

SAM - BUDGETING

THE BOND SALE

6880

(New 5/1998)

The bond sale process begins months in advance of the actual sale. Throughout the process, the framework for the sale is developed and the legal interests of the client department, the state, the prospective bondholders, and potential third-party financing entities (such as a vendor or local government entity) are reviewed and safeguarded. The brief discussion that follows assumes that the Legislature has authorized a financing, interim financing needs have been met, and the project is ready for a bond sale. For further information, contact the California Debt and Investment Advisory Commission which offers a course entitled *Mechanics of a Bond Sale*.

When STO is agent for sale: Pursuant to Government Code Section [5700](#), STO is the agent for sale for all state and JPA debt issuances, including those over \$10 million, unless statute specifies otherwise. In this context, *JPA* means any joint powers authority whether or not the state is a member. By policy, STO reserves the right to be agent for sale for any issuance in which ongoing disclosure is required relative to state credit.

Bond sales calendar/timing restrictions: Each spring and fall, STO prepares a sales calendar for the following half of the calendar year. Bond sales usually require a minimum of eight weeks of preparation before pricing is conducted. Closing (which is when funds become available) is typically two to four weeks following pricing. No sales using state General Fund disclosure (appendix A of the Official Statement) are conducted during the “blackout periods”—from January 1 to the issuance of the Governor’s Budget and the time between the May Revise and the enactment of the annual budget bill. In addition, certain holiday periods are avoided when scheduling sales due to slack market interest. Considering these timing factors, requests for a bond sale should be made *at least eight months in advance* of the proposed sale date, and preferably one year in advance.

Although STO routinely contacts client departments to determine sales needs, the responsibility for requesting a sales date lies with the client department (or DGS for projects it manages, and PWB for its projects). STO sets sales dates at its discretion, considering overall program priorities for access to the municipal bond market. See also Section 6860 for instructions on preparing PWB agenda requests bond sale.

Appointment of members to the financing team; kickoff meeting: For negotiated sales, the issuer appoints bond counsel and financial advisors; STO appoints the underwriters. PWB has delegated to STO the appointment of bond counsel and the selection of financial advisors for pricing of bond sales. These parties, the issuer, the client department, STO, DOF and other state agencies (and DGS for projects it manages) convene at a *kickoff meeting* to initiate the sale formally and to establish a *time and responsibilities (T&R) schedule* for the project.

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SAM - BUDGETING

(Continued)

THE BOND SALE

6880 (Cont. 1)

(New 5/1998)

Document review and due diligence: Bond sales involve the preparation of a number of documents. STO, other state agencies, department representatives, DOF and the financing team jointly review bond sales documents throughout a series of meetings, ensuring that the documents are properly drawn and that disclosure requirements are fully met. Brief definitions of key documents are provided in the following text:

1. **Authorizing resolution:** Authorizes the issuance of bonds, the execution of major legal documents, and delegates the authority to close the issue and administer the program. The resolution is executed by the governing body of the issuer (e.g., GO finance committee, PWB or a JPA).
2. **Indenture:** Pledges certain revenues and other property as security for the repayment of the issue, sets forth the terms of the bonds, and contains the responsibilities and duties of the trustee and the rights of the bondholders. (The responsibilities of the trustee are discussed in Section 6882.) The indenture may be in the form of bond and sales resolutions or trust agreement and typically contains the text to be printed on the bond. A supplemental indenture is an indenture that amends or supplements a prior indenture, whether that prior indenture stands by itself, is a general indenture, or a series indenture. The indenture is executed by an issuer and the trustee (who may be the STO). *The client departments administering lease-revenue bond programs should review the indenture carefully because it establishes the disposition of surplus project funds, if any.*
3. **Official statement (including preliminary official statement):** Provides all information that would be “material” to a prospective purchaser of the bonds, including descriptions of the issuer, terms of the bonds, security for the bonds, major legal documents, risk factors and tax matters, and financial statements.

The preliminary official statement is a version used by the issuer or underwriters to inform the marketplace of the terms of the bonds being issued prior to receipt of bids at a competitive sale or prior to the determination of interest rates and purchase price in a negotiated sale. *The official statement is of particular interest to the client departments administering lease-revenue bond programs because it contains departmental disclosure requirements and project descriptions, as well as debt service requirements and the cost of issuance. However, not that because GO bonds are backed by the full faith and credit of the state, disclosure about the client department(s) is not necessary.*

(Continued)

SAM - BUDGETING

(Continued)

THE BOND SALE

6880 (Cont. 2)

(New 5/1998)

4. **Bond purchase agreement/contract:** In a negotiated sale, an agreement between an issuer and an underwriter or group of underwriters, i.e., a syndicate who has agreed to purchase the issue. The agreement sets forth the purchase price, interest rates and other terms of the bonds (often by reference to the official statement), date and time of closing, representations and warranties of the issuer, conditions to underwriters' payment for bonds, and underwriter duties. In a competitive sale, the notice of sale serves the same function, specifying the factors used to determine the winning bid; the notice, the underwriter's bid, and the issuer's acceptance of the bid together constitute a bond purchase agreement.
5. **Continuing disclosure agreement:** Sets procedures for continuing disclosure, the contents of the annual report, and specific events to be disclosed. Parties to the document may include the issuer, trustee, dissemination agent, client department, and bond holders as third-party beneficiaries. See Section 6884 for a more complete discussion of continuing disclosure. *The client department, if an obligated party, should review its disclosure responsibilities carefully. Failure to disclose material events as required under the agreement can result in liability.*
6. **Tax certificate or agreement:** Certifies to the facts and expectations necessary for the tax-exempt treatment of interest on the bonds. Those signing the document include the issuer, and other obligated parties. For GO bonds, the client department signs a department tax certificate.
7. **Reimbursement agreement:** If applicable, provides: the terms of the repayment of credit enhancement (e.g., a letter of credit); the terms of obligation to reimburse, including the maturity and interest rate; the pledge of security for reimbursement obligation; and covenants and security. Parties to the document are the issuer, other obligated parties and the credit enhancement provider.
8. **Revenue source agreements:** The following descriptions are written from the perspective of PWB, but they apply to other lease-purchase financings. *The revenue source agreements require careful review by the client department because they outline departmental obligations to PWB.*
 - a. **Site lease:** The client department leases the site on which the project will be constructed to PWB for the term of the bonds. The rental fee is generally nominal and paid through the financing. PWB agrees to use the site solely for the purpose of constructing the project. It then leases the facility and site back to the department (see following facility lease). The term of the lease is the same as the debt repayment.

(Continued)

SAM - BUDGETING

(Continued)
THE BOND SALE
(New 5/1998)

6880 (Cont. 3)

- b. **Facility lease:** PWB leases the facility, defined as the project and the site, to the client department including, without limitation, the terms and conditions of the site lease. The department covenants to use the facility during the term of the lease solely for public purposes and to take no actions related to the facility that would jeopardize the tax-exempt status of the bonds. The term of the lease is the same as that of the debt related to the project. The rental amount is equal to the annual principal and interest on the bond debt, plus any additional rental amounts ordered by PWB (such as trustee fees, accounting fees, PWB costs, etc.). The lease includes a requirement for the department to maintain replacement insurance for loss, damage, and earthquake (the latter only if available at a reasonable cost), liability insurance, and rental interruption insurance (normally to cover an interruption of up to two years).
 - c. **Equipment lease:** PWB leases the facility equipment acquired with proceeds of either interim financing or the long-term bonds. The department covenants to use the equipment solely for public purposes. The term of the lease is consistent with the debt for the equipment (generally shorter than the facility lease). The rental amount is calculated in a manner similar to that for the facility lease. The lease contains a requirement that the department maintain both the equipment and insurance on it.
 - d. **Construction agreement:** PWB and the client department enter into an agreement wherein PWB finances the facility and the department—acting as PWB’s agent—performs all activities required to plan, construct and equip the facility, in accordance with the applicable provisions of the State Building Construction Act and the Budget Act.
9. **Closing documents:** Documentation of satisfaction of closing conditions, receipts, and legal opinions.

The term **due diligence** means the inquiry made to disclose all facts about the issuer, the client department, the issue, and the security for the issue that would be material to a prudent investor in making a decision to purchase the issue. Due diligence inquiries are made by underwriters, lawyers, and other members of the financing team to determine, for example, whether the issue follows the purpose and scope outlined by the enabling legislation, statutes, and resolutions of the issuer and whether all material facts have been accurately disclosed in the official statement.

In lease-revenue and financing lease transactions, the client department has an obligation to participate in the due diligence process and to disclose all material facts relating to the transaction. (This responsibility may also occur in third-party financings of operating leases; see Section 6876.) In GO bond sales, DOF, STO and the State Controller handle most due diligence tasks; the client department’s responsibility is limited to providing project cash flow needs.

(Continued)

SAM - BUDGETING

(Continued)
THE BOND SALE
(New 5/1998)

6880 (Cont. 4)

Structuring the issuance: The structure of an issue refers to the amount and timing of principal repayments (maturities) and interest payments. GO issuances are typically structured with *level principal repayment* (Section 6871); lease-revenue issuances are structured with *level total payments* (Section 6872). STO normally prepares a schedule which has serial maturities for the first 10 to 15 years, and term maturities subsequent to that. A serial maturity is one which is due every year. A term maturity is usually due from two to ten years beyond the last serial maturity. However, regardless of the structure of the serial and term maturities, departmental payments for debt service are still made every year into a bond sinking fund. The total repayment schedule for GO bonds may extend up to 50 years, although market pressures generally require maturities of half that length. Lease-revenue repayment schedules may extend to 35 years but are also usually only 20 or 25 years in length.

STO solicits information from client departments and PWB (or DOF) to assist in structuring lease-revenue issuances. Client departments provide information on cash flow needs and whether sub-schedules are needed for assets (such as equipment) with shorter effective life-spans than the main facility. PWB (or DOF) provide direction on the overall length of the issue.

Obtaining the bond rating: The state generally sells only investment-grade municipal securities. An investment rating is secured prior to the bond sale from one or more independent third parties, called rating agencies.

1. Generally, an investment rating lowers interest rates by giving investors additional comfort and increasing the universe of buyers.
2. Ratings are based on an analysis of the relative strengths and weaknesses of the various factors potentially affecting the likelihood of debt repayment for the specific obligation. (The ratings applies only to that obligation.)
3. Long-term debt ratings are expressed in symbol form: *Aaa* means the best quality, with extremely strong capacity to pay principal and interest. *Baa* means medium grade quality, with adequate capacity to pay principal and interest (the lowest "investment grade" long-term rating). *Ba* and lower means speculative quality with low capacity to pay principal and interest. Typically, the state receives ratings from three rating agencies: Moody's Investor Services, Standard & Poor's and Fitch Investor Services.

Presentations made to the rating agencies generally involve STO, the issuer, and potentially the client department when a new market credit is being established.

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SAM - BUDGETING

(Continued)

THE BOND SALE

6880 (Cont. 5)

(New 5/1998)

Pricing: GO bonds are sold on a competitive basis; low bid establishes price (i.e., interest rates and other underwriting costs). Lease-revenue bonds are normally sold on a negotiated basis. STO prices the bonds (i.e., negotiates interest rates and any discounts with the market). PWB delegates pricing to STO. STO advises the client department of the final financing costs by maturity and in total.

Bond closing: Moneys are not exchanged in a bond sale—and interest rates are not effective—until the bond sale closes, typically two to four weeks after pricing. The client department (in the case of lease-revenue bonds) and issuer must review and sign all pre-closing documents prior to closing to ensure a smooth conclusion to the sale, and should have a representative at the closing (except for GO sales). Net proceeds are normally transferred by the underwriter to the State Treasury by wire in immediately available funds.