File Code No. 120.03

CITY OF SANTA BARBARA

FINANCE COMMITTEE AGENDA REPORT

AGENDA DATE: November 26, 2013

TO: Mayor and Councilmembers

FROM: Administration Division, Finance Department
City Attorney's Office

SUBJECT: Waterfront Debt Refinancing

RECOMMENDATION:

That the Finance Committee hear a report from staff regarding the proposed refinancing of the Waterfront Department's 2002 Certificates of Participation through a private placement offering.

DISCUSSION:

Background

One of the impacts of the recent recession is the significant decline in interest rates, which has continued well beyond the official end of the recession. While the decline in interest rates has had a material impact on the City's earnings on its investment portfolio, the current interest rate environment offers the City an opportunity to refinance existing long-term debt sold prior to the recession, thereby reducing its interest costs. Refinancing existing debt would generate substantial savings over the remaining life of the debt.

Staff identified two outstanding obligations as potential candidates for refinancing:

1. 2002 Water Refunding Certificates of Participation
2. 2002 Waterfront Refunding Certificates of Participation

Staff has recently completed a refinancing of the 2002 Refunding Certificates of Participation (COPs), as well as one of the Water department's State Revolving Fund loans under the Safe Drinking Water program. That refunding resulted in combined present value savings of over $2.2 million (or over 8.5% of the refunded amount) over the remaining life of the obligations, or cash flow savings of over $180,000 per year.

It is important to note that, while capitalizing on the current low interest rate environment is prudent, there is considerable staff time and effort required to complete these refinancing transactions. There are also costs, which are paid from the debt proceeds, for professional consultants to assist staff through the process and to prepare all the required legal documents.

In this context, staff has identified a unique opportunity with the proposed refinancing of the 2002 Waterfront COPs which may substantially reduce the time and effort typically associated with a traditional refinancing transaction as well as result in reduced fees paid to professional consultants.

Proposed Private Placement Strategy

Normally, when a government agency sells bonds, COPs, or other types of long-term indebtedness, the underlying debt instruments are sold to an investment bank and ultimately made available and sold to private individuals and institutional investors. In other words, the bonds or COPs are made available to any investor interested in purchasing the municipal debt. These are defined as “public offerings.”

Alternatively, staff is proposing the issuance of refunding obligations that would be purchased in their entirety by a qualified institutional bank. The City’s refunding obligation would be in the form of an Installment Sale Agreement between the City and the Santa Barbara Financing Authority. The Authority would issue revenue bonds, secured by the Installment Sale Agreement, which would be privately placed. This type of approach is referred to as a “private placement” offering since the underlying debt instruments would not be available for purchase by general investors. In the past several years, such direct lending to municipalities has increased as banks seek new ways to put their capital to work.

Private Placement Offering vs. Public Offering

While not as common, there is nothing substantively different between a private placement issuance versus a traditional public issuance of bonds or other securities from a legal perspective. One key difference is that a private placement requires significantly less time and effort by City staff to prepare disclosure documents that meet federal securities laws.

Specifically, with a public offering, the City would be required to prepare an “official statement.” The official statement, which is prepared by disclosure counsel, contains a large amount of information about the City and the specific fund issuing the debt (in this case, the Waterfront Fund and secured by the General Fund). The information that goes into the official statement is compiled and/or prepared by City staff and is intended to present clear picture of the City’s and Waterfront Fund’s financial condition so that prospective investors can make an informed investment decision.

With a private placement offering, the City would not have to prepare an official statement. This is expected to save the City approximately $45,000 in consultant fees as well as save City staff many hours of work that would otherwise be necessary to prepare an official statement.

Similarly, unlike a public offering, a private placement wouldn't require obtaining a rating on the refunding obligations. Even a single rating would cost $15,000-$18,000 at a minimum, as well as further staff time and effort.

Another potential advantage of a private placement is that banks will sometimes accept credit structures that would not be welcomed in the public bond markets. The current Waterfront COPs are an obligation of the Waterfront Fund. In the current market, a refunding COP offered publically would have to be secured by a lease and leaseback of an unrelated City facility, and secured by the General Fund (although it would be paid back from Waterfront revenues). This restructuring, required by changes in the bond market, would add additional complexity to a refunding.

From a cost perspective, while transaction costs are typically lower with a private placement, the interest rates are typically higher than securities sold in "public offerings", reflecting the fact that private placement investments lack the liquidity in the secondary market that bonds offer. However, some banks are now offering aggressive interest rates that rival the interest rates on publicly offered bonds. The bid received by the City from BBVA Compass comes with a lower interest rate than what would likely be secured through a public offering transaction.

Potential Risks Associated With a Private Placement

There is some risk associated with a private placement that differs from the typical risk assumed through a public COP offering. The BBVA Compass offer includes a provision indicating that in the event that the bonds become taxable (lose their tax exempt status), the tax exempt rate would be subject to "gross-up in the event of taxability". It is most likely that an "event of taxability" would only occur in the unlikely event that the City violated its tax covenants. In that event, like a public offering, the City would have to remedy the matter and in the context of a private offering, the City would be subject to increased interest rates. Staff and our advisors will clarify this issue with BBVA prior to bringing final documents for approval to the City Council.

Another minor risk associated with the BBVA offer is the requirement that the City pay the bank's legal fees in an amount not to exceed $15,000 whether we close the transaction or not. In the context of a public offering, the City is not responsible to pay fees if the transaction does not close.

Staff and the City's financial and legal advisors do not believe either of the concerns outlined above pose significant risks but we will clarify the taxability issue prior to returning to City Council.

Selection Process

BBVA Compass was selected through a formal request for bids (RFB) process. The RFB was sent to thirteen qualified institutional banks and three brokers, and only two proposals were received. Given that BBVA's bid represented the lowest cost of funds and is within a reasonable range of what would be expected through a publicly offered deal (and likely lower), the bid is considered responsive and responsible.

As typical in such circumstances, the interest rate in BBVA's bid is indicative and subject to change pursuant to an index-based formula specified in their submittal. The City has the option to lock in the interest rate (subject to a breakage fee) up to 60 days before closing, and staff will consider locking in the rate as the anticipated closing date approaches.

Based on the bid received from BBVA and current market conditions, the Waterfront Fund would realize savings of $170,000 in Fiscal Year 2014 and $68,000 annually for Fiscal Years 2015 through 2028. This equates to more than $1.1 million in total savings over the remaining fourteen years of the bonds, and represents approximately $990,000 in savings in today's dollars (i.e., on a present value basis), or nearly 8% of the amount of refunded COPs.

Next Steps

Staff will seek Council introduction of the ordinance and approval of all of the documents needed to execute the transaction on December 10, 2013. The ordinance will require a second reading on December 17 related to the Installment Sale Agreement.

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APPROVED BY: City Administrator's Office