

Capital Markets Perspective



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Capital Markets Perspective

Speakers:

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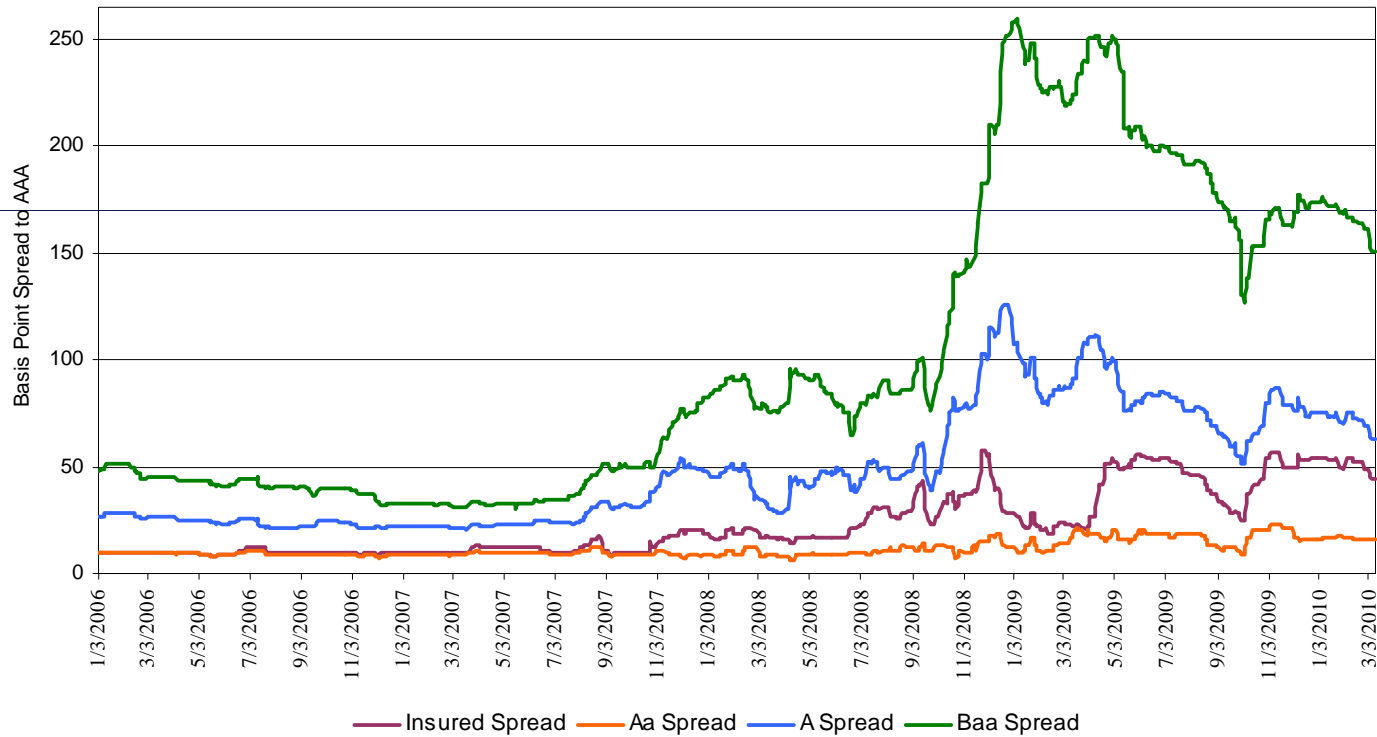
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Current Market Perspective: Credit Spreads

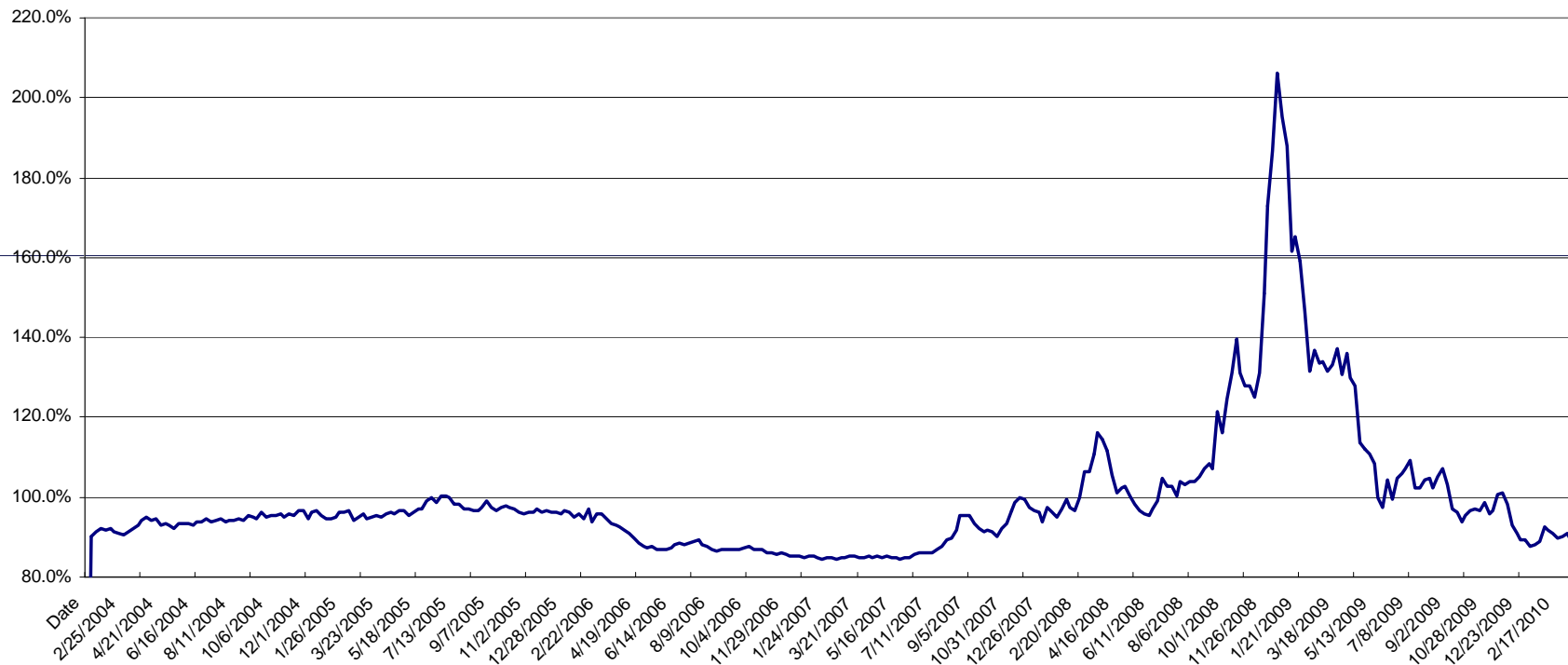
**MMD Spot Rate
30 Year Bond Spread to AAA Pure**



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Current Market Perspective: Taxable vs. Tax-Exempt

Long Term Tax-Exempt Rates
as a Percentage of Long Term Taxable 30-year Treasury Rates



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Current Market Perspective

American Recovery and Reinvestment Act Tools

Build America Bonds (BAB's)

- Restrictions
- Lower Grade Funds

Recovery Zone Economic Development Bonds (RZEDB's)

- Recovery Zone Facilities Bonds (RZFB's)



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Current Market Perspective

- Multi-Layered Sources of Funds
- Construction Negative Arbitrage
 - Stepped Coupon Bonds
 - Draw Bonds
- Split Distribution
 - Retail
 - Institutional



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F. Charles Goodwin

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Life after ARRA

ARRA currently sunsets on December 31, 2010

Build America Bonds and other Development Financing included in the sunset

Discussion now occurring at the Federal level on what provisions will be renewed and what will change

Other changes being discussed that could impact Development Bonds



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Future of Build America Bonds

President Obama proposed extending BABs, Goal is to be “revenue neutral to traditional tax-exempt bonds

Subsidy rate down to 28% from current 35%;

Expand to include using proceeds for refundings and working capital

Include 501(c)(3) non-profits as eligible borrower

No mention of other financing/subsidy programs



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Future of Build America Bonds: Growing Opposition

Subsidy is costing more than projected both in terms of greater direct payments to issuers and lower than expected tax rates of BAB investors

Wall Street Journal estimates that BABs will be 33% of 2010 municipal issuance

BABs criticized as subsidizing Wall Street more than Main Street: higher underwriter's discounts, mark-ups after primary sale



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Future of Build America Bonds

Other challenges still looming:

Still awaiting guidance from IRS on stripping tax credits to BABs with tax credits instead of direct subsidy

Potential for Federal “offsets” against funds owed by Issuer to the Federal government

CBO director warning that Federal deficit could scare away investors in US Debt



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Other Changes Impacting Development Bonds

Greater disclosure requirements

SEC/MSRB finishing up VRDB/ARS process, will 15c2-12 be revisited next?

Bond defaults could spur pressure from investors for additional disclosure both upfront and continuing.

Will increase upfront and on-going costs



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Other Changes Impacting Development Bonds

Pressure on Derivatives rapidly evolving

Domestic and International Agencies seeking more regulation

Credit default swaps being targeted, limitations on municipal credit default swaps magnified by contraction of monoline bond insurers

Discussion of repudiation by various issuers

Will be tougher to determine creative solutions



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Director

KeyBanc Capital Markets



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Future of Development Finance – Traditional Bank Underwriting

- Bank Construction Lending: As chronicled by the Federal Reserve Bank of San Francisco in a 2009 Economic Letter, traditional commercial banks have long been a significant source of real estate and development finance lending:
 - Over the past several decades, the commercial bank share of total real estate lending has slowly declined as other lenders have entered the market;
 - At the same time, however, the percentage of total bank assets exposed to real estate has increased for banks of all sizes;
 - In the mid-1980s, for most banks, about 20% of total bank assets were exposed to real estate, and today the exposure is about 50% for small (under \$500 million in year 2000-level dollars) and medium-sized banks (\$500 million to \$1 billion in 2000-level dollars) and just under 40% for large institutions;
 - This basic trend is even more pronounced when considering real estate loans as a share of the total loan portfolio (many banks found up to three-quarters of their total loan portfolios dedicated to real estate lending);
 - As such, as the economy and markets (credit, capital, etc.) have undergone a significant paradigm shift, so too has traditional bank underwriting criteria.



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Future of Development Finance – Traditional Bank Underwriting Criteria

- Traditional Bank Construction Lending Policy Areas: Commercial Development
 - Amount of Borrower's Equity: 10% - 20%
 - Loan-to-Cost: 80% - 90%
 - Amount of Pre-Leasing (Anchors)
 - Loan-to-Value: 75% - 90%
 - Debt Service Coverage: 1.05x - 1.35x
 - Financial Strength of Borrower
 - Level of Recourse
 - Property Location / Market Conditions



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Future of Development Finance – Traditional Bank Underwriting Criteria (cont.)

- Noticeable change in Bank Underwriting Criteria over the last few years (currently an extremely wide range of policy criterion from bank to bank):
 - Amount of Borrower's Equity: 20% - 40%
 - Loan-to-Cost: 60% - 80%
 - Amount of Pre-Leasing (Anchors)
 - Loan-to-Value: 55% - 75%
 - Debt Service Coverage: 1.25x - 1.85x
 - Financial Strength of Borrower
 - Level of Recourse
 - Property Location / Market Conditions



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Future of Development Finance – Special Purpose Development Agencies

- As an alternative to traditional bank financing, Special Purpose Development Agencies (“SPDA”) may play a greater role in the near future
- SPDAs (redevelopment agencies, port authorities) may be utilized for both private and public development projects or other public improvement projects
- Many special purpose development agencies provide significant funding and trade advantages to businesses expanding or relocating in the agency’s service area including:
- Economic Development:
 - Conduit Financing Programs
 - Issuance of securities to be used by third party
 - Fixed-Rate Bond Fund Programs (Public and Private Development)
 - Tax-exempt and taxable bonds underwritten with the SPDA’s underlying rating
 - Able to be utilized in conjunction with TIF for public improvements or public sector developments
- Brownfield Reclamation (land recycling)
- Foreign-Trade Zone
 - Companies engaging international commerce are able to experience savings through benefits that can reduce costs and lead times associated with international sourcing



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Future of Development Finance – Bond Fund Programs

- As credit continues to be of concern to banks and investors, pooled bond financing will continue to be a viable financing alternative for the future
- SPDA Bond Funds serve as a credit-enhancement vehicle based on a system of common “program” reserves established in special funds of the SPDA deposited with a qualified corporate trustee
- Program reserves funded in connection with each series of revenue bonds issued to finance costs of approved projects, the portfolio of loans that are made from those proceeds and the collateral for each such loan, are all pledged under the applicable trust agreement to support the revenue bonds issued for that project
- Program reserves are typically funded with a combination of local contributions, state loans, and bank letters of credit
- Many special development finance agencies have pooled the resources of their bond funds and of state programs to provide financing for projects of significant size and have used their bond funds to fill funding gaps on major economic development projects



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Future of Development Finance – Credit Tenant Leases

- Credit tenant leasing is a form of private placement where the credit of the tenant is used to determine the all-in coupon rate of the transaction
 - Must be a single tenant with an investment grade rating (BBB- or NAIC 2 or better); OR a non-rated company with strong financials
 - Investment grade tenant must be the master tenant of the property, but is allowed to subtenant space to other non-rated entities
- A credit tenant lease requires a triple net or “bondable” lease
 - Tenant is responsible for the payment of the building maintenance, real estate taxes, and insurance expenses
 - No tenant abatement/termination provisions
 - If the lease is not triple net, we can possibly mitigate these issues through reserves and lease enhancement insurance (casualty and condemnation) on a case by case basis



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Future of Development Finance – Credit Tenant Leases (cont.)

- Features
 - Leases 15 years and longer
 - Borrower can normally prepay at anytime. Prepayment is calculated as make whole (T+50) for borrower with no lockout period
 - Credit of the tenant is the most important factor (as opposed to strength of developer/landlord, location of the property, etc.)
 - Ability to take companies to the rating agencies (NAIC) prior to launch of transaction to ensure investment grade debt rating
 - Can go as high as 100% loan to value (determined as NPV of rental stream) and as low as 1.0x debt service coverage
 - No vacancy underwriting
 - Ability to lock in longer term transactions at currently low treasury rates
 - With additional guarantees and a date certain rent commencement, can combine construction to permanent financing within one set of loan documents



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Future of Development Finance – Tax Increment Financing Bonds

- Tax Increment Financing (“TIF”) is an economic development bond funding mechanism available in most states to finance public improvements, including in many instances, public infrastructure, land acquisition, demolition, environmental clean-up, public parking garages and, in certain circumstances, assist with the new construction of private improvements (i.e. commercial/industrial buildings).
- The value of real property improvements are exempted from taxes through local TIF authorizing legislation enacted by a municipality or county (some States also allow for the capture of sales taxes).
- A taxpayer (i.e. Developer / Company) whose property is located within a TIF District continues to make payments to the taxing jurisdiction in an amount equal to the real property tax liability that otherwise would have been due had the property not been exempted.
- A TIF works by locking in the taxable worth of real property at the value it holds at the time the authorizing legislation is approved. Payments derived from the increased assessed value of any improvements (i.e. rehabilitation and/or new construction) to real property beyond that amount are directed towards a separate fund.
- These “payments in lieu of taxes” (PILOTs), or Service Payments, are collected in the same manner as real property taxes, but are deposited into a separate fund to fund debt service on outstanding bonds.



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Future of Development Finance – TIF Security Sources

- Potential Developer/Company Sources of Security
 - Developer agreement to provide “Supplemental Payments” should there be any shortfall in anticipated PILOTs/Service Payments to cover Debt Service (i.e. Special Assessments – see below, etc.);
 - Developer Letter of Credit: Bonds structured around projected tax increment revenues available for debt service, but are also enhanced with a short-term back-up LOC through construction;
 - Developer contractual agreement/obligation to a minimum assessed valuation;
 - Developer-related entity purchase all or a portion of the TIF Bond Issue (becoming more common).
- Potential Municipal Sources of Security
 - Municipal General Obligation Pledge: City ability and willingness to utilize G.O. given potential impact on future funds and current debt limits;
 - Municipal Non-Tax Revenue Pledge: Building permit revenue, fines, fees, etc.;
 - Special Assessments: Can be levied but not collected, if annual PILOTs are sufficient
 - Debt Service Reserve Fund: City ability and willingness to agree to replenish the bond’s DSRF should the Fund ever be drawn upon.



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Future of Development Finance – TIF Credit Risk

MINIMIZING TIF BOND RISK

- Although a valuable economic development tool, TIF Bond Issues do not come without potential risks.
- Bradford Sprague, President of PRISM Financial Solutions, in his writings on the subject, defines two categories of potential TIF risk:
 - Development Risk: Centers around timely project completion and resulting assessed valuation of the project:
 - Least risky are projects that are proven, well-defined, have a reasonably short development horizon, and are controlled by an experienced Developer;
- As discussed previously, features that tend to minimize Development Risk include:
 - Structuring the TIF Bond Issue with excess Debt Service coverage and a conservative “ramp-up” period for the TIF PILOTs/Service Payments;
 - Requiring a Developer Letter of Credit until certain project hurdles are met;
 - Having the Developer waive the right to appeal the assessed valuation of the project;
 - Negotiating a minimum assessed valuation of the project with the Developer.



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Future of Development Finance – TIF Credit Risk (cont.)

MINIMIZING TIF BOND RISK (continued)

- Credit Risk: Has to do with the “Ability to Pay”:
- Overall ability to pay regarding PILOTs/Service Payments is greater when the project is not controlled by or dependent upon a single taxpayer/use (mixed-use projects tend to help minimize credit risk);
- Other Credit Risk factors: No guarantee that current tax rates will remain constant over time (roll-back and limited time bond levies), as well as potential future declines in assessed valuation;
- As discussed previously, features that tend to minimize Credit Risk include:
 - Adequately review all existing sources of property tax millage to determine any future bond levies that may expire prior to retirement of the TIF Bonds, as well as structuring the TIF Bond Issue with excess Debt Service coverage;
 - Structure the Bond Issue to have a back-up security of Special Assessments to be collected only if there is a Debt Service shortfall in any one year (lower than anticipated TIF PILOTs/Service Payments);
 - Having the Developer waive the right to appeal the assessed valuation of the project;
 - Negotiating a minimum assessed valuation of the project with the Developer.



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Questions



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Registration Now Open

Tuesday April 20, 2010 at 1:00pm Eastern CDFA – BNY Mellon Development Finance Webcast Series: Regulatory Issues Debate

Summary:

The regulatory and compliance landscape in the municipal bond industry has multiple players and can be difficult to navigate. With new regulations introduced each year, their purpose, effectiveness, and importance is often up for debate. In this second installment of the CDFA – BNY Mellon Development Finance Webcast Series, hear regulatory experts discuss the existing environment and how the bond industry is operating under the current regulations.

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