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Refinancing High-Coupon Tax-Exempt Debt: Understanding the Benefits and Risks of Alternative Strategies

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This report places both traditional and newly developed alternatives for refinancing high coupon debt in perspective and creates a framework for evaluating the relative merits of each approach. Because of the large difference between current interest rates (and forward rates) and the coupons on the outstanding issues, each alternative can provide substantial net present value savings to the company. Yet, each approach also has certain inherent limitations and risks that may not be readily apparent. These risks ultimately may diminish the net present value savings of an alternative over another. *The challenge facing corporate treasurers is how to decide which alternative, or combination of alternatives, provides the greatest balance between savings and risk.*

Background

In the early to mid-1980's, corporations sold billions of dollars of tax-exempt bonds with fixed rate coupons greater than 9%. Corporations paid for pollution control equipment with the bond proceeds to meet environmental standards and issued the bonds through a municipal authority which allowed them to be tax-exempt to investors. Most of these issues have a 30-year maturity. And, they were sold with a standard bond covenant that prevents the company from prepaying and refinancing the bonds for at least ten years from the date of their offering.

Less than ten years later, interest rates have fallen dramatically and these tax-exempt bonds have, often, become the most expensive debt on corporate balance sheets. Given today's low interest rates, a current refinancing of the debt could generate substantial savings. Unfortunately, the corporate treasurer does not have the option of redeeming and refinancing these bonds with new tax-exempt issues, because the first call dates are still several years away. Several attractive alternatives however do exist.

One alternative is simply to repurchase the outstanding bonds from investors and refinance the purchase with a low-cost refunding issue. The repurchase can be done in discrete open market transactions or through a public invitation to tender. An

open market approach is most appropriate for actively-traded securities and limited repurchases; the tender is best suited for large repurchases of securities with inactive markets.

Other alternatives are generally known as "municipal forwards." They come in varying forms, such as fixed or floating rate. Municipal forwards are contracts entered into today to deliver bonds at some future date (usually the first call date) at a rate (and, therefore, price) specified today. Forward products are similar to "hedging" instruments developed for traders in the taxable bond options market who speculate on the future of interest rates.

Many investment banks are marketing forward refinancing products, which are all variations on a common theme, as proprietary products that should be used to the exclusion of other alternatives. *Rather than offering a stark "either/or" choice, all refinancing alternatives should be viewed as complementary tools for use in a total refinancing strategy.* The use of one product over another depends on the company's tolerance for risk and how much the company will be paid (i.e., the economic benefits of the product or strategy) to assume those risks.

Product Descriptions

Bond Repurchase/Refinancing

A repurchase is a simple transaction that has several formats, such as a fixed priced or an auction (e.g., English or Dutch formats).

Fixed Price: A company offers to buy back its outstanding bonds at a pre- determined, non-negotiable price. Such price may be specified as either a spread over an index or as an absolute number. It pays that price to all bondholders who accept the purchase offer. *This approach is most appropriate for securities with highly liquid secondary trading markets in which the market price is easily determined.*

English Auction: A company invites bondholders to offer to sell their bonds to the company at prices determined by the bondholders. The company accepts offers from lowest to highest, up to the amount it wishes to purchase. Each holder receives only the price he/she bid.

Dutch Auction: A company invites bondholders to offer to sell their bonds to the company at prices determined by the bondholders. After reviewing the various offers to sell, the company then selects the price that it is willing to pay for the amount of bonds it wishes to buy. It pays that price to all bondholders who were at or below the accepted price. *The Dutch auction approach best suits securities with inactive secondary markets, such as high-coupon tax-exempt debt.*

Because interest rates are lower today than when the bonds were initially sold, the current market price of the bonds is generally higher than their par value. To persuade bondholders to sell all or some of their bonds today, a company must also pay more than the current market price. The amount over this price that bondholders require to sell their bonds today is called the *"market premium."*

Federal law allows the company to finance the repurchase of the tendered bonds with a tax-exempt refunding issue equal in size only to the principal amount of bonds repurchased. It pays the premium from cash or a new taxable debt financing. The company's net savings is the present value of the difference between the coupon on the outstanding bonds over the coupon on the refunding bonds less the cash premium paid

to repurchase and retire the outstanding bonds. (See *Appendix*)

Once the company concludes the repurchase and refinancing, the savings are "in the bank." There are no future risks that can diminish the savings in any way.

Municipal Forwards

The basic forward products are a "forward contract" and a "forward swap." Generally, a forward is a contract or commitment, entered into today with one or more parties, to deliver bonds at some future date (usually the first call date) at a rate (and, therefore, price) specified today. The forward contract is a fixed rate obligation, currently packaged under several service marks, and the forward swap is either a fixed or floating rate obligation.

Given the upward sloping interest rate yield curve, the coupon on forward contract bonds always will be higher than the rate available on bonds sold today. Further, the lack of market liquidity for forward instruments generally leads investors to require an additional liquidity premium in the forward coupon. The premium in the forward's coupon is analogous to the market premium required by investors to sell their bonds in a repurchase.

The forward swap is an agreement with a counterparty under which the company pays a fixed rate and receives a floating rate payment usually linked to an index such as LIBOR or J.J. Kenny Information Services, a private municipal securities evaluation service. In a perfect swap, the company would receive floating rate payments sufficient to pay the cost of variable rate demand bonds issued to fund the refinancing when the swap begins.

In both cases, the company does not retire the outstanding high-coupon bonds until the first call date. The rate on the refunding bonds (or forward swap) delivered in the future is always higher than the refinancing or swap rate that the company can get today. All the benefits from a lower-cost refinancing of the outstanding high-coupon bonds must be deferred until the first call date.

How to Compare the Alternatives

An "apples to apples" comparison of the repurchase/refinancing and the forward products is very difficult. The forward products, like all hedging products, expose the company to certain risks that are hard to quantify and ultimately may reduce the value of the savings generated in the refinancing. In a repurchase and refinancing the company completes the transaction under known market conditions and its savings are locked-in on the day of closing. Nothing can change them.

The forward products' risks do not eliminate their benefits. However, a company must evaluate the risks to assess the tradeoffs between the promised benefits and its exposure to risks of future events.

The first step is to calculate the potential economic benefits of one approach over another. To determine the potential present value savings realized by the company from all the different refinancing alternatives, generally accepted financial theory[1] requires corporations to calculate the *incremental after-tax cash flows[2] of these alternatives and to discount those flows at the real cost of funds that generated the flows, i.e., the after-tax refinancing rate.*

The after-tax cash amount required to pay the premium (whether the market premium, if repurchased, or the redemption premium,

if called pursuant to a forward transaction) plus any fees and expenses must be subtracted from the discounted present value coupon savings. This is the "net present value" of the refinancing. Discounting of the after-tax cost of cash spent on the premium is not necessary, because the net present value of cash spent today (regardless of how the company finances the cash) can only be the absolute dollar amount of the cash at the time of the transaction. This is because it is spent on the day to which all other cash flows are discounted.

These mathematical calculations are straightforward with respect to the fixed rate instruments, i.e., the bond repurchase/refinancing and the forward contract. The forward swap is more problematical because of the assumptions regarding the future cost of the floating rate obligation over a long time period.

The next step is to assess the non-quantifiable risks of the alternatives. The repurchase/refinancing approach generally gives the greatest savings with the least amount of risk because of the certainty of its savings on the day of closing. As such, it can be conservatively employed as the first step of a refinancing strategy. To the extent that not all the bonds are repurchased, then a forward product can be used on the remaining amount.

The structure of the refinancing bonds in a repurchase/refinancing (i.e., fixed or floating, short or long maturity, etc.) is an independent decision from whether to pursue the repurchase. For example, if a fixed rate swap can produce a lower cost than a direct issuance of fixed rate securities (subject to the other risks and qualifications of swaps (See below *Forward Swaps*), the company can finance the repurchase with variable rate tax-exempt securities and enter into a "current fixed-rate swap." By this, it can enjoy the benefits of immediate savings because of the repurchase and the lower swap rate.

Risks of Bond Repurchase/Refinancing

Timing: A repurchase program takes approximately 3–5 weeks to complete. One might be concerned with changes in the refinancing rate during this period. However, because preparing refunding bond documents takes approximately the same amount of time, and can be done concurrently with the repurchase program, this timing/market risk issue is not significantly different from all other alternatives.

Amount Repurchased: It is unlikely to get 100% bondholder participation in a tender. Consequently, two transactions would be required, one now and one on the first call date, to refinance the entire principal amount.

Risks of Forward Contracts and Forward Swap Products

ALL FORWARDS:

Legislative Risk: All forward products are exposed to changes in the federal tax code governing new issues of tax-exempt bonds. This is because the forward refunding bonds are not legally "issued" until many years in the future. Historically, industrial development bonds (IDBs) and other corporate tax-exempt bonds have been favorite targets of a revenue- strapped Congress. Precedent exists for unexpected and "unreasonable" changes in the law

governing new issues of corporate tax-exempts bonds.

Also, the forward financing is vulnerable to changes in regulations issued by the Treasury Department and the Internal Revenue Service. An unfavorable change in the treatment of tax-exempt bonds could cause the forward transaction to unwind. The company would then be exposed to market risk and will have forgone any savings that could have been locked in today.

Other Tax Risks: Tax opinions delivered by bond counsel in forward transactions are qualified opinions. They are not the traditional unqualified or "clean" opinions issued in current refundings. Because the forward products are new, certain tax aspects are uncertain and are the subject of much discussion among tax and bond counsels. For example, there is uncertainty on the proper issue price to be used in calculating the yield for IRS purposes. Further, the tax effects for investors of trading the forward contract before the bonds are issued on the first call date is highly uncertain. This may affect the coupon premium demanded by investors. This and other issues raise questions concerning the true economic outcome of the transaction. Whatever the result, these issues will tend to increase counsel fees on the forward transaction compared to a traditional repurchase and refinancing.

Political Risk: One legislature may not bind a future legislature. Although the company may receive regulatory approval today, it is still subject to ratification or recision by the future authority before the forward transaction is concluded. This potential future review requirement is charged with the possibility that the forward transaction could be challenged as "imprudent" if future market conditions have improved significantly. Further, the company could be held hostage should its political standing in the community change for whatever reason. A forward contract is more vulnerable to second guessing by shareholders, regulators and others than a current fixed rate refinancing.

Performance Risk: While the forward contract legally binds investors, potential legal sanctions may not be sufficient to prevent one or more investors from breaking the contract.

The most obvious performance risk is that the future financial condition of an individual investor may prevent that investor from honoring the contract. The investor may be bankrupt, may have left the municipal market, or may have been dissolved. (Take for example the recent trouble with several large insurance companies who are traditional investors in long-term tax-exempt securities.) The company may have a legitimate claim in any bankruptcy or other court proceeding, but the time and expense involved in litigation may not be cost-effective.

In addition, the future circumstances in which investors have the greatest economic incentive to break the contract willfully, i.e., much higher interest rates at the time the forward contract is to take effect, is also the scenario in which the company faces the greatest refinancing risk.

Some forward products seek to protect against this risk by requiring the investor to collateralize *a portion* of their commitment with a letter of credit or other security. These are, of course, additional costs passed along to the company.

Performance risk also extends to the municipal authority. Besides the political risks cited above, there is, unfortunately,

ample precedent of municipalities walking away from financial obligations. As many British banks (that entered into swaps with municipalities that were declared unenforceable when the municipal authorities subsequently wanted to cancel them) and the WPSS bondholders have learned the hard way, a financial technique widely used in the corporate arena may not be enforceable when governmental bodies are involved.

If the company must refinance even a small portion of the bonds on the first call date because of a performance default, the expected refinancing savings could be seriously reduced because of both market risk and transaction costs.

FORWARD SWAPS:

This alternative generally fixes the economic cost at or below a direct issuance or a forward contract. But the issuer must absorb all the other risks of variable rate debt. There are also some unique risks.

Basis Risk: In a swap, basis risk is the difference between the floating rate payment that the company receives from the swap counterparty (generally based on a market index) and the company's actual cost of financing. Ideally, the floating rate payment received should match the company's actual interest payments. No market index, however, exactly matches an issuer's cost. To calculate the true cost of the swap, the difference between the payments received and made must be added to or subtracted from the fixed payment the company is making. The degree to which it varies is another hard to quantify risk (cost) of the swap.

In taxable swaps, basis risk can be more easily quantified due to the size and liquidity of the taxable market. With taxables, there is a large track record and information is readily available. Taxable swaps are based upon the U.S. Federal Reserve AA Commercial Paper composite or LIBOR rather than a private marketing firm's judgement such as J.J. Kenny. The large number of players in the taxable swap market compared to only a handful in the tax-exempt market also suggests the stability of this market and the weakness of the still emerging tax- exempt swap market. An issuer therefore cannot be sure of the amount of basis risk it is assuming because the data is so new and subject to interpretation.

Some swap counterparties propose to eliminate basis risk by agreeing to pay the company's actual cost of funds. But, there is a catch. The company must maintain its current ratings (or always maintain a letter of credit or pay for bond insurance that adds to the cost of the refinancing). If the ratings drop below a specified level, the swap payments convert to an indexed basis and the company bears the basis risk. Typically, if the company's ratings fall further, the counterparty may cancel the swap. Under these arrangements, the company is effectively providing for or giving away credit protection to its investors. The cost of this credit protection must be included in the analysis of the savings of this refinancing approach.

Market (Variable Rate Bond) Risk: A forward swap succeeds if it effectively fixes the "cost" of the company's variable rate debt. Yet, in agreeing to pay a fixed rate to the counterparty and accept the floating payment in return, the company is assuming (in effect guaranteeing itself) that it can continue to sell its variable rate securities though it cannot directly control this result. *If the company cannot remarket (resell to other investors) at any time, the company must*

immediately pay the bondholders the full principal amount of their investment. The company is constantly exposed to this market risk because bondholders have the right to put the bonds back to the company typically at any time upon seven days notice. If the bonds are ever put and not remarketed to other investors, the company remains fully liable. And, this is most likely to occur when a company can least afford it. (See *"Counterparty Risk: The Remarketing Agent"* below.)

Counterparty Risk: The Swap Payer: The company is also exposed to the swap counterparty's ability to continue to make the swap payments throughout the life of the swap. The widely publicized financial difficulties of major banks and insurance companies highlight the nature of this risk.

Counterparty Risk: The Remarketing Agent: In a forward swap, the issuer is responsible for hiring and paying the fees of a remarketing agent to reprice and resell the variable rate bonds put to the company by investors. Usually, the broker of the swap requires that it be appointed the remarketing agent to earn this fee. Investment banking fees have been known to change over time (also their skill and desires to be in certain financial products have changed over time). If the remarketing agent agrees to fix its fees for the term of the swap, the company remains at risk. The remarketing agent can usually cancel the remarketing agreement in its entirety on 30-days notice.

The investment bank or broker-dealer rarely has a Moody's or S&P credit rating high enough for an issuer ever to accept the investment bank as a counterparty in the swap payments. But, the issuer in a forward swap must accept this risk in a more critical aspect of the swap, the constant remarketing of the bonds, where the entire principal, not just the interest payment, is at stake.

Some may dismiss the risk that an investment bank that earned the business based on its relationship with the company or its league table ranking would do anything to endanger that relationship or standing in the market. More realistic observers may recall that, in 1987, the number one ranked firm in the municipal bond business (and the remarketing agent on billions of dollars of variable rate tax-exempt debt) left the business literally overnight. Other firms have also abandoned this market or changed their "strategic direction."

Need for Liquidity Lines: Generally, for a variable rate demand bond issue (one that has an optional bondholder put at par upon one or seven day's notice) to appear as long-term debt on the balance sheet, the debt must be supported by a dedicated line (or direct-pay letter) of credit from a commercial bank. So, in addition to the remarketing costs, the company must consider the cost of these facilities. It is unlikely that the company could fix the cost of the lines over the life of the swap, which could diminish the savings from the swap. Moreover, given the current disruption among commercial banks, it is more likely that these costs will rise rather than fall over time. Thus, comparing the net present value savings of a swap to a fixed rate bond becomes even more difficult.

Other Limitations of Forward Products to Consider

All Benefits Deferred: With all forward products, the economic benefits of the refinancing do not begin to accrue until years in the future, usually the first call date.

Inability to Extend Maturity: In a bond repurchase/refinancing, the maturity of the new bonds can be easily extended beyond the maturity of the bonds repurchased (as long as the facility being financed has a sufficient useful life.) Maturity extension is accomplished through a public "TEFRA hearing" by the municipal authority just before pricing of the new bonds. In a forward transaction, the ability to extend maturities is severely restricted, because, by law, the TEFRA hearing must be held only within one year of the issuance of the new bonds. Most forward transactions are for bonds that will not be issued for several years after the deal is "done" today. To extend the maturity of the new bonds, one must consider the additional risk of the TEFRA hearing, the premium to be paid to the bondholder if the maturity is not extended for any reason, or worse, the risk of the entire deal collapsing.

Conclusion

In the 1960s and 1970s, one of the most popular television game shows in America was "Let's Make a Deal." Each day host Monty Hall offered contestants the choice between guaranteed cash or prizes or the uncertain benefits of "what's behind door number one, two or three." Cheered on by a studio audience (not directly affected by the decision), many contestants would forsake the guaranteed return and choose a door in the expectation of greater riches. More often than not, the contestant would find nothing of value behind the door and be left perhaps wiser but, unfortunately, empty–handed.

Today, when evaluating the risks and rewards offered by the financial products sold in the Wall Street bazaar, corporate treasurers frequently find themselves in a similar position as "Let's Make a Deal" contestants. Seasoned products and services that offer certain rewards are overlooked as Wall Street technicians continue to develop exotic new products that hold the *promise* of greater remuneration. Many of these innovations have risks that are not fully known or understood. A current paradigm of this old problem is the choice embodied in the various methods of refinancing expensive outstanding debt.

By looking behind the "door" before making a decision, by weighing all the risks and rewards today, the corporate treasurer will be in the best position to make a decision.

The risks of forward products can be mitigated in varying degrees but can never be eliminated. The risks may ultimately raise the cost of a refinancing, but a company cannot be definitely sure by how much until, with the forward contract, after the forward bonds are actually sold, and with a forward swap, after the transaction matures. *Because of these uncertainties, forward products should not be the refinancing alternative of first choice. That role belongs to the repurchase/ refinancing.*

An auction tender gives a company the opportunity to buy back as many bonds the company determines are offered at economically attractive prices. In a repurchase and refinancing *the company is in complete control* of the economic

outcome of the transaction. Its up–front investment is small and it is not committed to proceed unless the prices and refinancing rate suits its objectives. Through this procedure, a company can lock in substantial savings without additional risk.

Having determined what the market will bear with the auction, a company can then use the more expensive/more risky forward products to secure additional savings if the risk/reward profile of these products meets the company standards. By employing the refinancing tools in this sequence a company will be assured of the most cost effective and risk adjusted refinancing. The question is not one or the other but when and in what sequence and, most importantly, are the benefits of other than a certain refinancing, as with the repurchase/ refinancing, worth the risks.

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1. See Brealey and Myers, Principles of Corporate Finance, 2nd Edition, Chapter 6 "Making Investment Decisions with the Net Present Value Rule," and Weston and Copeland, Managerial Finance, 8th Edition, Appendix A to Chapter 26, "Refunding Decisions."

2. Because municipalities do not pay taxes, most Public Finance investment bankers do only a pre–tax analysis of the refinancing decision. This approach is incorrect for a tax– paying corporation that receives a 34% deduction (higher when state and local taxes are considered) for interest expense, market premiums, and other fees relating to the refinancing. These tax consequences, and their effects on cash flows, cannot be ignored if the analysis is to be accurate.

APPENDIX

A repurchase/refinancing analytical model is based on the following basic financial principles:

- only incremental cash flows are relevant;
- all incremental cash flows should be estimated on an after-tax basis;
- all future after-tax incremental cash flows should be discounted at the applicable after-tax refinancing rate of the given refinancing alternative that generated those after-tax cash flows.

A correct analysis uses these principles to calculate the net present value savings ("NPV") of the reduction in future annual bond interest payments gained through a refinancing program. The model can be used to analyze the savings of a repurchase/refinancing, a forward contract or a fixed rate forward swap. The basic mathematical formula to calculate the net present value of any refinancing strategy is as follows:

Where

t	= time in years
n	= remaining years to maturity of the old issue
T	= combined Federal, State and Local corporate income Tax rate
ARC	= Amortizable Refinancing Costs of new issue
DRC	= Deductible Repurchase Costs (cost of repurchasing old issue:premium, dealer fees)
ORC	= Original Refinancing Costs (unamortized discount, fees, etc.) of old issue
r_1	= coupon Rate on old bond
r_2	= coupon Rate on new bond
P	= Principal amount of bond

$$NPV = \{\sum_{t=1}^{n}((1-T)(r_1-r_2)P/[1+(1-T)\,r_2]^t)$$

$$\text{less } (1-T)DRC$$

$$\text{less } ARC$$

$$\text{plus } \sum_{t=1}^{n}((T)ARC/[1+(1-T)\,r_2]^t)$$

$$\text{plus } (T)ORC\}$$

The equation has five components:

1. The first component $\sum_{t=1}^{n}((1-T)(r_1-r_2)P/[1+(1-T)\ r_2]^t)$,

   calculates the present value of the differential in the after-tax coupons of the old bonds and the refinancing bonds. This component represents the most substantial portion of the net present value savings of any refinancing strategy.

2. The second component, **(1-T)DRC**, calculates the after-tax cash outlay to pay for certain repurchase costs which are immediately tax-deductible. Those items which are immediately tax-deductible are the repurchase or redemption premium and any tender dealer manager fees and certain expenses. This cash outlay is not affected in any way by the manner in which it is financed. If the cash outlay is financed with taxable debt, the present value of this amount is equal to the cash outlay regardless.

3. The third component, **ARC**, calculates the cash outlay to pay for certain refinancing costs which must be amortized for tax purposes over the life of the refinancing issue. Those refinancing items which are not immediately tax- deductible are the costs of issuance of the refinancing bond, any original issue discount of the refinancing bond and any refinancing bond insurance expenses. The deferred tax benefits of the deductibility of these items is represented by the fourth component.

4. The fourth component $\sum_{t=1}^{n}(T)ARC/[1+(1-T)\ r_2]^t$, calculates the

   present value of a lower tax liability generated by the deduction in future years of those refinancing costs which must be amortized for tax purposes over the life of the refinancing issue.

5. The final component, **(T)ORC**, calculates the benefit of the reduced current tax liability of the unamortized cost of issuance and original issue discount of the original bonds that can be deducted in full for tax purposes when the old bonds are repurchased and refinanced.

6. Where the repurchase/refinancing alternative has an NPV that is certain on the day of closing, and can be calculated by the equation, the equation cannot take into account the risks associated with the forward products. This must, unfortunately, be a judgement of the issuer.

Some analyses of corporate tax-exempt refinancings ignore the tax consequences for the tax-paying obligor of the pollution control revenue or industrial revenue bonds. As the above equation illustrates, every dollar expended in refinancing costs has certain tax consequences and the consequences vary by the type of cost. If one ignores the tax effects, one may obtain an incorrect net present value savings amount and may, consequently, make a misinformed decision.

The two most important determinants of net present value are the (i) refinancing rate and (ii) the refinancing costs, primarily the purchase premium. The negative impact on net present value savings of the purchase premium is muted by its tax deductibility. In effect, the corporation is shifting a payment from the federal government to the bondholders as part of a program to reduce interest expense immediately. The government also benefits from this reduction because there will be less tax–exempt interest paid and therefore fewer dollars lost from the Treasury.

The refinancing rate has the single largest impact on the net present value savings. Thus, any refinancing bond structure that lowers this refinancing rate improves the economics of the transaction dramatically.

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