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PUBLIC-PRIVATE INFRASTRUCTURE ADVISORY FACILITY

SUB-NATIONAL TECHNICAL ASSISTANCE PROGRAM

A Municipal Bond Case Study

Material drawn from USAID, Developing Sustainable and Inclusive Urban Infrastructure, TCG International, 2011

Case Study Overview

In January 1998, a developing city in South Asia floated a <u>local currency</u> municipal bond issue equivalent to $25 million, the first to be issued in their emerging market country without a government guaranty.

This pioneering bond issue illustrates the series of steps that lead to a successful municipal bond issue in emerging market countries.

Cities that implement these steps carefully can expect their bond issues to raise the financing needed to implement their projects.

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Step 1: Fiscal Strengthening and Capital Investment Planning

Get the city's financial house in order.

Debt financing is only possible once a city has established a reliable fiscal surplus of revenues (from all sources) over expenditures (for all purposes).

Though the case study city had accumulated significant losses up to 1994, it achieved a revenue surplus equivalent to US$9.5 million by the end of March 1995 through strong, committed leadership and improved revenue collection and property tax administration.

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Step 1: Fiscal Strengthening and Capital Investment Planning

Determine borrowing capacity

Prepare a capital investment plan for infrastructure projects that need to be implemented

Utilizing an iterative process involving estimated financial performance levels and borrowing terms, it was determined that the case study city could afford a local currency investment equivalent to between US$135 to US$150 million. Based on this analysis, the city reviewed different project priorities and worked out a 5-Year Capital Investment Plan equivalent to just under US$150 million for 1996-97 to 2000-01.

Step 2: Credit Rating

Obtain an institutional credit rating from a well respected rating agency using the national rating scale

The case study city took the first step toward issuance of municipal bonds when it requested and received a national scale municipal credit rating in February, 1996.

This was the country’s first municipal credit rating, and the city received an A+(ns) for a local currency general obligation bond equivalent to US$25 million, indicating adequate assurance that investors would be repaid.

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Step 2: Credit Rating

Once the bond is ready to be issued, obtain a rating for it as a specific security using the same credit rating agency

Later in 1997, structuring the bond with credit enhancements improved the national scale rating from A+(ns) to AA(ns) and resulted in interest cost savings for the city.

Step 3: Project Development

Complete all necessary detailed engineering, costing, and procurement planning for the project

Design projects to be financially viable and to operate commercially whenever possible

In the case study city, private local consulting engineering firms were contracted to prepare a citywide water supply project and a sewerage projects for the eastern parts of the city. The total local currency cost of the projects was estimated to be equivalent to US$122 million in 1997. The water supply project was designed to be financially viable using a commercial service charge, but the sewerage projects were not designed to generate revenues.

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Step 4: Financial Structuring

Structure the bond in a way that attracts private investors while minimizing the cost of interest to the local government

The case study city contracted a financial advisory firm to help them manage the bond issue in 1997. Market based financing for city infrastructure projects was relatively new to domestic capital market investors. A reassuring debt service structure for the bond was of crucial importance to investors.

The city chose a structured debt obligation bond which pledged repayment from the revenue of one specific and very reliable tax source.

The resulting rating increase from A+(ns) to AA(ns) reduced interest cost.

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Step 5: Authorization and Approval

Obtain all authorizations required by law and regulations

Most importantly, obtain irrevocable approval from the local government legislative council

The case study City Council irrevocably approved the financing of water supply and sewerage projects, worth the local currency equivalent of US$122 million in late 1997.

The approved financing arrangements included issuing local currency municipal bonds equivalent to US$25 million.

Step 6: Preparation of Documents

Prepare the Prospectus explaining the amount, purpose and structure of the bond issue

The draft prospectus for the city's bond issue was approved by the Securities Exchange regulator of the country, and in December, 1997, applications were filed and accepted in the national stock exchange and the city's own stock exchange. In January 1998, the issue was opened for offers.

Step 6: Preparation of Documents

Prepare the Trust Indenture and Notes which are the legal contract between the local government and the bondholders

The legal documents specified the face value of each bond was at least the equivalent of US$125 and allowed increments in equivalents of US$25 thereafter, with a coupon rate of 14%, length of seven years and principal repayment during the final three years,

These were considered excellent terms at that time in the country.

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Step 7: Marketing to Investors

Seek investors to purchase the bonds

The case study city marketed 75% of the bonds through a private placement sale based on pre-negotiated agreements with specific institutional investors.

The remaining 25% were sold on the competitive open market.

Step 8: Completion of the Transaction

Close the financing transaction

In the case study city, the private placement was allotted to a dozen domestic financial institutions, including a major bank, the country's largest mutual fund company, the largest private housing finance company, and smaller commercial banks and mutual funds.

Advertisement of the public issue was in newspapers, on buses, billboards, city cable television and kites.
Press conferences were also held in the city as well as in the country's financial center and its capital city.
Brokers conferences were held in those three cities as well as four others.

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Transaction Costs

✓ There are costs to the local government for doing a bond issue, just as there are loan origination costs charged to the by banks for their lending

✓ Completing all the steps for issuance of a municipal bond requires the assistance of a number of financial service providers: financial advisory firm, credit rating agency, bond counsel, and trustee at a minimum

In the case of the first municipal bond issued by the case study city in 1998, the transaction cost for the bond issue, including raters, underwriters, brokers and legal fees, as well as advertising and printing expenses, equaled 2.89% of the bond offering~~s~~ or <u>the local currency equivalent of US$722,500</u>.

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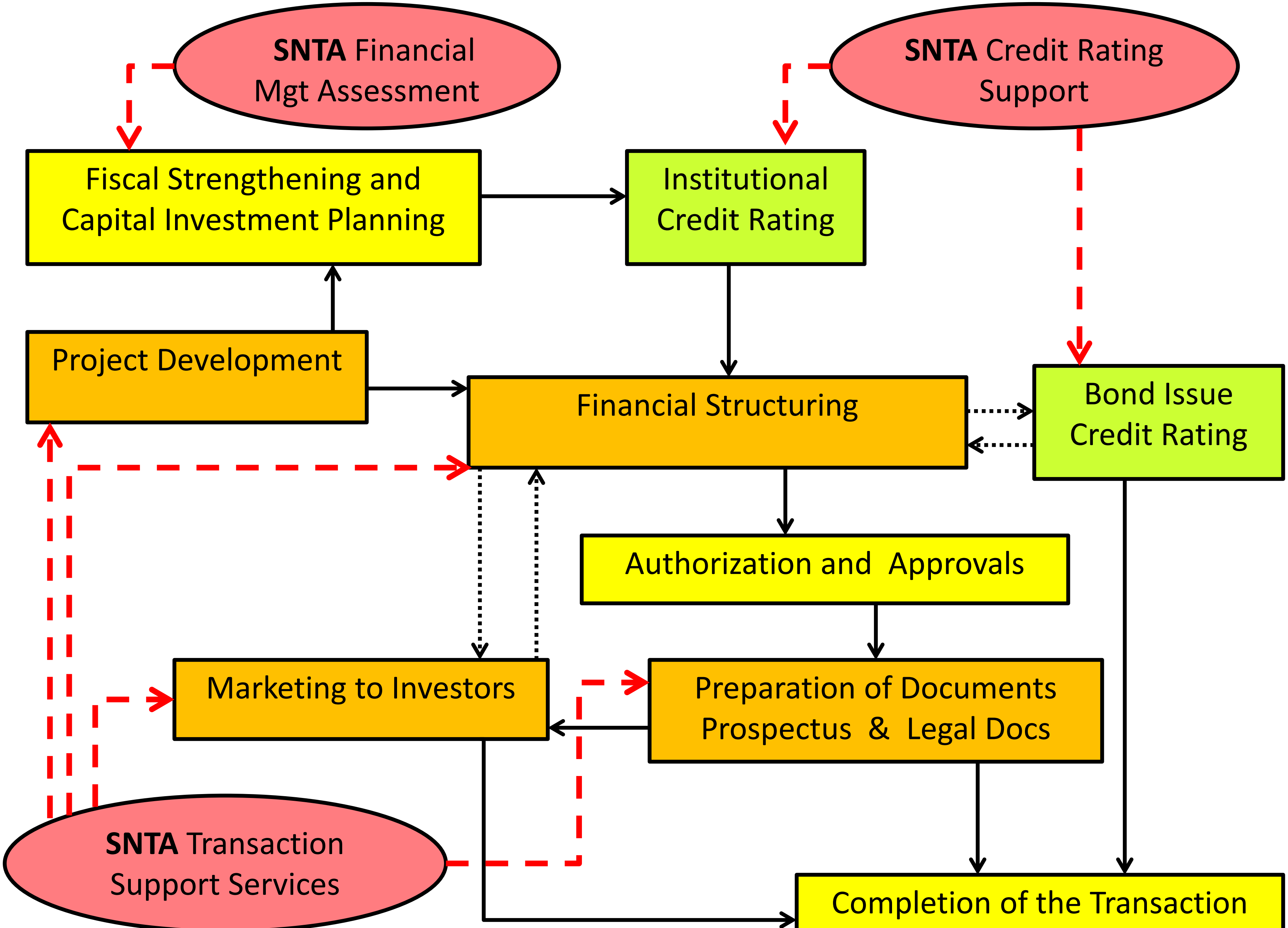
Recapping the Municipal Bond Issuance Process



SNTA Financial Mgt Assessment
SNTA Credit Rating Support
Fiscal Strengthening and Capital Investment Planning
Institutional Credit Rating
Project Development
Financial Structuring
Bond Issue Credit Rating
Authorization and Approvals
Marketing to Investors
Preparation of Documents Prospectus & Legal Docs
SNTA Transaction Support Services
Completion of the Transaction

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Thank you.