A BRIEF COURSE IN PUBLIC FINANCING

Everything you'll need to know about Municipal Leasing

Purpose

To acquaint the reader with the most commonly used methods of financing utilized by municipal governments and *when* Leasing is the best option.

Public agencies have numerous available options to acquire needed resources – equipment and/or project financing. Of course, paying cash is the most preferable method. This being said, cash may not be the best use of funds because agencies often have multiple simultaneous needs and a finite amount of available cash in their current or, possibly, future budget years to accomplish their goals.

Financing Options

- Most common methods of financing are:
- General Obligation Bonds
- Revenue Bonds
- Certificates of Participation
- Lease/Purchase

What is a bond?

In public finance, a bond is a piece of paper worth exactly $5,000.00 (not including interest). Bond issues are divisible into $5,000.00 units. A single $5,000,000.00 bond issue has 1000 bonds ($5,000,000.00 divided by $5,000.00 = 1000 bonds) and permits the underwriter to sell the issue in parts to multiple investors. It could be challenging to sell a $50,000,000.00 issue to a single investor.

Bonds have liquidity, which means they can be sold back to the underwriter by the original bondholder for an amount below their current par value, thus creating what's called a "secondary market." In other words, bonds are securities just like stocks and are subject to regulation by the SEC and NASD (National Association of Securities Dealers).

Securities require full disclosure to prospective investors in the form of an Official Statement ("OS") prepared under the supervision of an attorney called "Disclosure Counsel." In addition a "Bond Counsel" is responsible for the authenticity and tax issues related the bond documents. Other underwriting costs include: paying agent (collects and disburses payments), printing costs of the OS and fees associated with the sale of the bonds. Bonds are "priced-to-market" the day the bonds are sold, meaning they are sold to investors at the prevailing interest rate on that particular day. Payments are due to bondholders every 6 months.

General Obligation, or "GO" Bonds, are exactly as the name implies – a general obligation of the city, county or state whose taxpayers approve the bond sale at the voting booth. All GO Bonds require voter approval. GO Bonds average 20 years in length, larger is size, rated by rating services such as Standard & Poor's, Moody's or Fitch's and bond proceeds are generally used to finance larger ticket capital projects.

GO Bonds are not spontaneously conceived due to the time it takes to originate, sell the idea to the voters and hold an election – all of which is accomplished with public scrutiny. The process could take a year or more to complete and may or may not pass in the referendum.

Revenue Bonds have the same characteristics as a GO Bond with two exceptions: a) they do not require voter approval and, b) repayment is based on a defined source of revenue from the project being financed. A revenue bond would be approved by the board of the agency needing the funds after numerous meetings open to the public. Although the bonds are "revenue neutral" to the taxpayers, local input is encouraged for political and legal reasons.

Streets and sewers for a new housing development would be financed with revenue bonds since the repayment will be made by user fees charged to the local residents within the boundaries of the district. There are over 90,000 separate political sub-divisions in the US, many being sewer and water / waste water related.

To mitigate possible investor risk, underwriters will likely arrange to have the bonds insured against default. An insured bond issue may then be rated to investment grade and receive an A or AA rating, making the issue a safe, conservative investment. The added cost of insurance is worth every penny to the borrowing agency since the bonds pay a lower rate of interest to the investor(s) and cost the borrower less over the term.

By the same token, uninsured municipal bonds (not quite junk bonds) are sold at higher interest rates to entice more aggressive investors willing to take some risk for a higher yield on their money. These bonds can be very attractive to sophisticated investors who know what they are doing.

MUNICIPAL TAX-EXEMPT LEASES

"Tax-exempt" in this context means the interest portion of each lease payment is excludable from federal and state income taxes to the lessor, or their assignee. The issue has nothing to do with sales, use or property taxes.

Only agencies with taxing authority can issue a tax-exempt lease. A non-profit corporations tax-exempt status does not qualify them since they don't have the taxing authority reserved solely for public agencies.

Tax-exempt leases are, in most cases, installment *sales* containing "non-appropriation" language (also called "funding-out clause") and enabling the lessee to terminate the lease at the end of the current fiscal year, without further obligation, when the lessee is unable to obtain funding for the next fiscal year and beyond. Technically the lease is structured as a series of one-year renewable obligations subject to the lessee's ability to appropriate the money for payments due in future years. Cancellation for convenience is not implied by this provision.

Non-appropriation language permits the lessee to amortize the loan over a multiple year period. Without it included, leases would have to be fully amortized during the current fiscal year.

As a result, the payment constitutes a *current expense* of the lessee and is why the obligation is called a "Lease/Purchase" rather than a "Loan." In the sole event sufficient funds are not available next fiscal year, the lease is terminated at the end of the current fiscal year and the equipment is delivered to the lessor with 90 days prior written notice. A current expense item is *not considered debt*; therefore tax-exempt leases *do not require voter approval*, nor do they count against the lessee's debt ceiling, or borrowing limit. Being an installment sale, title to the equipment vests with the lessee *during* the lease term, and the lease will fully amortize to $0.00 with the final lease payment.

The two most common forms of a Tax-Exempt Lease are:
Certificates of Participation (COP) and Lease/Purchase Agreements

COP's are structured much like revenue bonds. They a) are sold to multiple investors in $5,000.00 each certificates, meaning they are "securitized" and require full disclosure in the form of an Official Statement (OS), b) payments are made semi-annually and, c) they require a Paying Agent, or Trustee. The main difference between the two is that COP lease payments may be tied to a lessee's General Operating Fund rather than to a specific revenue source such as monthly utility fees. COP's may extend out 20 years and are of sufficient $dollar size to warrant certificating them. Hence the name: "Certificates of Participation."

Lease/Purchase Agreements transactions are placed with a single investor, and generally limited to 10-12 years in length with an average maturity of about 5 years. Size runs from about $10,000.00 to $millions – depending on the *useful life* of the asset, transaction size and essentiality of the equipment. Vehicles and office equipment are typical items being financed.

Other advantages:

- **100% financing** including delivery, installation and sales tax (where applicable).
- **Cost effective** - Nominal associated origination costs, if any.
- **Equipment** and **Real Property** may be financed on a Lease/Purchase Agreement.
- **Flexible payments**: Monthly, Quarterly, Semi-Annual, Annual or Delayed Payments
- No Reserve Account required
- **Uncomplicated** documentation

MUNICIPAL LEASE VS. BOND COMPARISON

Financing Characteristics and/or Requirements	Public Bond Offering	Direct Source Financing	Why "No" is the Better Answer
Compliance with SEC Rule 15c2-12	YES	NO	Disclosure rules do not apply
Exact Rates Unknown Prior to Closing	YES	NO	Rates quoted before funding Rate lock option available
Underwriter's Fees	YES	NO	No additional fees
Rating Agency Fees	YES	NO	No additional fees
Printing Costs	YES	NO	No additional fees
Reserve Fund	YES	NO	Not required
Prepayment only on Call Dates	YES	NO	Prepayment options throughout term
Multiple Investors	YES	NO	Private placements
Semi-Annually Only	YES	NO	Payment schedule designed to meet your needs
Time Consuming Documentation Process	YES	NO	One simple process

Acquire the equipment you need *without* Disclosure. Beginning July 3, 1995, amended SEC Rule 15c2-12 governing disclosure obligations of municipal securities issuers and obligor went into effect. The new Rule is designed to protect investors by ensuring adequate ongoing disclosure of information relating to the financial health of the issuer and obligor. The Rule increases the complexity of debt issuance in the public market. **Direct source financing is not subject to disclosure requirements.**