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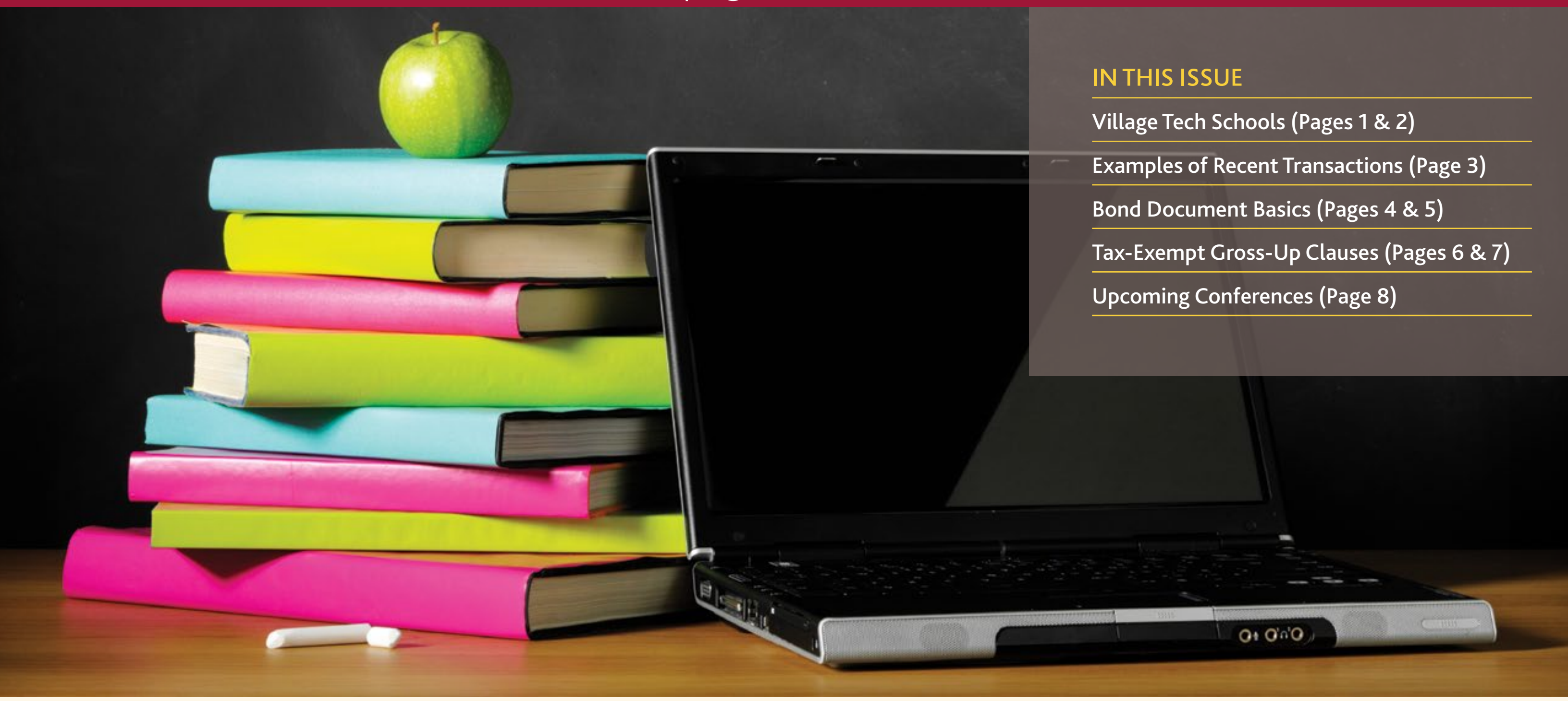
Charter School Finance Newsletter: Keeping Our Clients Ahead of the Curve – Volume 1, 2018



IN THIS ISSUE

Bringing Learning to Life: Village Tech Schools

Give people a strong sense of purpose, a strong sense of ownership and a strong support system, and there is no limit to what they can accomplish.

David Williams knows this. He sees it over and over, day after day, at Village Tech Schools in a suburb of Dallas.

This highly acclaimed Pre-K - 12th grade charter school has just completed its fifth year and in that short time has compiled an impressive list of technical, academic, professional and social-emotional outcomes – including a projected 100% graduation rate.

Williams, a Village Tech founding team member and CEO/ Superintendent, gives credit to a staff that embraces the school's mission with a level of enthusiasm and energy that is contagious.

"At Village Tech, we want to see public education re-imagined and transformed into a system that develops students who are competent, caring and courageous adults. We do this through teachers who are trained in design thinking, creation, leadership, interdisciplinary instruction, collaborative learning and relationship building.

"In short, we work to make learning rich by connecting subjects, skills and students to the world beyond the school."

With 923 students and 91 staff members, Village Tech is able to devote close personal attention to each student, providing opportunities to create products that bring their classroom learning to life.

"A commitment to teamwork is essential," said CFO and HR Director Amber Robinson, who has been a member of the Village

Village Tech encourages students to apply learning to practical, real-life situations. Many projects address community and global needs.

Tech team since the school's first year. "There is a strong sense of community here, extending from our administration to teachers to students. Every teacher and every student has a voice.

"You have to trust people to own the mission, take initiative and make decisions – as well as mistakes – without fear of failure," she emphasized. "The goal is to develop confidence and creativity. You can't micromanage."

Village Tech's recruiting process reflects its commitment to student involvement. New this year was the addition of a "hiring day." Applicants were invited to spend a day at the school, teaching classes and being presented with an article review and discussion around a controversial topic.

Students participated on interview panels. "It was powerful watching the students interact with the applicants, asking insightful questions and expressing our mission and standards of excellence really well," Robinson said. "In their written evaluations, the students demonstrated a high level of perceptiveness, sharing positives as well as things to watch for."

How do students absorb and communicate the school's mission and philosophy? "Through consistency in the language we use and, most important, through teachers who model it and are constantly asking themselves, 'Are you being VT?'"

LEARNING IN ACTION

The goal at Village Tech is not just teaching subject matter, but allowing and encouraging students to apply that learning to practical, real-life situations. Recently, for example, a team of students worked with Habitat for Humanity to focus on the need for effective ways to help first-time homeowners learn basic home maintenance. The team developed a package of training materials and videos with step-by-step instructions.

Another team worked with a local man who has cerebral palsy. They identified a need to redesign the footplate on his wheelchair based on interviews and observation. After several iterations, work on a patent is in progress.

Preschool and elementary students are also actively involved in practical problem-solving. Recently, third graders researched disease epidemics such as West Nile and Zika. They designed, built and painted bat houses to sell to the community as a natural solution to the mosquito problem.

"There has to be room for more innovation in education," Williams said. "It's not my quote but it is my firm conviction: I would rather fail while daring greatly than not to try at all."

CHALLENGES FOR CHARTERS

In an age of increasingly complex compliance, many schools have been reluctant to take risks, he said. "Especially among charter schools, taking risks and falling short can lead to closure. We certainly understand the need for vigilance when it comes to compliance, but we guard against letting that drive us. Our primary focus is on our mission and vision, fulfilling the promise we made to the State of Texas, our parents and our students."

"Like many charter schools, we live with funding challenges, which in our case, translates into $700-$1,000 less per student than an ISD, generally," Robinson said. "We also deal with misconceptions about charter schools and the need to clarify that our school is not exclusive to high-performing students or those with a specific area of interest such as arts or science.

"Our students come to us via open enrollment through a lottery system. They come from all walks of life and all levels of academic performance. This diverse population demonstrates that, regardless of where they begin and regardless of the career path they follow, our leadership-focused approach to student development makes a positive and lasting difference in their lives.

"We're excited about our upcoming expansion, scheduled for completion this fall. Our recent bond issue financed the renovation and development of a consolidated, permanent campus. Phase one gives us more space and resources to continue moving forward, reaching a growing number of students and equipping them for long-term success in a rapidly changing world."

CHARTER SCHOOL FINANCING HIGHLIGHTS

$192,290,000

Tax-Exempt
Fixed Rate Bonds
Sole Manager

American Leadership Academy

"I have been involved with charter school development for many years and have worked with many investment banking firms that served me well, but BB&T Capital Markets is head and shoulders above the industry."

– Glenn Way, Founder and Partner, Schoolhouse Development

"I can't speak highly enough about the BB&T Capital Markets team. Their client service and expertise were paramount in leading us to the successful completion of one of the largest charter school bond transactions EVER!"

– Robert Plowman, Chief Financial Officer

$21,385,000

Tax-Exempt and Taxable
Fixed Rate Bonds
Sole Manager

Corvian Community School

"The BB&T Capital Markets team took the time to get to know us and our philosophy, which helped to create a lifetime partnership. Because of their passion and dedication, Corvian is now able to complete our school's growth, which will directly benefit our school community. We consider BB&T Capital Markets a part of our Corvian family!"

– Stacey M. Haskell, Executive Director, Corvian Community School

$26,860,000

Tax-Exempt and Taxable
Fixed Rate Bonds
Sole Manager

Knowledge Academies

"Working with BB&T has been a pleasure, and they truly helped Knowledge Academies accelerate our vision, mission and journey."

– Art Fuller, Founder and President, Knowledge Academies, Inc.

$37,730,000

Tax-Exempt Fixed Rate Bonds
Sole Manager

Lake Norman Charter School

"After an extensive search to find the right financial partner to help us seek financing through the public bond market, it was clear that BB&T Capital Markets was the best choice. They showed a genuine interest in learning about our future goals and helping us to structure an offering that would provide the flexibility we need to meet our objectives. The BB&T Capital Markets team demonstrated that they would be accessible whenever needed to help us be successful."

– Shannon Stein, Head of School

$31,540,000

Tax-Exempt Fixed Rate Bonds
Sole Manager

Mountain Island Charter School

"As a growing and thriving school in its seventh year of operations, we were entering into the bond market for the first time with existing debt and a large and complex construction project. Mountain Island chose to work with BB&T Capital Markets because of their hands-on approach to guiding schools through each step of the process. The result was a record-breaking issuance that ensured our school will meet all of its construction and financial goals. We could not have asked for a stronger team and a better result than what was delivered by BB&T Capital Markets."

– Justin H. Matthews, M.Ed., Executive Director

$20,515,000

Tax-Exempt and Taxable
Fixed Rate Bonds
Sole Manager

Village Tech Schools

"The team at BB&T Capital Markets knows how to get the job done! In our first bond financing, we hit our goals and enjoyed working with them every step of the way. We could not have made a better choice."

– David Williams, Chief Executive Officer and Superintendent

"From the very beginning and throughout the entire process, we knew without a doubt we made the best decision by choosing BB&T Capital Markets. We are delighted with the results of this transaction and look forward to working with BB&T on future transactions."

– Amber Robinson, Chief Financial Officer

BOND DOCUMENT BASICS
Careful scrutiny is vital

Ben Kitto, Ice Miller LLP

"Emails with draft documents have been coming from bond counsel, underwriter's counsel and our counsel at lightning pace. What do I really need to read and when?"

This is a question we hear quite often from clients. As the incomparable Don Henley of The Eagles sang, "everything, all the time." The documents drafted by counsel in connection with a bond transaction are important, but some context may help you decide what to look for and when to focus your review on certain documents.[1]

The documents described below are those most often applicable to a publicly offered charter school bond deal in which the charter school and the borrower are the same entity. The critical parties to such a deal, other than the borrower, include:

- The conduit issuer, which issues the bonds and loans the proceeds of the sale of the bonds to the borrower;
- The trustee, which holds the collateral securing the bonds for the benefit of investors in the bonds or bondholders;
- The underwriter, which helps structure, market and sell the bonds to investors, generating proceeds for the benefit of the borrower.

In general, bond counsel drafts the documents by which the bonds are issued on a tax-exempt basis; underwriter's counsel drafts the documents by which the bonds are offered to investors and purchased by the underwriter; and borrower's counsel negotiates such documents on behalf of the borrower and helps the borrower comply with applicable law, its charter and its organizational documents (i.e., articles of incorporation, bylaws, etc.) in entering into the bond deal.

With input from others, bond counsel drafts the bond indenture, the loan agreement and the mortgage.

The trust indenture or bond indenture is the contract between the conduit issuer and the trustee. It sets the terms of the bonds, including interest rates and payment dates, and establishes a "trust estate" consisting of, among other things, the rights in the sources of repayment of the bonds and the security for the same. The trustee holds this trust estate for the benefit of bondholders and enforces their rights under the bond documents.

The loan agreement is the document by which the conduit issuer loans the proceeds of the sale of the bonds to the borrower. It establishes the terms by which the borrower must make payments that the issuer uses to repay the bonds. Most often, the loan agreement sets the timing for the borrower's payment obligations, financial covenants, and other covenants, such as required insurance coverage. Because the issuer is part of the bond deal only to facilitate the issuance of tax-exempt bonds, the borrower pledges its revenues and any other collateral to the repayment of the bonds in the loan agreement. The rights included in the borrower's pledge are part of the trust estate. Sometimes a note is also signed by the borrower to evidence its payment obligation under the loan agreement.

The mortgage or deed of trust is the document by which the borrower pledges (typically to the trustee) its ownership or other interest in real property, if the bonds are secured by real property.

UNDERWRITING DOCUMENTS

Underwriter's counsel drafts the offering document, the bond purchase agreement and the continuing disclosure agreement.

The offering document, most often called a preliminary official statement or a preliminary limited offering memorandum, is used by the underwriter to market the bonds to potential investors. The offering document describes the terms of the bonds; the security for the bonds; and the borrower, including related concepts, such as state law; and risks, such as that the borrower's charter might not be renewed. Once the offering document has been published, the underwriter provides it to investors to review and make investment decisions based on the information contained in the offering document.

The bonds are sold to the underwriter pursuant to the terms of a bond purchase agreement, which spells out the principal

[1] This publication is intended for general information purposes only and does not and is not intended to constitute legal advice. The reader should consult with legal counsel to determine how laws or decisions discussed herein apply to the reader's specific circumstances. Each party to a bond transaction should seek advice from its counsel and no one should seek legal advice from The Eagles.

amounts, interest rates and maturity dates of the bonds. After the bond purchase agreement is executed, a final offering document is prepared, which includes all of the information in the preliminary version, plus the terms of the bonds as determined during pricing. Investors buy the bonds from the underwriter based on the final offering document, and become bondholders.

To ensure bondholders and potential investors have the information they need to determine whether to sell or buy the bonds on the secondary market, a continuing disclosure agreement may be entered into by which the borrower agrees to provide certain financial and other information publicly on an annual, quarterly or other basis for as long as the bonds are outstanding.

KEY REMINDER

The borrower should work with its counsel to make sure it has reviewed the bond and underwriting documents, and understands what each document says about the transaction or requires of the borrower. In addition to understanding the terms of the business deal, the borrower should also closely review the offering document because the borrower is responsible for the information it contains even though others draft it. Digging into bond and underwriting documents early in the documentation process can help avoid, per the warning from The Eagles' Glenn Frey, "a heartache tonight," while the bonds are outstanding.

Ben Kitto is an attorney in Ice Miller LLP's Municipal Finance Group whose practice focuses on underwriter's counsel and bond counsel work in education financings, particularly for charter schools.

He has served as lead associate in underwriter's counsel and bond counsel roles on education and health care financings totaling more than $2 billion for borrowers or issuers in 20 states.

Choice Advisors

Independent Advisor. Trusted Advice. Comprehensive Solutions.

It is with mixed emotions that we bid farewell to three of our longtime and valued teammates. Paula Permenter, Matt O'Meara and Martha Martinez Karasch have decided to make a change in their careers from bond underwriting to financial advisory. They have started a new firm, Choice Advisors, that will assist charter schools and charter school networks with capital planning and execution. Although we will miss them as teammates, we are excited to work with them as industry partners in the future. We are certain that charter school clients across the country will greatly benefit from their wealth of knowledge, experience and devotion to the charter school movement.

Please join us in wishing Paula, Matt and Martha much success as they transition into this exciting new chapter in their careers.

Paula Permenter
Partner & Founder

paula@choiceadvisors.com
832-265-3420

Matthias O'Meara
Partner & Founder

matt@choiceadvisors.com
414-403-1454

Martha Karasch
Managing Director

martha@choiceadvisors.com
832-630-0329

TAX-EXEMPT GROSS-UP CLAUSES IN LIGHT OF THE TAX CUTS AND JOBS ACT OF 2017

By Gregory F. Fawcett, II, Principal, Piedmont Securities LLC

The Tax Cuts and Jobs Act of 2017 (TCJA) was signed into law by President Trump on Dec. 22, 2017, and became effective Jan. 1, 2018. With the signing of the TCJA, the U.S. corporate tax rate (C Corporations) was changed to a flat 21.00%. Prior to enactment of the TCJA, corporate tax rates ranged from a low of 15.00% to a high of 35.00% depending on the amount of corporate income subject to tax for the year. According to recent analysis performed by the Associated Press, large U.S. financial institutions had historically paid at the higher end of the corporate marginal tax range, approximately 28.00% to 31.00% of taxable income; however, as of the end of first quarter 2018, it is estimated the six largest U.S. banks by assets saved $3.59 billion in tax payments when compared to 2015 and 2016 payments made prior to the TCJA.

On the surface, the corporate tax savings by financial institutions is good news and is partly reflected in a majority of positive first-quarter earnings reports for many publicly traded financial institutions. But what may not be immediately clear is that lower taxes can reduce the overall benefit of tax-exempt income to these financial institutions, many of whom are also large tax-exempt bond purchasers and lenders to nonprofit and governmental entities. Through "gross-up clauses," financial institutions had long planned for the impact a reduction in corporate tax rates could have on after-tax returns. Although most borrowers did not like the existence of a gross-up clause in their bond documentation, most ultimately agreed to the provision in exchange for other generally favorable terms provided by the lender and the belief that a change in the corporate tax rate was not immediately foreseeable.

A CLOSER LOOK

Once explained, it is relatively easy to understand why the lowering of the corporate tax rate might allow a bank to invoke its gross-up clause in bond documents. What is not necessarily easy to understand is how and when the gross-up clause is exercised and the ultimate calculation of the adjusted interest rate. The reading and interpretation of a gross-up clause will likely require multiple cross-references to other definitions or sections within the bond documents.

A basic example of how such a calculation might work is set forth in the following hypothetical, which assumes a multi-modal Trust Indenture, Continuing Covenant Agreement and a $10 million tax-exempt bond currently outstanding in Fixed Rate Mode. The fixed rate prior to Jan. 1, 2018, is 3.00%.

The steps below show how to calculate the effective interest rate post-Jan. 1, 2018, considering gross-up clause in bond documents.

Note: Blank spaces show examples of bond document variables.

STEP 1. Determine Current Interest Mode Of Bonds

See Section ____ of Bond Indenture: Interest Rate Determinations Fixed Rate Mode

The first step in the process of determining the effect of any gross-up is to identify the current interest rate mode the subject bonds are outstanding in, and confirm how the underlying interest rate is calculated and for what period of time. In our hypothetical, it is assumed the bonds are held in Fixed Rate Mode by the originating financial institution.

STEP 2. Review Defined Terms That Govern Interest Rate Calculation

See Exhibit ____ of Bond Indenture: Definitions

Parallel with Step 1, it will be necessary to review and cross-reference certain defined terms listed within the applicable interest rate mode description, which may include some of the following definition examples:

- **"Applicable Margin"** means _______%.
- **"Conversion Date"** means the date established for the conversion of the interest rate on the bonds from one type of interest period to another type of interest period pursuant to Section ___ of the Indenture, which date shall be an interest payment date.
- **"Fixed Rate"** means the non-variable interest rate on the Series ___ Bonds established in accordance with Section ___ of the Indenture.
- **"Fixed Rate Bond"** means a Series ___ Bond bearing interest at a fixed rate.
- **"Fixed Rate Period"** means the period during which the fixed rate is in effect.

STEP 3. Identify Controlling Gross-Up Language of Covenant

See Section ____ of Continuing Covenant Agreement: Increased Payments

Applicable gross-up language may be found in the Continuing Covenant Agreement between the borrower and bank, or it may be referenced in the Bond Indenture, or sometimes both. The language written in the governing agreement will determine the method for calculating the appropriate gross-up factor and corresponding additional interest expense. Notwithstanding this general rule of construction, as mentioned before, even after identifying the controlling language or gross-up clause covenant, interpretation and application of the provisions can vary and, depending upon the calculation method applied, the resulting interest expense differential to the borrower can be material, as the below examples illustrate.

STEP 4. Calculate Additional Interest Expense Of Gross-Up

Approach 1.

1. 3.00% interest rate prior to TCJA
2. 35.00% (prior corporate tax rate) / 21.00% (current corporate tax rate) = 40.00% reduction
3. 3.00% (interest rate) x 40.00% (reduction) = 1.20% effective gross-up
4. 3.00% (interest rate) plus 1.20% (effective gross-up) = <u>4.20% interest rate after TCJA</u>

Approach 2.

1. 3.00% / (1-35.00%) = 4.6154% (Prior Taxable Equivalent Yield)
2. 3.00% / (1-21.00%) = 3.7975% (Current Taxable Equivalent Yield)
3. 4.6154% - 3.7975% = 0.8179% (Taxable Equivalent Yield Differential)
4. 3.00% + (0.8179 * 79.00%) = <u>3.6462%</u> (Tax-Exempt Interest Rate after Gross-Up)

Approach 3.

<u>Pre TCJA</u>

1. 3.00% originally stated tax-exempt interest rate
2. Assumed bank cost of funds is 1.95% when corporate income tax rates were 35.00%
3. (1.95% x 35.00%) = .6825% TEFRA Disallowance
4. 3.00% - .6825% = 2.3175% prior to gross-up at 35.00%
5. 2.3175% / (1-35.00%) = <u>3.5654% Taxable Equivalent Yield</u>

<u>Post TCJA</u>

1. 3.00% originally stated tax-exempt interest rate
2. Assumed bank cost of funds is 1.95% when corporate income tax rates were 21.00%
3. (1.95% x 21.00%) = .4095% TEFRA Disallowance
4. 3.00% - .4095% = 2.5905% prior to gross-up at 21.00%
5. 2.5905% / (1-21.00%) = 3.2791% <u>Taxable Equivalent Yield</u>
6. 3.565% - 3.2791% = 0.2863% Taxable Equivalent Yield Differential
7. 3.00% + (0.2863% * 79%) = 3.2262% Tax-Exempt Interest Rate after Gross-Up

Net Interest Rate Differential After Gross-Up: <u>3.2262% - 3.000% = 22.62 Basis Points</u>

SUMMARY OF RESULTS

As you will observe, depending on the gross-up method calculation applied, the resulting increase in interest rate can be as high as 120 basis points or as low as 23 basis points. As the potential disparity in interest rate increases further illustrates,

Calculation Method	Effective Interest Rate
Interest Rate Prior to the TCJA	3.00%
Approach 1 - Straight Percentage Increase	4.20%
Approach 2 - Tax-Equivalent Yield Approach	3.6462%
Approach 3 - Offsetting Deduction	3.2262%

gross-up language can be technical and subject to differing interpretation and ultimate application.

ADDITIONAL CONSIDERATIONS

Beyond the mathematical computation of the tax gross-up, there are other factors for both bank and borrower to consider. Examples of these additional considerations are outlined below:

1. Is the gross-up clause self-operative, or does the bank have discretion on whether to invoke the clause? If the gross-up clause is self-operative, meaning the gross-up clause is effective immediately upon the occurrence of a tax or regulatory event, then a waiver by the bank may result in a reissuance of the bonds under existing federal tax regulations.

2. Does the gross-up language provide for a nondiscrimination clause? Effectively, is the bank required to treat all similarly situated customers the same? The gross-up clause may require that the bank cannot selectively pick and choose which customers it will invoke the provision of the gross-up clause upon, but rather it must either invoke or waive the clause uniformly across an entire class of customers (e.g., all customers with $25 million or greater in assets).

3. If the borrower has an interest rate swap or other interest rate hedge product overlaying the bonds, how does the gross-up impact the effectiveness of the hedge?

4. What are the optional redemption provisions for the bonds? Does it make economic sense to refinance the bonds?

CONCLUSION

The intent of gross-up language is not to be punitive to the borrower or to act as a windfall to a financial institution but is simply intended to provide the bondholder/bank the same approximate after-tax return it bargained for prior to the tax or regulatory event triggering the gross-up. Borrowers with bonds subject to a gross-up clause should consult with their financial advisor or legal counsel for assistance in determining the most effective applicable method to be applied pursuant to their documents or whether there are other business/economic considerations or factors to be analyzed.

EDUCATION FINANCE GROUP

Rich Harmon
Managing Director and Group Head
Columbus, Ohio
614-358-4128
RHarmon@BBandTCM.com

Greg McKenna
Managing Director
Pittsburgh, Pa.
412-209-4401
GMcKenna@BBandTCM.com

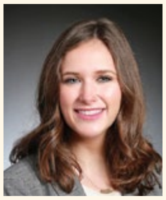
Bert Newsome
Managing Director
Charlotte, N.C.
704-954-1418
BNewsome@BBandTCM.com

Victoria White
Vice President
Denver, Colo.
303-305-5762
VWhite@BBandTCM.com

Daniel Mooney
Associate
Houston, Texas
713-425-2116
DMooney@BBandTCM.com

Israel Kalombo
Associate
Denver, Colo.
303-305-5761
IKalombo@BBandTCM.com

R.J. Watters
Analyst
Charlotte, N.C.
704-954-1563
RWatters@BBandTCM.com



Griffin Bradley
Analyst
Charlotte, N.C.
704-954-1542
GBradley@BBandTCM.com

CATCH THE BB&T TEAM AT UPCOMING CONFERENCES

North Carolina Association for Public Charter Schools Conference	July 15-17
Pennsylvania Education Leadership Summit	July 29-31
New Jersey Charter Schools Conference	October 11
Florida Charter School Conference	October 16-18
Texas Charter School Conference	October 24-26
Annual South Carolina Charter School Conference	November 27-29

FOR MORE INFORMATION

We invite you to contact any member of our Charter School Finance Team; visit us at BBTCapitalMarkets.com/Education, or send us an email at CharterSchools@BBandTCM.com.

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