

ITEM 128-1004-R0705



Series J 2005 Refunding and Facilities Improvement
Revenue Bonds and Synthetic Advance Refunding

July, 2005

The University of Montana

Series J 2005 Refunding and Facilities Improvement

Revenue Bonds and Synthetic Advance Refunding

Overview: What the University is trying to accomplish

Favorable market conditions, the presence of an option to advance refund a portion of the University's debt portfolio, the opportunity for significant up front cash savings, the requirement to build a new Multi-Purpose Building at UM Helena COT, pressing deferred maintenance and fire code projects, and the rapidly increasing need to build the University's research infrastructure present the University with a unique set of opportunities. The University will take advantage of these opportunities through the issuance of revenue bonds (both fixed and variable rate) and the execution of a variable to fixed swap agreement. A full description of the financing plan and the capital projects follows.

Financing and Facilities Improvement

This proposal has two financial components:

Series J 2005 Bonds

The University plans to issue the Series J 2005 (tax-exempt, fixed rate) revenue bonds to advance refund approximately \$10.0 million of the Series F 1999 bond. Based on today's market, the refunding will generate savings of \$700,000 (\$500,000 NPV). The Series J 2005 bonds also will have a new money component to finance the following facilities improvement projects:

\$5,750,000 Provides for the construction of a 25,000 square foot multi-purpose building to be located on the Helena College of Technology Campus. This facility will provide administrative space, office space and meeting space for the Board of Regents, the Commissioner's office, the Guaranteed Student Loan Program, and the campuses of the Montana University System.
Source of repayment: Income, rentals, and capital facilities use charges generated from the lease, use and occupancy of this facility.

\$750,000 Provides for the renovation of current space and the creation of new research/instructional space at the Avian Research Center located at Fort Missoula. In the last several years this Center has generated several million dollars in sponsored research from NIH, NSF and NASA.
Source of repayment: Indirect cost recoveries

\$750,000 Provides funding to complete the installation of dormitory sprinklers at Montana Tech and the University of Montana – Western.

Source of repayment: Auxiliary revenues

\$750,000 Provides funding to renovate the old Journalism Building (on the main UM campus) once the current occupants vacate it and move into Anderson Hall. Classrooms, offices, and common space will be modernized and rejuvenated during the course of this project.

Source of repayment: Indirect cost recoveries

\$1,800,000 Provides Student Services auxiliary funding for the auxiliary portion of the \$7.46 million steam line project (LRBP) funded by the 2005 Legislature.

Source of repayment: Auxiliary revenues

\$12,000,000 Provides funding for the construction and furnishing of a 47,000 square foot interdisciplinary research/instructional facility. The primary occupants of this building will be the Division of Biological Sciences and the Center for Bio-molecular Structures and Dynamics. Using the indirect cost rate of \$22.26 per square foot currently earned at the Skaggs Building as a comparative benchmark, the University anticipates that within two years of construction of this facility, it will generate over \$1,000,000 per year in indirect cost recoveries.

Source of repayment: Indirect cost recoveries

Synthetic Advance Refunding

As background, a tax exempt advance refunding of a major portion (not included in 2005 Series J bonds) of the University's 1999 Series F bonds is problematic for two reasons. First, tax code prevents use of tax-exempt debt for more than one advance refunding of any issue dated after 1986. A material portion of the Series F Bonds was an advance refunding of another outstanding Series. Second, the initial refunding proceeds were escrowed to the maturity of the refunded bonds at an extremely advantageous rate. As a result, even if a tax exempt financing was legally available (which it is not) to refund the bonds after the ten year call date, but prior to maturity of that escrow in 2019, an IRS transfer of proceeds penalty in excess of \$3 million would result, making the refunding economically unattractive.

As a result of today's low market rates, a unique window of opportunity exists for The University of Montana to utilize taxable variable rate debt to refund these bonds. The portion of the Series F bonds that had previously been refunded can be advance refunded without a transfer of proceeds penalty if taxable bonds are used. Use of the forward starting swap enables the University to lock in low taxable rates, below the existing tax-exempt rates, for issuance of the bonds at the call date. By using this technique and taking advantage of current market conditions, the University can achieve \$2.0 to \$3.0 million in refunding savings up front from an issue that had previously been considered non-refundable.

So, in conjunction with the 2005 Series J bonds, the University would enter into a Forward Starting Variable to Fixed Swap Agreement which enables the University to lock into taxable rates, lower than current tax exempt rates of the Series F bonds, for the issuance of bonds in 2010 and net \$2.0 to \$3.0 million in cash. On the call date in 2010 call date, the University would

issue the 2010 Series K taxable variable rate bonds to refund approximately \$47.0 million of the remaining 1999 Series F bonds. The \$47.0 million represents 35% of the University's current debt portfolio. Simultaneously, with the issuance of the 2010 Series K bonds, the University would exercise the forward starting swap agreeing to pay a fixed rate equal to the Series F rate in exchange for receiving 1 month LIBOR plus 25-35 basis points. The basis points would be used to pay liquidity and remarketing costs and the 1 month LIBOR would pay the variable rate bond interest cost.

Financial Summary:

Series J 2005 Bonds	
Advance Refunding	\$11,300,000
New Projects (Including Cost of Issuance and Capitalized Interest)	<u>23,325,000</u>
Total	\$34,625,000
Less Cash from Forward Starting Swap Agreement	(\$2.0 to \$3.0 million)
Maximum Total Series J 2005	\$32,625,000
Series K 2010 Bonds (Refunding Bonds)	\$47,000,000

Mitigation of Risk

Derivative financial products, such as interest rate swaps, have risk characteristics that differ from traditional revenue bonds. The University will take the steps necessary to mitigate the risks identified in The University of Montana Debt Management Policy. In the case of a variable to fixed interest rate swap, there is still the possibility that the interest rate the University pays on the 2010 Series K bonds and the interest rate received from the Swap Provider may differ – This is known as basis risk. This risk may incur unanticipated costs to the University. This is a risk, albeit small, that must be mitigated. For this synthetic advance refunding, the University will accumulate a reserve from 2006 to 2010, not to exceed \$500,000, as a hedge against future basis risk.

Other risks, as outlined in the UM Debt Management Policy, associated with this transaction are identified below along with the steps the University will take to mitigate the risk:

Counter Party Risk

The University will use an only highly-rated (AA or better) counterparty as the swap provider and will include contract terms in the agreement addressing credit ratings and collateral requirements.

Remarketing Risk

The University will retain a good remarketing agent, obtain a liquidity facility and maintain strong credit. There will be an ongoing monitoring of the remarketing agent to ensure the liquidity facility remains in place.

Termination Risk

Contractual provisions will be incorporated into the swap agreement to limit the sources for termination payment, by subordinating the lien status of the payments, and to spread any payments over time.

Benefit to the University

Taking advantage of this unique set of market, refunding, and new money conditions will produce the following benefits:

- The construction of a multi-purpose building at the UM Helena COT
- Repair and maintenance of buildings and infrastructure
- Increased capacity to conduct and attract sponsored research
- Significant up front cash to defray the amount of new funding required for the facilities improvement projects