FIELDMAN | ROLAPP & ASSOCIATES

MEMORANDUM

To: City of Newport Beach

From: Robert Porr, Senior Vice President, and Paul Pender, Vice President
Fieldman, Rolapp & Associates (Independent Financial Advisor)

Re: Analysis of Early Redemption of City's 2010B Build America Bonds

Date: March 24, 2015

Background

The City issued $123.3 million of Certificates of Participation (2010A and 2010B) to finance the Civic Center in November of 2010 ("Civic Center bonds"). This included $16.7 million of traditional municipal bonds and $106.575 million of Build America Bonds. As a whole, the 30-year financing had a cost to the City of a 4.45% effective interest rate, with annual payments of $7.6 million.

The tax-exempt portion of the bonds will be fully paid off in July, 2017. The Build America Bonds will be paid off in installments between 2018 and 2040, similar to a home mortgage. The Build America Bonds were utilized in lieu of traditional municipal bonds because they offered significant savings to the City. Under market conditions at the time, had the City utilized traditional bonds, it was estimated such bonds would have cost the City an additional $719,000 per year in annual payments ($21.6 million over 30 years).

The City's Build America Bonds may be redeemed early, subject to an additional "Make-Whole" premium. This premium is to account for changes in market conditions since the bonds were issued. Investors in such bonds require this provision to make a long-term investment, without taking the risk they might have their investment redeemed in a lower-investment environment. From the City's viewpoint, the redemption provisions offer the City flexibility, but not the likelihood of any financial or economic benefit.

Answers to FAQ

Is there likely to be an economic benefit to redeem Civic Center bonds early with City cash reserves in a low interest rate environment?

Interest rates are currently very low by historic standards. Based on current market interest rates (3/13/2015), early redemption of the bonds requires a Make-whole premium of price $45.3 million in addition to the $106.5 million of bonds outstanding. It would therefore cost the City $151.8 million to redeem all $106 million of bonds outstanding, or a cost of $1.43 for each $1.00 of bonds redeemed. This would eliminate the approximately $7.6 million per year in annual payments on the bonds (total of $188 million over next 25 years). However, it would cost the City the $151.8 redemption cost plus $4.6 million annually in lost investment earnings over the next 25 years, for a total cost of $266 million over 25 years. [1]

In today's dollars, this would have a net cost to the City of $21.6 million.[2]

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[1] Forgone earnings are based on the City's historic / assumed future long-term investment rate of return of 3.00%.

[2] Figure is based on the redemption cost of outstanding bonds as compared to the opportunity cost of forgone investment earnings and the elimination of future debt service costs Comparison is discounted to today's dollars at City's assumed long-run cash earning rate of 3.00%.

Is there likely to be an economic benefit to early redeem Civic Center bonds with City cash reserves in a high interest rate environment?

There is not likely to be an economic benefit to the City under most market conditions, including a significantly higher interest rate environment. An increase in US Treasury rates does result in a lower Make-Whole premium to redeem the Civic Center bonds. However, under such circumstances, the cost of any redemption to the City would increase significantly as well. The City's cost would increase due to the higher forgone investment earnings in the higher interest rate environment.

For example, if interest rates increase by 3.00% versus the current market, the Make-Whole premium is approximately $7 million, resulting in a total redemption cost of $113.5 million or about $1.06 for each $1.00 of bonds redeemed. However, the City would forego the earnings on the $113.5 million over 25 years at the significantly higher level of interest rates. The foregone earnings of an estimated $171.4 million still result in a net cost to the City under this scenario of $18.5 million in today's dollars.[3]

Hypothetically an interest rate environment could exist where long-term interest rates were high but the City did not anticipate such high rates to translate into its current or future cash reserve earnings. Such a scenario is highly unlikely, however, based on interest rate history and the basis of the City's expected investment earnings in the future.

Is it feasible to assume a tender offer to purchase bonds back would produce an economic benefit?

It can reasonably be assumed that the current owners of the bonds will not sell their bonds at less than the current market price. Because interest rates have declined significantly since the bonds were issued, the bonds will currently be valued at a high premium.

The concept of the "make whole" premium is to provide a mechanism to redeem bonds at an estimate of the market price. How investors view their bonds' market price may differ from the Make-Whole redemption price, but the two values are likely to be similar under any set of market conditions. Therefore, a tender offer to purchase the bonds would likely have a similar economic impact to the City as the cash redemption at the Make-Whole price.

Further, to successfully complete a tender offer to redeem a large amount of bonds, the City may have to offer a premium over investors' perceived market price. Additional broker-dealer and other execution fees would also apply.

Why didn't the City issue traditional COPs with the 10-year call provisions standard to most tax-exempt municipal bonds?

[3] Figure is based on comparing the future debt service costs, versus the cash redemption and forgone investment earnings. Comparison is discounted to today's dollars at City's an assumed long-run cash earnings rate of 6.00% under the "high rate" scenario.

Based on market conditions at the time of the Civic Center financing, had the City utilized traditional bonds, it was estimated such bonds would have cost the City an additional $719,000 per year in annual payments ($21.6 million over 30 years). The Build America Bonds were therefore utilized to provide the City a significant financial benefit.

Many, if not all major public agencies in California made the same determination in early November, 2010, including the Cities of Pasadena and Los Angeles, the County of Los Angeles, The University of California, and Los Angeles County MTA. In total, nearly $2.2 billion of Build America Bonds were issued between these agencies.

Why did the City agree to the make-whole call provision?

Make-whole provisions are standard in taxable bonds. The vast majority of the fixed-income market, including US Treasury bonds and corporate bonds, is either non-callable or subject to make-whole provisions. The provisions do allow the bond issuer the flexibility for early redemptions, but are not considered an "economic call feature."

At the time of the Civic Center bond sale, a 10-year optional redemption at par call feature was not feasible for Build America Bonds, given market conditions. The other comparable Build America Bond issues in California all had make-whole provisions substantially similar to the City's bonds. These included more than $2 billion of bonds for public agencies issued in early November, 2010, including the Cities of Pasadena and Los Angeles, the County of Los Angeles, The University of California, and Los Angeles County MTA.

Even had a 10-year optional call feature been available at the time, the City would have had to pay significantly higher interest rates on the Build America Bonds to obtain it.

Is there likely to be economic benefit to refund the Civic Center bonds with new, tax-exempt bonds in a different interest rate environment?

Under current market conditions, it is estimated the City could accomplish a tax-exempt financing at an interest rate of approximately 3.30% for a 25-year term. Refinancing the make-whole price of $151.8 million, plus issuance expenses, would result in average annual debt service of $9.1 million per year, or $230 million over 25 years.

In today's dollars, this would have a net cost to the City of $27 million.[4]

It is theoretically possible that a combination of higher US Treasury rates and lower tax-exempt municipal bond rates could make redeeming the Civic Center bonds economic. However, the scenarios under which this would occur are unlikely based on history and finance theory.

For example, for "breakeven" economic redemption under current market conditions, the City's 25-year borrowing cost would need to decrease to 1.65%, while holding US Treasury rates constant. Or,

[4] Figure is based on avoiding the current bond costs, as compared to the new bond debt service costs. Comparison is discounted to today's dollars at City's expected borrowing cost of 3.30%.

as another example, US Treasury rates would need to increase 3.00% while the City's borrowing cost only increased 0.85%. Neither scenario is likely to occur.