

Governance Brief

Bond sales: Questions and considerations for districts

Congratulations: You've passed a bond measure. Now what?

Once voters have approved a bond measure, a district must take the additional step of selling bonds to receive the funding needed for facility projects. This primer provides a foundation for considering bond sales in your district.

Why sell bonds?

Bond sales allow districts to construct long-term capital assets, like school facilities, and pay them off over time. Districts might choose to sell bonds because of an immediate need for facilities, to renovate older schools, or to take advantage of low construction and materials costs.

Regardless of the reason for selling bonds, board members must be prepared to explain their decision to tax the community through bonds, and to assure community members that their money is being used wisely. This can be accomplished by creating a plan to explain the benefits of the decision, such as taking advantage of low interest rates or a good bidding climate, or the ultimate outcome of meeting immediate facilities demands.

In the November 2012 election, 106 school and community college districts will bring \$14.4 billion in bonds to the ballot for public approval. In comparison, \$2 billion in bonds were approved in June 2012.

Selling bonds

Once a district receives bond authority from the voters, it should work with a bond advisor to size and sell the bonds on the investor market. It is important to have all the numbers in place to make your decision.

Some questions to consider include:

- How much money is needed?
- How soon is it needed?
- Subsequent sales needs (how soon will you need to sell more bonds?)
- What is the tax capacity of the district?
- What is the term (length) of the bond?
- What is the estimated interest rate?
- What is the annual payment rate?
- What is the total payment (principle + interest) at payoff?
- What is the debt service ratio (total payout to principal)?
- What are the prepayment terms?
- What is the availability of other funding (state matching funds)?
- How will the bond be structured?

Prepayment

Bonds may be sold with the ability to be prepaid before they are due to mature. Bond investors have a business interest in knowing the amount of income the loan will generate. If prepayment is allowed, investors typically expect to be compensated to offset that uncertainty. Having the option to prepay bonds may result in higher interest rates or require a penalty payment equal to a small percentage of the principal amount actually prepaid.

Projections

Projections are the assumptions a district makes in order to issue bonds. None of the projections are guaranteed, and developing them will require your staff's best estimates.

How much money will we need in the next 2-3 years?

You are neither required nor expected to sell all of the bonds a district is authorized to sell at one time. Federal law restricts arbitrage – holding bond money for the purpose of generating interest revenue. As a general rule, federal law requires spending 85 percent of the bonds a district has sold within three years.

What assessed value assumptions are built into your repayment projections? The more quickly you sell bonds, the higher the need for assessed valuation (AV) growth and political support.

Proposition 39 placed a limit on the maximum tax rate a district can ask voters to approve per election. The rate is capped at \$30 per \$100,000 of AV on property in an elementary or high school district, or \$60 per \$100,000 of AV in a unified school district. When issuing each series of bonds from the authorization, the district must sign a certificate stating that, based on reasonable projections, the tax rate for all bonds issued under the authorization will not exceed the Proposition 39 limits. However, the county tax collector is required to levy a tax sufficient to make the bond payments even if it exceeds the Proposition 39 limits. A decline in local assessed value may slow your ability to sell the bonds if you are at that cap, or it may result in taxpayers paying more than your promised rate to make up the difference.

How close are we to our debt limit? The Education Code limits the principal amount of bonds a school district may have outstanding at a given time. Elementary and high school districts may issue bonds up to 1.25 percent of the total assessed value within the district and unified districts may issue up to 2.50 percent. The available bonding

capacity increases as previously-issued bonds are repaid and/or assessed value increases. Pushing up against that cap will reduce a district's ability to generate revenue for projects. Some districts have been successful obtaining a waiver from this provision of the education code.

Bond structures

There are three common types of bonds issued by school districts. In each sale of bonds, bond advisors will typically recommend a mix of bond structures that match a district's unique circumstances. When bonds are sold, they are typically broken up into annual maturities, each with its own interest rate and a set amount of principal due on that date. A sale of bonds could include all three types of the bonds described below.

Current Interest Bonds (CIBs): These are traditional bonds where the principal is paid at maturity and interest is paid semi-annually based on a fixed coupon (interest) rate. In the current market, standard prepayment terms allow payment after 10 years at the principal amount plus accrued interest. Bonds may be sold with the ability to prepay sooner, however this results in a higher interest rate for the bonds. The most common term is 25 years, and the current maximum term is 40 years.

- The advantage of current interest bonds is that they have lower interest rates than capital appreciation bonds.
- The disadvantage of current interest bonds is that the semi-annual interest payments could result in exceeding tax rate limits (promised to the electors or the Proposition 39 cap) or reducing the amount of bonds a district can issue.

Capital Appreciation Bonds: Also called “zero-coupon bonds” or CABs. These bonds do not pay interest semi-annually. Instead, the interest compounds (interest accrues upon interest due) and is paid on the maturity date. The

Debt limit example

	Assessed Value = \$1,000,000	if assessed value goes down to \$800,000	if assessed value goes up to \$1,400,000
Bond Capacity	\$ 1,250,000	\$1,000,000	\$1,500,000
Bonds Authorized by voters = \$1,200,000			
Current Borrowing	\$1,000,000	\$1,000,000	\$1,000,000
Available bonding	\$200,000	\$0	\$200,000

amount due at maturity is called the “Maturity Value.” It is standard for capital appreciation bonds not to allow prepayment prior to maturity. Adding the ability to prepay capital appreciation bonds results in a higher interest rate for the bonds (typically 0.25 percent to 0.50 percent higher than capital appreciation bonds without a prepayment feature). A typical term is up to 25 years, but current law allows a 40-year repayment schedule.

- The advantage of capital appreciation bonds is that they allow districts to better sculpt debt service schedules to follow expected assessed value growth. This allows for more bonds to be issued (more projects completed) and remain within tax rate limits. The district is able to begin building despite lack of bonding capacity in the area.
- The disadvantages of capital appreciation bonds are that they have higher interest rates than current interest bonds and a smaller universe of potential investors, especially for prepayable capital appreciation bonds. By deferring payments, tax payers pay a higher overall bill in exchange for the ability to access more bonds immediately. Some members of the community may oppose the use of this debt instrument. Board members must be prepared to defend the final cost of the project.

Convertible Capital Appreciation Bonds: These bonds begin life as capital appreciation bonds. On a “conversion” date set in the bond sale package, they change into current interest bonds. During the period that the bonds are capital appreciation bonds, the bonds do not have semi-annual interest payments. Interest compounds and on the conversion date becomes part of the principal amount of

the new current interest bonds. From the conversion date to the maturity date, the bonds have semi-annual interest payments and the principal amount is paid at maturity. Convertible capital appreciation bonds may typically be prepaid between five to 10 years after the conversion date.

- The advantage of convertible capital appreciation bonds is that they may have lower interest rates than capital appreciation bonds that contain a prepayment feature. They also allow for the sculpting of debt service payments around previously issued bonds to managed tax rates. Districts are able to proceed with projects when CIB capacity is insufficient.
- The disadvantages of convertible capital appreciation bonds are higher interest rates than current interest bonds and a smaller universe of investors. These have similar political concerns regarding the final debt service ratio.

Bond Anticipation Notes

If a district continues to have bond sales authority, but lacks capacity to sell those bonds under its bond cap, a Bond Anticipation Note (BAN) is a short term loan whose collateral is eventual payment by a bond sale. These typically mature in one to five years. They can be rolled over or repaid in full within five years of issuance while waiting for AV to grow or the district to pay off older bonds. Bond anticipation notes may be issued as current interest bonds or capital appreciation bonds or a combination of the two. If the district does not have the capacity to issue general obligation bonds to pay off the BAN, the district would need to come up with another source of funds to repay the BAN, typically a Certificate of Participation.

Example bond costs

	CIB	Non-Callable CAB	Callable CAB	Convertible CAB
Amount Borrowed	\$1,000,000	\$1,000,000	\$1,000,000	\$1,000,000
Maturity Date (Term)	25 Years	25 Years	25 Years	25 Years
Annual Payment	\$37,500	—	—	\$72,489
Conversion Date	NA	NA	NA	10 Years
Total Paid after 25 Years	\$1,937,500	\$3,591,309	\$3,863,539	\$2,663,178
Debt Service Ratio	1.9:1	3.6:1	3.9:1	2.7:1
Option Prepayment	After 10 Years	None	After 10 Years	After 15 Years

Politics

There is proposed legislation that could limit the ability of districts to utilize Capital Appreciation Bonds including:

- Maximum final repayment ratio of not greater than four to one (interest + principle to principle alone) without prior approval of the county superintendent of schools
- Requiring the county treasurer to sign off prior to the bond sale
- Limiting the term of bonds to 25 years
- Requiring CABs with maturity dates greater than 10 years to be prepayable

Several districts have recently faced tough questions from local media regarding the use of CABs. Boards are encouraged to carefully review the cost-benefit analysis of using these bonds and keep the community involved in the decision to pay more in the long-term so that a project can be completed now.

Three important questions:

What do we need? Projections:

- Principal sought
- Average interest rate
- Term of the bond
- Total amount of principal and interest payments

What is our urgency to act?

- Will we lose access to matching funds?
- Do we have an immediate need for facilities?
- Will acting now save money while construction rates are low?
- How will this impact future bond sales?

What are our alternatives to issuing current interest bonds?

- Delay, eliminate or reduce the scope of projects
- Defer debt payments with use of CABs
- Issue bond anticipation notes or certificates of participation
- Ask the taxpayers for more bond authority (new tax limit) so we can use CIBs

CSBA Policies relative to bond financing include:

BP 7210 – Facilities Financing and BP and AR 7214 – General Obligation Bonds.

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