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The Allure of 5% Bonds: Coupon Levitation Creates Magical Savings

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By Andrew Kalotay

During the past few years it has become increasingly commonplace for municipalities to issue serial bonds of various maturities with identical above-market coupons — usually 5%. Depending on prevailing interest rates, these bonds are sold at modest to substantial premiums over par. Since 2007, over 50% of large, longer-term bonds were of this type.

This trend is attributed to institutional investors' preference for premium bonds over par bonds. Three reasons are often cited. First, the current yield of 5% bonds is higher. Second, if rates rise, premium bonds are less likely to fall below the de minimis discount level, where there is additional downward price pressure.

Third, assuming they are eligible, 5% bonds are more likely to be advance-refunded and thus rendered triple-A, with a commensurate price appreciation. Such bonds are particularly desirable because of the scarcity of triple-As following the decline of bond insurance.

For investors these are all good reasons to like premium bonds, and there is no obvious downside. But if you are a municipal treasurer, how should you view these bonds? Would they work for you as well as they do for the investors? Surprisingly the answer is a resounding yes.

Say you want to raise $100 million via conventional 30-year bonds — callable at par after 10 years and also eligible for advance refunding. Market levels indicate that you could issue $100 million of 4% bonds at par or $87 million of 5% bonds at 115 (3.23% yield to call). Let's disregard for now the roughly $1 million in various issuance expenses

Treasury rates are at historical lows at present, but let's pretend that they are above 4%. Then selling 5% bonds would make you look like a magician who produces savings out of thin air. How, you may ask? The answer is to immediately refund the 5% bonds with 4% bonds! The mechanics: sell $100 million of 4% bonds and use the proceeds to defease the $87 million of 5% bonds to their first call date, 10 years from now. The annual interest payments would decline by $350,000, to $4 million from $4.35 million, and the principal payment 30 years from now would increase by $13 million.

Discounting the resulting net cash flows at 4%, the TIC of the refunding bonds, results in present value savings of $2.1 million. The reader can do the math on the back of an envelope.

The $2.1 million savings amount to 2.4% of the outstanding $87 million principal. While it doesn't quite reach the GFOA-recommended 3% savings threshold for refunding, an interest rate decline of a mere 6 basis points would get you there. So you can do magic with 5% bonds — par bonds wouldn't do the trick!

Critical readers will notice that we have glossed over a couple of minor details. Refunding entails transaction costs — roughly $1 million in our example. Also, the 4% refunding bonds would not be eligible for advance refunding. Fortunately, nobody gets fired in muni finance for "saving money." Never mind that now there are two tax-exempt issues outstanding, instead of one, supporting the same project — not exactly what Uncle Sam intended when granting tax-exempt funding.

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On the other hand, the $1 million transaction fee will spread joy in the municipal finance community — underwriters, legal counsel, financial advisors, rating agencies and others. The moral of the story: coupon levitation creates magical savings.

Andrew Kalotay, president of Andrew Kalotay Associates, is a leading authority on institutional debt management and fixed-income valuation. He has a PhD in mathematics from the University of Toronto and has been named to the Fixed Income Analysts Society's Hall of Fame.

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