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# The Changing Bond Market and What it Means to Virginia GFOA Members

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**Presented by:**

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# Today's Topics

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- I. Increased Emphasis on Credit Quality / Change in Credit Spreads;
  
- II. How to Safeguard Your Credit Ratings in Difficult Times; and,
  
- III. What Might the Credit Markets Look Like in the Future as You Prepare Your Capital Funding Plans.

***I.***

***Increased Emphasis on Credit Quality /  
Change in Credit Spreads***

# Municipal Yields Since 1990

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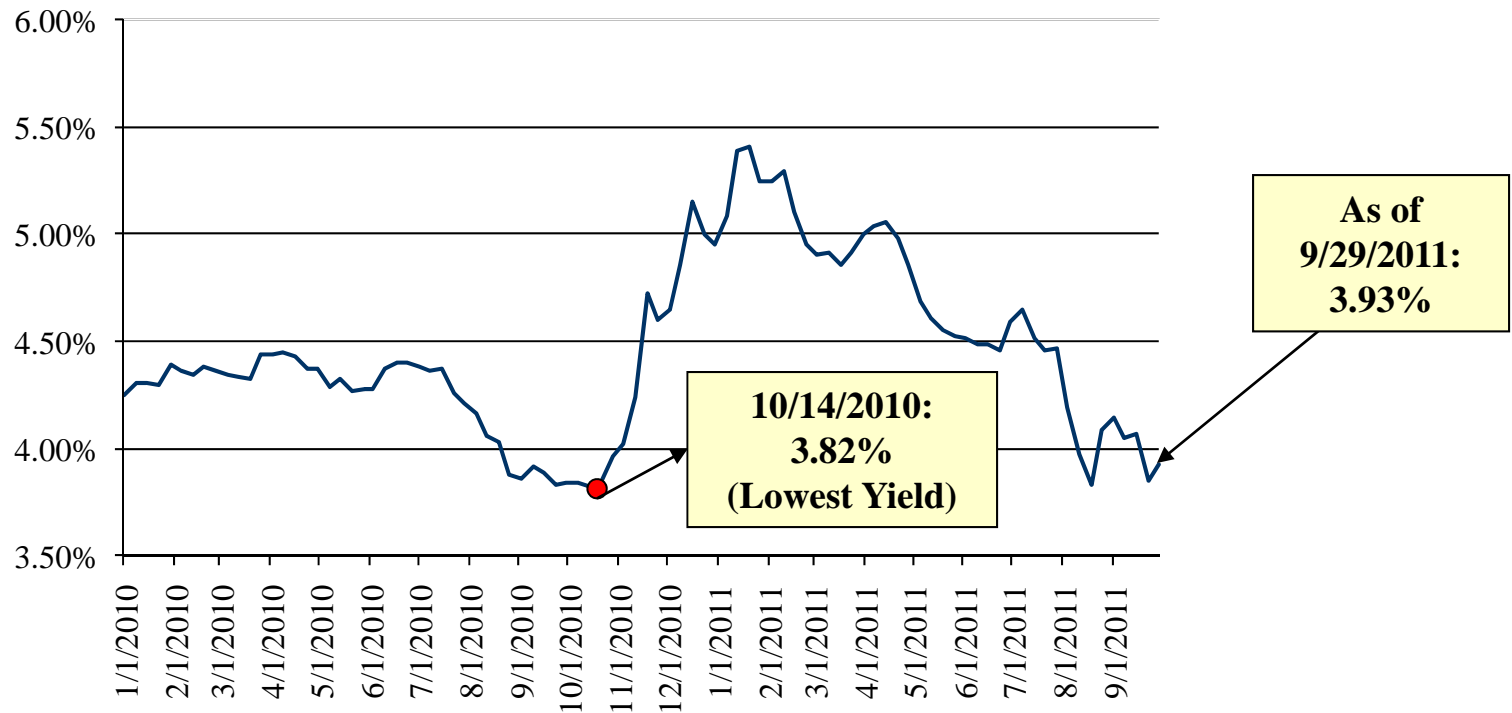
## 20-Bond Index Since 1990



- Average Since 1990: 5.33%
- Average Since 2006: 4.54%
- Average Since 2010: 4.45%
- Average Since 9/30/2010: 4.58%

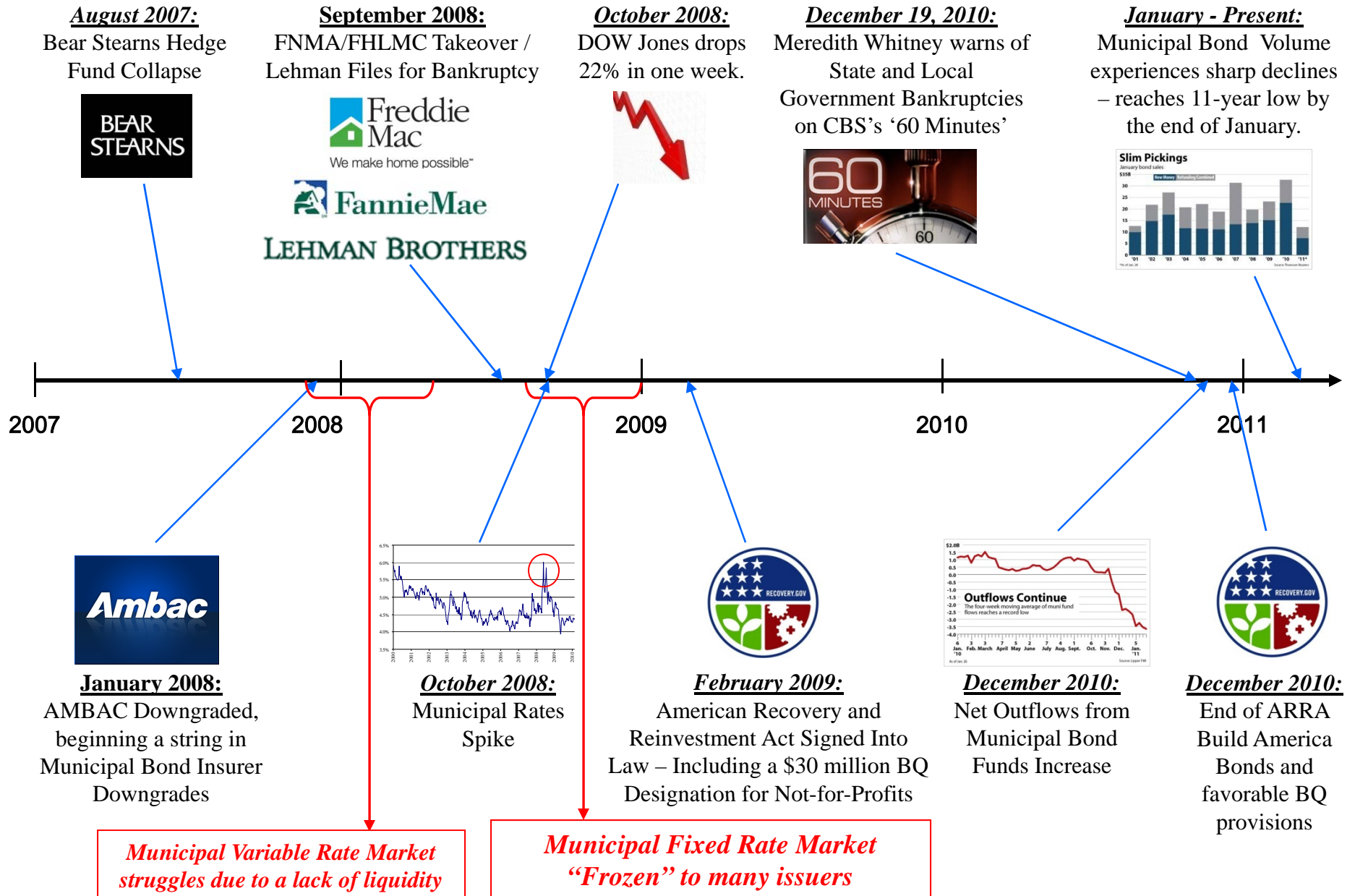
# Municipal Yields Since 2010

## 20-Bond Index Since 2010



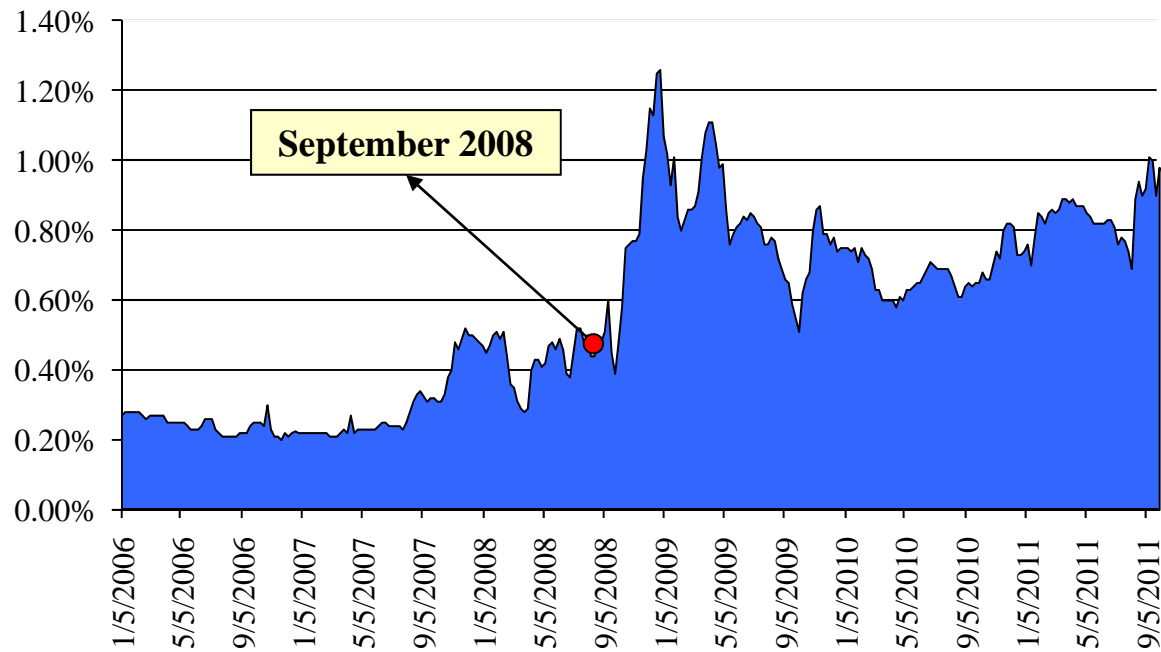
- Average Since 1990: 5.33%
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# Events that Shaped the “New” Municipal Marketplace



# 'A' Rated vs. 'AAA' Rated

Spread of 'A' Rated to 'AAA' Rated MMD

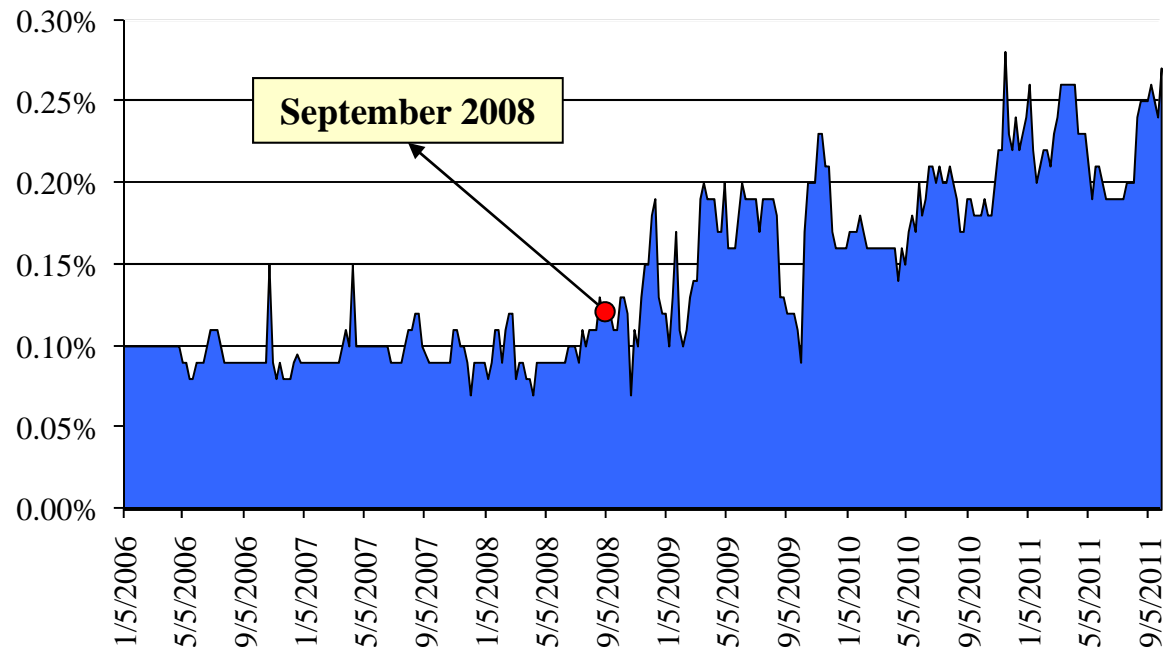


- Average Spread 2006 - Sept. 2008: 0.31%
- Average Spread Sept. 2008 - Present: 0.78%

# 'AA' Rated vs. 'AAA' Rated

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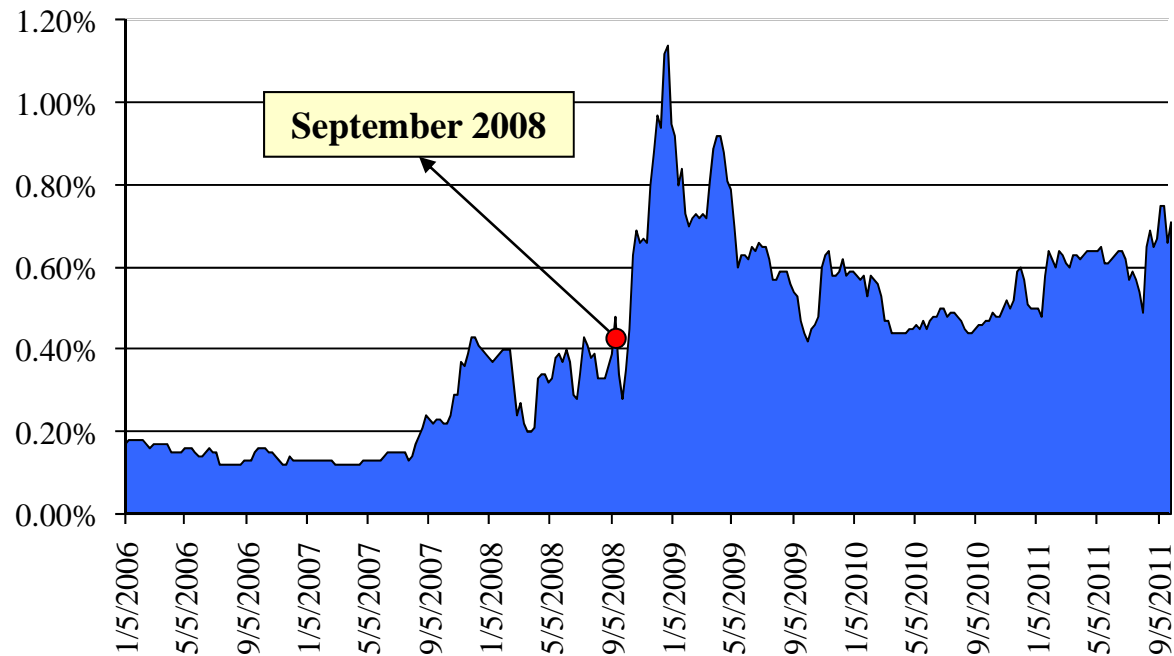
Spread of 'AA' Rated to 'AAA' Rated MMD



- Average Spread 2006 - Sept. 2008: 0.10%
- Average Spread Sept. 2008 - Present: 0.18%

# 'A' Rated vs. 'AA' Rated

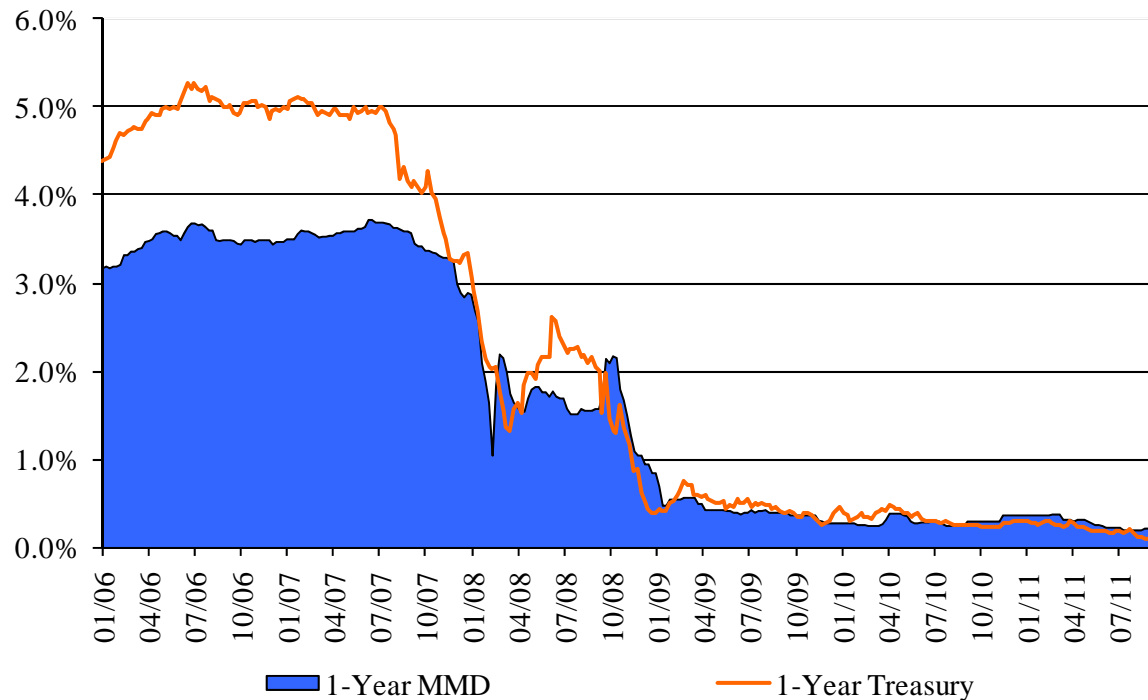
## Spread of 'A' Rated to 'AA' Rated MMD



- Average Spread 2006 - Sept. 2008: 0.22%
- Average Spread Sept. 2008 - Present: 0.60%

# Treasury Bonds vs. Municipals: 1-Year

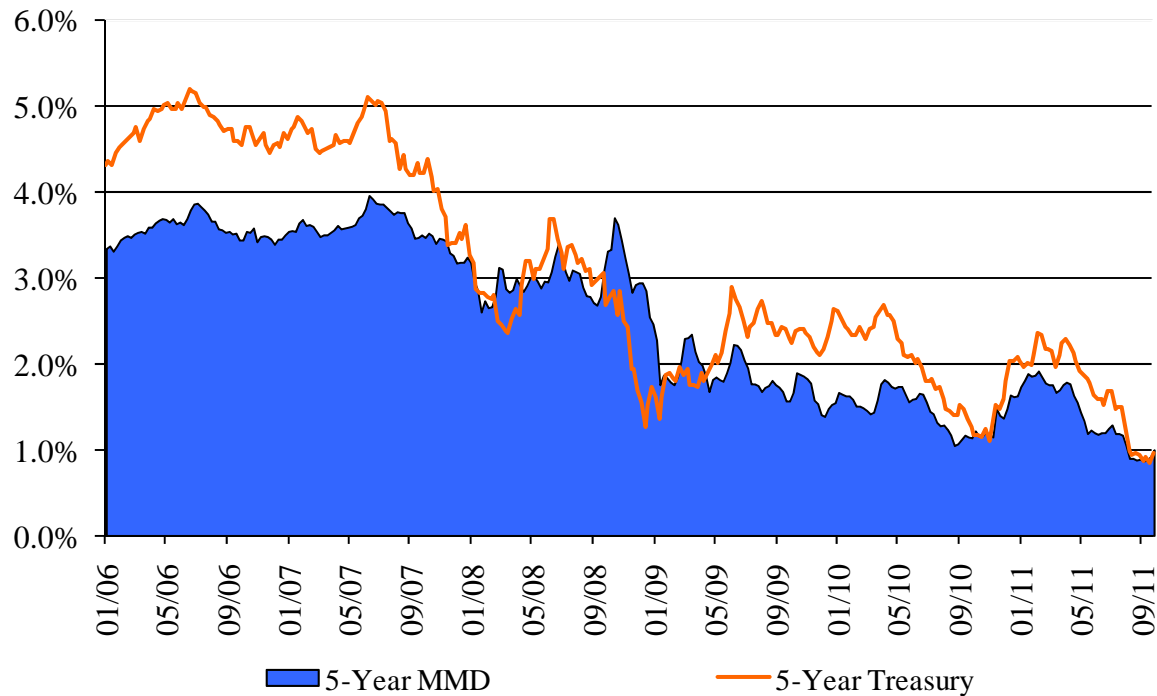
## 1-Year Treasuries vs. 1-Year Municipals



- Since September 2008, 1-year Municipal yields have been on average only 0.03% lower than 1-year Treasury yields.

# Treasury Bonds vs. Municipals: 5-Year

## 5-Year Treasuries vs. 5-Year Municipals

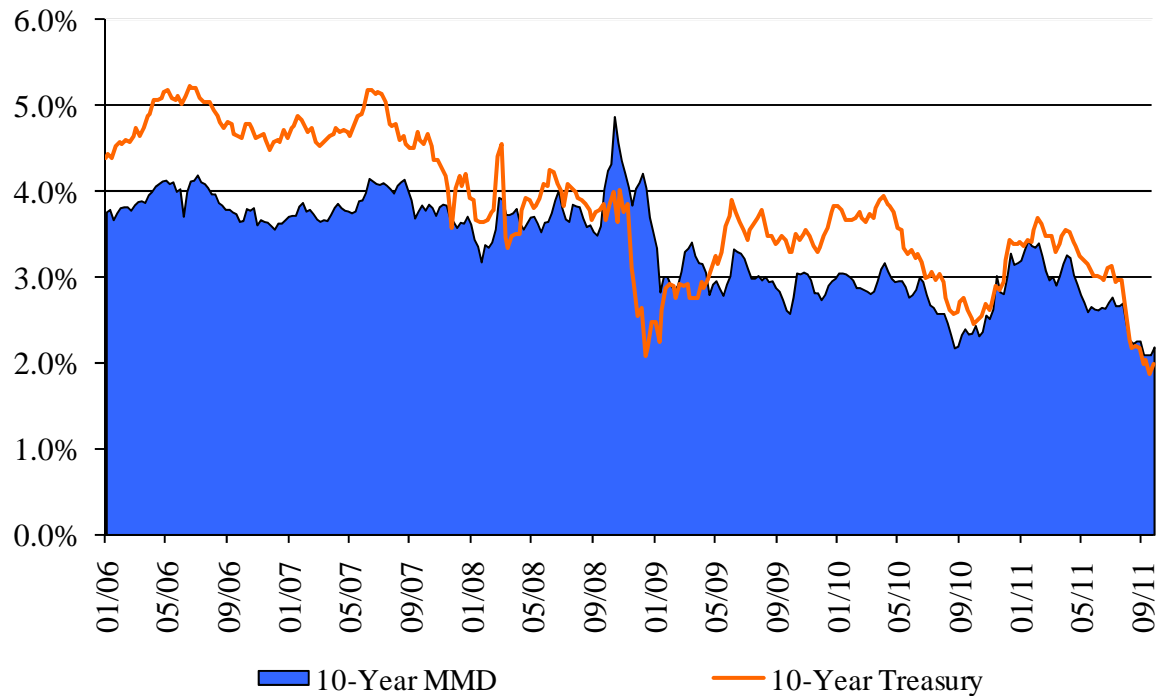


- Since September 2008, 5-year Municipal yields have been on average 0.27% lower than 5-year Treasury yields.

# Treasury Bonds vs. Municipals: 10-Year

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## 10-Year Treasuries vs. 10-Year Municipals



- Since September 2008, 10-year Municipal yields have been on average 0.22% lower than 10-year Treasury yields.

# Summary and Conclusions

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- Interest Rates are At or Near All-Time Lows.
- Credit Ratings are More Important Than Ever Before.
- The Treasury Market, Relative to the Municipal Market, is Acting Out of Character – This Has Created Certain Opportunities for Local Governments.

***II.***

***How to Safeguard Your Credit Ratings in  
Difficult Times***

# Overview of Credit Evaluation

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- Rating Agencies Articulate Fundamental Credit Criteria
  
- Criteria Factors Drive Lending Decisions At All Levels of the Market
  - Approval for State Pooled Borrowing Programs;
  
  - Bank and Lease Financing Institutions; and,
  
  - Public Markets.
  
- Four Key Factors
  1. Economy;
  2. Finances;
  3. Debt; and,
  4. Management.

# Factors That Drive Rating Changes

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## 1. Economy

- Significant development in the local tax base driving continued growth in total property values;
- Increased or decreased diversification of local economic base; and,
- Loss of key industry or employer with no workout plan.

## 2. Finances

- Expected augmentation or loss of financial flexibility; and,
- Expectation that significant growth or decline of reserves will continue.

# Factors That Drive Rating Changes (continued)

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## 3. Debt

- Significant increase in debt obligations without correlating development to offset tax-base leveraging; and,
- Utilization of debt structure not appropriately matched to asset's useful life.

## 4. Administration / Management

- Implementation of new strategies expected to augment or detract from operating flexibility; and,
- Change in political environment which affects ability to react to unanticipated events.

# The Six Sigma of Strong Municipal Management

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1. Conservative Budgeting Techniques;
2. Fund Balance Policies;
3. Debt Planning;
4. Succession and Contingency Planning;
5. Strategic Planning for Economic Development; and,
6. Timely Disclosure.

# Credit Factors Under Control of the Locality

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- Compliance with Financial Policy Guidelines (Strong Capital Pay-Go and Fund Balances);
- Multi-Year Capital Planning;
- Multi-Year Budget Modeling;
- Investment Management;
- Level and Timing of Debt Issuance;
- OPEB Funding;

# Credit Factors Under Control of the Locality (continued)

- Competitive Compensation Strategies and Investment in Employee Talent;
- Economic Development Strategy and Emphasis;
- Management Stability;
- Conservative Budgeting; and,
- Cohesive and Unified Council / Board of Supervisors.

# Credit Factors Not Under Control of the Locality

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- National Economic Climate;
- Federal Defense Cuts Based Upon Recent Debt Ceiling Debate in Congress;
- State Funding Cuts to Localities (e.g. Education, Criminal Justice, etc.);
- Rating(s) of the Commonwealth of Virginia and the United States of America;
- Unemployment Rates; and,
- Business Closings/Retrenchment Due to National Economic Climate, Tax Law Changes, Individual Business Competition, Mergers & Acquisitions for Corporate Strategy.

# Multi-Year Planning Enhances Credit Access

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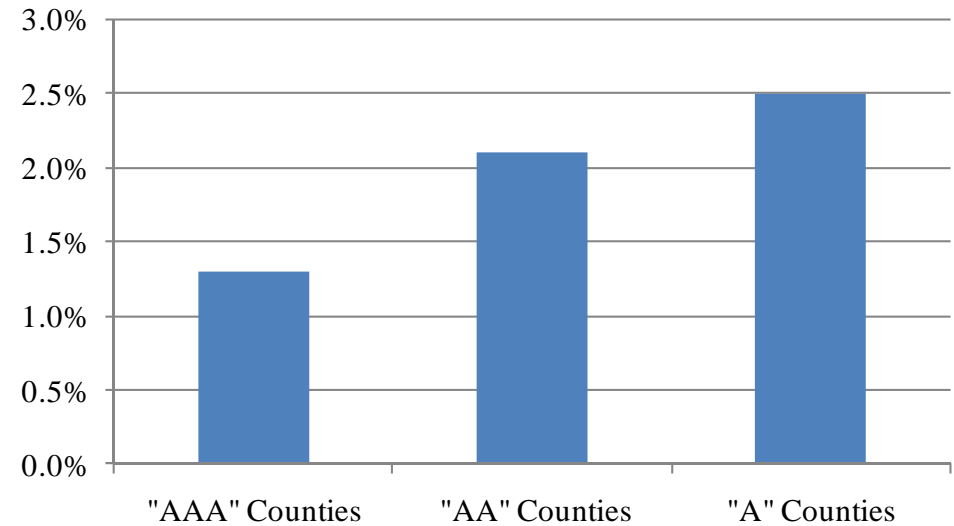
- Debt Levels are Somewhat Within Your Control
- Finances are Within Your Control
- Economy – Very Little Control
- Management Can Be Viewed as the “Glue” That Holds Everything Together

# Multi-Year Planning Enhances Credit Access (continued)

- Use of Multi-Year Planning Process Viewed Favorably by Wall Street and Lenders Generally as it Promotes:
  - Early Intervention to Solve Emerging Fiscal Problems;
  - Prioritization of Capital Needs;
  - Identification of Operating Budget Impacts Derived from Capital Spending; and,
  - More Rigorous Adherence to Financial and Debt Policy Guidelines.

# Virginia Medians: Debt Ratios

## ➤ Debt Burden (Overall Net Debt as % Full Value)

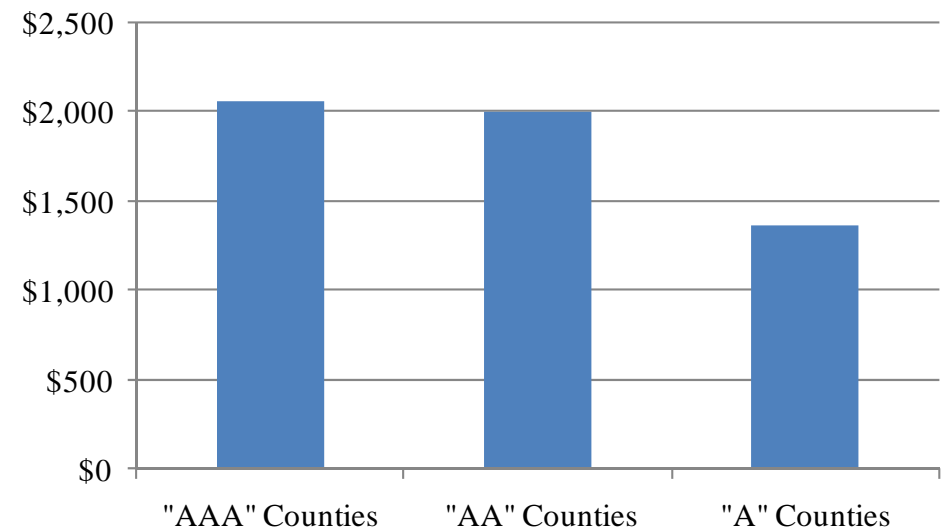
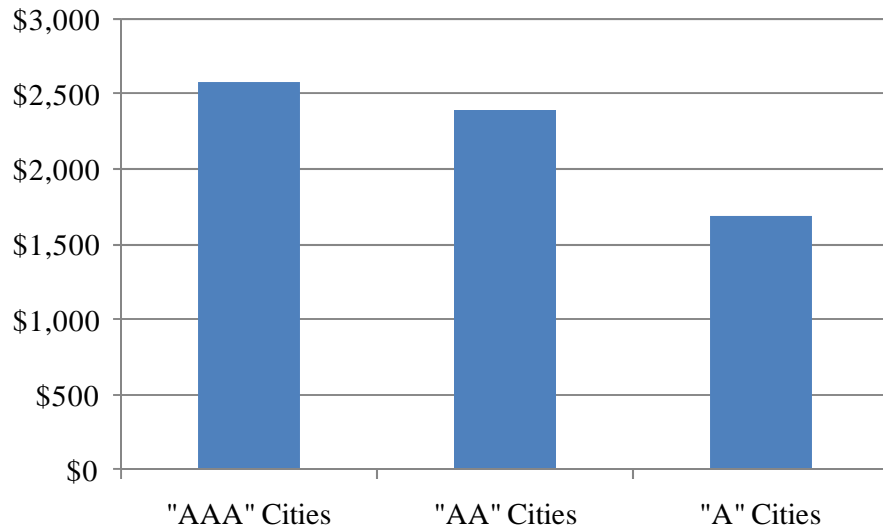


- Virginia "AAA" Cities: 1.3%
- Virginia "AA" Cities: 2.8%
- Virginia "A" Cities: 2.0%

- Virginia "AAA" Counties: 1.3%
- Virginia "AA" Counties : 2.1%
- Virginia "A" Counties : 2.5%

# Virginia Medians: Debt Ratios (continued)

## ➤ Overall Net Debt Per Capita (\$)



- Virginia "AAA" Cities: \$2,580
- Virginia "AA" Cities: \$2,393
- Virginia "A" Cities: \$1,686

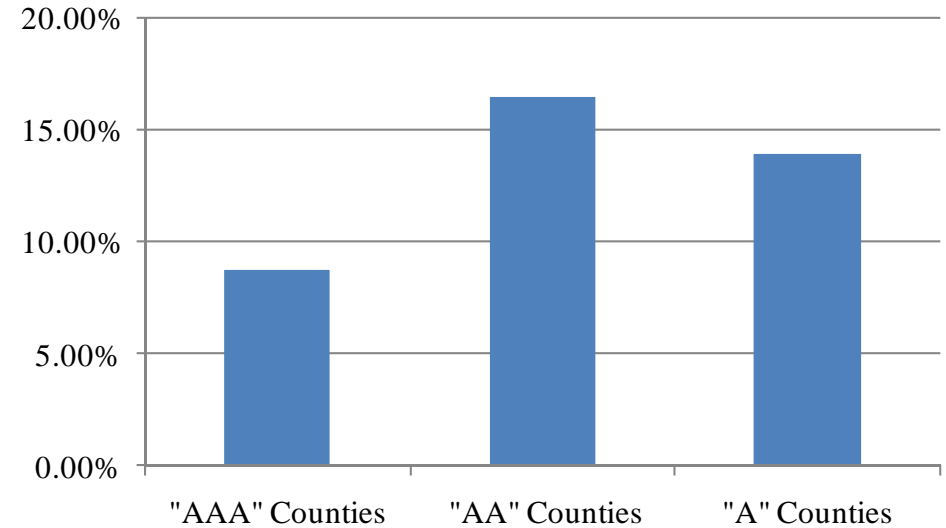
- Virginia "AAA" Counties: \$2,051
- Virginia "AA" Counties : \$1,996
- Virginia "A" Counties : \$1,358

# Virginia Medians: Financial Ratios

## ➤ Unreserved, Undesignated Operating Fund Balances as % of Revenues



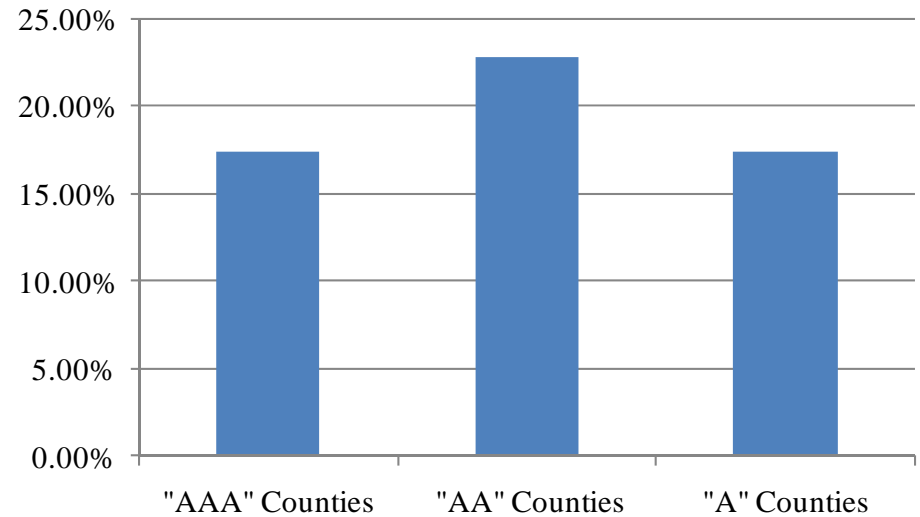
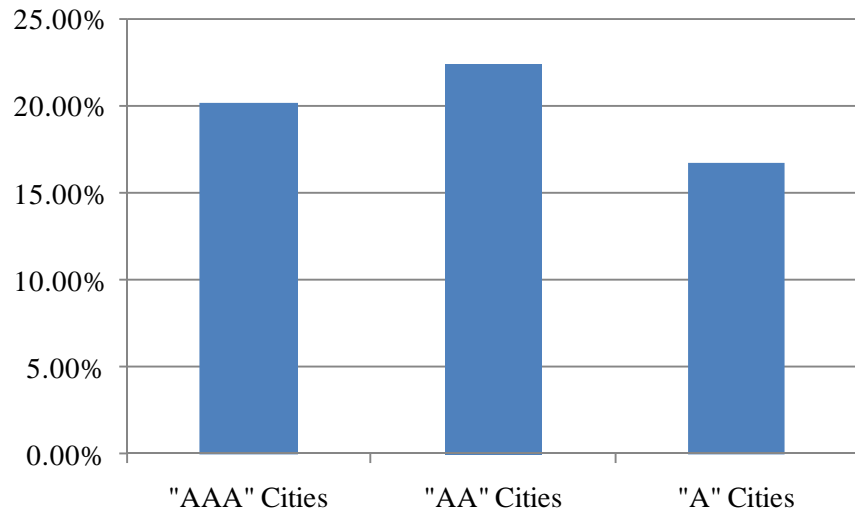
- Virginia "AAA" Cities: 15.9%
- Virginia "AA" Cities: 15.0%
- Virginia "A" Cities: 13.3%



- Virginia "AAA" Counties: 8.7%
- Virginia "AA" Counties : 16.4%
- Virginia "A" Counties : 13.9%

# Virginia Medians: Financial Ratios (continued)

## ➤ Operating Fund Balances as % of Revenues



- Virginia "AAA" Cities: 20.1%
- Virginia "AA" Cities: 22.4%
- Virginia "A" Cities: 16.7%

- Virginia "AAA" Counties: 17.4%
- Virginia "AA" Counties : 22.8%
- Virginia "A" Counties : 17.4%

### ***III.***

***What Might the Credit Markets Look  
Like in the Future as You Prepare  
Your Capital Funding Plans***

# Introduction

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- Recognize the Myriad of Options to Borrow Money:
  - Short-Term Bond Anticipation Notes;
  - Line of Credit;
  - Long-Term Issuance with Capitalized Interest during Construction;
  - Long-Term Issuance with Interest-Only during Construction;
  - Long-Term Issuance with Level Principal;
  - Long-Term Issuance with Level Debt Service;
  - Long-Term Issuance with Structured Debt Service (i.e. gradually increasing); or
  - Bank Qualified vs. Non-Bank Qualified.

# Introduction (continued)

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- In addition to Traditional Methods for Borrowing, Several Other Options Exist for Virginia's Localities as They Move Forward with Capital Funding Plans:
  - Bank Placements / the Private Marketplace;
  - Virginia Resources Authority Financing;
  - Asset Sales;
  - Commercial Paper; and,
  - Advance Refundings with Taxable Debt;

# Bank Placements / Private Marketplace

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- Bank financing can be an attractive alternative to the public markets depending on the specific needs of the locality.
  
- Generally, bank financing is most effective when the debt can carry the Bank-Qualified designation – simply, when no more than \$10.0 million in debt is issued by an entity within any given calendar year.
  - Bank-Qualified bonds give the bank an additional tax break, allowing the bank to accept a lower rate of interest on the Bank-Qualified bonds.

# Bank Placements / Private Marketplace (continued)

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- Bank financings can accommodate most any funding need and can provide many of the same “options” as are typically found in a public offering:
  - Wide range of credit pledges including General Obligation, Lease Revenue, Revenue, Moral Obligation/Subject to Appropriation, and Asset Backed.
  - Fixed or variable rate structures.
  - Short-term or long-term financing.
  - Various amortization options including capitalized interest, interest only and most any principal structure as required for “cash-flow” purposes.

# Bank Placements / Private Marketplace (continued)

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- Bank financings can provide an issuer with a number of benefits and advantages as compared to the public markets:
  - Streamlined issuance period – typically about 60 days from start to finish – can be done more quickly if needed.
  - Less cumbersome issuance process – no ratings required and less extensive offering documents – minimal staff time and resources are required.
  - Financing terms and related regulations are generally more favorable – shortened pre-payment lock-out term, if any at all, upfront and on-going fees are minimized by comparison and minimal on-going disclosure requirements.

# Bank Placements / Private Marketplace (continued)

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- Bank financings can be used to meet many of the financial challenges that local governments face:
  - Interim funding needs to meet cash-flow demands during project design and engineering. In some cases we've structured these short-term financings such that NO out-of-pocket monies are expended.
  - Liquidity needs in anticipation of state project funding (e.g. Literary Loans, Revolving Loans, VPSA and VRA funding), grants, tax receipts or other revenue sources.

# Bank Placements / Private Marketplace (continued)

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- Bank financing has not been spared the effects of recent financial turmoil. In fact, many of the most troubling headlines we read portend a wide-spread banking crisis.
- That said, many banks are still on solid footing and actively participate in municipal finance.
- Perhaps the greatest change we've seen in the bank funding environment over the last several months is the heightened level of loan-related credit analysis.

# Bank Placements / Private Marketplace (continued)

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- Based upon our experience with the bank funding process, Davenport recommends the following strategies to help insure a successful effort:
  - Develop a competitive process through a formalized RFP solicitation including all pertinent deal-related details:
    - Project overview;
    - Loan security and source of repayment; and,
    - Desired bond structure, term and repayment schedule.
  - Include as many banks in the RFP process as you can – local, regional and national entities – different banks have different lending capacities and needs at any given time.
  - Provide audited financials to all RFP recipients and be prepared for a series of due diligence inquiries.

# Bank Placements / Private Marketplace (continued)

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- Bank financing is a valuable tool for every local government.
- Whether for cash-flow purposes or for capital funding, bank financing provides streamlined access to the credit markets with flexible terms and conditions.
- The following pages include two case studies in which Davenport has assisted clients to access the Bank Marketplace.

# Case Study 1: Virginia Regional Utility Authority

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- The Challenge: The Authority had multiple Capital Projects in various stages of design, permitting, and bidding, but was not ready to make a final decision on permanent financing for the projects.
  - The Authority had a variety of options for permanent funding of the projects including Grants, State monies, and market driven financings.
  - Borrowing rates were at attractive levels, however investment yields were significantly lower creating a large amount of negative arbitrage.
  
- The Approach: Maximize use of the BQ designation by soliciting banks for funding proposals on two options:
  - Option 1: 2-year fixed rate Bond Anticipation Note
    - Bids ranged from 2.75% - 3.13%
  - Option 2: Line of Credit Facility up to \$10,000,000
    - Variable rate bids included 68% of LIBOR +151 bps and Prime - 124 bps
  
- The Result: Davenport, on behalf of the Authority, was able to negotiate a fixed rate line of credit over the entire 24-month period for up to \$10 million.
  - Provides the Authority with flexibility to draw down funds as needed.
  - Allows Authority to eliminate negative arbitrage by deferring interest expense and avoiding reinvestment of borrowed funds.

# Case Study 2: Rural Development Loan Refinancings

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- Overview: Over the past several years, Davenport has advised on multiple Rural Development (RD) Loan Refinancings aggregating upwards of \$40 million.
  - Each transaction refunded 1-9 separate RD Loans.
  
- Approach: Refinancing structures were tailored to meet localities' unique needs.
  - Reduction in interest rate to achieve level annual savings.
  - Reduction of loan amortization term for overall interest savings.
    - Any potential increase in annual debt service was within a manageable range.
  - Strategic debt restructuring to create specific cash flow result:
    - Ease short-term budgetary pressures.
    - Increase debt capacity for new project funding.
    - Free-up short-term funds to be used for Pay-Go needs.
  
- Benefits:
  - Debt service savings.
  - Enhances debt capacity.
  - Streamlines loan service payments (monthly payments become semi-annual payments).
  - Enhances interest earnings.
  - Provides Rural Development with increased lending capacity for new projects.

# Credit Impact of Direct Bank Placements / Loans

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- Increased Availability of Direct Bank Placements/Loans as an Alternative to Public Debt Transactions is a Credit Positive for Public Finance Issuers.
- Direct Loans Do Not Expose Issuers to Remarketing Risk (Unlike Variable Rate Demand Bonds) and Do Not Carry Risks Associated with Bank Credit Deterioration and Market Dislocation.
- Interest Rate Variability, Repayment Acceleration Risks, Market Access/Renewal Risk May Be Present in Direct Bank Placements/Loans, but Specific Terms/Risks Can Be Reviewed/Negotiated Prior to Closing.
- A Rated Issuer's Direct Bank Placements/Loans Effect Overall Debt Profile and Rating Agencies Rely on Ongoing Surveillance/Issuer's Disclosure of Transactions for Up-to-Date Information.

# Virginia Resources Authority Financing

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- Financing Available Anytime
  
- Revolving Loan Funds
  - Below market rates;
  - No issuance costs; and,
  - Collaborative effort with state partners.
  
- Virginia Pooled Financing Program
  - No bond insurance;
  - Custom-tailored to meet borrower objectives; and,
  - Terms up to 30 years.
  
- VRA Equipment & Term Financing
  
- Recently Created Short-Term Borrowing Program
  
- Expanded Options for Terms of 3 – 15 Years

# Asset Sales

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- In the wake of the financial crisis and national economic recession, fiscal conditions in some local governments have led to Asset Sales and Privatization initiatives.
  
- Recent examples include:
  - 99-Year Lease of the Chicago Skyway Toll Bridge System to a Consortium of Private Investors which is responsible for all operating and maintenance costs of the Skyway, but has the right to all toll and concession revenue. The City of Chicago received \$1.8 billion for the lease.
  
  - 75-Year Lease of the Indiana Toll Road by a Similar Group of Private Investors. The State received \$3.8 billion in exchange for the right to maintain, operate and collect tolls for the 75-year lease.
  
  - In Virginia, the Pocahontas Parkway was acquired by an Australian corporation via a 99-year concession for a total cost of \$611 million. The corporation has 100% control of the Parkway.

# Commercial Paper

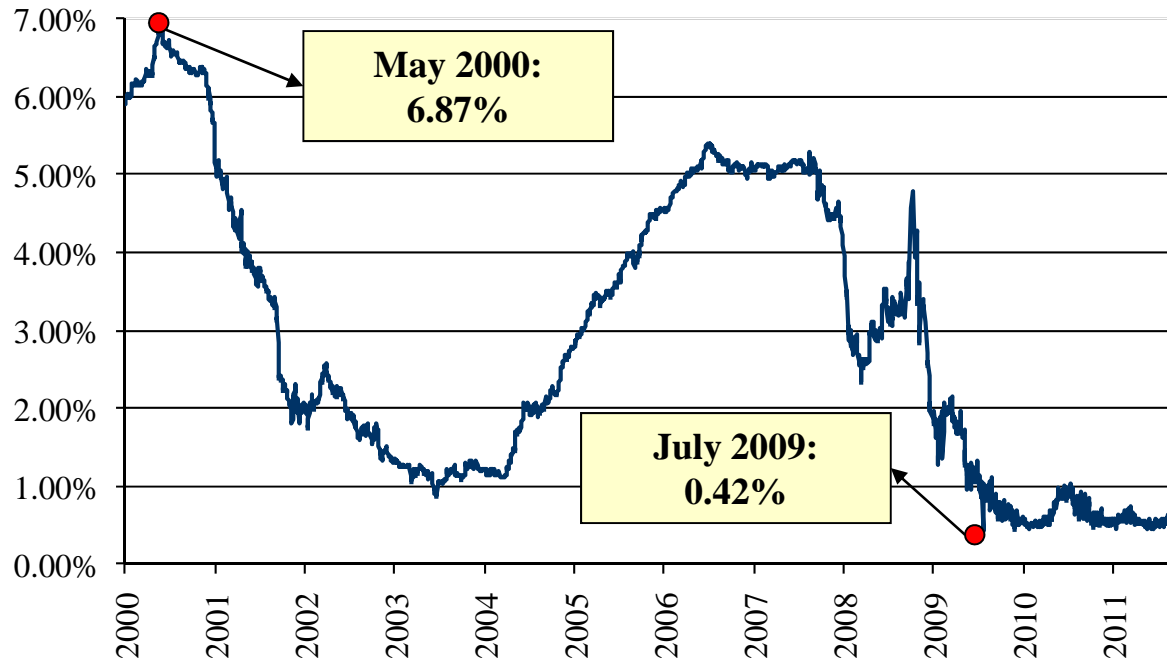
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- Commercial Paper is a Short-Term, Variable Rate Financing Option.
- Typically used to provide funding for Capital Improvements pending the issuance of Permanent, Long-Term Debt.
- Commercial Paper matures after 270 Days and is Purchased at a Discount.
- A Borrower has access to a Revolving Credit Facility via a Letter of Credit Provider and a Remarketing Agent.

# Historical Commercial Paper Rates

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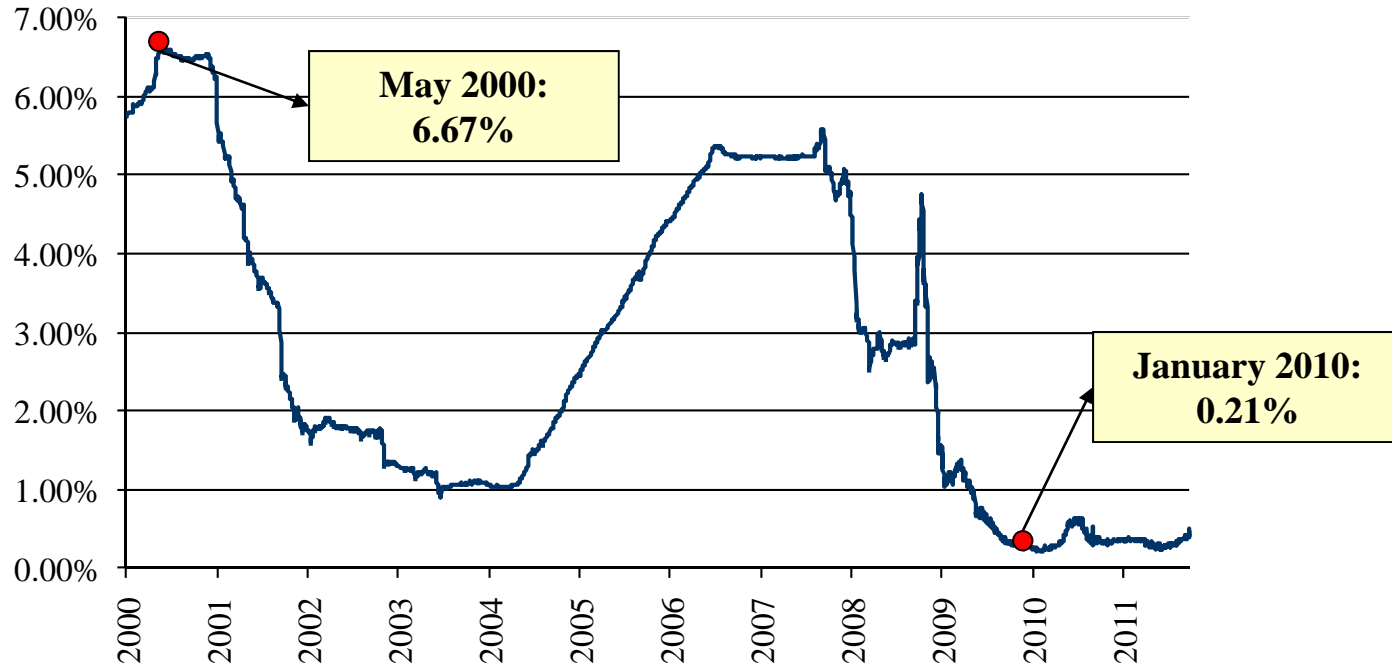
## 270-Day Commercial Paper Index



- High Since 2000: 6.87%
- Low Since 2000: 0.42%
- Average Since 2000: 2.88%

# Historical Commercial Paper Rates (continued)

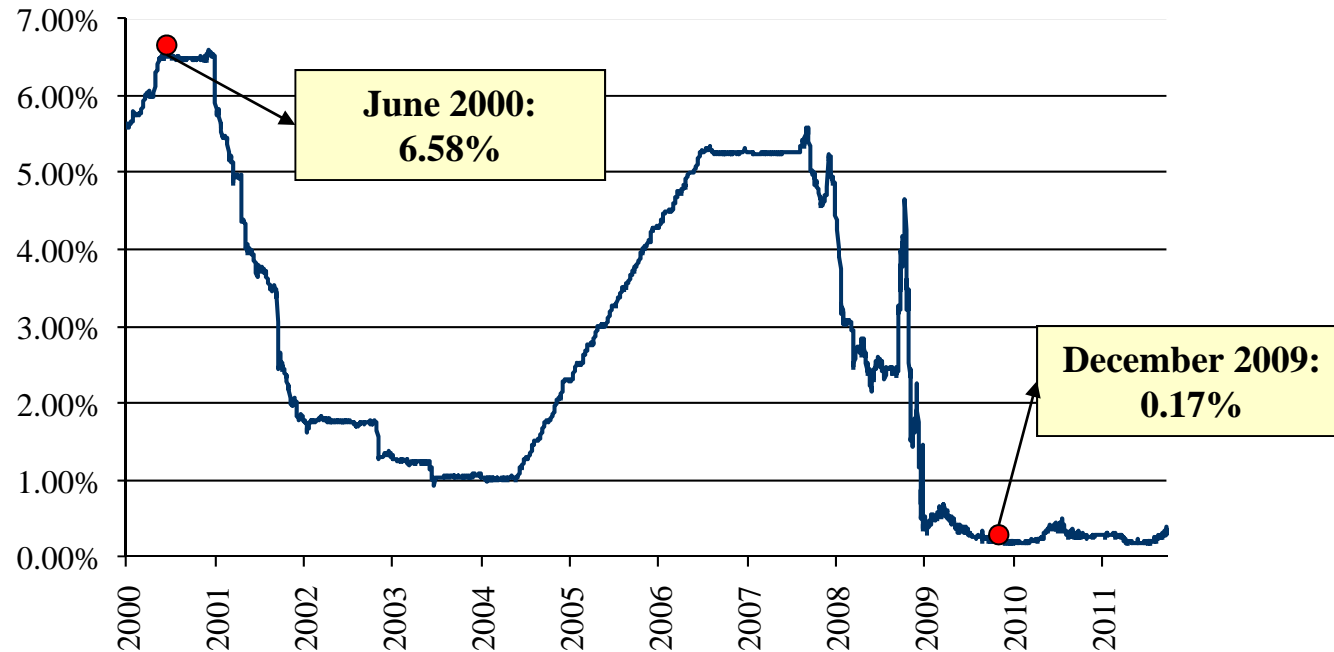
## 90-Day Commercial Paper Index



- High Since 2000: 6.67%
- Low Since 2000: 0.21%
- Average Since 2000: 2.74%

# Historical Commercial Paper Rates (continued)

## 30-Day Commercial Paper Index



- High Since 2000: 6.58%
- Low Since 2000: 0.17%
- Average Since 2000: 2.65%

# Advance Refunding with Taxable Debt

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- Advance Refundings post-1986:
  - Tax-Exempt Debt cannot be advance refunded (i.e. refunded more than 90 days prior to the call date) more than once.
    - Typically, this means that for “Public Debt” the local government gets one chance at an advance refunding in the first 10 years of the issue.
- As a result of recent interest rate changes, local governments are now discovering that they can Advance Refund an outstanding issue that was already advance refunded by accessing the Taxable versus Tax-Exempt markets.
- Taxable Bonds may be issued for multiple Advance Refundings of Tax-Exempt Debt without restrictions.

# Advance Refunding with Taxable Debt (continued)

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- For a “AA” Rated Virginia City, the Following Preliminary Refunding Analysis Shows the Viability of Issuing Taxable Debt for an Advance Refunding in Certain Cases:

	<u>Refunded Bonds</u>	
	<u>Series 2004A</u>	<u>Series 2002B</u>
Bonds Refunded	\$24,820,000	\$48,445,000
Interest Rates	5.00%	4.96%
Call Date	7/15/2014	7/15/2013
Call Price	100%	100%
	<u>Refunding Bonds (Standard 10-Year Call)</u>	
	<u>Series 2004A</u>	<u>Series 2002B</u>
Closing/Issuance Date	1/17/2012	1/17/2012
Refunding Bonds	\$23,980,000	\$52,365,000
True Interest Cost	2.68%	2.81%
Tax Status	Tax-Exempt	Taxable
Total Savings	\$1,287,326	\$3,824,724
PV Savings	\$1,071,994	\$3,210,580
PV Savings (% of Refunded Bonds)	4.32%	6.63%

*Questions / Comments*