

## THE NEXT BIG THING

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By now, everybody in the muni bond market has been inundated with talk of BABs, Build America Bonds, the “corporate-municipal” hybrid spawned by the stimulus package—the American Recovery and Reinvestment Act (ARRA). Like the Vince Gill song goes: “Everybody’s ready for the next big thing”, so, here it is—BABs are the next big thing. The federal payment of 35% of the interest on a direct payment BAB is a strong lure. For some issuers, in some situations, BABs are the right choice, in the same way that variable rate debt and interest rate swaps were the right choice for some issuers.

So, why did the ARRA provide for BABs in the first place? The point of BABs is to broaden the market for municipal bonds to include taxable bond buyers. A complementary intent is to remove supply from the tax-exempt bond market and, in theory, reduce tax-exempt interest rates. As to the first point, the reception for the first few BABs indicates success - new buyers are buying municipal debt as a alternative to corporate bonds. When the resulting net interest cost on debt is calculated, initial BAB issuers announced savings over a more traditional municipal bond structure ranging from about 35 to almost 70 basis points per year. Note: as we discuss below, the specific savings depend on how you value the loss of the call provision.

The rally in tax-exempt markets in the weeks immediately following the initial BABs issues provides anecdotal evidence that BABs are having the desired effect on the tax-exempt market as well. From the beginning of April to mid May, tax-exempt rates decreased between 10 and 25 basis points, with the largest decreases experienced for the longest maturities of highly rated issuers. This is precisely where the BABs are drawing supply from the tax-exempt market.

BABs are a hybrid—a taxable bond, reflecting the ways of the taxable bond market, grafted into the tax-exempt municipal bond market. The traditional structures vary significantly between the two. Taxable debt often is highly rated (AA/Aa and above) in very large blocks (\$250 million and up). It is generally structured as “bullet” maturities, all principal is due at final maturity with mandatory sinking fund redemptions providing the amortization. The standard redemption provision is a “make whole” provision based on a spread from the price of US Treasury Securities. The premium makes the issue effectively non-callable. Moreover, the taxable bond market acted like the IPO market, initial buyers of BABs realized significant gains when the interest rates in the secondary market decreased markedly (think 20 basis points) from the initial offering rates. That type of gain is not tolerable in the tax-exempt market, with issuers and advisers believing that the primary offering rates should reflect a long term rate.

Are BABs the right structure for your issue? First, recognize that the structure of BABs is evolving rapidly. The BAB market is moving to mirror the features of the traditional market for municipal bonds. Some market structures for BABs are now including smaller issues, serial bonds and 10 year par calls. In this period of change it appears that each of these differences from the traditional taxable structure brings with it some increase in the overall interest rate. Most recently, some competitively sold BAB issues had features sufficiently identical to tax-exempt deals that the receipt of bids provides taxable and tax-exempt pricing options. The issuer receives either type of offer and selects the lowest true interest cost, after considering the direct payment from the US. The effect is to create an “apples to apples” comparison as much as possible.

If your project is small or the rating is low, BABs may not be the best alternative. If you wish to retain the flexibility for future refinancing, the make whole call should be replaced with a more traditional municipal call structure. For smaller issues you may prefer structuring with serialization of bonds and ascending rates for longer maturities. Also, due to the higher gross interest cost, special provisions and definitions would be required to make BABs suitable for revenue bond programs having debt service coverage requirements and additional bond tests. Any costs of the financing that are influenced by the overall debt service level, like capitalized interest and reserve fund deposits, will be higher for BABs. Underwriting compensation is also higher in the taxable market. In the pricing of BABs you need to be aggressive in the primary pricing to realize the interest rates prevailing in the secondary market and avoid the gain to the initial purchasers.

Collecting the payments from the US Government present an additional set of considerations. First, your staff needs to be able to absorb the required application and auditing functions related to the direct payment. Second, the ARRA passed on a virtual party line vote. While reassurances from Congressional sources, a change in power in Washington seems like a potential risk to the 30 year string of subsidy payments.

In the final analysis, BABs seem to have reinvigorated the market for municipal debt. Rates overall have decreased for new issues, taxable and tax-exempt alike. For issuers that take the time to understand the implications, BABs may result in significant cost savings. Remember they are evolving rapidly and the problems arising today may be resolved in the weeks and months to come. Depending on your circumstances, the “next big thing” may deserve serious consideration. ♦

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