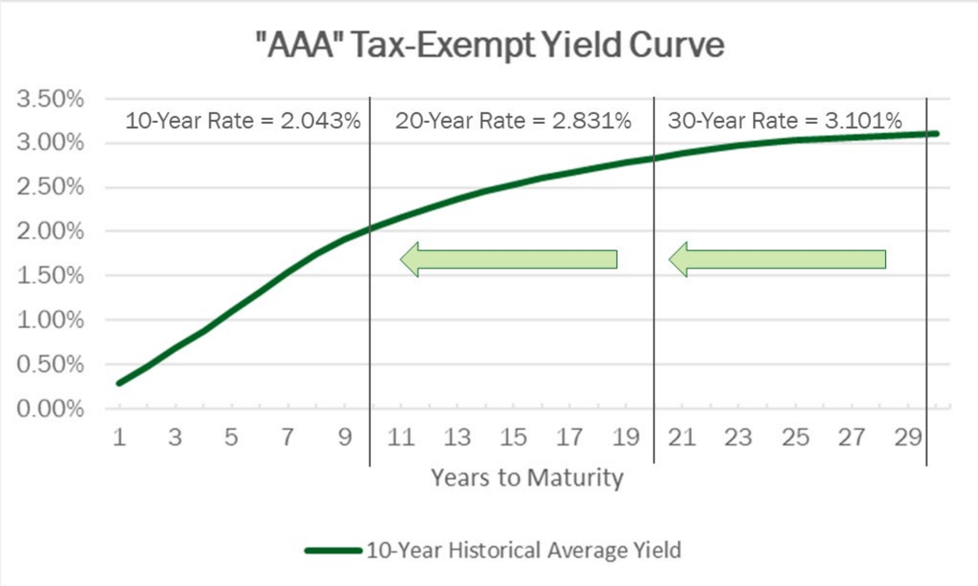
Annual Cost Savings is $1,440,000

Refunding Process

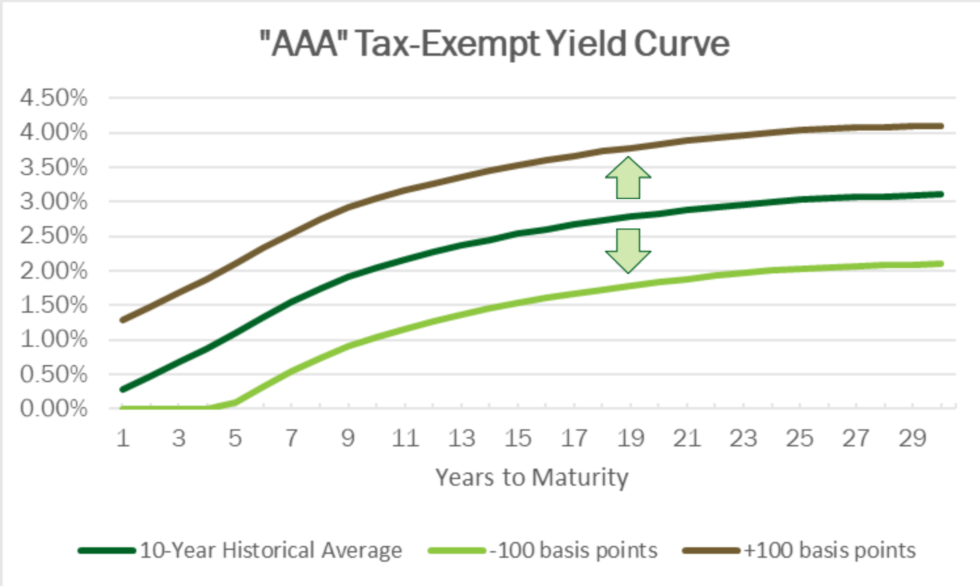


Why Do Refundings Occur?

Moving Down the Yield Curve

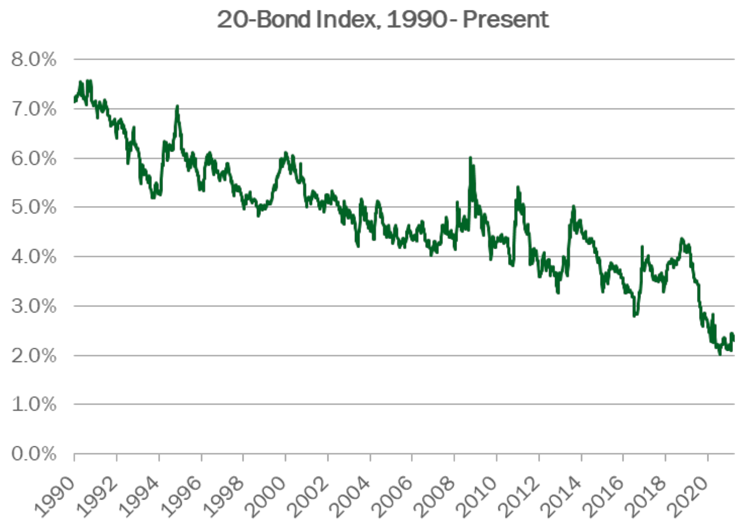


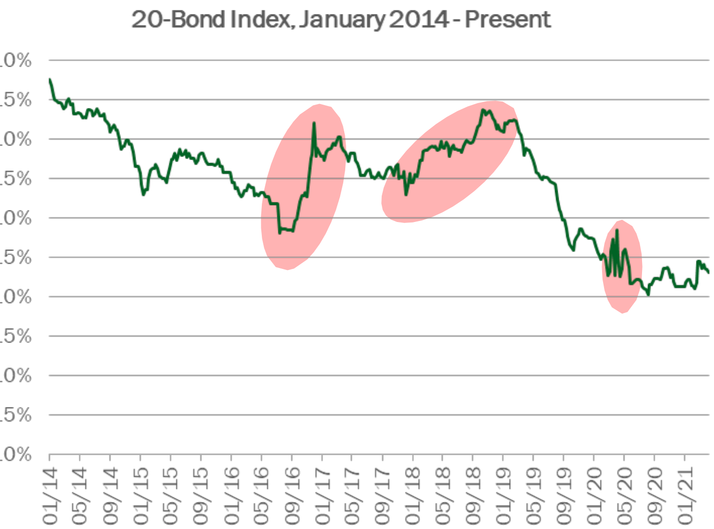
Changes in Market Conditions



Tax-Exempt Interest Rate Trends

- Interest rates for tax-exempt borrowings are hovering near historically low levels.
- Although interest rates remain near historical lows, it is impossible to predict how long rates will remain this favorable.
- Interest rates are capable of rising quickly, as evidenced by the roughly 100 basis point (1%) jumps that occurred November to December of 2016 and December 2017 to October 2018 and the roughly 60 basis point (0.6%) up and down that occurred in Spring 2020.



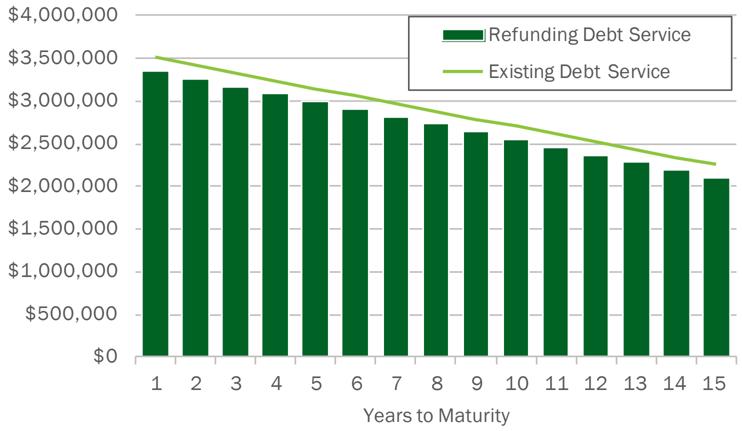


(1) The 20-year interest rates above show the Bond Buyer's "20-Bond Index" which consists of 20 tax-exempt bonds with an average rating of 'Aa2'/'AA' (Moody's / S&P) that mature in 20 years. The 20-Bond Index serves as a general indicator of prevailing interest rates for tax-exempt borrowers. Shown as of April 14, 2021.

Realizing Refunding Savings

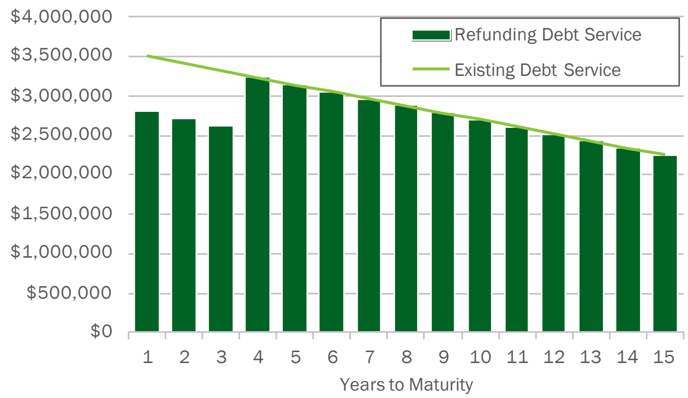
Level Savings

- Annual debt service is reduced by an equal amount in each year remaining until final maturity



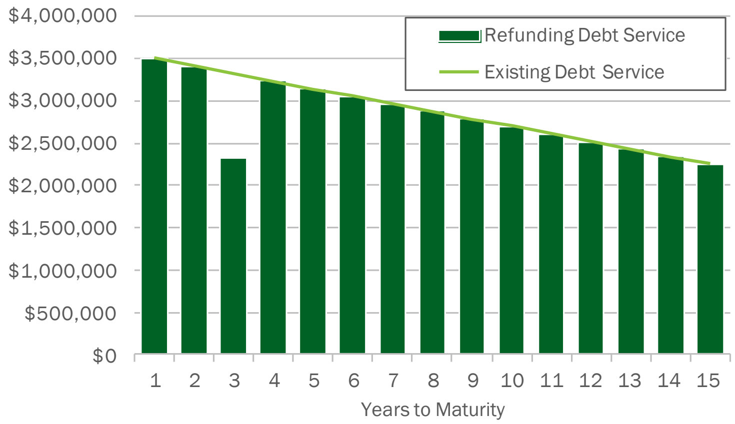
Upfront Savings

- Savings realized in earliest year(s) with debt service in remaining years unchanged



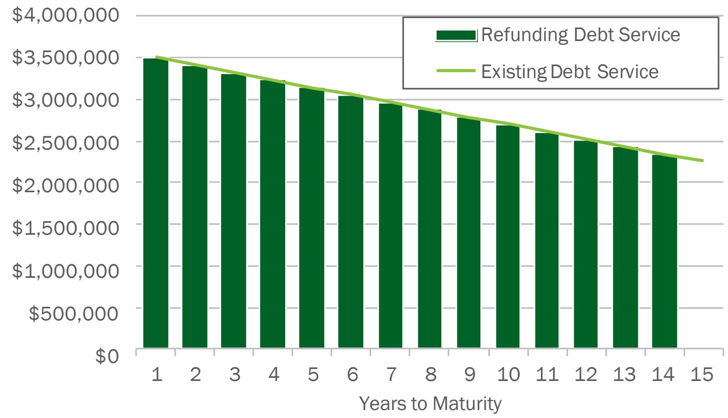
Targeted Savings

- Savings realized in specific year(s) to address specific circumstances



Deferred Savings

- Annual debt service payments remain unchanged, but final maturity is shortened
- Common for refunding of 40-year USDA Rural Development Loans



Types of Refundings

- Given that tax-exempt advanced refundings are no longer allowed under current tax law, state and local governments have a number of other options that they can explore to potentially generate debt service savings.

- The remainder of this presentation will provide an overview of each of these refunding options, the pros and cons associated with each financing method, and any tax implications to consider when pursing these options.

- The refunding options covered in this presentation include:
  - Current Tax-Exempt Refunding;
  - Taxable Advanced Refunding;
  - Forward Refunding;
  - Cinderella Refunding;
  - Tender Refunding; and
  - Cash Optimization.

Current Tax-Exempt Refunding

Current Tax-Exempt Refunding

- Overview:
  - Given that tax-exempt advanced refundings are no longer allowed under current tax law, one option would be wait until the bond was within 90 days of the call date so a current refunding could be completed.
  - Typically, tax-exempt refunding bonds are issued to payoff outstanding bonds at their call date and generate lower annual debt service costs.

Pros – Current Refunding	Cons – Current Refunding
▪ A current refunding is the most common refunding structure.	▪ Earliest that a current refunding can be completed on a tax-exempt basis is 90 days before the call date.
▪ Provides ability to refund on a tax-exempt basis.	▪ Potential opportunity cost to waiting for a current refunding if bonds are not within the 90 day period.
▪ A current refunding can either be completed in the public market or with a direct bank loan.	– Financial advisor can generate a breakeven analysis to assess that opportunity cost.
▪ Given that these bonds are currently callable and do not require a long escrow (or an escrow at all), negative arbitrage is not a factor.	

Example of Breakeven Analysis

	Taxable Advanced Refunding Current Taxable Market Rates Closing Date: 6/9/2021				Tax-Exempt Current Refunding Current Tax-Exempt Market Rates Closing Date: 4/4/2023			
Fiscal Year	Prior Debt Service	Refunding Debt Service	Savings	PV Savings[1]	Prior Debt Service	Refunding Debt Service	Savings	PV Savings[1]
2022	$1,133,489	$925,725	$207,764	$203,670	N/A	N/A	N/A	N/A
2023	1,133,489	926,246	207,243	199,156	N/A	N/A	N/A	N/A
2024	3,478,489	3,274,146	204,343	192,500	$3,478,489	$2,990,623	$487,866	$459,592
2025	3,480,208	3,274,946	205,262	189,556	3,480,208	2,993,000	487,208	449,928
2026	3,480,508	3,274,646	205,862	186,364	3,480,508	2,991,500	489,008	442,692
2027	3,480,308	3,273,626	206,682	183,419	3,480,308	2,990,250	490,058	434,901
2028	3,481,108	3,276,731	204,377	177,800	3,481,108	2,989,000	492,108	428,115
2029	3,482,708	3,276,937	205,771	175,485	3,482,708	2,992,500	490,208	418,059
2030	3,481,383	3,275,393	205,990	172,211	3,481,383	2,990,250	491,133	410,595
2031	3,478,113	3,273,293	204,820	167,859	3,478,113	2,987,250	490,863	402,284
2032	3,480,638	3,276,891	203,747	163,689	3,480,638	2,993,250	487,388	391,565
2033	3,479,850	3,275,840	204,010	160,671	3,479,850	2,992,500	487,350	383,820
Total	$37,070,286	$34,604,420	$2,465,866	$2,172,380	$34,803,309	$29,910,123	$4,893,186	$4,221,552
Difference in Savings vs. Advanced Refunding:			N/A	N/A			$2,427,320	$2,049,172

	Tax-Exempt Current Refunding Current Tax-Exempt Rates + 100 BP Closing Date: 4/4/2023				Tax-Exempt Current Refunding Current Tax-Exempt Rates + 158 BP Closing Date: 4/4/2023			
Fiscal Year	Prior Debt Service	Refunding Debt Service	Savings	PV Savings[1]	Prior Debt Service	Refunding Debt Service	Savings	PV Savings[1]
2022	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
2023	N/A	N/A	N/A	N/A	N/A	N/A	N/A	N/A
2024	$3,478,489	$3,144,131	$334,358	$314,980	$3,478,489	$3,233,344	$245,145	$230,938
2025	3,480,208	3,142,250	337,958	312,098	3,480,208	3,234,000	246,208	227,368
2026	3,480,508	3,146,000	334,508	302,825	3,480,508	3,234,750	245,758	222,481
2027	3,480,308	3,144,500	335,808	298,012	3,480,308	3,230,250	250,058	221,913
2028	3,481,108	3,142,750	338,358	294,358	3,481,108	3,235,500	245,608	213,669
2029	3,482,708	3,145,500	337,208	287,578	3,482,708	3,234,750	247,958	211,463
2030	3,481,383	3,142,250	339,133	283,521	3,481,383	3,233,000	248,383	207,652
2031	3,478,113	3,143,000	335,113	274,640	3,478,113	3,230,000	248,113	203,339
2032	3,480,638	3,142,250	338,388	271,859	3,480,638	3,230,500	250,138	200,960
2033	3,479,850	3,144,750	335,100	263,913	3,479,850	3,234,000	245,850	193,623
Total	$34,803,309	$31,437,381	$3,365,928	$2,903,784	$34,803,309	$32,330,094	$2,473,215	$2,133,407
Difference in Savings vs. Advanced Refunding:			$900,061	$731,404			$7,349	-$38,973

(1) Assumes 2% Discount Rate

Tax Considerations for Current Tax-Exempt Refunding

- Current refundings are permissible even multiple times for the same series of bonds.

- While waiting for an advanced refunding candidate to become a current refunding, tax law may change in the interim, resulting in the inability to refund on a tax-exempt basis and, by waiting, potentially a missed opportunity to lock in a lower rate by refunding on a taxable basis.

Taxable Advanced Refunding

Taxable Advanced Refunding

- Overview:
  - If the bonds to be refunded are outside of the 90-day current call window, an issuer could consider a taxable advanced refunding.
  - Taxable refunding bonds are issued to fund an escrow that will defease the outstanding bonds in advance of their call date, generating lower overall debt service costs.

Pros – Taxable Advanced Refunding

- A Taxable Advanced Refunding provides the ability to refund before 90 days prior to call date.
- Most straightforward advanced refunding option under current tax law.
- Refunding option became more common following the change in tax law in 2017, and then usage increased significantly when taxable rates fell in 2020.
- A advanced taxable refunding can either be completed in the public market or with a direct bank loan.

Cons – Taxable Advanced Refunding

- Taxable interest rates are typically higher than tax-exempt rates which can impact refunding candidates and overall savings levels.
- Potential negative arbitrage to consider if refunding more recent bond issuances with call dates further into the future.

Tax Considerations for Taxable Advanced Refunding

- All tax-exempt bond rule requirements remain with respect to the tax-advantaged refunded bond so long as the refunded bonds are still outstanding.
  - Use of Assets – Private Business Use, Sale of Assets.
  - Investment requirements for proceeds of the refunded bonds still apply (e.g., yield restriction, rebate/arbitrage).
  - If there are unexpended tax-exempt proceeds, such proceeds should be used either for their tax-exempt purpose (tax-exempt project costs) or to repay a portion of the tax-exempt bonds.
- Universal Cap
  - If outstanding/invested proceeds allocable to a bond issue (taxable or tax advantaged) exceed the amount outstanding of that issue complications may arise.
  - If a taxable refunding is repaid faster than the advanced refunding escrow is drawn down, then the excess will be allocated to the prior tax-exempt issue.
  - Potential yield reduction payment liability.
- In general, for non-private activity bonds and qualified 501(c)(3) bonds, permissible to refund taxable bonds with tax-advantaged bonds in the future as long as assets underlying taxable bonds remain governmental/501(c)(3).

Forward Refunding

Forward Refunding

- Overview:
  - If the bonds to be refunded are outside of the 90-day current call window, an issuer could consider a forward refunding whereby the tax-exempt bonds are sold but then delivered at a future date where the delivery period is longer than the typical 2-6 weeks.
  - Typically, the tax-exempt refunding bonds are delivered at a future date which corresponds to the outstanding bonds' call date.

Pros – Forward Refunding

- A forward refunding allows an issuer to lock-in a tax-exempt rate before the call date.
- Depending on market conditions, a forward delivery tax-exempt refunding can provide better overall economics than a taxable refunding.
- A forward refunding can be completed in the public market or with a direct bank loan.

Cons – Forward Refunding

- Depending on the market, the forward delivery period (period from sale date to delivery of bonds/outstanding bonds' call date) can be limited to 12-24 months.
- Issuer pays a premium for locking in tax-exempt rate ahead of call date, which can impact potential savings.
- Savings can't be realized until call date when bonds finally close.

Tax Considerations for Forward Refunding

- Forward Delivery Bonds are fully tax-exempt and all of the applicable tax-exempt bond rules apply.

- Bonds are not issued until they are delivered, not when they are sold.
  - Tax law may change after sale, but before delivery, eliminating tax-advantaged bond status or reducing the value of tax-advantaged bonds or current refundings.

- May be preferable or necessary to sell forward delivery bonds on their own.
  - Multipurpose allocation may be necessary if other Bonds sold within 15 days of forward delivery.

Cinderella Refunding

Cinderella Refunding

- Overview:
  - If the bonds to be refunded are outside of the 90-day current call window, an issuer could consider a Cinderella refunding.
  - Taxable refunding bonds are issued up until the outstanding bond's call date and then those bonds "crossover" to tax-exempt bonds after the call date.

Pros – Cinderella Refunding	Cons – Cinderella Refunding
▪ A Cinderella refunding can allow an issuer to benefit from a tax-exempt interest rate as of the call date. ▪ Issuer may also be able to realize savings prior to call date based on taxable interest rate. ▪ No stipulation on timing of call date as with forward refunding (within 12-to-24 months).	▪ Generally limited to direct bank loan market. ▪ Reissuance on conversion date.

Tax Considerations for Cinderella Refunding

- All tax-exempt bond rule requirements remain with respect to the tax-advantaged refunded bond so long as the refunded bonds are still outstanding.
  - Use of Assets – Private Business Use, Sale of Assets
  - Investment requirements for proceeds of the refunded bonds still apply (e.g., yield restriction, rebate/arbitrage).
  - If there are unexpended tax-exempt proceeds, such proceeds should be used either for their tax-exempt purpose (tax-exempt project costs) or to repay a portion of the tax-exempt bonds.
- Universal Cap
  - If outstanding/invested proceeds allocable to a bond issue (taxable or tax advantaged) exceed the amount outstanding of that issue complications may arise.
  - If a taxable refunding is repaid faster than the advanced refunding escrow is drawn down, then the excess will be allocated to the prior tax-exempt issue.
  - Potential yield reduction payment liability.
- Oversizing
  - If there are proceeds (e.g. debt service reserve fund) available to apply toward the advance refunding, those proceeds need to be used to downsize the interim taxable issue.
  - Open Market Securities ("OMS") or State and Local Government Securities ("SLGS")
    - Escrow needs to be sized as efficiently as possible.
    - SLGS are automatically deemed to be at fair market value.
    - OMS should go through bidding process in accordance with safe harbor to establish fair market value.
    - OMS must be most efficient than SLGS.
- Reissuance/Conversion to tax-exempt
  - Need a "significant modification" in connection with the conversion from taxable to tax-exempt.
  - Change in yield, call-rights, amortization schedule (whether or not explicitly within the terms of the Bonds).

Tender Offer & Tax-Exempt Refunding

Tender Offer & Tax-Exempt Refunding

- Overview:
  - If the bonds to be refunded are outside of the 90-day current call window, an issuer could consider exploring a tender offer.
  - As an alternative to a taxable advanced refunding, the issuer could negotiate with interested/willing investors of existing bonds to have them tender their holding, which can be purchased on a current basis and thus funded with tax-exempt bonds.

Pros – Tender Refunding	Cons – Tender Refunding
▪ A success tender offer provides the ability to potentially refund a portion of outstanding debt on a tax-exempt basis, which could increase savings.	▪ The success of a tender refunding is dependent upon the existing investors and their willingness to consider a tender. ▪ Requires additional steps in the process, which can increase the overall effort involved with a transaction. ▪ Target audience would be focused on larger issuers.

Tax Considerations for Tender Refunding

- In general, bonds are treated as retired, for tax-purposes, when they are held by the issuer, unless the bonds are structured as qualified tender bonds.

- Reissuing or refunding bonds subsequently may be possible in certain circumstances, but would have to pass muster of current tax-exempt bond rules (not always possible).

Cash Optimization

Cash Optimization

- Overview:
  - Under cash optimization, an issuer might consider utilizing available cash/funds to defease existing high coupon debt and issue new tax-exempt bonds to fund projects that would have been funded with PAYGO.

Pros – Cash Optimization

- Cash Optimization can provide an opportunity for an issuer to generate economic benefit within the outstanding debt portfolio.

Cons – Cash Optimization

- Issuer needs PAYGO projects to fund with tax-exempt borrowing.
- Cash optimization is the most complex of the refunding options.

Tax Considerations for Cash Optimization

- Most difficult to analyze under tax-rules from all other options.
- Facts and circumstances need to be analyzed to determine if any abuse or creation of replacement proceeds occurs.
- Will need some time between issuance of tax-exempt bonds and the repayment of prior tax-exempt bonds.

Questions?

Appendix: Risk Disclosures

Risk Disclosures

Fixed Rate Bonds[1]

Material Risk Consideration	Description of Risk	Potential Consequences
Issuer Default Risk	Possibility that the Issuer defaults under the authorizing documents	• Range of available remedies may be brought against Issuer (e.g., forcing Issuer to raise taxes or rates) • Credit ratings negatively impacted • Access to capital markets impaired • Possibility of receivership or bankruptcy for certain issuers
Redemption Risk	The ability to redeem the bonds prior to maturity may be limited	• Inability to refinance at lower interest rates
Refinancing Risk	Possibility that the bonds cannot be refinanced	• Inability to refinance at lower interest rates
Reinvestment Risk	Possibility that the Issuer may be unable to invest unspent proceeds at or near the interest rate on the bonds	• Negative arbitrage resulting in a higher cost of funds
Tax Compliance Risk	For tax-exempt bonds, possibility that failure to comply with tax- related covenants results in the bonds becoming taxable obligations	• Increase in debt service costs retroactively to date of issuance • Possible mandatory redemption of bonds affected • Risk of IRS audit • Difficulty in refinancing the bonds • Access to tax-exempt market impacted • Difficulty in issuing future tax-exempt debt

(1) You should consult with your financial and/or municipal, legal, accounting, tax and other advisors, as applicable, to the extent you deem appropriate concerning such risks.

Risk Disclosures

Convertible Advance Refunding (Cinderella) Bonds[1]

Material Risk Consideration	Description of Risk	Potential Consequences
Tax Compliance Risk	Possibility that at tax reissuance at the call date of refunded bonds does not occur	• Continue to pay interest at taxable rate • Anticipated savings will be lower • Access to tax-exempt market impacted • Difficulty in issuing future tax-exempt debt
Cost Considerations	Tax-exempt rates are based on current market and include premium based on time to conversion	• Tax-exempt rates are lower at conversion date • Increase in debt service costs
Reinvestment Risk	Possibility that Issuer may be unable to invest proceeds at or near the interest rate on the bonds	• Negative arbitrage resulting in higher costs
Fewer Potential Purchasers	Risk that the universe of potential purchasers is limited	• Pricing of bonds and the amount of premium may be adversely impacted
Availability of Better Alternatives	Possibility that it is more advantageous to wait and refinance bonds	• May not obtain the best economic result by proceeding with issuance of Cinderella Bonds

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Risk Disclosures

Forward Delivery Bonds[1]

Material Risk Consideration	Description of Risk	Potential Consequences
Risk of Inability to Satisfy Conditions for Delivery of Bonds	Possibility that conditions to closing cannot be met on delivery date (e.g., intervening changes in law (resulting in either a change in tax status or any other reason that would prevent counsel from delivering an opinion), material litigation filed, adverse change in rating on the bonds or an event of default or material adverse change occurs)	• Transaction cannot be consummated
Underwriter Default Risk	Possibility that underwriter cannot perform on delivery date	• Transaction cannot be consummated
Fewer Potential Purchasers	Risk that the universe of potential investors may be limited to additional risks	• Pricing of the bonds and the amount of the forward delivery premium may be adversely affected
Availability of Better Alternatives	Possibility that it is more advantageous to wait and remarket or refinance outstanding bonds	• May not obtain the best economic result by proceeding with issuance of forward delivery bonds

(1) You should consult with your financial and/or municipal, legal, accounting, tax and other advisors, as applicable, to the extent you deem appropriate concerning such risks.

Risk Disclosures

Tender Offers [1]

Material Risk Consideration	Description of Risk	Potential Consequences
Uncertainty of Results	Uncertainty of results	• Tender offer is not successfully consummated or the amount of bonds tendered may be less than expected • May be required to increase price that is paid
Varying Impact on Bondholders	Bondholders may be impacted differently by the terms of the tender offer	• Holders of other bonds may be affected • May impact results of tender offer
Alternatives May Be Better	Waiting to refinance or remarket may be economically advantageous	• Higher costs may be incurred • May not obtain the best economic result

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Risk Disclosures

Exchange Offers (1)

Material Risk Consideration	Description of Risk	Potential Consequences
Uncertainty of Results	Uncertainty of results	• Exchange offer is not successfully consummated or the amount of bonds exchanged may be less than expected • Impact to overall economics of exchange
Varying Impact on Bondholders	Bondholders may be impacted differently by the terms or structure of the exchange offer	• Holders of other bonds may be affected • May impact results of exchange offer
Alternatives May Be Better	Alternatives may provide better economic results	• Higher costs may be incurred • May not obtain the best economic result

(1) *You should consult with your financial and/or municipal, legal, accounting, tax and other advisors, as applicable, to the extent you deem appropriate concerning such risks.*

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