

Private Placement Debt Financing for Public Entities

By Lance S. Holman



Jane Doe, the finance director of School District USA, needs \$20 million to finance the construction of a new school facility. She decides to finance the project over a 20-year period rather than use her reserves. Next, she compares the benefits of single-investor private placement financing with a traditional municipal bond offering.

An investor credit-approves the school district for \$20 million to build the new facility. The investor allows Jane Doe the flexibility to customize the payment stream to match her current budget and expected financial capabilities. She can make monthly, quarterly, semiannual, or annual payments in advance or in arrears.

Jane decides to reduce her interest expense by tens of thousands of dol-

lars by making monthly payments in arrears versus annually. She structures the financing with the option of prepaying in full on any scheduled payment date, which enhances financial flexibility to react appropriately when the school district receives an influx of funds or interest rates decline. She opts to prepay her legal fees at closing rather than include them in the financing amount or in the interest rate.

The investor uses its in-house team of public finance professionals to conduct its internal credit analysis, legal review, and documentation and to provide ongoing customer service. When necessary, a local outside counsel is engaged to ensure that the transaction is documented properly according to federal and state laws and local regulations.

After receiving governing body approval to proceed, the investor and school district execute the financing agreement, and the funds are deposited via check or wire into an account at an escrow bank for the benefit of the school district.

When a vendor payment is due, the school district submits a vendor invoice, payment request form, and certificate of acceptance to the escrow bank, which disburses the funds to the vendor within a few business days. Overall, this model lowers the financing cost to create an efficient “loan factory” for public finance transactions.

Looking at Options

Next, Jane Doe contacts her local investment bank to review the benefits of structuring and selling bonds in the public debt market to determine the best option for the school district. The investment banker informs her that she can extend the financing term to 30 years to lower the payments over the life of the facility. He discloses that the interest cost will increase as a result. She ultimately decides to stick with a 20-year financing term and agrees to pay the principal annually and the interest semiannually (which is standard in the public debt market).

The bonds are structured with a 10-year no-call period and a sliding prepayment scale thereafter. The investment banker engages (a) the rating agencies to independently credit-score the bonds, (b) trustees to collect payments and represent the bondholders, and (c) outside bond and tax counsel to ensure that the transaction

Table 1. Private Placement Debt Obligations vs. Traditional Municipal Bonds

Private Placement Debt Obligations	Traditional Municipal Bonds
<ul style="list-style-type: none"> • Maximum payment flexibility • Single investor • Prepayment flexibility • Expedient funding (30–45 days) • Lower legal fees • Transactions: \$100,000–\$50 million • Financing terms: 1–30 years • Secured by collateral or revenue stream • All asset classes • Requires governing body approval • Less financial disclosure • Project escrow funding • Competitive tax-exempt rates 	<ul style="list-style-type: none"> • Less payment flexibility • Multiple investors • Prepayment restrictions • Extended funding cycle (30–120 days) • Higher legal fees • Transactions: \$1 million and up • Financing terms: 1–40 years • Secured by collateral or revenue stream • All asset classes • Requires governing body approval • Ongoing disclosure requirements • Project escrow funding • Slightly lower tax-exempt rates

is properly documented via an official statement and bond indenture.

On receiving governing-body approval, the bonds are purchased by the investment-banking firm, which resells them to multiple investors, and the funds are deposited into an escrow account to pay for the project and cost of issuance. Overall, this model is best suited for larger and longer-term transactions, and when the borrower agrees to accept some restrictions in exchange for a slightly lower rate.

Private Placement Financing

Private placement financing is typically a debt or capital lease obligation arranged between a municipality or a 501(c)(3) not-for-profit organization and a single sophisticated institutional investor. The investor can be a bank, insurance company, finance company, hedge fund, or high-net worth individual.

Private placement financing is similar to municipal bonds and notes because it is used to finance a public agency’s capital equipment, real property, infrastructure, technology, and working capital needs.

Financing in the private placement world is typically structured as nonappropriation leases, installment purchase agreements, or debt. The investment is secured by the collateral being financed, a revenue stream (i.e., tax pledge or enterprise fund), or both.

The investor provides up to 100% of the capital (including sales tax) to fund the acquisition or refinancing needs of the borrower/lessee up to approximately \$50 million. The borrower’s payments are spread over the asset’s economic useful life, which typically ranges from 3 to 30 years.

Section 103 of the Internal Revenue Code exempts the interest income the investor receives from federal taxation. Thus, the tax-exempt rate the borrower pays

should be about one-third less than a taxable rate of equivalent financing term and credit quality.

Since the borrower arranges the financing with one investor, private placement financing is generally more flexible and is a quicker funding solution than a municipal bond. The borrower should expect to have (a) the ability to prepay the obligation more frequently; (b) increased payment options, as well as the ability to fund smaller and larger transactions; and (c) lower issuance fees.

Private placement loans and leases have less market liquidity, but they offer slightly higher rates, which complement the investor’s “buy and hold” strategy.

Table 1 compares the private placement and public debt structures.

An Efficient Solution

Private placement obligations offer an efficient solution for borrowers who want additional payment and prepayment flexibility and a quick funding solution, and who will accept a slightly higher rate.

Traditional municipal bonds allow borrowers access to the capital markets for small and large transactions with extended financing terms, and some prepayment restrictions, in exchange for a slightly lower rate.

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