



PROMOTING CHOICE AND PRESERVING INDEPENDENCE SINCE 1970

SPECIAL PURPOSE REVENUE BONDS: HOW IT WORKS

Scores of independent schools tap into the huge market for tax-exempt debt each year. Following the lead of universities and hospitals, they weigh the benefits of leveraging their financial operation and determine that taking on long-term debt is a prudent course.

Low long-term interest rates, the need to maintain and upgrade facilities, the desire to retain and build endowment, and the prospect of a capital campaign are some of the factors that combine to set the stage for the long-term debt strategy. Over time you are likely to achieve higher rates of return on your endowment portfolio than you are paying in interest on the debt. The IRS does not allow you to directly "arbitrage" tax-exempt debt in your investment portfolio. It does allow you, however, to borrow on a tax-exempt basis to provide for capital projects.

The Board of Trustees faces its fiduciary responsibility head-on with the decision to take on debt. To what extent is the school likely to be strengthened or weakened a decade or two decades down the road if it borrows \$X million for a building program today? The board has to have a firm understanding of the school's current and long-range financial structure in order to make a sound decision. Some boards take years to become comfortable with the concept of debt, and some quite prudently never come around to accepting the risk that debt will bring to the institution.

When the chair of the Finance Committee asks you to "begin looking into tax-exempt debt," where do you look for help? There are plenty of resources around us: bankers, underwriters, financial advisors, attorneys, and other schools. I would recommend gathering advice and war stories from as many people as possible. At first it may seem complex, but eventually you will learn the lingo.

Many parties play a role in a bond issue:

- o The school is the "borrower."
- o The "underwriter" will buy the debt, and will sell it to outside purchasers, who become the "bond holders" or "creditors." Depending on the type of issue, the underwriter may sell your debt only once, or as often as weekly. If the underwriter re-sells the debt periodically, it is called the "re-marketer."
- o After the debt is issued, the "trustee" represents the interests of the bond holders. The trustee (perhaps a bank's trust department) holds the proceeds of the bond issue which have not yet been spent for the designated purpose, and supervises the school's payment of debt service and any payments into a sinking fund.

- o The "conduit" is the government authority that authorizes the issue of the debt and approves its tax-exempt status. Often this is a regional industrial development authority.
- o In the early stages of the process, there are attorneys everywhere: an attorney for the school; an attorney for the bond issue; an attorney for the underwriters; and, an attorney for the conduit. It is important that each of these persons are experienced and expert in the issuance of tax-exempt debt. The laws are complex and technical, and you don't want the IRS to come back at any time in the future and disqualify the issuance.
- o You may experience a day when three or four attorneys simultaneously descend on your office files to perform "due diligence" on the bond issue.
- o A "rating agency" may be hired to provide bond purchasers with an independent assessment of the credit-worthiness of your organization. If you would like Moody's or Standard & Poor to give you an indication what your rating is likely to be without having it in the public domain, you can arrange for a "shadow rating" first. If you go the route of a rated public bond issue, your rating agency will contact you periodically as it monitors your credit-worthiness over the term of the bond issue.
- o "Credit enhancement" is a means by which a financial institution improves your credit-worthiness by guaranteeing the bond issue. With credit enhancement from a highly-rated bank (with a "letter of credit"), or insurance organizations such as MBIA or AMBAC, you will lower the risk of default in the eyes of the bond purchasers. The lower risk results in a lower rate for your bond issue. You will pay an annual or up-front fee for the credit enhancement.

There are so many financial institutions looking for a piece of this lucrative action that a "financial adviser" may be needed to help the school to assess its options and choose the best way to go. This person may take the initiative in putting the deal together. He or she should have considerable experience in this field, should know the players in your region, and should not have any ties to the other parties.

As you learn the cast of players, be sure to assess the expertise you have at hand working SOLELY for the best interests of the school. Do you have a Board member or two with an understanding of the process? Is the school's attorney experienced with tax-exempt bonds? Is your financial adviser working with the school's best interests in mind? Remember to stay alert, choose carefully, and monitor regularly. Don't be afraid to ask stupid questions.

As chief financial officer of the school, you are likely to play several roles in the decision to borrow:

- You will discuss and document the school's financial position with many of the above parties in numbing detail.
- You will provide your Finance Committee with long-range projections which show the opportunities and risks of taking on debt. If you have been providing the trustees with a three-year look-ahead model, you will want to expand your horizon to ten or twenty years. This is an important spreadsheet you can build yourself. Be careful about allowing an outside party to build it for you; you know your school's financial structure better than anyone else. Be sure to "stress" this model for several poor years of return to the endowment, or several years of declining enrollment.
- You will learn to tote up your school's unrestricted liquid net assets, and define the strengths of your school's admissions and enrollment situation. According to the rating agencies, these are among the key indicators of a school's ability to repay its debt.
- You will explain to your Development Committee that it cannot solicit gifts restricted for the capital project (i.e. a new Science Center) once the project has been paid for by the proceeds of the bond issue. Although the gift may be "in spirit" for the Science Center, the donor needs to give an equivalent unrestricted gift to the school. You can't use a donor-restricted gift to pay down the debt if the gift is restricted for a building project.
- You will help the Finance Committee determine where to carry the debt service in future financial statements: in the operating budget? in the plant fund? in a new bond fund?
- You will help the Finance Committee to build a consensus on the amount and the type of debt your school will take on. Will the interest rate be fixed or variable (the variable rate is less, at least for now)? If you go out for a variable rate, should you buy a cap? Should you go out for 10, 20 or 30 years? Do you need to set up a sinking fund, or can you arrange for a "bullet" where the entire debt is due at the end? What provisions do you want for prepayment? What risk are you willing to bear that the creditor could call the debt in early? The possibilities are limited only by the creativity of the underwriters.
- You will learn to assess the advantages and disadvantages of a "bond pool." This is a predetermined amount of tax-exempt funds (perhaps \$100 million) set up by an underwriter and a bank. The pool seeks the participation of universities and hospitals, sharing its administration costs among the participants. Often an independent school can join such a pool. For a smaller debt issue, the advantage of participating in the pool may more than offset the lower rates you may achieve in a stand-alone deal. Where do you find a pool in your area? Start asking around, and they will find you.
- If you decide to proceed with a stand-alone deal, you (or someone in your office) should be prepared for two months of sweat equity pulling together the information and statistics necessary for the "offering statement." You can be a committee of one, or, if you are a good delegator, you will prod many of the departments around the school for information on admissions, financial aid, college placement, long-range plans, et al.
- You will also help the Finance Committee to assess the different types of credit enhancement. If you buy a "letter of credit" (LOC) from a bank, are you willing to risk its re-assessment of your credit-worthiness when the LOC renews in five years?
- After you successfully float a public bond issue, SEC regulations require you to provide an annual report that updates financial and enrollment information to designated "information depositories, such as the bond trustee." This information is provided on behalf of investors.
- You may wish to expend the bond proceeds within a limited period of time. The IRS defines several "spend down" schedules. If you do not spend the funds fast enough (a safe harbor is to spend 100% within 24 months), you will have to rebate to the IRS any

interest income on the unspent bond proceeds which exceeds the interest you are paying on the tax-exempt debt.

- Since the tax-exempt bond is for construction or renovation, you can prepare to put on your engineering, architectural, and project management hats.

Good luck with the analysis. Using tax-exempt debt to leverage your financial operations can be a powerful tool. It adds a good deal of complexity to your school's finances, and it is not without risk. The money has to be repaid at some point and the school will assume the new expense of debt service.

Two of the best reasons to take on debt are to build facilities which generate income, and to maintain your quasi-endowment so it can grow with the world's markets. An additional benefit comes from the discipline, however time-consuming, of assessing the bond issue: you and the trustees will gain new insights into your institution that you would not otherwise have. If used carefully, debt can be a way to strengthen the institution today AND for generations ahead.

Reprinted from NAIS Business Services Bulletin, Spring 1999 #1: Tax-Exempt Bond Financing - The First Steps by James R. Pugh, assistant headmaster for finance and administration at The Hill School in Pottstown, PA.