



42ND ANNUAL AGLF CONFERENCE

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The Basics of Municipal Leasing

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How do State & Local Governments Traditionally Raise Capital?

1. **Dedicated Capital Outlay Funds**

- Cash from Fees or User Charges
- Cash from Property Taxes or other Tax Revenues

2. **Borrow Money (Bonds, Notes, & Other Obligations)**

- General Obligation
 1. Pledge of Full Faith and Credit
 2. Secured by Property Taxes (“Ad Valorem”)
- Revenue Backed Obligation
 1. Water & Sewer
 2. Sales Tax
 3. Project-Specific Revenues

Ability of State & Local Governments to Issue Debt may be Limited

- **What is Debt?**

- Unconditional Obligation (no Set-Off Rights)
- Multi-Year (Binding upon Future Governing Bodies and Budgets)
- Potential Tax Impact (Rate Increase may be Required)

- **Debt Issuance may be Limited**

- By State Constitution
- By Statute

- **Examples of Limitations**

- Term Restrictions (ex. 10 years maximum for school bus)
- Maximum Rate Caps (ex. \$1.50 per \$100 of Taxable Assessed Valuation)
- Maximum Debt Caps (ex. 10% of Taxable Assessed Valuation)
- Voter Approval may be Required

The Other Alternative!!!: Municipal Lease-Purchase

A hybrid structure with features similar to a Loan and a Lease.

- **Like a Loan** – Lessee owns the asset subject to Lessor’s security interest, and has lien-free ownership at end of term after making all payments.
 - No FMV end-of-term purchase option; and
 - Capital lease treatment under GAAP accounting.

- **Like a Lease** – Lease payments are subject to annual renewal, and the Lease may be terminated at the option of the Lessee.
 - Not a “Debt” from a constitutional perspective.
 - Why: **Annual Appropriations Clause at Lessee’s Option**
 - Not an absolute obligation – can be terminated;
 - Not a multi-year obligation – can be terminated;
 - Lessee has “Unfettered Right” to Non-Appropriate.

What is a Municipal Lease?

A Lease/Purchase Agreement, pursuant to which:

- A state or local government as the Lessee (*a/k/a* the “borrower”)
 - 1) purchases specific Capital Assets (real or personal property) from the Lessor (*a/k/a* the “lender”);
 - 2) is the titled owner of the property (subject to the Lessor’s security interest), and maintains & insures the property;
 - 3) makes periodic rental payments over an agreed-upon term;
 - 4) has rental payments that are subject to annual appropriation (or abatement in CA and IN);
 - 5) receives lien-free ownership at end of term after making all rental payments (i.e. conditional sale or installment sale financing);
- The interest portion of the rental payments may be Tax-Exempt. Section 103 of IRS Code requires Lessee to have one or more of the following powers:
Taxing Authority, Police Powers, and/or Eminent Domain.

What a Municipal Lease is Not

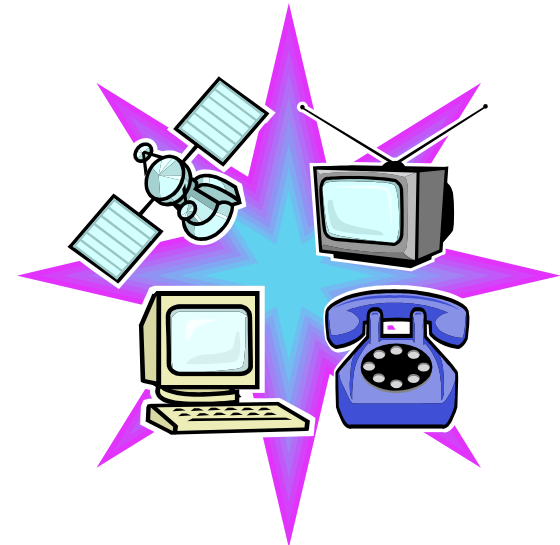
A Lease/Purchase Agreement is NOT:

- A “Tax Lease” or “Operating Lease”, where
 - 1) the non-cancelable lease term is less than 75% of asset’s useful life;
 - 2) the present value of lease payments is less than 90% of asset’s fair market value;
 - 3) the Lessee does not have a bargain purchase price at end of term, and must instead pay fair market value to purchase; or
 - 4) the Lessor may take depreciation benefits and book a residual value in connection with the asset financed.

What Can Be Leased-Purchased?

Personal Property Examples

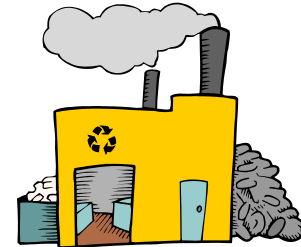
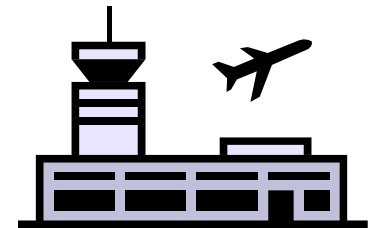
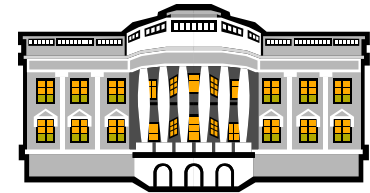
- Vehicles,
 - Fire Trucks, Police Cars, Ambulances, Refuse Trucks, Street Sweepers & School Buses
- Telecommunications Equipment
- Computers & Software
- Copiers & Other Office Equipment
- Safety Equipment (911 Systems)
- Energy Equipment
 - HVAC, Lighting, Building Controls & Solar Panels
- Medical Equipment
- Modular Buildings
- Substitute Collateral



What Can Be Leased-Purchased?

Real Property Examples

- School Facilities
- Courthouses
- City Halls
- Fire Houses
- Hospitals
- Nursing Homes
- Correctional Facilities
- Public Utility Facilities
- Libraries
- Airport Facilities
- Recreational Facilities
- Manufacturing Facilities
- Substitute Collateral
 - Example: Completed Facility instead of To-Be-Built Facility



Who are Eligible Lessees?

Direct Issuers: (Approx. 100,000 Nationally)

- States & State Agencies
- Local Governments & Other Political Subdivisions
 - Such as:
 - Cities & Counties
 - Public School Districts
 - Public Utility Districts
 - Fire Protection Districts
 - Ambulance Districts
 - Public Housing Authorities
- Native American Tribal Governments (Sovereign)
 - Note:
 - Government Projects Only
 - Not for Enterprises/Casinos

Entities Requiring On-Behalf of Issuer for Tax-Exempt Issuance:

- 501(c)(3) Organizations
 - Private Entities (not Public)
 - Such as:
 - Charitable Organizations
 - Religious Organizations
 - Non-Profit Colleges
 - Non-Profit Hospitals
 - Private Schools
- Certain Private Activity Projects
 - Such as:
 - Economic Development
 - Manufacturing Facilities
 - Other Exempt Facilities

Who are Eligible Lessors?

(Almost Anyone!)

- Brokers/Packagers
- Vendors
- Investment Bankers
- Banks, as lenders
- Banks & Trust Companies, as trustees
- Captive Finance Companies
- Independent Finance Companies
- Other Governmental Entities
- Non-Profit Corporations
- Investment Funds

Active Secondary Market

A Lease/Purchase Agreement may be Assigned by Lessor:

- Assignment Agreement
 - Typically a Sale in Whole
 - Lessor's Right, Title and Interest in Lease, Collateral & Rental Payments
- Assignment Economics
 - Present Value of Remaining Rental Payments
 - Purchase at Par (Remaining Principal) or Premium (Principal plus Fee)
- Servicing Considerations
 - Initial Lessor to Continue Servicing on Behalf of New Lessor?
 - New Lessor named on UCC-1's, Recordings, and Insurance Certificates?
- Recourse Considerations
 - For Credit Defaults or Non-Appropriations?
 - For Purchase Premium in Excess of Lease Payoff Amount?
- Notice of Assignment
 - Notice to Lessee or Trustee (recordkeeping of Tax-Exempt holder)
 - Lessee Notice or Consent may be Required to Effectuate Assignment

Why Use Lease-Purchase Financing?

- Conserves cash by alleviating liquidity-drain caused by a lump-sum capital expenditure.
 - Lessee can instead spread payments over asset's useful life.
 - Not classified as "Debt", therefore typically:
 - No voter approval required; and
 - Not subject to legal Debt limitations.
 - Typically, no encumbrance of tax or other revenues, therefore:
 - Revenues available to secure future bonded Debt; and
 - Enhances borrowing flexibility.
- More structuring flexibility than with a bond.
 - Can match separate lease terms with each asset's expected useful life.
 - Collateral provisions.
 - Prepayment provisions.
 - Benefits to Lessee of a lease versus a public bond offering:
 - Lower transaction costs;
 - Faster closing timeline;
 - Less complicated docs;
 - Rate lock re: Lease;
 - No ratings or bond insurance;
 - No official statement; and
 - No continuing disclosure.

Why Are Municipal Leases Attractive to Investors?

- Yield Considerations

3.75% (Municipal Lease Coupon Rate)

÷ .79 (One Minus 21% Corporate Tax Rate)

4.75% Taxable Equivalent Yield

- Credit Considerations

- Governments face less competition;
- Governments may have better credit profiles; and
- Governments may have better risk ratings.

- Adequate Yield given Reduced Risk Profile

Typical Structures for Municipal Leases

- Lease-Purchase Agreement
 - Secured by Equipment, Vehicles or Real Property
 - Subject to Annual Appropriations
 - Subject to Abatement re: Lack of Beneficial Use (CA & IN)
 - Master Lease with Schedules, or Single Lease
 - Terms 1-20 Years, typically
- Installment Payment Agreement
- Lease Revenue Bond
 - Secured by Rental Payments subject to Annual Appropriation
- Certificates of Participation (“COPs”)
- 501(c)(3) Conduit Financings & Industrial Revenue Bonds
 - Lease/Sub-Lease or Loan/Sub-Loan
 - Conduit is Non-Recourse; Borrower is Full-Recourse

Common Municipal Leasing Terms

- Bank Qualified:** The Lessee expects to issue \$10 Million or less in tax-exempt obligations during the calendar year. The Lessee designates the Lease as a “qualified tax-exempt obligation.”
- Non-Bank Qualified:** The Lessee does not designate the lease as Bank Qualified because the Lessee expects to issue more than \$10 Million in calendar year.
- Private Activity:** Over 10% of the financed facility or equipment will be used by a private entity and/or for private activities.
- Non-Substitution:** The Lessee is prohibited from replacing the collateral with similar assets for a period of time following a non-appropriation.
Courts have determined that a Non-Substitution clause may cause the Lease to be INVALID because the Lessee is COMPELLED to make the Rental Payment.
- Reimbursement Resolution:** Allows reimbursement of prior cash outlays from tax-exempt bond or lease proceeds, for expenditures made up to 60 days prior to the resolution, but not later than 3 years after the expenditure.

Common Municipal Leasing Terms (Continued)

Essentiality:	A relative term that describes how important the asset is to the Lessee's operations or services, with a higher degree of essentiality deemed to potentially reduce the risk of non-appropriation.
Appropriation:	An official act by a Lessee to approve (by budget) an expenditure of funds (including Lease rental payments) during a fiscal year.
Non-Appropriation:	The Lessee fails to appropriate sufficient funds to make the rental payments due under the Lease, and elects to terminate the Lease.
Current Expense:	Lease rental payments are a "current expense" of the Lessee because the rental payments, absent continued appropriations, are a "current" year obligation only, and are an operating "expense", not a Debt.
Purchase Price:	The prepayment amount required for the Lessee to payoff the Lease in advance of its maturity date, typically expressed as principal outstanding plus a premium (if any).
Firm-Term Lease:	A Lease that is <u>not</u> subject to annual appropriation.
Abatement:	Ability of Lessee to discontinue making rental payments during a period in which Lessee does not have beneficial use of asset financed.

Municipal Leasing Credit Considerations

1) Essential Purpose

- A. Essentiality of the Service Provided (i.e. Fire Protection)
- B. Essentiality of the Collateral (i.e. Fire Truck) to the Service Provided
- C. Lessee Difficulty re: Foregoing or Replacing the Service or Collateral

2) Financial Capacity

A. General Analysis

- Assessed Valuation & Tax Revenue
- Demographic Trends (Population, Employment, Wealth, etc.)
- Available Funds or Liquidity (Lessee's General Fund)

B. Revenue Specific

- Sources & Stability of Revenue Pledged
 - Taxes (Property, Sales, Hotel, Income, etc.)
 - Utility (Water, Gas, Electric, Telecom)
- Voter-Approved, Sunset Expiry or Evergreen, Rate-Set Covenant?
- Historical and Pro-Forma Debt Service Coverage

3) Debt & Pension Load

A. Debt Obligations, Covenants & Capacity

B. Funding Status of Pension Obligations & Annual Pension Costs

Municipal Leasing Credit Considerations (Cont.)

Detroit General Obligation Bonds in Bankruptcy

- Secured or Unsecured Pledge of Tax Revenue?
- Treatment versus Unsecured Pensioners

Puerto Rico Special Revenue Bonds in Bankruptcy

- Pledged Revenues Stayed from Bond Payments?

Illinois Pension Funding Intercept

- Mandatory Intercept of Local Govt. Revenues prior to Debt Service Payments

City of Albany (GA) Non-Appropriation

- Non-Appropriation due to Equipment Failure, not Financial Distress
- Rating Agency Actions

Abatement Lease Issues/Concerns

- Rental Interruption Insurance for Rental Payments during Abatement Period
- Construction Risk, Earthquake Risk, and Base Lease (Ground Lease) Term

Platte County (MO) Backstop Appropriation

- Private Project (Zona Rosa Shopping Mall) – Not an Essential Government Service
- County (Aa2 Rated) Backstop Appropriation if Project Default
- Backstop Reliance if Non-Essential Project?

Municipal Leasing Documentation Considerations

STANDARD EQUIPMENT OR VEHICLE LEASE-PURCHASE DOCUMENTS:

- Resolution or Ordinance (Dillon's Rule)
 - Authorizing Asset Purchase and Lease-Purchase Financing
- Municipal or General Certificate
 - Incumbency Certificate
- Lease-Purchase Agreement
 - Equipment Schedule
 - Rental Payment Schedule (including Interest column)
- Escrow Agreement (if construction/implementation is required)
- Delivery & Acceptance Certificate
- Attorney's Opinion (Legal, Valid, Binding & Enforceable)
- IRS 8038-G Form
 - Lessee's Legal Name, Address and Taxpayer ID Number
 - Issue Amount, Yield and Weighted-Average Maturity
- Proof of Insurance (Property and Liability) or Self-Insurance
- UCC-1 Financing Statement

Municipal Leasing Documentation Considerations (Cont.)

OTHER POTENTIAL DOCUMENTS:

- Bank Qualified Certificate
- Essentiality Certificate
- Project Bonding for Contractor Work
- Tax Certificate & Tax Opinion
 - Matter of Lessor Preference or Policy
 - Decision often based on Lease Size or Complexity
- Real Property or Leasehold Interest
 - Survey
 - Environmental
 - Flood Insurance
 - Appraisal
 - Title Report
 - Recording
- Statutory Limitations (Late Payment Fees, Default Rates, Liability Caps)
- Assignment Agreement and Notice of Assignment

Rationale for Private Placements

Lease-Purchase Agreements are Private Placements

- Treatment as Direct Bank Loan, not a Municipal Security

Rationale for Bonds to be deemed as Private Placements:

- Name (i.e. "Bond") is not Dispositive
- No Official Statement
- Physical Bond versus DTC Registered
- No CUSIP Number
- No Bond Rating
- No Bond Insurance
- No Small Denominations
- Representation re: Bank Loan vs. Security Treatment

Implications or Requirements:

- Purchase / Representation Letter often Required
- No Mark-to-Market Requirement for Bank Loans

The Regulatory Environment

Heightened Regulation of Municipal Securities Market

- Some changes have been beneficial for Municipal Leasing
 - Pension disclosure rules
 - Rules for Advisors, Underwriters, and Broker-Dealers re: bonds
 - SEC enforcement actions re: bad disclosures.
- Some changes have caused concern for Municipal Leasing
 - Introduction of “Municipal Advisor” role
 - Broad definition of “Advice”
 - Potential blurring of lines - Municipal Lease vs. Municipal Security
 - Potential for CUSIPs for Municipal Leases & Private Placements
 - Potential for SEC Rule 15c2-12 Disclosures re: Municipal Leases
 - Potential for ESG Disclosure & Evaluation

CAUTION: Seek counsel’s advice about your role in the process when working with governments and their municipal advisors, to avoid any painful consequences.

Tax Reform of 2017

No Longer a Level Playing Field:

- **Prior to Tax Reform:**
 - 35% Corporate Tax Rate
 - 35% or 39.6% Individual Tax Rate (top 2 brackets)

- **After Tax Reform:**
 - 21% Corporate Tax Rate
 - 35% or 37% Individual Tax Rate (top 2 brackets)

- **Pricing Advantage for Public Bond Offerings**
 - 70% of T/E Bonds held by Individuals;
 - Given an identical Tax-Exempt Rate:
 - **Higher Taxable Equivalent Yield for Individual**
 - **Lower Taxable Equivalent Yield for Corporation**

- **Result:** Pressure on Bank Lending Spreads in order to remain Price Competitive with Public Bond Yields.

The Process

- Pre-Screen the Transaction
- Structure & Price the Transaction
- Propose & Sign Up the Deal (Get the Award)
- Submit the Deal Internally for Due Diligence
- Credit Approval
- Documentation Approval
- Funding (i.e. Closing)
- Annual Customer Reviews
- Portfolio Surveillance

Thank You And Good Luck!!