THE MARKET WELCOMES "BUILD AMERICA BONDS"

Build America Bonds (BABs) create new opportunities for taxable investors. What are BABs and what will they mean to the tax-exempt municipal market?

The $800B American Recovery and Reinvestment Act of 2009 ("ARRA") includes provisions that could dramatically broaden investor demand in the municipal bond market. Public issuers may look to replace tax-exempt financings with taxable bonds, most of which will be known as Build America Bonds.

WHAT ARE BABs?

ARRA allows state and local municipal issuers, who are able to issue tax-free bonds, the option of issuing new types of taxable bonds instead. Most of these new taxable bonds are BABs, which come in two flavors. The first is the Tax Credit Bond, which is a taxable bond that provides a taxable 35% tax credit to the investor. The second flavor is the Direct Pay Bond which also is a taxable municipal bond but is restricted to bonds issued to provide funds for qualified capital expenditures. Issuers of Direct Pay Bonds would receive a 35% rebate of interest paid from the federal government.

WHAT DOES THIS MEAN TO INVESTORS AND ISSUERS OF MUNICIPAL BONDS?

Issuers will need to determine the lowest net interest cost, consider the debt structure needed to attract taxable investors and than decide to utilize a traditional tax-exempt structure, a new taxable structure or a combination of tax-exempt and taxable bonds. Taxable buyers will likely include insurers, pension funds, corporations, trusts, traditional investors and even foreign investors. Since both the interest and the 35% tax credit of Tax Credit Bonds are taxable, investors in lower tax brackets will receive more after tax income than if they were in a higher tax bracket. However, since the tax credit can be carried forward and can be stripped from the bond, i.e. it can be sold to another investor, it is possible that any investor, regardless of their U.S. tax liability, will buy these bonds after a mechanism and market for tax credit sales is developed. Nevertheless, Conning believes that Direct Pay Bonds, because they are less complex, plain vanilla taxable bonds, should be more favored by issuers due to the generous, non-taxable federal subsidy paid to the issuer by the U.S. Treasury.

HOW WILL THIS AFFECT INSURERS AND OTHER TRADITIONAL MUNICIPAL INVESTORS?

Sales of BABs are expected to replace and reduce tax-exempt financings. If the Build America Bond program is widely used and accepted, and if Congress extends the two year program beyond 2010, tax-free municipal bond issuance almost certainly will be permanently reduced. Traditional tax-exempt buyers could see fewer tax-free investment opportunities, although they might be attracted to the new taxable bonds. Traditional taxable buyers, including insurers, will see a new market of taxable municipal bonds that will feature generally higher ratings than corporate bonds with much higher interest rates than Treasury bonds.

WHAT HURDLES NEED TO BE OVERCOME?

Mr. Taxable Buyer, meet Mr. Municipal Issuer. Taxable buyers are used to fixed rate bullet maturity bonds, rigid quarterly disclosure requirements, make-whole calls only and issuers that they recognize. Municipal issuers are used to relatively level debt service (a combination of serial bonds and term bonds with required sinking fund redemptions), spotty disclosure at best, ten-year call rights and literally thousands of issuers, some of whom are not even obligated to make debt service payments. ARRA includes provisions making it possible for issuers and buyers to resolve many of these disparities, but because corporate and municipal issuers are not regulated by the same entities, differences will remain. A little 'give and take' from both issuer and taxable investor will be required to ensure that these transactions go smoothly. Early issuers of BABs have accommodated the structural preferences of taxable investors.

WHY DID THE FEDERAL GOVERNMENT DO THIS NOW?

The taxable tax credit concept has been around since 1997, although in a more limited form. With this larger initiative, the government wanted to broaden investor demand in the narrow, retail-dominated municipal market and counteract periods of poor liquidity and inefficient pricing. Over the past several months, municipal bonds have traded at very high premiums to treasury bonds, even for very highly-rated 'blue chip' municipal issuers. Tax-exempt bonds result in lost federal income tax revenues meant to subsidize public finance needs, but this subsidy system is not always effective and has been criticized as inefficient. The government hopes that with a much larger and diverse municipal bond investor community, better liquidity will follow. In addition, the government subsidy for these new taxable municipal issues, which will now be in the form of tax credits and interest expense subsidies, will actually result in reduced municipal financing costs and lower federal expenses as well. Lastly, it is important to note that the Direct Pay Bonds require that most bond proceeds be used for qualified capital expenditures designed to stimulate the economy.

WHAT ARE THE KEY FACTORS OF THE BUILD AMERICA BONDS?

- Allow taxable buyers to diversify their portfolios with high quality paper
- Reduce tax-exempt financings, which could improve the value of tax-exempt holdings
- 2010 expiration date may be extended or even made permanent
- BAB issuers retain the option of issuing bonds on a tax-exempt basis;
- Taxable qualified capital purpose bonds can be issued on a Direct Pay or Tax Credit basis;
- Taxable general or other purpose bonds can be issued only as Taxable Tax Credit Bonds;
- No federal guaranty – security is equal to tax-exempt bonds

WHAT ARE THE RESULTS OF EARLY BAB ISSUES?

Early indications would indicate that the BAB program is 1) reducing net interest expense for issuers able to accommodate taxable buyers, and 2) that there is significant interest from taxable buyers for high-quality taxable municipal paper.

On April 15, 2009, the University of Virginia sold $250 million in Direct Pay BABs rated Aaa/AAA (Moody's/S&P). These 30 year bonds yielded about 6.2% and, while federally taxable, were free of Virginia income taxes. The deal was five times over-subscribed. UVA saved 80bp in interest expense after their 35% interest expense rebate from the federal government.

Five days later, on April 20, 2009, the New Jersey Turnpike Authority sold $1.375 billion in Direct Pay BABs rated A3/A+ (Moody's/S&P). These 30+ year bonds yielded about 7.41%, which was 3.70% higher than 30-year Treasury bonds. However, after the 35% federal interest expense subsidy, the net interest rate to the Authority was 4.82%. This issue included $375 million in tax-exempt bonds, with the 30-year bonds priced at a 5.35% yield. Therefore, the Authority saved 53bp (5.35% less 4.82%), or $7.15 million in annual interest expense by issuing taxable BAB bonds in lieu of tax-exempt bonds. The deal was 'several times over-subscribed' per a Wall Street Journal news article.

Early BAB Sales – Results for Issuers

Credit Name	**University of Virginia**	**NJ Turnpike**
Credit Ratings	Aaa/AAA	A3/A+
Size of BAB deal	$250MM	$1,375MM
Date of Sale	4/15/09	4/20/09
Term of BAB	30 Years (Direct Pay)	30 Years (Direct Pay)
Call Provisions (1)	Make Whole (Tsy + 40 BP)	Make Whole (Tsy + 50 BP)
Coupon Rate (1)	6.200%	7.414%
Interest Rate (1)	6.221%	7.414%
Federal Subsidy (35%)	2.170%	2.594%
Net Cost	4.051%	4.820%
Tax-Exempt Rate	4.851%	5.35% (3)
Annual Savings	0.80% (2)	0.53%
Spread to 30-Yr Treasuries	+2.50%	+3.70%

Notes *(1) Bloomberg*
(2) JP Morgan estimate
(3) Tax-Exempt Portion of Issue

CONCLUSION

Based on these early-issue BABs, we believe these bonds are the biggest change to the municipal market in many years. BABs have given issuers new financing options, opening the tax-exempt market to taxable investors who rarely (if ever) participated in the past. BABs will give taxable investors the opportunity to diversify their portfolios with these new taxable municipal investments. ◆