Palo Verde Community College District

Annual Update to Board of Trustees

Refinancing of 2008 Certificates of Participation

Debt Mitigation Plan & Road Map

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The History

- The College issued $18.6 million (approximate) of “auction rate certificates of participation” in January 2007 to pay for its physical education center and a new computer system in the combined amount of $14.0 million.
- Auction rate securities have variable interest rates and require periodic “remarketing” to investors.
- During the financial crisis of 2008-09, the market for auction rate securities ceased functioning.
- The 2007 issue was subsequently re-financed as a fixed rate issue, and additional borrowing was done for the College’s Fine & Performing Arts Center for $9.8 million, raising the total indebtedness.

Other Important Features of Both Borrowings

- Each of the two borrowings (the 2007 auction rate & the 2008 refinancing) also included “funded interest” (sometimes called “capitalized interest”) and transaction costs.
- Funded interest is a device used to borrow the money required to “carry” a loan until regular, programmatic payments are made, somewhat like deferring payments on a mortgage for several years after “move-in.”
- The combined funded interest on the two loans was about $8.0 million; it was exhausted by the end of 2012.
- Payments on this refinanced loan (the 2008 issue) began in January 2013 at $2.35 million annually.

A Major Hurdle: The Prior Borrowing Lacks a Reserve Fund

- When public agencies borrow money, almost all of the time they establish a “reserve fund” from the proceeds of the borrowing.
- A reserve fund is a sum of money—usually about one year’s debt service—that is added to the borrowed funds and then used as a form of additional security for the holders of the bonds.
- In the final year of the bond issue, this reserve fund is withdrawn and used to pay the final year’s debt service.
- CHALLENGE: The College’s 2008 issue did NOT establish a reserve fund; today, this is a “non-starter” in the market.
- Accordingly, any borrowing today must ADD an amount needed to fund up a reserve fund—exacerbating the economics of the refinancing transaction. THIS ADDS ABOUT $2.7 million to the principal sum to be borrowed. (More on the effect of this later)

Can the 2008 COPs Be Refinanced to Save Money?

- Not right now.
- Why; aren't rates lower now than they were in 2008?

  Yes, they are. But there are some complicating issues embedded in the 2008 COPs:

  1. The 2008 COPs may not be "called" (*read: paid off*) until January 2016;
  2. Because the 2008 COPs may not be paid off until 2016, selling bonds today requires that (a) new bonds be issued—at a cost of about 5%, and the proceeds of that issue be invested in interest bearing securities until 2016, at which point, the "old" bonds may be redeemed;
  3. The interest bearing investments available today earn less than 0.50% —creating what is called "negative arbitrage"—that is, the borrowed money is costing interest at a higher rate than the earnings.
  4. Any borrowing done today must also be large enough to create a new reserve fund.

The “Cost” of the Negative Arbitrage

- Is significant—close to $2.5 million.
- That requires that the College borrow even more than it already owes—and then pay off the larger amount over the same period.
- Result: *lower interest* costs, but *higher payments*.
- We measure these differentials in payment using “present value.”
- Present value is a measurement that financial people use to determine if a particular course of action produces better economic results over time.
- Remember that reserve fund? That adds to the problem; it accounts for the lion’s share of the negative arbitrage because the College must pay interest on the increased borrowing, but the earnings on the reserve fund between now and the last year of the borrowing are less than its cost.

The Present Value "Cost" of Refinancing Today

- Refinancing would require about $335,000 per year more in annual payments—because of the "negative arbitrage."
- Then, we must add transaction costs to the negative arbitrage and compare the annual payments going forward.
- Bottom line: refinancing today would cost about $3.8 million, *in present value terms*.
- This is AFTER funding a reserve fund in the amount of about $2.6 million.

What About Refinancing in 2016?

- Refinancing in 2016 eliminates (or reduces to a small amount) the "negative arbitrage." But, it still doesn't address the "missing" reserve fund.
- It also exposes the College to the risk that:
  - Rates may rise between now and then;
  - Any annual savings in debt service must be spread over a smaller number of years (assuming that there is no desire to extend the final maturity of the certificates), thus requiring a larger reduction in interest rates to accomplish the same outcome.
- Assuming that today's rates are still available in 2016, waiting doesn't help very much—in fact, it ends up "costing" about $250,000 per year in increased payments—a present value "cost" of about $1.7 million. A lot of that comes from the reserve fund, which doesn't earn the same rate as the bonds "cost."
- However, if ***short-term*** investment rates rise, then the picture could change—perhaps to a considerable degree.

What to Do?

- In December 2012, we concurred with the interim president's' recommendations presented to the Board in the "Debt Mitigation Plan & Road Map":
  1. Continue "earmarking" $855,000 per year from the General Fund, beginning in FY 15-16;
  2. Apply savings from SERP (estimated at $760,000 per year) beginning in 2016, after recognizing costs of the SERP plan in the interim;
  3. Continue drawing down reserves presently held in the State Treasurer's LAIF (local agency investment fund) until a threshold, minimum level is reached (last year's estimate was that these funds might be exhausted by 2025).
  4. Begin thinking <u>now</u> about how to handle the remaining shortfall in annual requirements, presently estimated to be between $100,000 and $350,000 per year, beginning in 2018.
  5. Be aware of improvements in short-term investment rates that would make the funding of the reserve fund more practical.

Recommendation:

- Continue “watchful waiting.”
- Monitor interest rate environment semi-annually (that’s a change from last year).
- When investment rates begin to rise again (and they surely will), consider stepping up frequency of review to quarterly—since negative arbitrage is the major “stumbling block,” and that can change rapidly, a more frequent review is called for.
- Confirm the feasibility of drawing down LAIF reserves and applying SERP savings to debt service.

Questions and Discussion