What is bonding capacity?

Bonding capacity represents the maximum amount of money Hardin Co. Schools (HCS) can borrow today given several constraints.

Simply put, bonding capacity is calculated using a multi-step process.

1) Determine the type of repayment terms HCS wants to employ. Typically, HCS borrows money for new construction projects with repayment occurring over a 20 year period. This serves the purpose of matching liabilities (the loan or bond) with assets (the project). Prudent measures are taken to ensure the length of the loan does not exceed the useful life of the project being financed. For example, while it would customary to finance the costs of a new building over a twenty-year period, it would not be prudent to finance the costs of computers (with a 3-year useful life) over a twenty-year period. For purposes of calculating bonding capacity, we typically assume the borrowing structure will be a twenty-year, fixed-rate loan.
2) Calculate expected annual cash flows available for debt service for the twenty-year period. Available cash flows are defined as excess revenues over expenses.
    a. Sum all available revenues for debt service as of today and assume the revenues will remain constant for the twenty-year term. Per policy of Kentucky Department of Education (KDE), only revenues in restricted funds such as the Building Fund and Capital Outlay Fund may be considered when determining revenues available for debt service. Typically, HCS keeps revenues of the Capital Outlay Fund unencumbered from debt. This measure allows HCS to accumulate cash to pay for routine maintenance, unexpected repairs and other "cash-only" purchases. Therefore, when we calculate HCS's revenues available for debt service, we exclude the revenues in the Capital Outlay Fund. Note, the State annually contributes to the Capital Outlay Fund of HCS $100 per student as calculated according to Average Daily Attendance as of November of each year.
    b. On an annual basis, subtract from revenue (as calculated above) the principal and interest requirements of existing debt obligations of HCS. To determine expenses for the twenty-year period, we calculate the annual principal and interest payments for all existing debt of HCS to be repaid with Restricted Revenues.

The annual differences of the revenues and expenses for the twenty-year period represent the "free" cash flows available for new debt.

3) Forecast projected borrowing rates and use debt-sizing software to model the optimal loan structure that will maximize the use of HCS's free cash flows to service a new twenty-year loan without exceeding revenue constraints and still meet the principal and interest of existing debt. During this calculation, we make an assumption of market interest rates. This is an important aspect of the analysis as too low of an interest rate assumption will overstate bonding capacity and too high of an interest rate will understate bonding capacity.

What revenues does HCS have available for debt service?

As mentioned above, only those revenues within the restricted Building Fund and Capital Outlay Fund may be used when determining bonding capacity. While KDE policy allows Kentucky school districts to borrow against 100% of expected future Building Fund revenues and 80% of expected future Capital Outlay Fund revenues, HCS prudently only considers the Building Fund revenues as available for debt repayment. This conservative practice ensures HCS will always be able to meet emergency and routine maintenance needs of its facilities and other assets (e.g. busing vehicles) on a cash basis. HCS has multiple sources of revenue flowing into the Building Fund. They are listed as follows:

1) Local Nickel
2) Local Growth Nickel
3) State equalization of Local Nickel
4) Local BRAC Nickel
5) State equalization of BRAC Nickel (partially funded)

Further discussion of revenue sources

1) Local Nickel: The Local Five Cent (5¢) Equivalent Tax, commonly referred to as the "Local Nickel", is a source of revenue contributed to the Building Fund by local Hardin County taxpayers. The HCS Board levies this required tax per Kentucky Revised Statute (KRS) 157.440 guidelines. Of the total school taxes paid by Hardin County property owners, 5¢ per $100 of assessed taxable property will be allocated and restricted to the Building Fund.
2) Local Growth Nickel: The Growth District Five Cent (5¢) Equivalent Tax, commonly referred to as the "Growth Nickel", is an additional source of revenue contributed to the Building Fund by local Hardin County taxpayers. Prior legislation (KRS 157.621(1)(a)&(b)) allowed school districts such as HCS meeting certain conditions related to student population growth during that time period to levy an additional local 5¢ equivalent tax for facilities. This measure was not subject to voter recall. HCS Board levied this tax. As such, of the total school taxes paid by Hardin County property owners, an additional 5¢ per $100 of assessed taxable property will be allocated and restricted to the Building Fund.

3) State equalization of Local Nickel: Because HCS levied the required Local Nickel (item 1 referenced above), the Commonwealth of Kentucky "matches" this local effort with a contribution to the restricted Building Fund. This source of revenue is known as "Facilities Support Program of Kentucky (FSPK) state equalization of the first five cent equivalent tax" and is commonly referred to as "FSPK equalization". The "match" is not a dollar-for-dollar match, per se, more it is a contribution made by the State to the schools for the purposes of making sure all Kentucky schools receive adequate facility funding irrespective of county wealth levels.

   The FSPK equalization is calculated by using the following formula:

   FSPK Equalization = (Avg. Daily Att. * FSPK funding level) – (5¢/$100 * Total Assessed Valuation)

   This funding formula has several important factors that influence how much money HCS will receive from the State in the form of FSPK Equalization. Average Daily Attendance (ADA) is calculated as of November of each school year. The General Assembly determines the dollar amount of the FSPK funding level every budget session. During the current 2012 Biennium Budget, the FSPK funding is $368 per child. Again, this key figure serves the purpose of ensuring every child in public school receives adequate funding for facilities regardless of the wealth of his or her tax base. Total Assessed Valuation is the sum value of all taxable property within HCS's taxing district.

   A couple things to keep in mind that may cause the FSPK Equalization amount to increase or decrease. If all other components are held constant and the ADA increases, HCS will receive more dollars from the State in the form of FSPK Equalization. Likewise, if all other components are held constant and the General Assembly raises per pupil dollar amount of FSPK funding level (currently at $368), HCS will receive more FSPK Equalization dollars. Conversely, if all other components are held constant and the taxable property value of HCS increases, HCS will receive less FSPK equalization. Practically speaking, the wealthier the school district as measured by assessed property, the less contribution it will receive in the form of FSPK equalization on a percentage basis.

4) Local BRAC Nickel: The Additional Five Cent (5¢) Equivalent Tax, commonly referred to as the "BRAC Nickel", is an additional source of revenue contributed to the Building Fund by local Hardin County taxpayers. Prior legislation (KRS 157.621(1)(c)) allowed school districts such as HCS meeting certain conditions related expected student population growth due to the impact of the Base Realignment and Closure (BRAC) in Fort Knox to levy an additional local 5¢ equivalent tax

for facilities. This measure was not subject to voter recall. HCS Board levied this tax during the allowable time period. As such, of the total school taxes paid by Hardin County property owners, an additional 5¢ per $100 of assessed taxable property will be allocated and restricted to the Building Fund.

5) State Equalization of BRAC Nickel: Because HCS levied the Local BRAC Nickel (item 4 referenced above), the Commonwealth of Kentucky "matches" this local effort with a contribution to the restricted Building Fund. This source of revenue is known as "Retroactive Equalized Facility Funding" and is commonly referred to as "BRAC Equalization". For the 2010-2012 fiscal biennium, the General Assembly provided the BRAC Equalization to HCS at 25 percent of the calculated equalization funding in fiscal year 2011-2012. The FSPK equalization is calculated by using the following formula:

   BRAC Equalization = (Avg. Daily Att. * FSPK funding level) – (5¢/$100 * Total Assessed Valuation)

   As noted above, the General Assembly only provided 25% of the above calculation. According to 2012 State Budget language, the 2010 General Assembly intended that any school district receiving partial equalization, such as HCS, shall receive full calculated equalization in the 2012-2014 fiscal biennium and thereafter. Obviously, if the 2012 General Assembly ratifies the 2014 Biennium Budget with an inclusion of 100% funding for the BRAC Nickel, the bonding capacity of HCS will increase.

In summary, HCS has the following sources of revenue flowing into the Building Fund.

Revenues	Revenue Source
$2,878,320	Local Nickel Revenue (TAV of $5,756,640,133)
2,878,320	Local Growth Nickel Revenue
1,906,082	State Equalization of Local Nickel ($368 per ADA)
2,878,320	Local BRAC Nickel
476,521	State Equalization of BRAC Nickel
$11,017,563	Total

This $11,017,563 represents the total revenues available to HCS for debt service not including funds from the Capital Outlay Fund. Importantly, these funds are restricted with few exceptions to either paying debt service or paying cash for facilities or facility-related projects. From these restricted funds, HCS is committed to paying principal and interest on existing debt.

When calculating bonding capacity, we ignore any debt supported by revenues of the General Fund. For example, HCS's Energy Conservation Bonds Series 2005 is repaid with General Fund revenues. Incidentally, this bond was structured with the General Fund as the repayment source because utility-type expenses are borne by the General Fund.

Bonding capacity is a point in time calculation that can increase or decrease depending on many factors. The following list is the universe of factors that can change the bonding capacity:

- Legislative issues (other nickels and equalization)
  - If the General Assembly authorizes other permissible tax levies and the HCS Board adopts them, bonding capacity would increase.

- Changes to the FSPK funding level
  - As mentioned previously, the General Assembly sets the FSPK funding level during every budget session. Currently, the FSPK funding level is set at $368 per child. In subsequent budget sessions, increases or decreases in the FSPK funding level will increase or decrease bonding capacity. For context, the FSPK funding level increased roughly 10% per biennium from the 1990s to 2010. During the most recent budget sessions, the FSPK funding level basically flat lined.

- Leveraging more than 0% Capital Outlay
  - As mentioned previously, HCS currently does not include revenues of Capital Outlay Fund when calculating bonding capacity. While leveraging revenues of this fund would increase bonding capacity, HCS would not be afforded the necessary cushion to meet routine and unexpected cash needs of its existing facilities. For districts the size of HCS, it is prudent to accumulate the restricted revenues of this fund in the form of cash.

- Interest rate fluctuation
  - When HCS borrows money, it does so at market interest rates. Lower interest rates allow HCS to use more of its free cash flows to service principal repayment and less interest expense. Conversely, higher interest rates require HCS to use more of its free cash flows to service interest payments and leaves less room to repay principal. In addition to allowing HCS the ability to pay for routine maintenance, accumulating cash in the Capital Outlay Fund affords HCS an interest rate hedge against future higher borrowing costs. Not only will the cash fund earn interest at higher interest rate levels, but were HCS encounter the need to pay for a renovation project, it could use a cash down payment to lessen the debt load thereby decreasing interest expense. Interest rate fluctuation dramatically increases and decreases the bonding capacity of HCS.

- Retiring old debt
  - Pre-paying existing debt with cash increases future cash flows available for debt service, which in turn, increases bonding capacity. Likewise, there are certain instances when the bonding capacity of HCS will increase, ceteris paribus, when it retires existing per the normal amortization schedules.

- Refunding existing issues
  - Refunding prior bond issues for interest expense savings increase the bonding capacity of HCS. This is because when HCS economically refunds prior debts, it does so in a fashion that lessens the future annual payments on an equal basis.

- ADA fluctuation
  - Changes to Average Daily Attendance can dramatically increase or decrease the bonding capacity of HCS. As described above during the explanation of revenues available for debt service, ADA is a key component of the dollars HCS will receive from the State in the form of FSPK Equalization and BRAC equalization. As HCS experienced significant ADA growth during the 1990s and 2000s, the bonding capacity of HCS increased accordingly.

- Future School Facilities Construction Commission (SFCC) Offers of Assistance
  - Currently, HCS does not have any outstanding SFCC Offers of Assistance. In years past, HCS has received SFCC Offers of Assistance. This Offer of Assistance afforded to qualifying school districts is funded by the General Assembly on a biennial basis and is determined by a funding formula. The funding formula is driven by what is referred to as "Unmet Need". Simply put, unmet need is defined as the facility funding needs as stated by the district's Facility Plan that cannot be met with the current bonding capacity of the school district. In the future, when HCS modifies its existing Facility Plan, the unmet need calculation may result in an Offer of Assistance from the SFCC. This will occur if the General Assembly has funded a new Offer of Assistance and HCS added to its facility plan needs that exceed the local bonding capacity of the district.

What is the typical sequence of events for financing a new construction project and what role does the Financial Advisor serve?

The process can be separated into six phases. They are as follows:

1) Planning

2) Project Design
3) Receipt of Construction Bids
4) Approval of Construction Bids and Financing
5) Bond Sale
6) Construction Phase

Further discussion of the six phases and the role of the Financial Advisor follow:

1) Planning Phase: This phase is where HCS identifies the need to address a particular facility need based on the Facility Plan of HCS. HCS administration determines the scope of the project to include total construction cost needs, project contingency needs, and professional service expenses (i.e. architect, engineer, and finance-related fees). Once the HCS Board determines the total scope of the project fits within the financing capabilities of HCS, the board will hire the Architect(s) and Financial Advisor to formalize project financing costs, develop the appropriate structure of the financing plan and create a planned schedule of events. It is also at this point where HCS may determine the merits of employing a construction manager. The Financial Advisor will organize and mobilize of the finance team necessary to ensure the financing package is delivered when desired by the board. The Financial Advisor will also select the appropriate date to sell the bonds. The finance team will include, but not be limited to, the Administration, Financial Advisor, Bond Counsel, Rating Agency, Paying Agent Bank, KDE, SFCC, Underwriting Firm(s) and a Bond Insurance Company, if necessary. The finance team member roles will include the following:
    i. The Financial Advisor will shepherd the financing team members, develop the financing plan, prepare HCS for a bond offering, secure funding from capital markets, and help close the financing package.
    ii. Bond Counsel will draft necessary legal document, ensure HCS conforms to State and Federal tax law by drafting a legal opinion.
    iii. The Rating Agency will provide a rating of the security of the bonds. This serves the important function of ensuring HCS receives favorable bids from interested underwriting firms providing the loan proceeds. The higher the rating, the lower the interest rate demanded by investors represented by the underwriting firms. Incidentally, HCS currently garners an Aa3 rating from Moody's Investors Service, a nationally recognized rating agency. HCS earns this high investment grade rating because the State guarantees repayment of debt in the event the school is unable to meet its debt obligations.
    iv. The Paying Agent Bank will receive bond proceeds and disperse according to explicit instructions from the administration. The

Paying Agent Bank will also receive payments for the bonds and ensure bond holders receive principal and interest due.

v. KDE provides oversight of financing plan affirming the proposed borrowing structure meets KDE guidelines. Separately, KDE provides oversight of the design aspects of the project affirming the proposed project meets KDE guidelines.

vi. The SFCC provides oversight of financing plan and ensures HCS meets all necessary legislative approvals related to the project to include that of the Capital Projects Bond Oversight committee comprised of legislative members. If the SFCC is providing an Offer of Assistance, the SFCC office will ensure the financing plan meets SFCC guidelines for employing its Offer of Assistance(s).

vii. Underwriting firms will provide the necessary capital for the project. Current Kentucky law requires that all public schools in Kentucky issue bonds via a competitive bid. This process will be further explained below here.

viii. If further credit enhancement is necessary, the Financial Advisor will make such recommendation and facilitate a Bond Insurance Company with providing a bond insurance policy. A bond insurance policy gives bond investors an extra layer of security that it will receive the promised principal and interest payments because the Bond Insurance Company guarantees as much. Currently, HCS sells bonds un-insured because HCS garners no additional credit enhancement by utilizing such a product. It is not worth the premium. Were the credit rating of HCS (i.e. the creditworthiness of the State's promise to pay) to fall, such credit enhancement may prove of benefit.

2) <u>Project Design</u>: After the Architect and the Board have agreed on an initial design of the facility, the Administration of HCS will draft an initial BG-1 with the assistance of the financial advisor and architect. The initial BG-1 will serve the purpose of informing KDE and other interest State parties of how much the project will cost and how it will pay for it. The Board will approve the initial BG-1 and then submit the form to KDE's Department of Facilities Management. The Financial Advisor will submit the preliminary finance plan to KDE's Department of Finance. The Architect will submit preliminary schematics to KDE. The architect will subsequently follow-up with final schematics. The Financial Advisor will work with the SFCC to ensure the Legislative Bond Oversight Committee approves the finance plan during its Capital Projects Bond Oversight committee meeting.

3) <u>Receipt of Construction Bids</u>: The Architect will publish bid requests seeking contracting bids from firms wishing to build the project. It is during this time, the Financial Advisor will help the administration select a paying agent bank. Once HCS receives the construction bids, the

administration will work with the Architect to assimilate the bids into a recommendation. The administration will also work with the Financial Advisor to amend the preliminary finance plan according the construction bids received. Any dramatic changes are quickly communicated to all necessary finance team members. Bond Counsel will forward all necessary legal documents to the administration that will incorporate them into the pending board meeting.

4) Approval of Construction Bids and Financing: During a regular or special meeting of the board, HCS will consider and approve construction bids and approved the revised BG-1 reflecting actual construction needs according to recommended bid(s). Often during this meeting, or shortly thereafter in a subsequent board meeting, the HCS board will authorize all financing-related legal documents as prepared by Bond Counsel and reviewed by the administration and Financial Advisor. Upon formal board approval of revised BG-1, the administration will forward the revised BG-1 to KDE along with Board minutes and construction bid information. The Financial Advisor will submit the final finance plan to KDE. It is also during this time period when the Financial Advisor will secure a rating of the proposed bond issue from a nationally recognized rating agency and secure credit enhancement, if necessary.
5) Bond Sale: As mentioned above, HCS must conform to State statutes when selling bonds. Most notably, HCS must sell bonds utilizing a competitive bid process. Simply, the competitive bid process is where HCS determines in advance the terms and conditions of the bond issue (i.e. how much HCS will borrow, when and how it will repay the loan and under what terms is will repay the loan), schedules a date/time certain in the future to sell bonds and solicits on that date/time from interested underwriting firms interest rate bids and pricing structures. The underwriting firm offering to buy the debt at the lowest costs inclusive of interest rates and all underwriting costs will win the bid. Incidentally, if the solicitation garners bids outside the scope necessary to meet the finance objectives of the Administration, HCS may reject the bids.

   Many rules must be followed and it is incumbent upon the Financial Advisor and Bond Counsel to help the administration follow all necessary steps to legally issue HCS debt. It is the duty of the Financial Advisor to help HCS sell bonds under the most favorable terms possible. The following will serve as a summary of such steps. Bond Counsel will publish a "notice of bond sale" in the local newspaper and the newspaper with the largest statewide circulation. The Financial Advisor will draft and post a "preliminary official statement" in advance of the proposed bond sale date. Typically, this occurs seven days prior to scheduled bond sale date. At the pre-determined time on the pre-determined bond sale date, the Financial Advisor will solicit bids from underwriting firms, assimilate the bids and form a recommendation for the Administration. Upon approval from the Administration of the bids received, the Financial Advisor will award the winning Underwriting Firm the bonds and re-size the debt structure to ensuring the revised structure meets the financing goals of the Administration and meets the terms and conditions previously offered to the Underwriting Firm. At that point, the Financial Advisor will work the finance team to ensure the bond sale successfully closes. By drafting explicit closing instructions and circulating to all necessary finance team members, the Financial Advisor ensures the closing occurs in a smooth fashion. Generally, closing occurs two to three weeks after the bond sale. It is at this point when HCS will have the bond proceeds on deposit for expenditures related to the construction project.

What are important considerations when employing a Financial Advisor?

The Financial Advisor's strict adherence to moral and ethical principles, honesty, dedication to HCS needs, and deep quantitative and qualitative skills as they relate to bond financing rank paramount among important considerations. The Financial Advisor must demonstrate excellent communication and inter-personal skills. While it is imperative the Financial Advisor be an expert in all school bond finance related matters including those of the legislature, it is equally important the Financial Advisor demonstrate cross-discipline among all forms of municipal finance. This ensures HCS receives advice tempered from other business disciplines such as higher education, public utilities, not-for profit institutions, and state and local governments. HCS needs to draw upon all available resources for sound ideas and business practices, not just those of public school peers. The Financial Advisor should be a trustworthy and reliable resource for the needs of the HCS Board and Administration.

HCS must also consider the merits of the firm employing and outfitting the Financial Advisor. The firm employing the Financial Advisor should evidence superior staffing capabilities, demonstrate commitment to the municipal bond market, and evidence peerless technological resources of benefit to HCS. HCS parents demand unmatched staffing capabilities and superior technological resources of HCS administration and the HCS Board should ensure the firm of its Financial Advisor exhibits the same exacting qualities and capabilities. The firm of the Financial Advisor should be currently registered and in good standing with appropriate federal and state governing bodies. Further, because HCS issues long-term debt for periods up to twenty years, it should engage firms who demonstrate the ability to service the future needs of HCS during the expected term of its borrowing. The firm should evidence staffing redundancy to ensure the needs of HCS will always be met no matter any circumstances. Because continuing education is a vital to the growth and development of the HCS Board and its administration, HCS should expect the firm to commit time and resources to industry-related associations such as Kentucky School Board Association, Kentucky Association of School Superintendents, Kentucky Association of School Administrators, etc.