



By Michael Sudsina

Seek Maximum Flexibility with Your Next Bond Issue

Call Features and Why They Matter More with Tax Reform

Hopefully you are all now up to speed on the fact the "Tax Cut and Jobs Act" put the big whammy on school districts' ability to advance refund bond issues to afford taxpayers debt service savings (if not, see the article on page 48 of this magazine). The long and short of it is that all you are left with is a current refunding that can only be executed within 90 days of the call date.

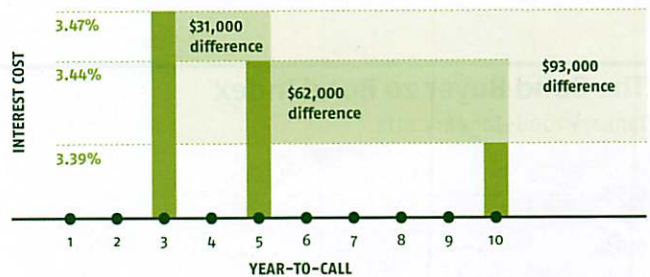
So, what can you do to ensure reasonable flexibility to refund your next bond issue now that the federal government has eliminated your one chance to advance refund before the call date? How about a shorter call date?

For decades the convention with municipal bonds has been to make issues non-callable for the first 10 years. That was not all bad when we were able to have at least one shot at an advance refunding. Now that the government has taken that away, one solution is to shorten the first call date from the traditional 10 years to something less. Fortunately we have recently seen many Ohio school bond issues being marketed with shorter calls; eight-years, five-years and in some cases even three-years. Unfortunately, at times, there is an additional cost associated with a shorter call in the form of higher interest rates. Fortunately we haven't seen any sort of penalty with eight-year calls, but once you get shorter than eight you run the risk. That said, you will want to ask your financing team about the viability of a shorter call and what the impact might be on your overall financing costs.

One common argument against a shorter call is that the yield-to-maturity increases, even if the reoffering yield (yield-to-call) remains the same, commonly called the yield "kick." Investors interpret this as

beneficial because they are betting that you will never refund the bonds, therefore, they will achieve the higher yield-to-maturity by holding the investment until the final maturity. By setting a shorter call date, you hold the opposite position, assuming interest rates will favor a refunding within the call period. Is this a reasonable assumption? The answer is a resounding "yes" when you realize that nearly all the Ohio school bond issues that could be refunded have been. In fact, most taxpayers would agree it is the district's responsibility to refund bonds that would generate savings. At the same time, with every refunding, positive financial news can be distributed to the community which is always good for the administration. Of course we have enjoyed historically low interest rates for the past eight years or so, but even in different interest rate environments, you will want to provide yourself call flexibility in the new year without the possibility of advance refundings.

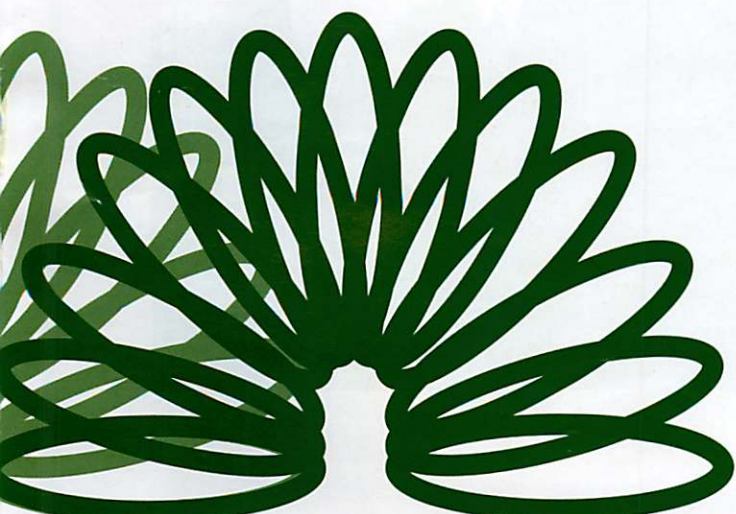
The Cost of a Shorter Call



What is the cost of a shorter call? There are many answers to this question thanks to several variables that can be put into play. For example, let's assume three scenarios for a 37-year, \$10,000,000 bond issue with the exact same coupons and reoffering yields, ranging from 2 percent to 4 percent, structured with a 10-year, five-year or three-year call option. Since the assumption is that the coupons and yields are the same, the debt service over the life of the bonds is exactly the same with each scenario. However, thanks to the yield-to-maturity "kicker" the resulting true interest cost of each is 3.39 percent, 3.44 percent and 3.47 percent respectively and the present value interest cost difference between a five-year call and a three-year call is approximately \$31,000; a 10-year call and the five-year call is approximately \$62,000; and 10 versus three is about \$93,000 due to the differences in yield-to-maturity vs. yield-to-call. So is a shorter call it worth it?

If a three-year call was selected with the original issue and interest rates didn't change over that three-year period, the current refunding would yield an acceptable level of present value savings at 3 percent or nearly \$300,000, since we are now issuing 34 year bonds instead of 37.

Continued on next page.



Not bad for having foregone the \$62,000 original cost versus the five-year call or even the \$93,000 added cost compared to the 10-year call. Naturally, if interest rates rose over the first three years, the issue would probably not make sense right at the three-year mark, but you would have that flexibility over the next two years should rates change enough to favor a refunding over the five-year call and the next seven years versus the 10-year call.

The example above assumes no reoffering yield penalty for the shorter call. Should you request the shorter call analysis from your financing team you might be told that it could be done, but the reoffering yields and/or coupons would have to change, making the cost of the shorter call more egregious. To combat this, another technique to consider is a return to call premiums, which have been absent from the market for a good 10 years now. The way call premiums work is that with our three-year call example the bond documents would include language indicating that the investor would receive a premium, say 102 percent of the value of the called bonds if the three-year call is invoked. Typically that premium would decline over time, usually two years so that if the bonds were called at the four-year mark the premium would decrease to 101 percent and if you wait five years to refund there would be no premium. Adding call premiums to the structure would hopefully ward off increases in coupons or yields with the original bond issue. If rates didn't change over the first three years, your refunding

might not be "in the money" at the three-year mark because you'd have to pay that premium, but at least you should have received lower rates with the original issue and maintain the flexibility to refund sooner should interests change in favor of the refunding.

The previous two examples assume fairly similar interest rate coupon and yield structures, but what if your bankers told you that their traders favor 5 percent coupons for most of the maturities rather than the 2-4 percent coupons in our examples? This is a case where you clearly want to make a case for shorter calls because you definitely don't want to be stuck with 5 percent interest rates for 10 years with no chance to refinance.

We have all heard that the Federal Open Market Committee (FOMC) has been raising interest rates and plans more hikes in the near-term. Economists in general are saying rates are on the rise. That said, should we return to the much higher rates of days gone by much of this refunding talk may be for naught, however, this chart depicting municipal bond rates since 2008 shows that rates rise and fall regularly and frequently. The key with your next bond issue is to structure it with sufficient flexibility to take advantage of low interest rates and return the debt service savings to your taxpayers. ■

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