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The Basics of Municipal Leasing

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How do State & Local Governments Traditionally Raise Capital?

1. Cash from Fees or User Charges
2. Cash from Property Taxes or Other Taxes
3. Borrow Money (Bonds, Notes, & Other Obligations)
 - General Obligation
 1. Full Faith and Credit
 2. Secured by Property Taxes (“Ad Valorem”)
 - Revenue Backed
 1. Water & Sewer
 2. Sales Tax
 3. Project-Specific Revenues

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

- What is Debt?
 - 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
 - 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

- Hybrid structure with features similar to both 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;

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 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 is typically tax-exempt.
 - ✓ Section 103 of the IRS code

What a Municipal Lease is Not

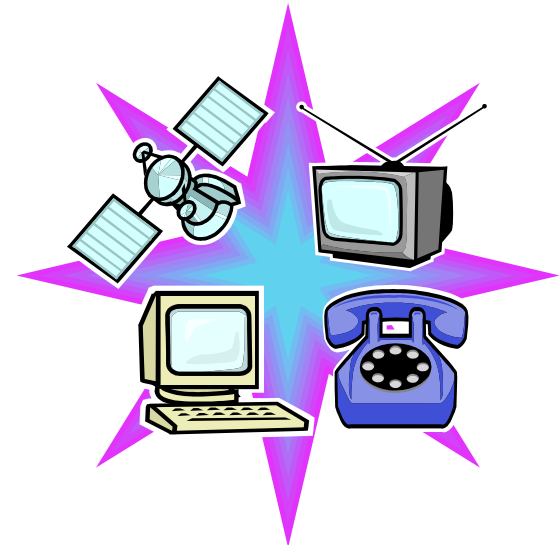
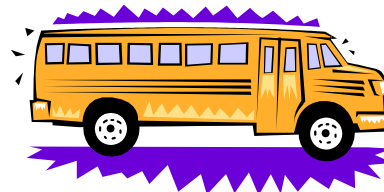
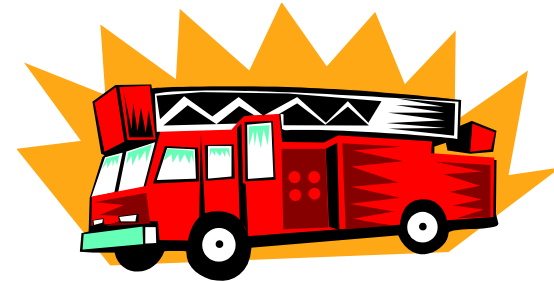
A Lease/Purchase Agreement is NOT:

- 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

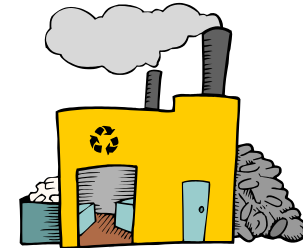
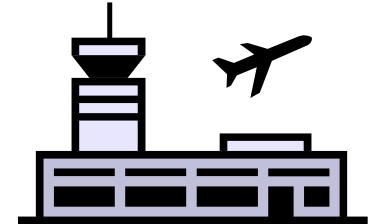
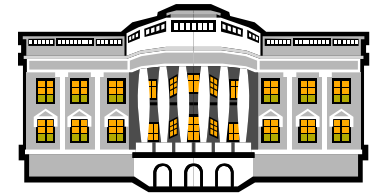
- Vehicles,
 - Fire Trucks, Police Cars, Ambulances, Refuse Trucks, Street Sweepers & School Buses
- Telecommunications Equipment
- Computers & Software
- Copiers & Other Office Equipment
- Safety Equipment (911 Systems)
- Energy Equipment
 - HVAC, Lighting, Building Controls & Solar Panels
- Medical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



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:
 - Governmental Only
 - Not for 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 Other Private Parties
 - Re: Economic Development
 - Such as:
 - Manufacturers
 - Other Exempt Facilities

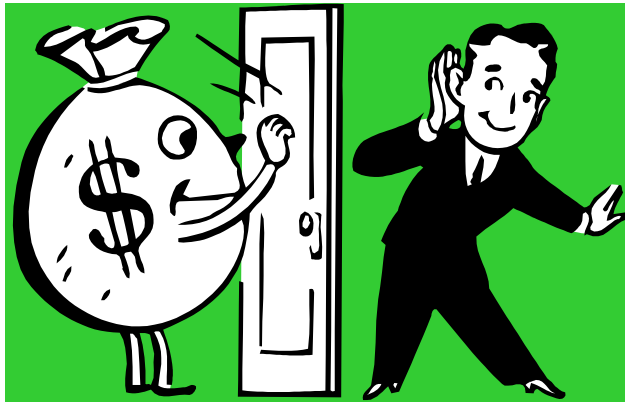
Who are Eligible Lessors?

(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

Who are the Investors?

(Or, Who is Providing the Upfront Proceeds?)



- Banks
- Leasing Companies
- Corporations
- Investment / Mutual Funds
- High-Yield Funds
- Insurance Companies
- Individuals
- Grantor Trusts
(Securitization)
- Investment Bankers

Why Use Lease-Purchase Financing?

- Alleviates 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;
 - 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)

\div .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.

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 concern.
- 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.
- Reimbursement Resolution:** Allows a Lessee to reimburse prior cash outlays from bond or lease proceeds. Reimbursement is valid 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 Collateral to the Service Provided (i.e. Fire Truck)
- B. Essentiality of the Service Provided (i.e. Fire Protection)
- C. Lessee Difficulty re: Foregoing the Collateral or Service

2) Financial Capacity

- A. General Analysis
 - I. Assessed Valuation & Tax Revenue
 - II. Demographic Trends (Population, Employment, Wealth, etc.)
 - III. Available Funds or Liquidity
- B. Revenue Specific
 - I. Sources & Stability of Revenue Pledged
 - 1. Taxes (Property, Sales, Hotel, Income, etc.)
 - 2. Utility (Water, Gas, Electric, Telecom)

3) Debt & Pension Load

- A. Debt Obligations, Covenants & Capacity
- B. Funding Level of Pension Obligations
- C. Potential "Crowding-Out" Effect

Municipal Leasing Documentation Considerations

STANDARD EQUIPMENT OR VEHICLE LEASE-PURCHASE DOCUMENTS:

- Resolution or Ordinance
 - Authorizing Asset Purchase and Lease-Purchase Financing
- Municipal or General Certificate
 - Incumbency Certificate
- Lease-Purchase Agreement
 - Equipment Schedule
 - Rental Payment Schedule (including Purchase Price)
- 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
 - Lessee's Taxpayer ID #
- Proof of Insurance
- UCC-1 Financing Statement

Municipal Leasing Documentation Considerations (Cont.)

OTHER POTENTIAL DOCUMENTS:

- Bank Qualified Certificate
- Essentiality Certificate
- Project Bonding by Contractor
- 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

Municipal Leasing Issues & Trends

Pre-2008 Financial Crisis:

- Cash-rich government entities with large reserves;
- Bond issues easy to pass in good economic times; and
- Few defaults since Great Depression of 1930s.

Since Then:

- Weak economic recovery until recently;
- Depleted, albeit recovering, governmental reserves;
- Several large defaults led to bond market uncertainty;
- Regulations driving bond complexity & expense; and
- Rising pension and OPEB obligations.

The Result – Governmental Demand For:

- Financing of capital assets;
- Financing flexibility; and
- Private Placements, including Municipal Leases!!!

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

Dodd-Frank Changed Everything:

- Heightened SEC Regulation of the Municipal Securities Market
- Some changes have been beneficial for Municipal Leasing
 - Rules for Advisors, Underwriters, and Broker-Dealers regarding bonds;
 - SEC enforcement activities 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
 - SEC Rule 15c2-12 Disclosure requirements.

CAUTION: Seek your counsel’s advice about your role in the process when working with governments and their 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 a 3.50% Tax-Exempt Rate:
 - **Higher Taxable Equivalent Yield for Individual**
 - **Lower Taxable Equivalent Yield for Corporation**
- Result: Tax Rate Discrepancy has caused Banks to accept Lower Lending Spreads in order to remain Price Competitive with Public Market 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!!