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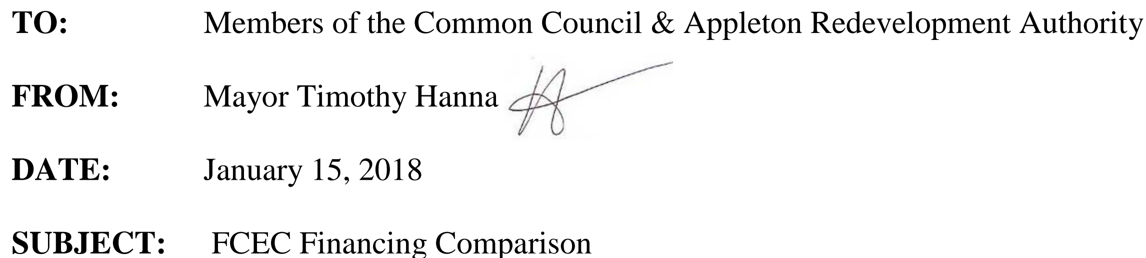

TO: Members of the Common Council & Appleton Redevelopment Authority

FROM: Mayor Timothy Hanna

DATE: January 15, 2018

SUBJECT: FCEC Financing Comparison

There has been much discussion lately about the permanent financing for the Fox Cities Exhibition Center project. I will attempt to provide you with context and clarification regarding these discussions as well as pertinent points to consider as you make a decision as to the best path forward.

It is important that we begin with the goal. The goal in choosing the best method for financing the FCEC is to pick the method that gives us the best opportunity to pay down the debt using the available room taxes as quickly as possible while minimizing the risk to the participating municipalities.

The essence of this goal is embodied in the Exhibition Center Cooperation Agreement adopted by the ten participating municipalities in 2015. Here is the relevant section of the agreement:

Section 2.05 <u>Nature of Financing Transaction</u>

The ARA will be responsible for acting as conduit issuer of the Bonds and payment of all debt service on the Bonds shall be made solely from the proceeds of the Room Tax Rate. The ARA's budget will not be collateral for the Bonds. Pursuant to the Pledge and Security Agreement, the Pledged Room Tax revenues will be pledged to the Trustee for purposes of paying debt service on the Bonds.

The Bonds will be limited obligations of the ARA and shall not constitute a debt or obligation of the ARA or the Municipalities and shall not be a charge against the general credit or taxing powers of the ARA or the Municipalities except for and limited to the Pledged Room Tax revenues pursuant to the Pledge and Security Agreement.

At the time the Cooperation Agreement was adopted (2015), it was anticipated the cost to construct the EC would be in the range of $24 to $27 million. The decision to accept the alternative design of the Center in 2016 pushed the construction costs to $31 million which subsequently had an effect on the

ability to secure traditional bonds based solely on projected room tax revenues as required by Section 2.05 of the cooperation agreement. Information provided by Speer Financial, the financial advisor used on this project, indicated that historic and projected 3% room tax would leverage $26 to $28 million in the traditional bond market. With this information, alternative financing was pursued to be able to meet the terms of the Cooperation Agreement.

In late November, 2017, I was approached by two of our partner municipalities and asked to again look at the possibility of a fixed rate revenue bond. It was their belief that a fixed rate bond issue could be accomplished according to their conversations with bond advisors. I took them at their word and agreed to investigate a fixed rate bond. In early December Finance Director Saucerman and I met with representatives of Baird Financial to discuss the possibility of issuing revenue bonds for the FCEC. At that meeting, they provided a summary of hypothetical financing plans, one tax-exempt and one taxable. Under these scenarios the tax-exempt plan would net $31,111,583 for the project and the taxable plan would net $28,390,409 for the project. It was agreed at this meeting that a preliminary opinion from bond counsel as to the taxability of the issue would be in order.

In late December Attorney Walsh, Director Saucerman and I had a conference call with Foley & Lardner regarding the taxability of a bond issue. During that conversation Foley & Lardner indicated that based on the agreement for the management of the FCEC, they could not give an unqualified opinion that the issue would be tax-exempt. Therefore, it was determined that future discussions regarding revenue bonds should be based on them being taxable. In the meantime, due to more favorable conditions in the bond market, Baird revised their hypothetical financing plans and indicated that a fixed rate taxable bond issue could net the amount required for the project. That plan is the one presented to the Finance Committee on January 8.

I have provided this background in an attempt to clarify how we have arrived at this point with two options for permanent financing for you to consider.

Comparison of Financing Models

Issuer: Both options have the ARA as the issuer of the bonds in accordance with the Cooperation Agreement.

Trustee: The private placement model anticipates using BMO Harris Bank, N.A. as the administrative agent. The fixed rate option anticipates using Associated Bank as the trustee of the funds. This is the same trustee that has been used for the PAC bonds.

Amount of Bonds: The private placement model anticipates the amount of the bonds to be $31,000,000. This option assumes that room tax funds collected to date that haven't been applied to construction costs would be used to fund closing costs and required Debt Service Reserve amounts. The fixed rate option presented by Baird shows closing costs, including Debt Service Reserve, being funded through the bonds. The fixed rate option would require a separate bond stabilization fund of $900,000 to be funded through available resources. Under the fixed rate option excess funds could be applied before closing reducing the total amount of the bonds. In that case Baird would need to revise their amortization schedule based on a lessor amount.

Interest Rate: The private placement option has an initial interest rate determined by the 5-year treasury rate plus 220 basis points (2.2%). As of January 12, that rate would be 4.53%. The initial rate

would be determined on the day of closing. Once the rate is determined, the rate is locked in for 5 years and would be adjusted every 5 years thereafter according to the current 5 year treasury rate. The hypothetical fixed rate option presented by Baird is 4.07%. This projection is presented as of December 6, 2017 per the disclosure. The fixed rate is based on a number of factors which I will touch on later. The final fixed rate will be determined when the bonds are sold.

Maturity: The fixed rate option and debt service schedule is based on a 32 year amortization. The private funding option does not have an amortization schedule. This option matures in 25 years. The only debt service requirement is the interest accrued since the last payment date. The *expected* maturity under either option is subject to the *actual* collection of room taxes. Both options have presented expected maturity dates around 20 years based on projected increases in room tax collections.

Interest Payments: The private placement option requires interest payments each quarter after room taxes have been collected. The fixed rate option requires semi-annual interest payments.

Principal Payments: Fixed rate bonds will require annual principal payments according to the bond schedule. Additional principal payments may be made semi-annually on any interest due date in amounts of no less than $100,000 without penalty or premium. Additional principal payments would be applied to the oldest bonds outstanding in reverse order. Principal payments on the private placement bonds may be made on any interest due date in any amount. Room taxes collected in excess of the interest due would be applied to principal without penalty.

Prepayment Option: The private placement bonds may be prepaid at any time without penalty. The prepayment option on the fixed rate bonds is yet to be determined.

Debt Service Coverage: The private placement bonds have no debt service coverage requirement because they are interest only bonds. The fixed rate bonds are projected to have a debt service coverage ratio of 1.25X. This simply means the amortization schedule of required payments is based on revenue projections that are 1.25X the annual debt service payments. The redemption of the bonds is based on the actual amount of room tax collected.

Debt Service Reserve Fund and Stabilization Fund: Both options require a debt service reserve fund. Baird estimates the debt service reserve fund requirement for the fixed rate bonds to be $2,529,995.80. This is based on the total of their projected Bond Proceeds ($34,435,000). As stated earlier, the actual bond proceed amount could be less using available resources at closing. A smaller bond proceed amount would require a smaller debt service reserve fund. The fixed rate option also requires a stabilization fund of $900,000. The private placement bonds require a minimum debt service reserve fund of $1,500,000. The initial balance of this reserve fund is to be $3.4 million. The deposit into this fund would be based on available resources at closing.

Security: Security for the debt under the private placement bonds is a pledge of that portion of the room taxes collected to support the debt service under the Cooperation Agreement (3%). There is no other security for this debt. This is in keeping with Section 2.05 of the cooperation agreement. Security for the fixed rate bonds is also a pledge of the same room taxes (3%). There is additional security in the form of a “Quiet Enjoyment Lease” between ARA and the City of Appleton. This means that because the ARA is the issuer of the debt it needs to “own” the building and provide a lease to the City of Appleton for its use until the debt is paid in full. Under the fixed rate option, this is what makes the ARA the “lessor”, the City of Appleton the “lessee”, and the City of Appleton the “obligor”. This is important to understand. This arrangement needs to be in place so that the bonds can be “rated” with the City of

Appleton as the underlying obligor. This will allow Moody's to assign a rating based on the City's excellent credit history. It also places the City of Appleton at risk should room taxes fall to the point where the stabilization fund and the debt service reserve fund are depleted in order to make the required debt service payments. Putting the City at risk in any way is not consistent with section 2.05 of the cooperation agreement.

How does the DSRF work under each scenario? In the case of the fixed rate bonds, should room tax collections fall short of the required debt service payment, funds from the stabilization fund would be used. If succeeding collections are more than required to meet the debt service payment, the excess would first be used to replenish the stabilization fund and then be used for an additional principal payment according to the terms of the bonds. If succeeding collections continue to fall short of required debt service payments, first the stabilizations fund would be used followed by the debt service reserve fund. If both the stabilization fund and debt service fund are depleted the City of Appleton as the obligor would be required to make the debt service payments.

In the case of the private placement bonds, the City has already agreed to guarantee that the debt service reserve fund would not fall below $1,500,000. However, any advance made to the debt service reserve fund would be refunded to the City, with interest, from future room tax collections. This arrangement is in keeping with Section 2.05 of the Cooperation Agreement in that the City would me made whole through the room tax.

Debt is all about risk. There is risk taken on by the debtor as well as risk taken on by the lender. The terms of any debt arrangement are made to mitigate risk to both parties to insure that the debt will be repaid as planned. Each of the options before us has risk which I will briefly discuss.

Revenue Risk: Each of these options relies on future room tax revenues for debt service payments. The best historical example we have of room tax revenues is the PAC bonds. The *average* yearly increase in room tax revenues over the life of those bonds has been around 4%. But the *range* of yearly changes in room tax collections is 12.14% in 2006 to -16.48% in 2009, meaning there is a fair amount of volatility in room tax revenues. This volatility puts the greatest risk on the debtor when the loan balance is at its greatest, or in the first several years of the loan. In the case of the fixed rate bonds, this risk is mitigated through an amortization schedule requiring lower debt service payments in the early years and increasing as time goes on. You can see this debt service schedule in the Baird presentation under the column labeled "Original Debt Service". In the case of the private placement bonds the revenue risk is mitigated through the use of an interest only arrangement, meaning if room tax revenue should decline in the early years of the loan the only debt service due is the interest on the loan. I have attached a chart with the actual room tax collected (adjusted to show 3% room tax) over the course of the PAC bonds along with a graph of the percentage of year to year changes.

Rate Risk: Rate risk can be mitigated by executing a fixed rate loan. With a fixed rate, the only remaining risk is if future rates fall far enough below your fixed rate that your debt could be restructured to pay the debt off sooner given any refinancing costs. With the current fixed rate proposal, it is hard to tell how far rates would have to fall without knowing the terms of the prepayment option. The rate risk with the private placement bonds is in the uncertainty of the rate at the rate reset date. If the 5 year treasury rate is higher at the reset date, then more of the future revenue will be required for interest payments and if the rate is lower at the reset date more of the future revenue can be used to pay down the principal. Because the rate in the private placement option is tied to the 5 year

treasury index, one could make the assumption that if rates are higher at the reset date, it would be an indication that the economy is doing well which should theoretically translate into higher room tax collections. If there is a desire to lock in a rate in the future, the private placement bonds allow for prepayment without penalty at any time. To give you a sense of the volatility of the 5 year treasury rate, I have attached a graph showing the historical changes over the last 16 years.

So, what does the economic future look like and how will it affect future room tax collections and interest rates? Which option before us mitigates the greatest risk going forward? According to the terms of the Cooperation Agreement, it is the responsibility of the Appleton Redevelopment Authority to issue the debt. But given the terms of the private placement bonds requiring the City of Appleton to guarantee a minimum or $1,500,000 in the debt service account, or the terms of the fixed rate bonds requiring the City of Appleton be the obligor of the bonds, it is not unreasonable for the Common Council to make a recommendation to the ARA. It is also not unreasonable that once a decision is made, the other parties to the Cooperation Agreement fulfill their obligations under the agreement in a timely manner.