Finance Committee Memorandum

To: Committee Members
From: Jim Culotta, City Administrator
Date: 3/19/18
Re: Loan Refinancing Options

EXECUTIVE SUMMARY

Several options have been identified to address the existing loan for the Washington 223 property. Depending upon which option is selected, the decision to refinance this debt will have a direct impact on the Debt Service Fund and/or City reserves.

BACKGROUND

In September of 2013, the City obtained a promissory note from Morton Community Bank to finance the acquisition of the property commonly referred to as Washington 223. This $4,965,800 loan was issued with an interest rate of 2.75% and is due in September 2020. Annual interest only payments are $138,540.

Refinancing this borrowing with a local bank loan or bond has been studied. The City issued a request for proposals to local banks and received several responses. The request asked for: 10 and 15-year terms, an interest rate fixed to maturity, prepayment provisions, and other fees/expenses. The proposal from Morton Community Bank has been identified as the most responsive and is detailed in the attachment. Mesirow Financial has been consulted on bonding several different amounts, including $5 million and $2 million with 10 and 15-year terms and fixed interest rates to maturity.

ANALYSIS

Three financing alternatives are below: City Self-Financing, Local Bank Financing and Bond Financing.

City Self-Financing

This option calls for the City to pay off the current interest-only loan in full ($4,965,800) using reserve funds and/or other sources. The primary benefit of this option is that it allows the City to avoid a significant amount of money that would be spent on bank loan interest. For example, a 15-year, tax-exempt borrowing would save $1,523,418 in interest expenses and a $911,477 if it's a 10-year tax-exempt borrowing. For taxable borrowings, interest expenses of $1,322,187 over 10 years or $2,236,723 over 15 years can be avoided by self-financing.

Local Bank Financing Option

Based on the proposals received from local lenders, Morton Community Bank (MCB) best meets the needs of the City. MCB will not charge a penalty to prepay the loan and the City will be free to prepay the loan in any manner it chooses. MCB will not charge any fees or expenses other than the interest expense.

The loan will be subject to IRS regulations (i.e. private payment test) and must be identified as either a tax-exempt or taxable borrowing. MCB has provided proposals for both scenarios and the City may consider both options. However, because the property for which the borrowing is for is being used for private purposes and the City is receiving revenue (farm lease), certain criteria must be met for a tax-exempt borrowing. Under the current farm lease, the City is to receive $59,744 in rent income this year.

Tax-Exempt Borrowing

In order to be considered a tax-exempt borrowing, IRS regulations limit how much revenue can be generated from a municipally-owned parcel that is used for private purposes. If revenue is generated it can still be considered a tax-exempt borrowing if annual revenue applicable to the percentage financed does not exceed 10% of the annual debt service. As shown for each debt level scenario below, the City would need to revise the current farm lease in order to get under the maximum allowed for a tax-exempt borrowing. Consider the following scenario. If the debt is $4,965,000 and the City paid down the debt by $965,000 from cash on hand and finance the balance of $4,000,000 on a tax-exempt basis the City has financed 81% of the initial debt (4,000,000/4,965,000 =80.56% (say 81%)). The debt service on the $4,000,000 is $473,432 per year. Applying the private payment test, the maximum rent **applicable to the tax exempt financed portion** is $47,343 (10% of $473,432). If the rent were capped at $47,343, one would be ignoring that a portion of the property was not financed by tax exempt debt. If we take $47,343 (maximum rent applicable to tax exempt financed portion) and divide by the percentage of the original debt financed by tax exempt financing (81%), the amount is $58,448.

New Debt	Percentage Financed	10 Yr Term with 3.22% Interest Rate	Max Farm Lease Applicable to Exempt Debt	Max Allowable Farm Lease	15 Yr Term with 3.56% Interest Rate	Max Farm Lease applicable to Exempt Debt	Max Allowable Farm Lease
$4,965,000	100%	$587,648	$58,765	$58,765	$432,562	$43,256	$43,256
$4,000,000	81%	$473,432	$47,343	$58,448	$348,488	$34,849	$43,023
$3,000,000	61%	$355,074	$35,507	$58,208	$261,366	$26,137	$42,847
$2,500,000	51%	$295,896	$29,589	$58,019	$217,806	$21,781	$42,707

Taxable Borrowing

If the borrowing is financed "taxable" there are no restrictions in terms of how much rent the City can receive from the farm lease. In addition, the City will not be faced with a future issue in terms of sale of a portion of the property if financed as a taxable borrowing. By way of example, if the property is financed as tax exempt, the City cannot sell a portion of the property without running afoul of the private payment test unless it pays off the debt from cash on hand or from taxable debt at that time. In the future, if the City desires to cause the property to be developed by a developer, (private use) and receive consideration (private payment) then the City can (assuming that the tax-exempt debt allows for prepayment) refinance at that time. Also note the interest rate is higher for taxable borrowings.

Debt	10 Yr Term 4.57% Interest Rate	Max Farm Lease	15 Yr Term 5.06% Interest Rate	Max Farm Lease
$4,965,000	$ 628,718	No limit	$ 480,114	No limit
$4,000,000	$ 506,520	No limit	$ 386,800	No limit
$3,000,000	$ 379,890	No limit	$ 290,100	No limit
$2,500,000	$ 316,575	No limit	$ 241,750	No limit

Bond Financing

Based on conservative estimates from Mesirow Financial, bonding offers fixed-rate financing at very competitive rates. Note the estimates below are subject to change before closing and do not include issuance costs, which are typically 2-3% of the amount borrowed. The City's ability to prepay will likely be limited or not allowed during the first seven years of the term. Also, in order to qualify for tax-exempt status, revenue from a farm lease may not exceed 10% of the annual debt service payment. This requirement is similar to the revenue test for tax-exempt bank loans.

Tax-Exempt Bond Amounts:	**$5 Million**		**$2 Million**	
Repayment Options	**10 Yr Term 2.58% Interest Rate**	**15 Yr Term 3.26% Interest Rate**	**10 Yr Term 2.58% Interest Rate**	**15 Yr Term 3.26% Interest Rate**
Avg. Annual Debt Service	$529,000	$396,000	$212,000	$159,000
Total Debt Service Paid	$5,817,883	$6,338,799	$2,327,333	$2,537,240

REQUESTED ACTION

Staff requests Committee discussion and direction.