Supporting local economic development with industrial development bonds

One of the biggest obstacles facing small- to medium-sized manufacturers is the pressure to increase production and compete in a global marketplace that demands lower prices. Often, the best way to meet this demand is to purchase the latest equipment and modernize the plant to increase efficiency and productivity. This can come at a significant cost to the company, however, and without cash reserves on hand, the decision to proceed with the capital project is frequently left to a commercial bank's scrutiny and financing costs. This is a difficult situation for any company to face.

When the decision to proceed with a project comes down to cost, it is in the company's best interest to consider an Industrial Development Bond (IDB) to finance the project. In most cases, the amount of interest saved over the life of the capital project can be upwards of three percent per annum with an IDB.

Furthermore, new legislation took effect on Dec. 31, 2006, that will increase the prevalence of this often overlooked financing tool for manufacturing companies. The legislation doubles the capital expenditure limit for companies from $10 million to $20 million. This will both expand the playing field to larger manufacturing companies and provide the necessary incentives to make capital investments and grow the domestic manufacturing sector.

What is an IDB?

IDBs offer tax-exempt financing for small- to medium-sized manufacturers, resulting in lower-interest costs for the company compared to conventional bank financing.

An industrial development authority or other designated governmental body has the authority to issue tax-exempt revenue bonds that are repaid by the private company. The governmental authority serves as a conduit for the private financing, making these bonds available to qualifying projects and companies on a tax-exempt basis without assuming project risk. Since there are no funds at risk, these designated authorities can authorize the issuance of such bonds without a vote of the local electorate. The decision to award bond allocation is ultimately linked to the local economic benefits

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William Reisner is vice president of Stern Brothers & Co., located at 8000 Maryland Ave., Suite 800, St. Louis, Missouri 63105. He can be reached at 314-743-4017 or by email at wreisner@sternbrothers.com.

realized by the project, which can be based on the number of jobs created or the impact of the capital investment in the community. As a result, issuers have a desire to award bond allocation to worthy capital projects and manufacturers have an incentive to access these funds. It is a program that promotes capital investment at low interest rates, creating a win-win for both the manufacturer and local economy.

IDBs are typically credit-enhanced, which means they are secured by direct-pay letters of credit supplied by commercial banks. This structure allows the bonds to trade on the strength of the letter of credit provider rather than relying solely on the credit of the borrower. Further, the company is able to fund the project with tax-exempt interest rates while maintaining minimal disclosure of proprietary information.

As an example, Stern Brothers & Co. recently completed an IDB for a commercial printing business in Missouri. The company faced a critical decision — either continue to serve the existing customer base in a smaller facility with old and outdated printing equipment, or expand the business to meet the demands of its customers and the broader marketplace. According to the company, the amount of interest saved versus a conventional package was in excess of three percent per annum. The bond proceeds paid for securing a new location for the plant and expansion of the core manufacturing process, as well as costs of issuance. In this example, it made sense to finance the capital project with an IDB. Management was aware of its financing options early in the process and understood that in order make the project a reality, a lower form of financing was required.

What is the process?

In the example above, the IDB option was evaluated during the developmental stages of the capital project. Since the process of funding an IDB can take time, it is important to involve an investment banking firm early to evaluate the project and the appropriateness of an IDB. The investment bank will act as the quarterback in the financing. Typically speaking, the actual funding of an IDB, when left in the hands of an experienced banker, can run smoothly.

Once it is determined that an IDB makes sense, the next step is applying for the bond allocation to the appropriate state or local governmental issuing authority. Bond allocation is available to fund new capital projects, whether that includes the construction of a manufacturing plant, purchase and rehabilitation of an existing one, or the purchase of new equipment. The allocation is available as an economic development tool to fund new capital investment among the community's manufacturing base. During this process, the expected local economic benefit of the project is weighed against other projects competing for the same allocation. As a result, used equipment generally cannot be financed with IDBs. It is important to note that there are limitations imposed by the internal revenue code, a few of which are noted here:

1. Not more than 25 percent of the bond proceeds may be used to finance non-core items at the manufacturing facility, such as offices, showrooms, loading docks and other ancillary items.
2. When purchasing an existing facility, at least 15 percent of bond proceeds must be allocated for rehabilitation expenses.
3. Not more than 25 percent of the bond proceeds may be used to acquire land.
4. Capital expenditures incurred by the company are limited to $20 million over a six-year period surrounding the date of issuance.
5. Capital expenditures must be incurred in the same jurisdiction as the bond issuance, and include not only the par amount of the proposed bonds, but also all other capital expenditures.

Once the allocation is awarded and the project "induced," it is the responsibility of the financing team to document the bond issue for resale to the capital markets while keeping the manufacturer apprised of the anticipated funding date.

Before committing to an IDB, our firm always recommends consulting with a qualified bond attorney or investment bank to determine its application for a capital project and whether there are other limitations that may come into play. In these situations, there is no substitute for IDB experience.

How does the new legislation impact the industry?

The Council of Development Finance Agencies (CDFA) is a national association serving the interests of the development finance industry. Through the leadership of the CDFA, legislation was enacted to double the capital expenditure limitation currently imposed on manufacturers that have or will utilize an IDB to finance a capital project. The limitation is in place as a low-cost financing tool for small- to medium-sized manufacturers, and at its prior level of $10 million, many businesses were unable to access these funds. Increasing the limitation to $20 million provides companies with greater flexibility, raising the amount of capital expenditures they can incur over a six-year horizon (three years prior and three years subsequent to the date of issuance of the IDB).

"Practically speaking, the increase was needed to keep up with the inflationary changes over the last 30 years," said Toby Rittner, executive director of the CDFA. "We now have companies that are able to plan their capital expenditures without running into the limitation. Manufacturers now have the opportunity to save jobs, buck the current trend in the industry and invest in capital improvements where they are located. For the industry, this is just another improvement of a great financing tool. It is a tried and true method that is now improved."

What is next for the industry?

The capital expenditure increase was a logical step for the manufacturing industry. The CDFA is also leading other exciting initiatives for the industry, including a definitional change of manufacturing, which could have lasting impacts on IDB issuance.

The decision to consider using an IDB to finance your next capital project should be the easiest financing

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decision your business can make. It means a lower interest rate and financing cost for the life of the project. The challenge faced by investment banking firms is getting this information into the hands of small- to medium-sized manufacturing companies when these capital projects are in their developmental stages. The involvement of an investment banking firm early in the process is critical to obtaining the most efficient and cost-effective financing.

The recent legislation is great news for the industry and with organizations such as the CDFA dedicated to the advancement of development finance, we expect more positive changes for the industry. In the end, improvements to this financing tool should have a lasting impact on the domestic manufacturing sector in general and help manufacturing companies achieve their profitability and growth objectives. ■

Stern Brothers & Co., member SIPC, is an independent investment bank that specializes in providing its clients with money saving financial solutions and long-term value by completing complex transactions on time. Since its founding in 1917, Stern Brothers & Co. has been assisting private and public decision makers finance major capital projects with timely, well-designed and low-cost tax-exempt and taxable bond issues. Stern Brothers & Co. has offices in St. Louis, Kansas City, Chicago and Tampa. For more information, please visit www.sternbrothers.com.

Reprinted from *The Illinois Manufacturer,* Spring, 2007 issue, with permission.

The Illinois Manufacturer is the official publication of the Illinois Manufacturers' Association (IMA)

220 East Adams Street • Springfield, Illinois 62701 • 217-522-1240 • Fax: 217-522-2367
1211 West 22nd Street • Suite 620 • Oak Brook, Illinois 60523 • 630-368-5300 • Fax: 630-218-7467

www.ima-net.org

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