Issue 14 Update 4

Refunding and defeasance

May 11, 2012

Overview

The Cleveland Metropolitan School District issued $20,855,000 of School Improvement Refunding Bonds on January 11, 2012, part of an effort to reduce future payments on Issue 14 debt. The District combined the refunding bond proceeds with $8 million in cash on hand from its Bond Retirement Fund in an escrow fund that will be used this year to pay off interest and principal for $28.6 million of Issue 14 bonds that were originally issued in 2002.

The Refunding Bonds were issued to take advantage of interest rates for municipal securities that were lower than those at the time of the original issue. The effect is similar to that achieved when a homeowner refinances a mortgage obtained when home loan rates were much higher.

The Board of Education authorized the bond refunding and defeasance on October 25, 2011. Final pricing of the Refunding Bonds was obtained on Dec. 19, 2011, and the delivery date was Jan. 11, 2012.

The estimated interest savings for District taxpayers is about $2.3 million.

Interest rate

The refunded 2002 Issue 14 bonds carried an average interest rate of about 4.92 percent, according to the deal's Official Statement prepared by RBC Capital Markets Corp. The average interest rate on the Refunding Bonds was about 3.93 percent. The True Interest Cost percentage (the effective rate of interest paid by the issuer on a debt security that is sold at a discount)
reported by RBC was 2.93 percent. The All-In True Interest Cost (the effective actual rate paid as a percentage of the face amount of the bonds, taking into account the net present value of all payments of principal, interest, and future expenses, discounts, premiums, costs of issuance, etc.,) was about 3.06 percent, according to the Official Statement.

Cost of issuance

The cost of issuance totaled about $181,000, including $67,500 for the bond counsel, Squire Sanders; $28,240 for financial adviser Fifth Third Securities; $24,220 for financial adviser CastleOak Securities; and $44,000 for bond-rating agencies.

Debt service reduction

The refunding proceeds and the $8 million in cash on hand will be used to pay off the

2002 bonds at the earliest allowable date, Dec. 1, 2012.

According to the Official Statement, the net present value of the interest savings attributable to the refunding bonds alone was about $2.3 million. Overall, according to the District, the early retirement of the 2002 bonds will reduce future debt service by about $12.4 million, which has a present value of about $10.3 million.

Last October, the District's financial advisers had estimated that the refunding and defeasance would lower necessary future tax collections by $14.3 million, which they said was based on market rates at the time.

Bond ratings

The refunding bonds were rated (AA) by Fitch Ratings, thanks to the District's participation in the Ohio School District Credit Enhancement Program, which requires the Ohio Department of Education to use the District's state operating subsidy to service the bond debt should the District fail to make the payment. Without the state credit enhancement, Fitch rated the bonds (A-).

Fitch investment-grade ratings range from (AAA) to (BBB), as follows:

AAA: Ratings denote the lowest expectation of default risk. They are assigned only in cases of exceptionally strong capacity for payment of financial commitments. This capacity is highly unlikely to be adversely affected by foreseeable events.

AA: Very low default risk, very strong capacity for payment of financial commitments. Not significantly vulnerable to foreseeable events.

A: Low default risk. Capacity for payment of financial commitments is considered strong but may be more vulnerable to adverse business or economic conditions than is the case for higher ratings.

BBB: Expectations of default risk are currently low. Capacity for payment of financial commitments is considered adequate but adverse business or economic conditions are more likely to impair this capacity.

Moody's Investor Service assigned the bonds a similar underlying rating of (A2). According to Moody's, "obligations rated A are considered upper-medium grade and are subject to low credit risk." Moody's adds numerical modifiers 1, 2, and 3 to each generic rating classification. "The modifier 1 indicates that the obligation ranks in the higher end of its generic rating category; the modifier 2 indicates a mid-range ranking; and the modifier 3 indicates a ranking in the lower end of that generic rating category."

District strategy

The District's goal was to reduce the amount of 2002 bond debt on its books (defeasance).

The refunding and defeasance extended the District's previous aggressive bond retirement strategy. In 2010, the District reported defeasance of $14.675 million in bonds from the 2002 issue, which resulted in a reported reduction of more than $25 million in necessary future tax collections.

The District's bond-retirement strategy was addressed in "Issue 14 Bond Issues" (April 6, 2010), an analysis prepared for the BAC by American Governmental Financial Services Co. of Sacramento, Calif., in conjunction with Government Financial Strategies Inc., Delphis-Hanover Corp., and the Law Office of Perry Israel.

"... The District's overall strategy involves retiring principal as rapidly as possible within the bond retirement millage target. This is done with the intent to facilitate potential [bond] rating upgrades, as well as to allow for capacity within the bond retirement millage rate target at the time the District might bring another bond issue before voters," the report says.

The transaction also could allow the District to issue more construction bonds later without increasing tax bills beyond what they are now or to lower tax bills if the construction and renovation program were halted.

Service of Issue 14 debt currently costs property owners the equivalent of about $5.30 to $5.50 per thousand dollars of assessed market value. In Ohio, assessed market value is 35 percent of "fair market value," which means that for a $100,000 home recent tax collections for the construction program have amounted to about $175 to $182 a year.

The $335 million in bonds authorized by voters under Issue 14 in May 2001 was not enough money to execute the entire construction program; the amount would need to have been in excess of $500 million *in 2002 dollars.* Nationally, construction costs have increased roughly

40 percent since then.

Now, with many schools cut from the construction program due to declining enrollment, it appears that the District will need between $140 million and $200 million in additional bond authorization to complete the construction/renovation program and repair its other schools.

Bond rating agencies reported that the District may seek voter approval this year of $225 million in new bond authority.

The window for a "no additional taxes" bond vote in the future had already been opened by the District's debt-retirement strategy. The recent refunding and defeasance simply opens that window a little wider. Although the numbers involved have changed, this window is illustrated on Page 111 of "Issue 14 Bond Issues," which provides a detailed discussion of the District's cash-flow needs and debt strategy on Pages 104-114. The report is available for review on the School District's Website at:

http://www.cmsdnet.net/en/Resources/Community/~/media/Files/Resources/Community/BAC/Black%20%20White%20Commissions.ashx .

Method of sale

The District followed its financial advisers' recommendation to undertake a negotiated underwriting process, in which a group of underwriters are solicited and selected according to the District's criteria before the securities are structured. The selected underwriters participate in the structuring efforts and they are able to engage in pre-marketing efforts because they have confidence that they will be able to purchase and resell the securities.

The BAC's consultants had previously made a general recommendation for competitively bid deals, in which offered securities are structured by the issuer, its financial advisers, and its bond counsel. Under this method, the sale occurs through a process that advertises the sale and solicits bids by underwriting firms. The firm proposing the lowest overall interest cost in a competitive bid wins the bid.

The District's advisers said negotiated deals allow flexibility to change the sale date and amount/identity of targeted bonds in response to changing market conditions, provide transparency in fees charged by underwriters, can be used to provide for inclusion of minority underwriting firms, and can provide District residents with first access to investment in the refunding bonds. The advisers noted that the vast majority of municipal bond sales are negotiated.

The BAC's consultants in the 2010 report (Pages 12-22) essentially rejected such arguments as being irrelevant to achieving the ultimate goal: the lowest possible interest rate to be borne by Cleveland's taxpayers. The report noted that under the circumstances of CMSD's bond issues, a competitive deal would be most likely to yield the best results for local taxpayers:

> "One of the ironies of the municipal securities market is that large numbers of issuers that otherwise are frugal and that carefully evaluate costs and money-saving alternatives in making even relatively small purchases nevertheless choose to ignore strong evidence that competitive bidding produces better pricing in certain securities financings of significant size. ....
>
> "With CMSD's own credit level, the enhanced ratings provided through CMSD's participation in the Department of Education's enhancement program, and standardized terms of unlimited tax general obligation Bonds, a competitive bid is preferable in terms of producing optimized yields for CMSD and the taxpayers."

The Government Finance Officers Association (GFOA), widely regarded as the good-government advisory body for the industry in the United States and Canada, notes in its official "Best Practices" recommendations that the desire to include minority underwriters or local firms is one factor that could favor use of a negotiated, rather than a competitive, method of sale. It also lists a number of factors applicable to the District's situation that would favor a competitive deal. For the entire "Best Practices" statement of the GFOA on this subject, go to

http://www.gfoa.org/index.php?option=com_content&task=view&id=1582

Selection of underwriters

Selection of underwriters is typically done through a Request for Proposals (RFP) process in which an issuer, such as the District, evaluates underwriter proposals according to set criteria and then selects a syndicate of underwriters with one or two designated as the lead managers.

The GFOA's Best Practice statement "Selecting Underwriters for Negotiated Bond Sales," is available in full at http://www.gfoa.org/index.php?option=com_content&task=view&id=1585 It says in part:

> "The issuer's goal in a negotiated bond sale is to obtain the highest possible price (lowest interest cost) for the bonds. To maximize the potential of this occurring, the issuer's goal in the underwriter selection process is to select the underwriter(s) that has the best potential for providing that price. Those underwriters are typically the ones that have demonstrated both experience underwriting the type of bonds being proposed and the best marketing/distribution capabilities. . . . No firm should be given an unfair advantage in the RFP process."

It is on this point, notwithstanding the District's good results using negotiated sales in its 2002 and 2004 bond issues, that the BAC's consultants took issue with CMSD's past practice of heavily favoring selection of local underwriters with which it had done business in the past.

When the District's advisers indicated late last year that they advocated continuing this preferential system, the BAC pressed the point that such a system might not be the best for the local taxpayers in terms of which underwriters would provide them with the best deal. The District eventually settled on an underwriter rating system weighted more toward abilities and less toward location and past relationships.

The BAC's consultants previously found that the District's underwriter selection criteria, employed for a possible 2007 Issue 14 refunding that was not executed and for a planned 2009 bond issue that was not executed, were weighted in such a way as to potentially exclude firms that could provide the lowest interest cost for the bonds. In part, the consultants said:

> "The criteria and weighting utilized by CMSD were as follows—
>
> Fees and expenses—25%
> Ability to distribute tax-exempt debt—20%
> Commitment to and/or ownership by minority groups—20%
> Corporate presence in the District—20%
> Performance on previous District bond or note issues—15%
>
> "That is, CMSD gave a 20% credit for local firms and another 15% credit for firms that performed satisfactorily in prior CMSD transactions. . . . Members of prior CMSD underwriting teams . . . had a significant 35% head start that could not be overcome easily by other, potentially more qualified firms. Meanwhile, the ability to sell tax-exempt debt at optimal yields for CMSD and the taxpayers—the most important component to be considered—rated only 20%. . . .
>
> "As does GFOA, we believe that the ability to provide issuers, such as CMSD, with the lowest overall costs is the key factor to consider for CMSD and the taxpayers.
>
> "As noted, we also believe that, in general, low Bond yields are significantly more important to CMSD than the level of underwriting fees and expenses. That is because the Bond yields represent, by far, the largest cost for the District and the taxpayers. ... The weighting criteria should be changed to reflect what is most important to the taxpayers, namely the lowest *overall cost."*

In 2002, the underwriting team was led by NatCity Investments, based in Cleveland, and also included Banc One Capital Markets, based in Chicago and formerly based in Columbus, and Loop Capital Markets, an MBE based in Chicago with a Cleveland office. The 2004 issue went to NatCity and KeyBank Capital Markets, both based in Cleveland. The team chosen for the abandoned 2009 issue was Huntington Investment, based in Columbus; JP Morgan, based in New York; KeyBank Capital, Loop Capital Markets, and Cleveland-based NatCity, which was acquired at the time by Pittsburgh-based PNC Capital Markets.

For the recent refunding, the selection criteria weighting was changed to:

> Ability to distribute tax-exempt bonds – 35%.
> Fees and expenses – 35%.
> Experience with Ohio school bonds and tax-exempt bonds – 15%.
> Commitment to and/or ownership role by minority groups – 5%.
> Corporate presence in the District – 5%.
> Performance on previous District bond or note issues – 5%.

The underwriters selected for the recent refunding were RBC Capital Markets, based in Toronto with offices in Cleveland, Columbus and Cincinnati, lead and senior manager; Loop Capital Markets, co-manager; Stifel, Nicolaus & Co., based in St. Louis with offices throughout Ohio, co-manager.

A Request For Quotations (RFQ) reportedly had been sent to George K. Baum & Co., based in Kansas City, Missouri, with an office in Columbus; Huntington Investment Co.; KeyBank Capital Markets; Loop Capital Markets; PNC Capital Markets; Rice Financial Products, based in New York with an office in Columbus; Robert W. Baird & Co., based in Milwaukee with offices in Columbus and Cincinnati; Ross Sinclaire & Associates, based in Cincinnai with an office in Columbus; RBC Capital Markets; Stifel, Nicolaus & Co.; Siebert, Brandford, Shank & Co., based in New York and Oakland, California; JP Morgan Chase Securities, Chicago office.

Conclusion

The District and its advisers did revise the its underwriter selection criteria to give more weight to factors most important to reducing the interest rate that taxpayers must pay for Issue 14 borrowing. However, the criteria still attach more importance to fees and expenses than the BAC's consultants deemed appropriate.

The District continues to follow its advisers' recommendation to use the negotiated method of bond issuance, counter to the BAC consultants' advice that competitive deals offer the best chance of winning the lowest interest rates for taxpayers.

In the end, however, determination of whether the District got a good deal rests with analysis of the actual sale results. The District will not know whether it obtained competitive results unless it commissions such an analysis.