PFM®
The PFM Group
Public Financial Management, Inc.
PFM Asset Management LLC
PFM Advisors

Lincoln Plaza
Suite 1170
300 S. Orange Avenue
Orlando, FL
32801-3470

407-648-2208
407-648-1323 fax
www.pfm.com

January 30, 2012

Memorandum

To: David Fernandez, Assistant City Manager

From: David Moore, Public Financial Management

Re: $4 Million Sewer System Revenue Bond, Series 2012 – Recommendation Memo

---

On November 4, 2011, Public Financial Management, Inc. (PFM) distributed Requests for Proposals (RFP) on behalf of The City of Key West, Florida (the "City") to identify financial institutions that could provide the City with a fixed rate, bank-qualified term loan in the form of a Sewer System Revenue Bond (the "Term Loan"). This debt will be a private placement and the City does not anticipate preparing any disclosure documents. The proposed Term Loan will be used to: (1) provide funds for the financing of sewer projects originally funded through the State of Florida Department of Emergency Management in the amount of approximately $4 million; (2) fund a debt service reserve fund; and (3) to pay the associated cost of issuance. The principal of and interest on the proposed Series 2012 Bonds will be secured by the Net Revenue derived from the City's Sewer System.

Prior to the submittal deadline (November 22, 2011) the City received four (4) proposals from the following firms: BB&T, First State Bank, JP Morgan Chase and SunTrust Bank. A summary of each proposal is included as Exhibit A.

A bank loan proposal is different than a "hard bid" proposal in that the unique terms and conditions of each proposal must be considered in order to determine the optimal financing proposal. The actual interest rate charged is the primary factor, but call provision, legal provisions and the potential for adjustment in the "fixed rate" are also critical factors. In this case the critical factors under consideration—in addition to the interest rate—are financing duration, call provisions and change in interest rate provisions.

- Financing duration – Historically, the City has maintained a very conservative approach to issuing debt and amortized debt as quickly as possible. The RFP allowed banks to submit proposals with duration of 10-years, 15-years and 20-years. As you would expect the interest rates increase with the duration of the financing so a shorter financing is preferred. However, as the term of the financing decreases, the annual payment increases. Based on discussions with staff, it was determined that a fifteen year financing was optimal.
- Call provisions – Typically, tax exempt bonds are called (can be paid off) after ten years. Banks offer a wider variety of prepayment options including: non-callable, five or ten year call options, "make-whole call" and a set redemption premium. Non-callable bonds have the lowest interest rates, but leave the City with limited flexibility. Make-whole call

provisions also generally have very low interest rates, but in certain interest rate environments, the prepayment penalty can be very large. Conversely, shorter call periods and bonds that are callable at any time offer the greatest flexibility, but typically have higher interest rates. Based on our discussions with staff, we determined that the City wants the bonds to be callable with as small of a premium as possible.

- Change in interest rate provisions – Bank loans typically include the ability to change the fixed interest rate in the event the bonds are determined to be taxable and/or the Federal corporate tax rate changes. However, in the aftermath of the financial crisis in 2007 and 2008, some banks have developed very broad change in interest rate language. The language allows the bank to increase the interest rate in the event that capital charges change and/or the banks cost of funds change. These provisions are often vague and difficult to quantify. And, the change in interest rate could be material. While bank loans with these provisions generally have lower interest rates, based on our discussions with staff we determined that the City would prefer to limit the ability of the bank to change the interest rate unless the savings was very material.

Our approach to reviewing proposals is to begin eliminating proposers and get to a list of a couple firms for final consideration. In this case, First State Bank submitted a strong proposal, but the interest rate was materially higher than other banks, so they were eliminated. BB&T, JP Morgan Chase and SunTrust all had very low interest rates, but each had different terms and conditions.

The terms and conditions for JP Morgan Chase and SunTrust Bank include the more onerous adjustment to interest rate language, while the BB&T proposal did not. Since the JP Morgan Chase interest rates were lower than the SunTrust interest rates we eliminated SunTrust Bank. This left JP Morgan Chase and BB&T as the final two banks under consideration. The 10-year rate proposal for JP Morgan Chase based on a 5-year par call was indicated at 2.00% (note this is an indication and is not locked in). The 10-year rate proposal BB&T submitted for bonds that can be called at any time with no prepayment penalty if called after the first half of the term is 2.07%. So the BB&T proposal is 0.07% higher, but eliminates most of the risk of the interest rate changing over time.

Recommendation
After discussing these options with staff, PFM recommends that the City accept the BB&T proposal with a 10-year term. The interest rate is very low and the terms and conditions offer the City the least risk of an increase in interest rate at a later date. The 10-year term is a good option for the City since the debt is repaid faster than typical governmental financings (20 or 30 years), and avoids rate increases that are higher than current projections. It is worth noting that if revenues grow more than projected over the next few years, the BB&T loan can be prepaid prior to maturity. In summary, the BB&T 10-year loan offers the City the optimal mix of low rates, favorable terms and the ability to avoid additional sewer rate increases in the future.