BB&T Capital Markets

Tax-Exempt Financing Primer

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WHO CAN ACCESS TAX-EXEMPT DEBT?

Tax-exempt financing has been a very advantageous vehicle for qualifying organizations to finance their debt during the past several decades. Municipalities and 501(c)3 organizations, including nonprofit senior living facilities, schools and social service entities, are the primary users of tax-exempt debt. Their not-for-profit exemption qualifies them to have access to tax-exempt debt.

WHY TAX-EXEMPT DEBT?

Historically speaking, tax-exempt debt has been a relatively less expensive vehicle to finance a project than traditional taxable options (bank loan/mortgage). The relative benefit has equated to (approximately) the tax bracket of the holder. For example, a taxable bank loan may be priced at LIBOR + 1.5 percent. A tax-exempt bank loan could be priced at 67 percent x (LIBOR + 1.5 percent). For example, if LIBOR were 2 percent, the taxable bank loan would cost 3.5 percent, compared to a cost of 2.34 percent for a tax-exempt bank loan. Typically, banks, institutional investors or high-net-worth retail investors purchase the tax-exempt debt. The investor/bank is able to price the bonds at a discount as they do not pay taxes on the interest income. That savings is passed along to the borrower.

There are added up-front costs of issuance required to complete a tax-exempt financing. These costs (up to a certain amount) can be rolled into the financing amount and amortized for the life of the bonds. Because of the higher up-front costs, it often does not make sense to issue tax-exempt debt for projects (with debt loads) less than $5 million. Your BB&T banker is able to help you assess the cost/benefits of financing smaller projects.

ELIGIBLE USES

IRS restrictions require that the proceeds from tax-exempt debt be used for capital purposes (including refinancing of debt originally used for capital purposes). Tax-exempt debt cannot be used for operating cash flow. There are certain restrictions on uses as it pertains to capital projects, primarily religious "indoctrination" restriction. To abide by the separation of church and state as set forth in the Constitution, tax-exempt bond proceeds cannot be used for capital projects that are religious in nature, particularly where there are activities of indoctrination (i.e., a religious education class at a parochial school). BB&T Capital Markets can help you navigate eligible uses and restrictions on reimbursements. BB&T Capital Markets can also help you maximize your future financing flexibility with assistance in adopting reimbursement resolutions.

TYPES OF TAX-EXEMPT DEBT

The most commonly used types of tax-exempt debt are tax-exempt bank placements and tax-exempt fixed rate bonds. There are pros and cons of both types of tax-exempt debt, and it's not one-size-fits-all. Your investment banker should listen to you, the borrower, and learn your objectives to appropriately help you understand which option might be best for your organization. This often includes executive management team and board education. BB&T Capital Markets will usually dual track the two types of financings to keep options open while obtaining all information required to best determine which type of debt is most appropriate for your project. For additional information, please visit BBT's website for the three-part video series on direct tax-exempt bank placements by John Franklin, managing director and group head, BB&T Capital Markets Healthcare Finance Group.

TYPICAL PROCESS FOR TAX-EXEMPT BANK FINANCINGS

Your investment banking partner will usually quarterback the tax-exempt financing process. S/He will establish a calendar based on certain parameters, including coordinating the issuing authority process. The investment banker will work with the borrower to develop a credit package that outlines the preliminary terms of the opportunity and tells the credit story of the borrower (i.e., history, financial strength, project description, etc.). That credit package will be distributed to an agreed-upon list of potential banks. The banks will review the package, possibly make a site visit, and either put forth a proposal or decide to pass. Once bank proposals are received, the investment banker reviews and presents the results to the borrower. Often a short list of banks is created, and in-person interviews are conducted to determine which bank is the best fit for the borrower.

Once a bank is chosen, it may require an internal approval process before providing a formal commitment. Upon receipt of a formal bank commitment, work on legal documentation and due diligence (i.e., appraisals, environmental studies, etc.) begins. At the same time, the investment banker will coordinate with the issuer to get issuer approval for the financing. This is all done simultaneously and spearheaded by the investment banker.

Once all parties are satisfied with the legal documentation, the deal closes and funds. In general, the process takes 10-15 weeks.

TYPICAL STRUCTURE OF TAX-EXEMPT BANK FINANCINGS

Tax-exempt direct (bank) placements, also known as bank qualified or non-bank qualified bank debt, are placed directly with a bank to be held in its portfolio. In most cases, the governing documents are between the bank and the borrower. This debt, like any other tax-exempt debt incurred by a 501(c)3, must be issued through an issuing authority (see "Typical Parties Involved" below).

Typical terms include a 20-25 year amortization and a five-15 year bank commitment, with a rate based on a percentage of LIBOR plus a bank spread (see "Why Tax-Exempt Debt" above). Covenants and security depend on the strength of the borrower. Security can range from a negative pledge (bank doesn't take the property/project as collateral but prohibits borrower from offering project/property as collateral to others) to a full mortgage. Covenants will usually include a debt service coverage covenant (cash flow must cover principal and interest on debt by a certain amount) and a liquidity covenant that maintains a minimum level of cash and investments (e.g., a days-cash-on-hand covenant).

TYPICAL PROCESS FOR TAX-EXEMPT FIXED RATE BOND FINANCING

There are many similarities in regards to the timing for using either tax-exempt fixed rate bonds or a tax-exempt bank loan. When using a bank loan, the process is usually shorter than accessing the tax-exempt bond market. Typically, it takes a borrower two to three months to close a bank deal and often, deals close much quicker. The closing process for bank debt is quicker for several reasons: 1) unlike issuing fixed rate bonds, no marketing period is required to sell bank debt, and 2) closing is faster simply because fewer parties are involved in a bank deal.

The timeline for using tax-exempt fixed rate bonds is about three to four months. During this time, each party involved participates in conference calls, meetings and various presentations as the transaction is prepared to go to market. During these meetings, conversations center on the structure of the offering and legal documents. Legal documents required include the Trust Indenture, Loan Agreement and Official Statement. These documents distinctly define the requirements of the borrower, the roles of parties once the bonds are issued and material information about the borrower, project/refunding and legal structure. Other legal documents are required, but a discussion of those is beyond the scope of this paper. Key documents have been highlighted above.

Before the bonds can go to market, the Preliminary Official Statement (POS) is mailed to investors. The POS communicates vital information on the borrower to investors. During the marketing period, the investment banker usually sets up an investor site visit and presentation to give the market (investors) additional information on the bond offering. This period is typically referred to as the marketing period.

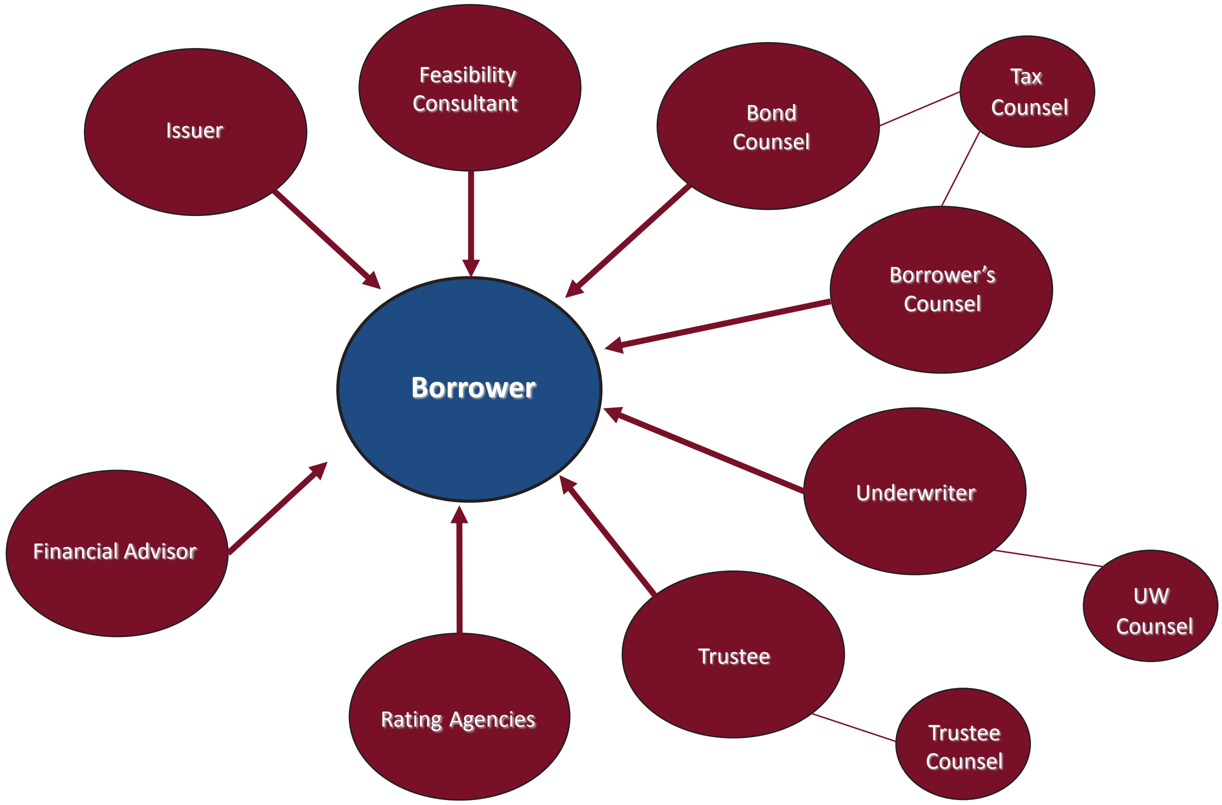
When the transaction goes to market, also known as "pricing," investors bid on the different maturities, and interest rates are determined based on investor demand. After pricing, there is typically a two- to four-week period to finalize documents prior to closing (funding). During that timeframe, the counsels prepare the final legal documents, including the final Official Statement. Once preparations are completed and all parties believe the bond issue is in order and in compliance with tax laws and statutes, funds are wired by the investment banking firm to the trustee, which, in turn, deposits the funds into the proper accounts, and the bond issue is closed.

TYPICAL STRUCTURE FOR TAX-EXEMPT FIXED RATE BOND FINANCING

Buyers of tax-exempt fixed rate bonds usually buy the bonds with the intention of holding them until maturity. Unlike bank placements that have a five-15 year commitment, investors of fixed rate bonds are committed to holding the bonds through their maturity. Typical terms include a 25-35 year amortization. The rates are based on a spread over the Municipal Market Data indexed rate (MMD). MMD is the industry average for "AAA" rated tax-exempt debt. The spread over MMD is reflective of the strength of the issuance (i.e., structure, security and strength of the borrower). Covenants and security depend on the strength of the borrower as well. Security for lower rated credits generally includes a first mortgage on the project. Covenants in fixed rate bond transactions are often more flexible than bank covenants. Flexibility comes in the form of fewer covenants, less restrictive financial metrics and fewer testing dates.

TYPICAL PARTIES INVOLVED

The parties involved in using tax-exempt debt are very similar for bank debt and bond debt, all playing distinctive roles. For simplicity's sake, let's assume the decision has been made to use tax-exempt bonds as the most efficient and effective use of capital for a particular project and/or refinancing. Generally, the parties involved include the borrower, the investment banker (underwriter), investors, respective counsels, the issuer and the trustee. There are many other parties involved, depending on the nature and scope of the transaction; however, the six mentioned above will always be present in a tax-exempt bond financing.



The borrower – Entity or organization that has a financing need with ability to access the tax-exempt bond market. Borrowers in the tax-exempt bond market typically include not-for-profits/501(c)3 organizations (i.e., usually hospitals, higher education, CCRCs and other mission-based organizations).

The underwriter – A broker-dealer and/or an investment banking firm with the proper registration with regulators to offer underwriting, financial and structuring services to borrowers; the underwriter acts as intermediary between the borrower and investors.

Investors – Institutions (i.e., usually tax-exempt mutual funds) or individuals (known as retail investors) who lend money to the borrower and receive a rate of return plus principal at maturity. Examples of institutional investors include Vanguard, Blackrock, Franklin, MFS or T. Rowe Price. Insurance companies and some commercial banks may also purchase bonds.

Counsels – Bond lawyers who ensure the proper documents for the transaction are completed and written correctly. Examples of lawyers involved in a bond issuance include: bond counsel, borrower counsel, underwriter counsel and trustee counsel.

Bond counsel – An attorney or law firm retained, typically by the issuer, to give the bond counsel opinion on the issue, such as tax status and validity to the issue.

Borrower counsel – An attorney or law firm retained by the borrower to provide the following services: advise the business on the financing; advocate for the borrower's interest; and render a legal opinion on the bond documents as it relates to the business.

Underwriter counsel – An attorney or law firm retained to represent the interests of the underwriter (e.g., BB&T Capital Markets). Duties of underwriter's counsel may include: review of issuer's bond resolution; writing and reviewing disclosure documents; and reviewing bond documents and their relation to the underwriter.

Trustee counsel – An attorney or law firm that acts with the trustee's interest in mind during the bond documentation formation; in a default situation, trustee's counsel advises the trustee on its rights and/or remedies.

Issuer – An independent, third-party conduit through which the bonds are issued. The issuer must be a governmental entity to access tax-exempt debt. Examples include the North Carolina Medical Care Commission, the Illinois Finance Authority and the Public Finance Authority.

Trustee – An entity that controls the flow of funds (i.e., principal and interest payments from the borrower go to the trustee, then the trustee disburses the payments to each respective account/investor). A trustee is typically a financial institution.

IN SUMMARY

The savings that tax-exempt debt offers compared to traditional taxable loans can be significant. While it is a little more cumbersome and expensive to access, an experienced and qualified investment banker can help minimize the expense and help the borrower through the process.