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Arbitrage Today & Investing Bond Proceeds

PRESENTED BY:

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Project Fund Investing

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1. Work with issuer and construction manager to understand cash flow requirements
2. Review investment policy, economic conditions, and investment opportunities
3. Formulate and execute investment strategy
4. Ongoing discussions with issuer on the status of project; adjust strategy as needed

Project Fund Allocations

- Ensure funds are available to meet project expenditures, while maximizing interest earnings

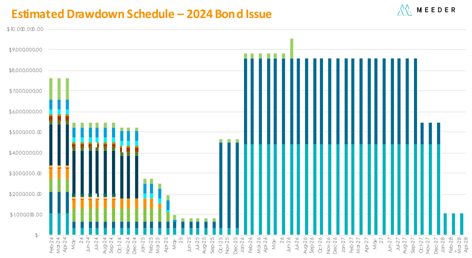
Securities (Cash Flow Matched)
- Treasuries
- Agencies
- Commercial Paper

Cash Equivalents (Same Day Liquidity)
- Local Government Investment Pools
- Money Market Mutual Funds

Hypothetical School District – 2024 Bond Issue Schedule

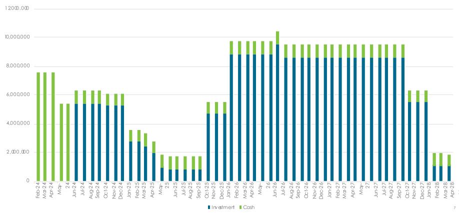
Projects	Amount	Start	Completion
High School Rebuild	$125,000,000	Winter 2023	Summer 2028
Middle School Rebuild	$115,000,000	Winter 2023	Spring 2028
Security Improvements	$25,000,000	Winter 2023	Winter 2024
Maintenance	$25,000,000	Winter 2023	Winter 2024
Technology Project 1	$3,000,000	Winter 2023	Winter 2024
District Overhead Costs	$2,000,000	Winter 2023	Winter 2024
Technology Project 2	$10,000,000	Winter 2023	Winter 2024
New Construction Project C	$10,000,000	Winter 2023	Summer 2028
Contingency Costs	$35,000,000		
Total	$350,000,00		

Estimated Drawdown Schedule – 2024 Bond Issue



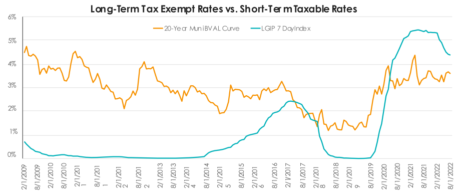
Investment Schedule

Cash: $75,870,000
Securities: $284,130,000



Arbitrage and Yield Restriction

Long-Term Tax Exempt Rates vs. Short-Term Taxable Rates



SOURCE: BLOOMBERG

Tax Exempt Bonds

What are they? What are they used for?

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Tax-exempt Bonds

- Tax-exempt bonds are the primary mechanism through which state and local governments raise capital to finance essential public projects
- Example projects:
  - Schools
  - Roads, bridges, highways
  - Airports
  - Water and waste water facilities

Tax Treatment

- Bonds issued by government entities generally bear interest that is excluded from gross income for federal income tax purposes
- This preferential treatment generally results in municipal securities bearing a lower interest rate than taxable fixed income securities (such as corporate bonds)
- The Federal tax exemption functions as an indirect subsidy: by not taxing the interest on municipal bonds, municipalities receive a lower borrowing rate from capital market investors

Federal Tax Law: Arbitrage Rebate and Yield Restriction

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The Federal tax exemption comes with strings attached for state and local governments

- **Because the Federal Government is forgoing tax revenue with tax-exempt municipal bonds, the tax code is designed to prevent governments from:**
  - Issuing more tax-exempt bonds than needed
  - Issuing tax-exempt bonds earlier than needed
  - Keeping tax-exempt bonds outstanding longer than needed
- **One of the ways the tax code limits the amount of outstanding tax-exempt bonds is through the arbitrage rebate and yield restriction rules**
- **The arbitrage rebate and yield restriction rules are a "belt and suspenders" approach**
  - They both place limitations on the investment earnings from tax-exempt bond proceed

Yield Restriction

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The yield restriction rules outline when a public issuer may invest bonds proceeds at a yield above the bond yield

These rules do not address when a public issuer may keep the excess earnings

- **The most common exception to yield restriction is the three-year temporary period exception for new money project funds**
  - Must expect to spend 85% of proceeds within three (3) years
  - Must incur binding obligation to spend at least 5% of proceeds within six (6) months of issuance
  - Must proceed with due diligence in spending proceeds
  - Temporary period can be extended to five (5) years if it is certified that a longer period is necessary to complete project
- **After three (3) years, if proceeds are unspent, must make "yield reduction payments"**
- **The temporary period election is made at the time of issuance and is reflected in the tax certificate**

Arbitrage Rebate

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The arbitrage rebate rules determine whether a public issuer may keep earnings above the bond yield

- Arbitrage rebate requires the issuer to pay the U.S. treasury investment returns earned above the bond yield after five years, unless an exception is satisfied
- The primary exceptions to arbitrage rebate are the spending exceptions listed below:
  - Small issuer exception (issue <$5M in a year)
  - Debt service fund exception

1 — 6-month Exception
No rebate owed if all proceeds spent within 6 months

2 — 18-month Exception
Issue must spend based on below schedule:
6 months: 15%
12 months: 60%
18 months: 100%

3 — 24-month Exception
Only applicable to construction issues—the issuer must spend based on below schedule:
6 months: 10%
12 months: 45%
18 months: 75%
24 months: 100%

How do these Rules Work Together?

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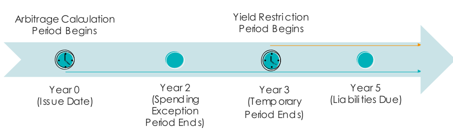

Exceptions to Arbitrage Rebate & Yield Restriction

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Investments excluded from limitations on interest earnings

- Tax-exempt bonds
- Tax-exempt money funds
- Demand Deposit State and Local Government Securities (SLGS)

SLGS are special obligations of the US Treasury with a pledge of the full-faith and credit of the United States, designed to assist public issuers with complying with the arbitrage and yield restriction rules.

TWO TYPES OF SLGS

- **Demand Deposit:**
  One-day certificate of indebtedness that are rolled daily until redemption. Depending on the size of the redemption, they can be redeemed on 1-3 days' notice
- **Time Deposit:**
  Time deposit securities with maturities ranging from 15 days to 40 years. Public issuer can select interest rate ranging from 1 basis point below the current matching treasury to 0%

Demand Deposit SLGS Mechanics

Characteristics

Book-entry form; non-marketable

- **One-day certificate of indebtedness**
- **Interest** is capitalized daily on principal and prior accrued interest; paid at redemption
- **Rate** based on an adjustment of the average yield in most recent 13-week bill auction (reset daily)
- **Minimum: $1,000; Maximum: None**

Subscriptions

Made through TreasuryDirect's SLGSafe website

- **Subscriptions for <$10 million:** Five (5) calendar days before issue date
- **Subscriptions for >$10 million** Seven (7) calendar days before issue date
- **TIN of the "issuer"** is needed for subscription

Redemptions

Made through TreasuryDirect's SLGSafe website

- **Redemptions for <$10M:** One (1) calendar days' notice
- **Redemptions for >$10M:** Three (3) calendar days' notice

Today's Environment: Challenges and Strategies

Case Study #1

ASSUMPTIONS

1. Bonds issued on **April 15, 2020**
2. New money construction project
3. **Arbitrage yield of 2%**
4. Project fund qualified for **3-year temporary period**
5. Did not meet rebate exceptions
6. Expect to spend remaining proceeds over next 12 months

Rebate analysis

- Will be based on earnings since issuance
- Negative arbitrage from early years of investments can be used to offset positive arbitrage since rate hikes

Yield restriction

- Began to apply on April 15, 2023
- Earlier negative arbitrage cannot be used in yield restriction analysis

Demand deposit SLGS

Case Study #1:
Bonds Issued on April 15, 2020 at 2%

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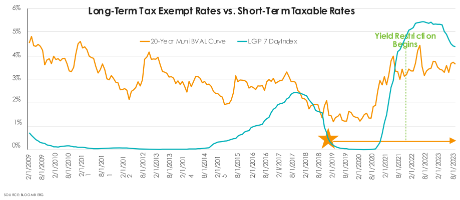

Case Study #2

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ASSUMPTIONS

1. Bonds issued on **August 15, 2022**
2. New money construction project
3. **Arbitrage yield of 3.00%**
4. Project fund qualified for **3-year temporary period**
5. Did not meet rebate exceptions
6. Average investment rate to date of **4%**

Rebate analysis

- Will be based on earnings since issuance
- Significant positive arbitrage during first two (2) years since issuance

Investment strategy

- May be driven by expected spend down of unspent proceeds
  - If proceeds expect to be expended over next 6-12 months, SLGS may be appropriate.
  - If spend down expected to occur over longer time frame, continuing to maximize earnings may be prudent

Case Study #2:
Bonds Issued on August 15, 2022 at 3%

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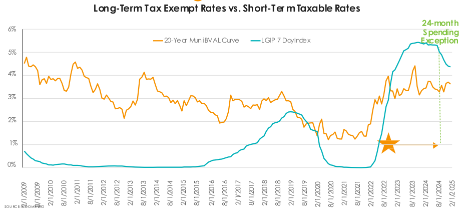

Key Takeaways

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- Understand the structuring decisions and tax elections made at the time of issuance
- Monitor spend down of proceeds and rebate exception compliance
- An arbitrage rebate or yield restriction liability is not a bad thing
- Avoid surprises
  - Work with your arbitrage calculation firm to monitor your investment earnings
  - Ensure sufficient funds are set aside if a material liability is accrued
- Be aware of the full investment toolkit
  - Demand deposit SLGS
  - Tax-exempt municipals
- Optimizing your project fund investments is highly fact specific
- Goal: Maximize the investment earnings that you can retain

Disclosures

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Past performance does not guarantee future results.

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