

MEMORANDUM

TO: Board of Directors
Massachusetts School Building Authority

FROM: John K. McCarthy, Executive Director and Maureen Valente, Chief Executive Officer

DATE: September 23, 2015

RE: Refunding Authorization

To date, the Massachusetts School Building Authority (“MSBA”) has issued \$6.7 billion of “new money” bonds to support the MSBA’s grant programs. Additionally, the MSBA has issued approximately \$1.76 billion of refunding bonds in order to reduce interest costs associated with previously issued bonds.¹ As of September 1, 2015, the MSBA had \$5.7 billion bonds outstanding.

Staff continuously monitors potential savings from executing a refunding. The ongoing occurrence of low interest rates indicates the Authority may be able again to realize significant debt service savings through the issuance of refunding bonds on some of the Authority’s outstanding callable debt.

At this time, the 2007 Series A bond issue has the most potential for significant refunding savings. The 2007 issue had an original par of \$1.5 billion and a call date of August 2017. \$1.3 billion of callable bonds are still outstanding. Most of the bonds under consideration to refund carry 5% coupons with no coupons under 4.35%.

At this time, staff recommends that the Authority prepare for the execution of a refunding. Staff recommends an authorization to issue an aggregate principal amount up to \$1.2 billion of refunding bonds in one or more series of refunding debt issuances. Staff recommends that a refunding go forward only if the net present value of a refunding is 6.0% or greater than the amount of the refunding bonds.

The Authority recently requested that members of the Authority’s pool of twelve qualified senior underwriters provide specific information and analysis associated with a refunding of the Authority’s debt at this time. The underwriters have commented that the savings on the 2007 Series A bonds from a refunding in the current interest rate environment are greater today than they would have been in previous years. The underwriters have also provided estimated ranges for the increase in interest rates that would need to occur in order to decrease the amount of savings from executing a refunding in the current interest rate environment.

Additionally, the Authority has received a request from a holder of over \$320 million of bonds of the \$1.5 billion 2007 Series A issue.² The investor would like to extend the call date from 2017 to

¹ The first refunding was in 2012 with a par amount of \$766,140,000. The second refunding was also in 2012 with a par amount of \$916,350,000. The third refunding was in 2015 for \$76,315,000.

² The investor owns \$250,965,000 of a \$508,005,000 term bond maturing in 2037 and \$70,000,000 of a \$314,240,000 maturing in 2032. It is rare that one investor has such a significant share of a large term bond.

2025. A refunding with a tender component is being proposed by one of the Authority's underwriters and the investor owning the bonds.

A conventional advance refunding consists of the issuance of a new bond issue with the proceeds placed in escrow to pay the debt service until the call date of the bonds being refunded. In the current interest rate environment escrows yields are lower than the interest rate on the new bond issue. This negative arbitrage has the effect of significantly lowering the net refunding savings.

A tender refunding does not require the creation of an escrow. Rather the holders of the bonds being refunded are given the option to tender those securities³ and receive new (but fewer) bonds with the same final maturity and a ten year call. Because there is no escrow with its inherent cost, a tender refunding can produce greater savings than a conventional advance refunding. This means lower debt service and an improved coverage ratio on our debt when compared to a conventional refunding.

There are two additional benefits of a tender refunding over a conventional refunding. A tender refunding is considered a current refunding, not an advance refunding. This means the MSBA will be able to do an advance refunding on these bonds at a later date and may achieve further debt service savings at that time. A second benefit is that the refunded bonds are retired and no longer available in the bond marketplace. This means that fewer MSBA bonds are in existence and either the scarcity is greater or the over saturation is less.

Staff is also analyzing doing a portion of the refunding on a subordinate lien basis. This would be done to improve the MSBA senior coverage ratio. Calculated as required in our trust agreement, the MSBA's current senior coverage ratio is 2.16. However, each of the rating agencies uses a somewhat different methodology to calculate coverage. Those methodologies result in lower ratios and at less than two times coverage. By issuing refunding debt on a subordinate lien basis the rating agencies may calculate our senior coverage ratio at over two times coverage. Being greater than two times coverage is important in maintaining our current ratings. The downside of a subordinate lien is a higher interest cost of about 5-10 basis points required to issue the debt and a somewhat lower savings from the refunding. The above estimate of a higher interest cost going subordinate assumes the subordinate refunding bonds would be rated only one notch below senior lien debt. Staff plans to request an unpublished rating from one rating agency to confirm that the rating would still be in the double A category. However, should the unpublished rating indicate a single A category rating, the refunding will be done on a senior lien basis.

Staff intends to engage First Southwest to act as an independent financial advisor to the MSBA on the refunding transaction. First Southwest was one of the firms selected, through a procurement process in 2014, to assist the MSBA with debt management financial advisory services. Staff may also ask Public Resources Advisory Group (PRAG) to review the specifics of the tender refunding and pricing methodology. PRAG also was selected in the 2014 procurement.

Bond Counsel for these transactions will be Mintz, Levin, Cohn, Ferris, Glovsky, and Popeo, P.C. Disclosure counsel will be Greenberg Traurig, LLP. Each of these firms was qualified pursuant to a procurement process conducted for bond and disclosure counsels services in February 2013, and have served in these roles for the MSBA since that time.

³ The tender offer would be made to all investors holding the maturities in the two term bonds, not just the investor who has approached the Authority.

As mentioned above staff issued a Request for Information, and has received responses from the pre-qualified pool of senior underwriters. If the Board votes to give the refunding authorization, the underwriters are expected to be chosen in October.

One of the most challenging aspects of executing a refunding is the determination of the timing of the transaction. Whereas the timing of a “new money” issuance is determined by the need to raise funds to assist with cash flow to support specific capital projects, the determination of the timing of a refunding issue is not directly linked to the need for cash flow to support the underlying capital projects. The opportune time to execute a refunding is more difficult to determine, as the issuer is executing the transaction in order to realize savings on the debt service associated with the original issuance of bonds being refunded rather than being driven to issue by the need to raise funds to continue to support capital projects.