

SPECIAL REPORT

ZIEGLER CREDIT SURVEILLANCE AND ANALYTICS

 DIRECT PRIVATE PLACEMENT CONTINUING DISCLOSURE
 BEST PRACTICE GUIDELINES

 NOT-FOR-PROFIT BORROWER DISCLOSURE BEST PRACTICES
 INVOLVING THE INCURRENCE OF DEBT THROUGH A DIRECT
 PRIVATE PLACEMENT OF A LOAN, BOND, OR SECURITIES TO A BANK
 OR A NON-BANK

EXECUTIVE SUMMARY

This publication is an update to an original publication dated November 25, 2013 related to private, direct placements of municipal bonds, notes, loans, or securities with bank and non-bank lenders. These transactions go by various names, including: bank and non-bank loans, direct bank placements, direct-purchase debt, private loans, and private bond placements. From the point of view of the bank and non-bank lender, these are called ‘direct purchases.’ Lenders can be commercial banks or non-banks such as large finance companies.

Ziegler Credit Surveillance and Analytics (ZCS) is a strong advocate for both municipal bond investors and Ziegler’s not-for-profit borrower clients. We champion continuing disclosure best practices. Hence, this special report offering **recommendations that borrowers should follow when incurring privately placed debt** — regardless of who the lender may be. We intend this report to be used primarily by not-for-profit conduit borrowers who already have tax exempt municipal bond debt outstanding issued through a governmental conduit issuer.

Direct, privately-placed loans may benefit not-for-profit borrowers when compared to traditional available capital funding structures such as a typical public offering of underwritten municipal bonds. Benefits include: cost savings, capital structure risk reduction vs. letter of credit backed variable rate demand bonds, ease of execution, and comparably lower issuance costs.

The direct placement loans take many substantive forms. Some may be tax-exempt bonds issued via a conduit authority, the only difference being the issue is designed to not be offered to the general public. Some may be privately negotiated loans. Regardless of the structure and given the **important premise that existing municipal debt is already outstanding**, managers at not-for-profit organizations should take into consideration the existence of outstanding bond documents. Such existing documents for not-for-profit borrowers usually involve a Master Trust Indenture (MTI), a Loan Agreement, a Bond Indenture, and frequently a mortgage. When a privately placed loan takes place, these existing documents govern the issuance of additional debt. While the privately placed loan may take the form of a direct loan, usually a supplement to the MTI and, if applicable, the mortgage must be prepared. In the past, privately placed loan transactions were rarely ‘underwritten.’ However, in recent years, more privately placed transactions have been underwritten based upon the premise that the underlying bonds may trade versus being held to maturity by the original private purchaser.

A borrower’s existing investors want and need detailed information about such debt incurrence. The terms and conditions negotiated with the lender are important information.

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 Past performance is no guarantee of future results. This Special Report does not constitute a solicitation or an offer to purchase or sell any type of security described herein.

Since we assume existing public debt is outstanding, we think the incurrence of any directly placed debt is a ‘material’ factor in assessing a borrower’s financial wherewithal. However, in many instances the information about the loan is not reasonably accessible to the municipal capital markets dealing in the outstanding debt of a borrower. It is possible that no ‘official statement’ is prepared or filed with Electronic Municipal Market Access (EMMA). That being said, we posit that a direct placement is material, and as such, imposes an existing securities-related obligation on the part of the borrower to disclose. The obligation to disclose arises because, absent disclosure, whenever the borrower talks to the securities market about its existing debt, it would be omitting material information. We think a direct placement’s features, terms, conditions, etc. would be considered significant by most reasonable investors. Such facts would be material to assessing the potential risks of the outstanding bonds. Both Fitch Ratings and Moody’s Investor Service have published reports encouraging disclosure and emphasizing that this information is material to the securities market.

Our disclosure recommendations utilize a format that addresses five Ws concerning a privately placed loan:

1. Why should there be disclosure?
2. Who is the audience for the disclosure?
3. What exactly should be disclosed?
4. When should the disclosure take place?
5. Where should the disclosure be made available?

This special report is directed towards borrowers, thus, **for ease of understanding, henceforth we will use ‘you,’ ‘your,’ ‘obligor,’ ‘borrower’ and ‘management’ interchangeably** to signify we are addressing this special report to the borrower spokesperson.

Participants in the municipal debt capital markets understand additional debt may be incurred from time to time. **Investors need to know the details of direct privately placed loans in order to evaluate their holdings of your existing debt.** Managers who proactively address the five Ws concerning a privately placed loan have the advantage of possibly improving their investor relations.

THE FIVE WS

1. Why should there be disclosure?

Borrowers who follow our best practice guidelines have the opportunity to create satisfied and loyal bond investors. Fostering a larger pool of bond investors predisposed to buying your future additional debt may lower the borrowing costs of such future debt. While terms and conditions can be more favorable for some borrowers in the bank and non-bank private placement markets — versus the municipal public market — the regular public bond market capital source could be accessed at some point in the future. If and when a future public bond issue is floated, and if there is a spotty history of continuing disclosure, select investors may refuse to purchase your possible future issuance of bonds at any interest rate, potentially raising the cost of capital for your organization. Continuing disclosure may also enhance the liquidity of your existing bonds in the secondary market. Financial institutions cannot trade or distribute existing municipal bonds unless all material information is available to the purchasers. Disclosure should take place so that existing bond investors, as well as pricing services, can accurately establish a market price of the existing debt in light of any new direct placement debt. Indeed, many institutional bond mutual funds are required to price their holdings on a daily basis.

A direct placement needs to be analyzed by investors in terms of its impact on your existing credit profile. All three major debt rating agencies have concluded that issuers and borrowers should promptly notify them when they take on new debt, regardless of structure. That stance helps the agencies maintain the credibility of their ratings, but it does little for an existing bondholder if the information disclosed to the rating agency is not shared with existing investors. The agencies’ stance is especially moot if the existing debt is unrated. Poor transparency surrounding total debt and capital structure hurts the value (price) of your existing debt.

Poor transparency hurts the ease of trading such existing debt in the secondary market. A privately placed loan's terms and conditions affect the ability to pay pre-existing debts. The capital market's knowledge that a placement has occurred will affect the daily pricing of your existing bonds in the secondary market.

Management cannot omit a material fact that would result in a misleading statement. Furthermore, effective and transparent continuing disclosure helps protect management from inadvertently violating securities rules associated with selective disclosure of material nonpublic information. The SEC has consistently stated information is 'material' if there is a substantial likelihood that a reasonable investor would consider it important in making an investment decision.

2. Who is the audience for the disclosure?

The key audience for any disclosure about a privately placed loan is existing bondholders. These investors have a strong interest in making sure they are paid the principal and interest owed to them. Debt investors want your organization to thrive. Other constituencies may also want to know the details of any placement. Besides EMMA posting (addressed later in this report), additional constituents who should be informed of your privately placed loan include, as applicable:

- Known investors;
 - Bank credit enhancement providers of your existing debt (Letter of Credit and Standby Bond Purchase providers);
 - Bond insurers;
 - VRDO remarketing agents;
 - Master and bond indenture trustees;
 - Rating agencies;
 - Bond pricing services;
 - Conduit governmental issuers;
 - Swap counterparties;
 - Existing Bond debt underwriter(s), and
- Other entities, as applicable.

3. What exactly should be disclosed?

Fees, contacts and other proprietary information should be redacted from privately placed loan documents that are filed to EMMA.

The privately placed loan's security collateral is a particularly important piece of information that should be disclosed to existing debt holders. In normal conduit borrower financings involving a not-for-profit borrower, the tax-exempt bonds issued are usually the most senior debt within the borrower's capital structure. Thus, it is unlikely that a private lender could be given lien priority over existing bondholders. Therefore, to date, most privately placed loans are secured on a parity basis with existing bonds. Most public bond issues for not-for-profit organizations have an original 30-year final maturity. Many privately placed loans are financings with shorter maturities or bank commitments — generally five- to 10-years. That said, some argue direct placement lenders generally have a more beneficial position — vis-à-vis existing debt holders — due to their shorter maturity and accelerated debt service schedules. That may be the perception, but insofar as security is concerned, with the exception of perhaps some required tying of cash accounts to the lender who retains either a contractual or statutory right of set off, no priority of lien is generally in place.

The legal documented form that the privately placed loan obligation takes is usually a supplement to the existing master trust indenture, although other ways to evidence the loan could be present. Supplements to the MTI could be quite simple, or could contain operating and business covenants that may be set at a higher level than in the existing bond documents, the provisions of which would have been typically disclosed in the official statement's summary of legal provisions. Moreover, new covenants could be imposed by the lender. We note that a violation of a privately placed loan covenant can be easily waived by the private lender, versus the difficulty of obtaining consents to waive from public and widely held issues. If the actual entire-but-redacted loan documents are not going to be disclosed, then the following minimum information should be disclosed:

- Security
- Term of the loan
- Mandatory amortization schedule
- Covenants that have higher thresholds than those of the existing bond documents
- Covenants not contained in existing bond documents
- Summary of the Events of Default (EODs)
- Remedies in case an EOD is experienced or declared
- Automatic occurrences (without an EOD being declared) if the loan goes into covenant or monetary default
- Any incorporation by reference of terms of future agreements which could affect EODs
- Term-out provisions on any demand or put date
- An aggregate debt service schedule that includes: – The annual principal and expected interest alongside the existing debt’s annual obligations – If applicable, a reasonable assumption regarding the variable interest rate — this helps investors compute financial ratios
- The rate protection afforded to the bank, or non-bank lender, if an increase in the cost of funds or regulatory changes occur
- Lender’s ability to sell the loan, and
Additional event-driven lender options

4. When Should the Disclosure Take Place?

When to report the privately placed loan depends on of the frequency of routine continuing disclosure. Most borrowers provide voluntary routine submissions to EMMA on a quarterly basis. If the frequency is quarterly, then the bank loan should be reported in the quarterly release associated with the quarter in which the loan was funded. The period’s ‘as of’ Balance Sheet showing the debt and the Management Discussion & Analysis accompanying the unaudited interim financial statements is the recommended location where discussion of the privately placed loan should occur.

If reporting is less frequent, say annually, we believe that management should not wait to disclose the details of a privately placed loan via the footnotes to an audit. If disclosure is delayed and downplayed in this way, an existing investor’s discovery of a privately placed loan by reading an audit can damage the trust relationship the borrower has developed. Moreover, investors buying or selling bonds in the secondary market will not possess important information that has a direct effect on price. Investors’ expectations generally align with quarterly reporting and market transparency. In the instance of only annual reporting, we recommend a special filing be made to EMMA discussing the direct placement.

The time to report gets more complicated and perhaps more urgent if your existing debt is rated. Private lenders usually do not require a credit rating be assigned to the loan they are making. We assume management would inform the rating agency of the transaction — either before or immediately after the loan is funded. A scenario could unfold where the agency takes some sort of action as a result of the privately placed loan and then announces its action via a press release or full report. What action the agency takes could manifest itself in several forms. Regardless of the agencies’ action, we strongly believe investors should not initially learn about a privately placed loan via a rating agency report or agency press release. Allowing the rating agency to be the announcer of a privately placed loan abrogates proactive communication by management with existing investors. Investors hearing about the loan this way may potentially diminish their trust in management. This would be especially egregious if, by sole virtue of the incurrence of the private debt, the agency downgrades the existing fixed rate debt or assigns a negative outlook. Our recommendation is that management should be disclosing the bank loan ahead of the publication of any rating agency report. Managing investors’ expectations about any rating ramifications is a best practice in terms of investor relations. The optimal course of action would be to publish a special dedicated disclosure about the privately placed loan, and follow it up with an investor conference call.

5. Where Should the Disclosure Be Made?

EMMA is the standard public electronic repository that would be the place to upload the written communication about the privately placed loan. The outstanding bonds' CUSIPs would be the key links used (see MSRB Notice 2012-18). This can be immediately followed up with a direct communication with other known constituents as outlined in Question #3.

CONCLUSION

Management should not hold back information from existing public bond investors. Participants in the municipal debt capital markets understand additional debt will be incurred from time to time. Investors need to know the details of direct privately placed loans in order to evaluate their holdings of your existing debt. Managers proactively addressing the five Ws concerning a privately placed loan having the advantage of possibly improving their investor relations.

As a final note, in 2013 the Ziegler Credit Surveillance and Analytics team published a related document: "Best Practice Guidelines for Continuing Disclosure," that address not-for-profit hospitals and senior living providers. Many basic conceptual ideas about disclosure are contained in these reports and are equally applicable to colleges, universities and charter schools. Although the reports originated in 2013 (and in the process of being updated), the same basic tenets hold. We urge readers to familiarize themselves with the contents, as we do not go into detail in this special report about such topics. These reports are available on www.ZieglerCreditSurveillance.com

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ANALYST CERTIFICATION

I, Lavinia Criswell, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject securities, issuers and borrowers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendation or view expressed in this research report. The opinions expressed here reflect my judgment and are subject to change. This is not a complete analysis of every material fact regarding any company, industry or security. Information has been obtained from sources considered reliable, but Ziegler cannot guarantee the accuracy. Additional information is available upon request. Other departments of Ziegler may have information, which is not available to Ziegler Credit Surveillance and Analytics, about companies mentioned in the report. Ziegler may execute transactions in the securities mentioned in the report, which may not be consistent with the report conclusions. Past performance should not be taken as an indication or guarantee of future performance. Ziegler may perform investment banking or other services for, or solicit investment banking business from, any company mentioned in this report. This document may not be reprinted without permission.

Clients are encouraged to speak with their Ziegler representative to discuss any matters detailed in this Special Report. This report is also not legal advice. We encourage providers to consult with counsel on many of these recommendations.

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