By Edward Cavezza, Esq.

Direct Placements—Why What You Don't Know Might be Costing You

Public offerings of bonds and notes are traditionally the first line of thought when many finance officers think of borrowing money for their school district. Whether it is to fund a project, refund outstanding debt, or even fund short-term cash flow needs, this is a well-established avenue for political subdivisions engaging in tax-exempt borrowing.

In a public offering, a political subdivision sells such securities to an underwriter who then resells those securities to retail and/or institutional investors through established markets.

Another option, growing in popularity among public finance officers, is a "direct placement."

Direct placements, in contrast to public offerings, are generally placed directly with banks or other financial institutions.

One of the primary reasons direct placements have grown in popularity is the level of interest banks and other institutional investors have shown in them. Banks, who generally have been pushing to expand their loan business over the past several years, view government borrowers as low-risk options. School bond holdings improve the credit quality of their overall portfolio.

Banks may also view direct placements as a way to gain a relationship with the government borrower to attract other business, such as their deposit accounts. For some banks, the relationship may also serve a PR function, helping identify them as a community leader through their support of the local school district.

While not appropriate in all circumstances, direct placements have several benefits for borrowers when compared to a traditional public offering.

+ Faster
Direct placements can be significantly faster, because there is often no need to prepare traditional public offering documents, including an official statement. Instead, the banks or institutional investors purchasing the obligations are able to conduct their own credit review directly with the borrower.

+ No Rating Necessary
In addition, direct placements rarely require the borrower to go through the process of obtaining a rating from an agency such as Moody's or Standard and Poor's.

+ Ability to Negotiate
Further, borrowers—or the placement agent on their behalf—are able to negotiate the terms of the obligations directly with the purchasers; including rates, financial covenants for the borrower to adhere to, and call or prepayment features.

+ Lower Cost
As a result of these differences, direct placements often have lower costs of issuance associated with them than traditional public offerings. For example, a direct placement could potentially save a borrower several thousands in issuance costs, dollars for underwriters, rating agencies, paying agents, and printers.

On the flipside, direct placements also have characteristics that borrowers may find undesirable for their specific situation.

– Shorter Maturity
Because the purchasing bank or financial institution is lending the borrower the money with an intention to hold—rather than resell—the obligation, it may prefer a shorter maturity on the obligation than a borrower had anticipated for projects with longer useful lives (typically fifteen years or less).

– Lending Terms
The bank may also require certain lending terms and conditions the borrower may not be comfortable with, or charge a higher interest rate than could be obtained through a traditional public offering.

Borrowers should remember that direct placements must still meet all federal tax laws to ensure that any interest paid on the obligations remains tax-exempt for the purchaser. This includes the requirement for the borrower to make all necessary arbitrage rebate and yield reduction payments. Borrowers must also be aware that the same Ohio constitutional and statutory debt limit restrictions apply to direct placements. Bond counsel is generally retained to assure such debt is legal, valid and binding.

When deciding between a traditional public offering and a direct placement, a borrower should consider several factors. For example, they should compare the economic terms:

- How do costs of issuance compare?
- Are the covenants more restrictive?
- What are the prepayment or call options?
- Is the cost of funds significantly higher?

These are all important questions for any given financing, and the answers may make a direct placement either a more or less attractive option in a particular scenario.

When examining direct placement options, a placement agent is equipped to seek several different proposals for their issuer. Appetite for direct placements can vary greatly between different banks and financial institutions, as can their ability to offer certain long-or short-term maturities, call dates, or interest rate terms. This means it's important for the borrower and the placement agent to carefully examine just which lender or lenders would work best to suit the borrower's needs.

So now that we've talked a little about the benefits and drawbacks of direct placements, just how do they work in real life? Here's a scenario where a direct placement worked perfectly for the needs of a client.

A school district had started to experience difficulties with its HVAC system and was seeking financing to repair and upgrade the system. The district had an immediate funding need, as temperatures within the same building could fluctuate up to fifteen degrees, and cooling and heating equipment would often run at the same time. The district had also applied for a grant to finance a part of the upgrade, but the timeline for awarding the grant was much longer than their prospective timeline to upgrade the HVAC system.

The immediate need for financing and the desire to use grant proceeds (if they were awarded) to prepay part of the financing were both factors that would have made a traditional public offering problematic.

Instead, the district chose to go the direct placement route, and negotiated the terms of the financing with a single lender. The lender and district were able to fund the transaction within a few weeks and even worked in a call feature that allowed the district to prepay the obligation in part or full without penalty if it was awarded the grant.

The fact that the district received the funding so quickly allowed them to get work started on the upgrades much sooner. The lending bank was able to postpone the first debt service payment date, providing the district with additional flexibility. Here, the direct placement was able to provide the district with everything it needed in this particular financing.

While a direct placement might not always be the best option for Ohio school borrowers, it is a great choice for certain types of financings, helping save issuance costs and providing flexibility. When considering any financing, it is important to examine all options with your team of finance professionals to determine the best for you.

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