



Build America Bonds – One Year Later

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Build America Bonds (BABs) were created by the America Recovery and Reinvestment Act (“ARRA,” or “the Act”) enacted in February of 2009, also known as the Stimulus Bill. A major component of the Act for the municipal market is that it allows state and local government to sell taxable bonds for eligible capital projects with a 35% interest expense subsidy from the U.S. Treasury for the life of the bonds. This program was designed to broaden access to the capital markets for municipalities, while lowering borrowing costs and spurring economic activity. The credit features of BABs are the same as tax-exempt municipals – the difference lies in issuer access to the broader taxable capital markets.

The Act also created a new tax credit bond type called Qualified School Construction Bonds (QSCBs). Initially, their use was limited by volume caps and the lack of interest in tax credit bonds. The Congress has now allowed QSCBs to be issued with a federal cash subsidy similar to BABs, which could further increase taxable municipal volume.

The first major BAB was issued on April 15, 2009 by the University of Virginia. This AAA rated issue came to market at +250 basis points (bps) over Treasury 4.5% due 5/15/38. The current spread on this deal at the beginning of May was +65bps over its benchmark Treasury. Overall performance has been strong not only for the University of Virginia deal but others as well (see Figure 1).

Over the past 12 months, over \$92 billion of BABs have been issued. According to a recent Greenwich Associates report, the taxable municipals sector was the fastest growing segment of the municipal market during 2009. For 2010, BAB issuance is expected to represent 30% of total new issue municipal volume or \$120 billion out of \$400 billion.

Figure 1. BAB Performance / Source: Barclays Capital / April 5, 2010

Issue Date	Spread (bp) at Issuance	Current Spread (April 5, 2010)	Issuer	Cpn	Maturity	Ratings (Moody's, S&P, Fitch)	Subsidy or Tax Credit	Size (\$mn)	Yield	After-Subsidy "Cost"	Approx. Tax-Exempt Cost (at Issuance)	Approx. Net Savings to Issuer
4/15/09	+250	+90	University of Virginia	6.20%	2039	Aaa/AAA	Subsidy	250	6.22%	4.03%	4.65%	0.62%
4/20/09	+370	+155	NJ Turnpike Authority	7.41%	1/1/2040	A3/A+/A	Subsidy	1,375	7.41%	4.82%	5.35%	0.53%
4/22/09	+365	+247	State of California	7.50%	4/1/2034	Baa1/A/A	Subsidy	2,000	7.43%	4.88%	5.35%	0.48%
4/22/09	+365	+255	State of California	7.55%	4/1/2039	Baa1/A/A	Subsidy	3,000	7.43%	4.91%	5.40%	0.49%
4/23/09	+350	+180	NY MTA	7.34%	11/15/2039	AA/A+	Subsidy	750	7.34%	4.77%	5.13%	0.36%
6/22/09	+165	+125	Pennsylvania Turnpike	6.11%	12/1/2039	Aa3/A+	Subsidy	275	6.11%	3.97%	5.85%	1.88%
8/11/09	+125	+92	Chicago Water	5.72%	12/1/2038	Aaa/AAA/AAA	Subsidy	600	5.72%	3.72%	4.35%	0.63%
8/18/09	+130	+115	NY State Dorm Authority	5.63%	3/15/2039	AAA/AA-	Subsidy	577	5.63%	3.66%	4.40%	0.74%
8/19/09	+145	+145	University of California	5.77%	5/15/2043	Aa1/AA	Subsidy	758	5.78%	3.75%	4.45%	0.70%
8/19/09	+120	+80	Texas State	5.52%	4/1/2039	Aa1/AA+/AA+	Subsidy	1,148	5.52%	3.59%	4.40%	0.81%

Authorization for Build America Bonds is scheduled to expire on December 31, 2010 absent any action by the Federal Government. It now appears likely that some form of extension will be approved. The House Ways and Means Commission recently proposed extending BABs through 2013, but at a lower subsidy rate of 33%, declining in steps to 30% in 2013. President Obama has proposed an even lower federal subsidy rate of 28%. Another part of the proposal is expected to increase the number of projects eligible for BAB financing, helping to lower the cost of issuance of public purpose financing across a wider range of issuers and spurring further job growth. The bill currently sits in the Senate where it is expected to be reviewed this spring.

The Basics

There are two types of BABs, direct payment bonds and tax credit bonds. Direct payment bonds are bonds where the issuer currently receives a 35% interest subsidy directly from the Treasury and thus lowers the issuer's cost of funds

(see Direct Payment Example at right). Tax credit bonds are bonds in which the holders of the securities receive a tax credit equal to 35% of interest in the bonds.

Direct Payment Example	
30yr issue	4.67% Treasury yield + 150 bps = 6.17% coupon
After 35% subsidy, net interest cost to issuer =	4.01%
	6.17% x (35%) = 2.16%
	or
	6.17% - 2.16% = 4.01%

Because very few of the tax credit bonds have been issued, in this article we will focus on direct payment BABs with a 35% subsidy.

The incremental cost to the Federal Government is minimal given that BAB financings replace tax-exempt financings. Tax-exempt bond interest costs the Treasury in the form of foregone tax receipts as typically investors do not pay taxes on coupon payments. The Treasury assumes the tax loss is at the highest

marginal tax rate, currently 35%. Since the credit is taxable, the subsidy is far less than the cost to the IRS since some holders pay taxes on BAB coupon payments.

Deal Structures

There are two basic BAB structures. The first is more like a corporate bond that features a make-whole call and bullet maturity. The other structure is more traditional, featuring a 10-year call and a sinking fund. Generally speaking, the corporate structure produces better liquidity as the universe of buyers is much greater. The municipal structure with its call option typically commands additional yield to the tune of 40-50 bps over a comparable credit with a non-call or make whole call structure.

Municipal issuers achieve the greatest present value benefit by structuring their BAB maturities far out on the yield curve. Accordingly, the majority of BAB issuance has come in the 20-30 year space. This makes the product ideal for long duration buyers such as life insurance companies, pension funds and foreign entities. The corresponding reduction in tax-exempt issuance in the 20-30 year space has resulted in a scarcity value component for traditional tax-exempts in the longer end of the curve.

Index Eligibility

Taxable municipal bonds are listed under the Government-Related Local Authorities sector of the Barclay's U.S. Aggregate and the Foreign Local Government sector of the Barclay's U.S. Government/Credit Index. Given the success of the BAB program, we have seen an increase as a percentage of the Aggregate from 0.35% at the end of March 2009 to 0.55% at the end of March 2010.

Currently, there are 143 taxable municipal bonds with a market value of \$79.2 billion that are in the aggregate eligible Barclays index. The BAB component is comprised of 85 issues with a market value of \$47.2 billion as of April 16. The basic criteria for a BAB to be index-eligible are at least one year to final maturity regardless of call, at least \$250mm par amount outstanding, a rating of Baa3/BBB- or higher and a fixed rate.

BABs vs. Corporates

The overall spread performance for the BAB sector has been remarkable. Early deals were priced with sizable concessions in order to entice buyers. Since inception, there has been considerable spread compression in the BAB space as buyers became more comfortable with the asset class. This is clearly shown in **Figure 1** on page 1.

Even though spreads in general have tightened in the BAB space, the sector still offers value when compared to high grade corporate bonds. For example, a long duration buyer can purchase Orlando FL Utility (Aa1/AA) 5.662% due 10/1/2040 with a 2038 average life, at around +100bps to the old long bond compared to San Diego Gas & Electric (Aa3/A+) at around +80bp over the old long bond.

Key Findings

- Over the past 12 months, there has been wide market acceptance of Build America Bonds by both issuers and taxable investors new to munis;
- An active secondary market has developed;

- Program extension beyond 2010 is now viewed as likely, which should further improve liquidity;
- Early BAB investors have been rewarded with strong relative performance;
- For taxable buyer accounts, BABs continue to offer equal or higher yields than equivalently rated corporate bonds, especially for long duration securities; and
- BABs provide municipal credit diversity for taxable portfolios.

Our Thoughts

One year later, the Build America Bond program has accomplished its primary objective of providing lower financing costs for eligible municipal projects. At the same time, the program has provided investors with attractive bond yields. This has been accomplished by providing issuers with a 35% interest expense subsidy and by broadening the universe of municipal buyers to include taxable buyers. It has been a win-win for issuers and investors (taxable and tax-exempt).

For traditional tax-exempt buyers, the market embrace of BABs has meant extra price gains due to the scarcity factor of tax-exempt issuance. We expect this technical support to increase as BAB issuance surges to meet the year-end expiration of the 35% subsidy. This will provide traditional tax-exempt buyers with price support through at least year end. Conning maintains a stable fundamental outlook on essential purpose revenue bonds and bonds backed by dedicated taxes.

The success of the program has made it all but certain that the BAB program will continue beyond its scheduled December 31, 2010 expiration. While the interest cost subsidy will likely be lower than its current 35%, it will still provide many municipal issuers with a lower cost of funds than is seen in traditional tax-exempt financing. While early BAB investors have been rewarded with strong relative performance, this sector continues to perform well. Conning has been an early and active participant in the BAB market and we believe BABs will remain an attractive investment alternative to high quality corporate bonds. ♦

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