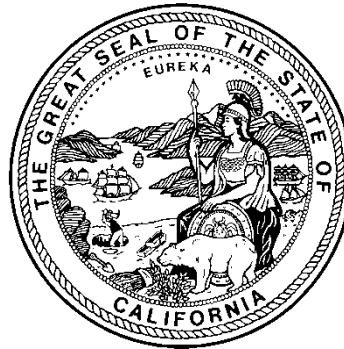


# *New Frontiers in Public Finance: A Return to Direct Lending*



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# A RETURN TO DIRECT LENDING

p. 2

## Presenters

Alex Wallace (moderator)  
Manager Director – Head of Public Finance  
US Bancorp Municipal Securities Group  
alex.wallace@usbank.com  
(704) 335-4643

Glenn R. Casterline  
Managing Director  
BLX Group LLC  
gcasterline@blxgroup.com  
(213) 6112-2229

Jim Manire  
Managing Director  
BLX Group LLC  
jmanire@blxgroup.com  
(303) 699-4464

Brian Forbath, Esq.  
Shareholder  
Stradling Yocca Carlson & Rauth  
bforbath@sycr.com  
(949) 725-4193



# A RETURN TO DIRECT LENDING

p. 3

## Overview

- What is a direct purchase/private placement financing?
- Why the resurgence over the last few years?
  
- Considerations for the borrower when evaluating a direct purchase
- Direct Purchase vs Public Offering
- Participating Banks
  
- Legal Structure
- Disclosure
- Common legal considerations
  
- Future of direct purchases?
- Questions



# A RETURN TO DIRECT LENDING

p. 4

## What is direct purchase/private placement financing?

- Definition
  - Tax-exempt financing (fixed or variable) that is privately-placed or directly purchased by an investor or bank
  - Also known as Direct Purchase, Direct Placement, Private Placement, Funded Loan, or Direct loan
- Tax Treatment
  - Common form of tax-exempt financing prior to the Tax Reform Act of 1986
  - Bank Qualified
  - Non-Bank Qualified
  - Taxable
- Types of Credits
  - General Obligation Bonds
  - Appropriation Bonds
  - Revenue Bonds
  - Lease Revenue Bonds
  - Private Activity Bonds



# A RETURN TO DIRECT LENDING

p. 5

## What is direct purchase/private placement financing? (Cont'd)

- Use of Proceeds
  - Equipment purchases
  - Real estate or project development
  
- General Characteristics
  - Principally purchased by one investor or bank
  - With or without a placement agent
  - Executed as a loan or as a security
  - Exempt from SEC 15c2-12, but may not be exempt from underwriter obligations under MSRB rules
  - Highly adaptable structures with the ability to customize to existing industry standards and bond documentation
  - Pricing can be either fixed rate or variable rate (spread over an index) for a defined commitment period



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p. 6

## Why the resurgence over the last few years?

### Market Factors

- For 2009 and 2010, the American Reinvestment and Recovery Act's ("ARRA") "de minimis provision" suspended the cost of carry disallowance for banks, thereby increasing the value of certain tax-exempt holdings
- Downgrades to insurers and liquidity/credit/swap providers (domestic & foreign banks) forced market participants to seek alternative structures.
- High volume of expiring credit/liquidity facilities
- Favorable taxable/tax-exempt ratios (relationship between Libor and SIFMA)



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p. 7

Why the resurgence over the last few years? *(cont'd)*

## Issuer Factors

- Restructuring/conversion of existing variable rate transactions
- Elimination of bank downgrade risk
- Elimination of “put risk” due to credit or market events
- Elimination of trading risk volatility
- Opportunity to avoid basis risk (alignment of indices between financing and swap)
- Ease of execution (reduced costs and limited public disclosure requirement)



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p. 8

Why the resurgence over the last few years? *(cont'd)*

## Bank Factors

- Lower-rated banks are able participate as a lender / investor
- Basel III regulatory changes have encouraged Banks to pursue funded loans vs. contingent liabilities
- Reduced opportunities for traditional lending
- Banks are able to recognize tax-exempt income vs taxable income
- Positive correlation between bank profits and municipal holdings
- Commercial banks have become the third largest holder of municipal securities behind only households and mutual funds and ahead of money market funds. Commercial banks hold \$327.4 billion in municipal securities as of June 30, 2012.<sup>1</sup>



<sup>1</sup> Source: Bond Buyer and Federal Reserve Flow of Funds, Includes Direct Purchases structured as securities only



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p. 9

## Considerations for the borrower when evaluating a direct purchase

- Compare economic terms
  - can be fixed rate or variable
  - can be new money, refunding, or a variable rate conversion
  - how do costs and interest rates compare?
- Compare legal covenants
  - make primary covenants non-negotiable
  - request specific terms (prepayment options, no debt service reserve)
  - conform to existing covenants in parity issues
- Compare financial structure
  - maturities beyond 10-12 years not always available
- Seek several proposals
  - bank preferences and appetites vary
  - request alternative quotes for callable, non-callable
- Arrive at an informed choice on performance and any potential risk



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p. 10

## Direct Purchase vs Public Offering – fixed rate

- Fixed rate financings
  - competitive pricing available from several purchasers (subject to credit and tenor)
  - seek similar terms to refunded or parity issues
    - optional redemption may be more flexible
    - seek amortization based on issuer objectives
  - direct purchases often do not require a debt service reserve fund
  - credit ratings typically unnecessary when entering into a direct purchase
  - direct purchases have a lower costs of issuance
    - no underwriter's discount
    - no rating fees



# A RETURN TO DIRECT LENDING

p. 11

## Direct Purchase vs Public Offering – variable rate

- Variable rate financings
  - publicly offered
    - variable rate demand obligations (“VRDOs”)
      - ✓ typically remarketed daily or weekly; paid monthly
      - ✓ remarketing rates (interest) on VRDOs are based on the credit strength of the underlying letter of credit bank
    - floating rate notes (“FRNs”)
      - ✓ reset weekly; paid monthly
      - ✓ interest is based on a published index
        - SIFMA (+ a spread)
        - % of 1M LIBOR (+ a spread)
  - private placement
    - direct purchase
      - ✓ reset weekly; paid monthly
      - ✓ interest is based on a published index
        - SIFMA (+ a spread)
        - % of 1M LIBOR (+ a spread)



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p. 12

## Direct Purchase vs Public Offering – variable rate *(cont'd)*

- Direct purchase/FRNs vs VRDOs
  - competitive pricing
  - similar terms
    - long-term variable rate financings
    - amortization
    - lends to hedging alternatives
  - renewal risk
    - will the institution (lender) renew the direct purchase or letter of credit?
  - direct purchases and FRNs eliminate LOC bank counterparty risk
    - Allied Irish Bank
    - Bank of America



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p. 13

## Direct Purchase vs Public Offering – variable rate *(cont'd)*

	LOC Backed VRDBs	Direct Purchase	LIBOR/ SIFMA Index Bonds (FRNs)
<b>Commitment Period:</b>	1 to 3 years	1 to 7 years	1 to 7 years
<b>Failed Remarketing:</b>	Put to bank; Subject to bank rate/ acceleration	<u>Soft put</u> : Generally subject to penalty rate/ acceleration	<u>Hard put/ Maturity</u> : Default <u>Soft put</u> : Penalty rate
<b>Bank Exposure:</b>	Ongoing exposure	Limited exposure	None
<b>Issuer's Credit:</b>	Cost increases in event of downgrade	Cost increases in event of downgrade	No cost impact in event of downgrade
<b>Interest:</b>	Resets weekly, paid monthly	Resets weekly, paid monthly	Resets weekly, paid monthly
<b>Primary Investors:</b>	Money market funds	Held by bank	<u>≤ 13 months</u> : Money market funds <u>&gt; 13 months</u> : Intermediate funds
<b>Call Option:</b>	At any time; potentially subject to breakage fees	Any time; potentially subject to breakage fees	Generally 3 to 6 months prior to maturity
<b>Considerations:</b>	<ul style="list-style-type: none"> <li>• Long-term variable rate financing alternative</li> <li>• Prepayment and amortization flexibility</li> <li>• Structure lends to hedging alternatives</li> <li>• Quick execution. Easiest option to implement</li> </ul>	<ul style="list-style-type: none"> <li>• Long-term variable rate financing alternative</li> <li>• Prepayment and amortization flexibility</li> <li>• Structure lends to hedging alternatives</li> <li>• Bank liquidity facility not required</li> <li>• Eliminates bank counterparty risk (credit and remarketing) and costs</li> </ul>	<ul style="list-style-type: none"> <li>• Long-term variable rate financing alternative</li> <li>• Prepayment and amortization flexibility</li> <li>• Structure lends to hedging alternatives</li> <li>• Diversifies investor base</li> <li>• Bank liquidity facility not required</li> <li>• Eliminates bank counterparty risk (credit and remarketing) and costs</li> </ul>



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p. 14

## Variable Rate Direct Purchase vs FRNs

Structure:	Floating Rate Notes	Direct Purchase
▪ <b>Market</b>	› Public	› Private
▪ <b>Investor Base</b>	› Money market funds, short bond funds, SMAs, insurance companies	› Commercial and investment banks
▪ <b>Index</b>	› Predominantly SIFMA, but also % of LIBOR	› Predominantly % of LIBOR, but also SIFMA › Fixed rate
▪ <b>Term</b>	› Up to 7 years	› 1-7 year initial maturity
▪ <b>Maturity/Put</b>	› Maturity and hard put less costly	› Maturity with soft put
▪ <b>Credit enhancement and Remarketing</b>	› N/A	› N/A
▪ <b>Trading Risk Volatility</b>	› None	› None
▪ <b>Matching Versus Swap Terms</b>	› Some ability to match terms to swap receipts	› Greater ability to structure terms to match swap receipts



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p. 15

## Participating Banks

- Banks active in California include....
  - ✓ Bank of America
  - ✓ Bank of the West
  - ✓ BBVA Compass Bank
  - ✓ Citibank
  - ✓ Comerica Bank
  - ✓ First Republic Bank
  - ✓ J.P. Morgan Chase
  - ✓ Northern Trust
  - ✓ RBC
  - ✓ Union Bank
  - ✓ US Bank
  - ✓ Wells Fargo
  - ✓ Zions First National Bank



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p. 16

## Legal Structure

- Common Types of Direct Lending Financings
  - general fund lease revenue financings
  - general obligation
  - water/sewer/electric revenue
  - land secured
  - 501(c)(3)
- Need Legal Authority for the Transaction
  - same constitutional and statutory debt limit restrictions apply





# A RETURN TO DIRECT LENDING

p. 17

## Legal Structure *(cont'd)*

- Typically Direct Purchases use the same form of legal documentation as public offering
- Same sources of security and pledge or lien on revenues or assets as in public offering
- Typically same or similar covenants as in public offering
- Sometimes these covenants will be set forth in a Continuing Covenants Agreement



# A RETURN TO DIRECT LENDING

p. 18

## Legal Structure *(cont'd)*

- Bonds are either sold directly to the Purchaser or the Purchaser is a party to the Lease, Installment Purchase Agreement, or Loan Agreement and directly receives Lease Payments, Installment Payments, or Loan Payments
- Depending on structure sometimes no Trustee and payments made directly to Purchaser
- Swaps – Sometimes Banks want to spread revenues to different arms of the bank and will propose a floating rate based on an index and a spread and a swap where the Issuer makes a fixed rate payment and receives back a floating rate and spread identical to what they pay on the underlying security
- Typically same closing documents, certifications and opinions as public sale



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p. 19

## Disclosure

- Usually structured to avoid Rule 15c2-12 requirements
  - no official statement required
  - no requirement to provide/file continuing disclosure with EMMA, however, continuing disclosure is often required to be provided directly to the Purchaser
- Still subject to the Anti-Fraud provisions of Section 17 of the Securities Act of 1933 which make it unlawful to obtain money in interstate commerce by means of an untrue statement of a material fact in the offer or sale of securities, or by omission of material facts
  - direct purchaser's might require 10b5 types of representation as to information provided to them
  - direct purchasers do conduct due diligence and will require budgets, audits, operating data, projections, etc.
- Investor Letter (“Big Boy Letter”)
  - representation that purchaser is an “accredited investor” or a “qualified institutional buyer”
  - purchaser is purchasing for its own account and not with a view to resell
  - purchaser has done its own due diligence
  - sometimes transfer restrictions or “traveling” letter



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p. 20

## Common legal considerations

- Authority to do direct lending
- Covenant Negotiation
  - abatement risk/substitution of asset provisions in lease transactions
  - set off
  - cross default
  - liquidity tests
- Assignment/Transfer
- Default Rates/Terms Outs
- Consent Rights



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p. 21

## Future of direct purchases?

### Market Factors

- Regulatory uncertainty (MSRB & SEC evolving views on disclosure)
- Legislative uncertainty (status of tax exemption and tax policy)
- Interest rate environment and corresponding taxable/tax-exempt ratios
- Emergence of alternative structures or re-emergence of traditional structures

### Issuer Considerations

- Competitive pricing vs market alternatives
- Cost of issuance
- Disclosure requirements
- Renewal / restructuring risk at end of term
- Debt Policy guidelines



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p. 22

## Future of direct purchases? *(cont'd)*

### Bank Considerations

- Basel III uncertainty (2015 implementation date)
- Recovery of bank ratings
- Assessment of tax risk by banks (micro/macro level)
- Uncertainty of Renewal Cycle
- Corporate earnings (i.e., return of traditional or new lending opportunities) will have some impact on banks appetite and capacity for direct purchases



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p. 23

## Questions

