



Volume 1, Issue 1

March 2008

Inside this issue:

Boom to Bust,
Managing the Cash 1

QZABs . . . They
CAN Be Issued in
the Current Econ-
omy 1

The Credit Crunch
& Housing Market
Downturn Has
Destabilized the
Municipal Bond
Market 3

Sound advice has
arrived . . . 4

Newsflash:

10-year, \$511,000 equipment lease-purchase financing for Dos Palos-Oro Loma Joint USD competitively bid on February 1, 2008 received a low interest rate of **3.58%**!

Public Finance Perspectives

Boom to Bust, Managing the Cash



Cash flow concerns are running rampant through California school districts. This is due to the current credit crunch, the proposed State budget cuts and deferrals, lack of real estate development, and declining enrollment.

Since 2000, school districts, community college districts and county offices of education have seen conflicting trends affecting their cash flow. From boom to bust, changes in district demographics have resulted in strains on cash flow. Traditionally, school districts that were either Basic Aid or relied heavily on property taxes to fund a majority of their revenue limit, required cash flow financing to fund cash flow shortfalls that would occur within the first half of the fiscal year. Local educational

agencies (LEA) in general used a combination of methods to manage short term cash shortfalls: internal borrowings from available capital funds, temporary borrowings from the county treasurer, or issuance of tax and revenue anticipation notes (TRANS).

For 2008, local educational agencies can expect their operating cash to be strained again. Over the last three years or so, there has been a growing increase in cash flow shortages. From a prolonged real estate boom leading into an abrupt real estate bust, school districts were left with a cash flow pinch. During the boom, districts had growing enrollment, rapidly increasing property taxes, the need for new schools and plentiful facilities funding – and had cash flow concerns. With widespread declining enrollment, slow downs in growth and a “busted” real estate market, and now the proposal for extreme deferrals of state

See Managing the Cash—Page 2

QZABs . . . They CAN Be Issued in the Current Economy

Many school districts have had difficulty issuing Qualified Zone Academy Bonds (QZABs) under the new IRS regulations, coupled with the current banking environment. It is not hopeless, though.

Capitol PFG was able to successfully assist San Juan Unified School District in a successful \$2.4 million QZAB issuance, at a 1% borrowing rate, utilizing a unique approach to

marketing debt. Although QZABs are marketed by the State and Federal governments as 0% interest loans, they simply are not that any longer. However, they are low interest loans, in the 1%-2% range, which of course, can benefit any district.

So, if your district is having difficulty issuing your QZAB, find relief in the fact that there is a viable solution.

Public Finance Perspectives

Page 2



***“For 2008,
local
educational
agencies can
expect their
operating cash
to be strained
again.”***



Managing the Cash (Continued from Page 1)

apportionments, cash flow projections look even worse.

Boom times mean ...

Increasing property taxes – In general, rapidly growing property taxes result in lesser levels of steady, monthly State Aid. Due to the twice annual distributions of property taxes, Basic Aid districts and districts with rapid growth have historically relied on devices such as a TRAN to fund early cash flow needs each year. The more a district receives in December and April, the greater the likelihood the district would need cash flow assistance.

Rapidly increasing enrollment – In areas of rapid growth, such as subdivisions sprouting throughout a district, cash demands are high for new teachers, books and facilities. Since cash receipts from the State mirror prior years' levels, there is a catch-up period each year until the new higher level of property taxes and revised State Aid calculations provide an improved cash position in the spring. In this case as above, there is a justified need for some type of cash flow augmentation.

Facilities demands – During the boom building years, districts relied on State funding, escalating developer fees and CFD revenues, and easy access to the credit markets to meet the demand for facilities. Even when rapid growth resulted in general fund cash shortfalls, facilities funds were flush and provided adequate financial resources to carry out facilities expansion or cover general fund shortfalls.

Bust times mean ...

Declining property values – The current environment of declining property values is causing home owners to be underwater on their mortgages and leaves many facing foreclosure and relocation away from their previously growing districts. Many districts that, just last year, experienced rapid growth are facing declining enrollment in the current year.

Declining enrollment – As over half of the districts in California understand, in a declining enrollment environment, revenues decline faster than expenditures can be reduced. This causes greater reliance on fund balance, which represents a school district's working capital reserve. In many cases, this lack of liquidity causes cash flow shortfalls of an unforeseen and unprecedented magnitude.

Facilities funds dry up – Given declining enrollment and a general slow down in enrollment growth, there is a drain on the general fund caused by a reduction in available facilities funds. Projects that must be completed end up encroaching on the general fund. Due to defaults and foreclosures, there is an erosion of creditworthiness of CFD tax revenues, and due to the slow down in building, there is a decline in the level of developer fees. While these are not specifically general fund cash sources, facilities revenues have been available in the past for internal borrowings to cover general fund cash shortfalls.

See Managing the Cash—Page 4

The Credit Crunch & Housing Market Downturn Has Destabilized the Municipal Bond Market



Everyone knows by now that home sales have been in sharp decline due to high default and foreclosure rates on sub-prime and adjustable rate mortgages. What you may not know, however, is that many municipal bond insurers have suffered substantial losses because they have insured mortgage backed products. In some cases, this has caused the most respected bond insurers to lose their "AAA" credit rating, and others to be placed on credit watch with a negative outlook. This affects the municipal bond market and directly impacts school districts.

Rating Scorecard on the Municipal Bond Insurers

	Moody's	S&P	Fitch
Ambac	Aaa, Watchlist Negative	AAA, CreditWatch Negative	AA, Negative Watch
Assured Guaranty	Aaa, Stable Outlook	AAA, Stable Outlook	AAA, Stable Outlook
CIFG	Aaa, Watchlist Negative	AAA, Negative Outlook	AAA, Negative Watch
FGIC	A3, Watchlist Negative	A, CreditWatch Negative	AA, Negative Watch
FSA	Aaa, Stable Outlook	AAA, Stable Outlook	AAA, Stable Outlook
MBIA	Aaa, Negative Outlook	AAA, Negative Outlook	AAA, Negative Watch
Radian	Aa3, Stable	AA, Stable	A+, Watch Evolving
XL Capital	A3, Negative Outlook	A-, CreditWatch Negative	A, Negative Watch

There are 2 AAA bond insurers with a stable outlook—Assured Guaranty & FSA. The remaining bond insurers have been downgraded and/or have a negative outlook.

In particular, the auction rate securities (ARS) markets have been most affected by the credit rating downgrades assigned to bond insurers such as AM-BAC, MBIA, FGIC and XL. ARS are long-term, variable rate bonds that are tied to short-term interest rates. The interest rates reset every 7, 28 or 35 days based on an auction process, hence the name. Recently, many ARS issuers have experienced "failed auctions" because bond investors are concerned about the credit rating downgrades of bond insurers. Plus, the broker-dealers who bring the ARS to market have a diminished capacity to support auctions because their capital has been committed to absorb other losses. Consequently, many municipal issuers are paying high borrowing costs from failed auctions.



As a result of the credit crunch, municipal issuers of long-term, fixed rate debt are also experiencing higher borrowing costs when entering the capital markets. The bond insurers are more selective when determining which bond issues to insure, plus they are able to charge a higher premium for the insurance. Using a financial advisor is the best way for a school district to navigate through this difficult time in the municipal bond market.



Remember to Update Your Developer Fees . . .

In January, the State Allocation Board approved an inflationary increase to the statutory Level 1 developer fee. The current maximum fee is \$2.97 per square foot for residential construction and \$0.47 per square foot for commercial/industrial construction. During this time of financial uncertainty, it is more important than ever for school districts to keep pace with the increased fee in order to maximize revenue. So, now is the time for school districts to increase their developer fee, by completing, or updating, a developer fee justification study.



Capitol Public Finance Group, LLC

1900 Point West Way
Suite 273
Sacramento, CA 95815

T (916) 641 2734
F (916) 921 2734

On the Web at:

www.capitolpfg.com

Capitol PFG is:

Jeffrey Small, *Managing Director*
jsmall@capitolpfg.com

Cathleen Dominico, *Dir. of Client Relations*
cdominico@capitolpfg.com

Christopher Terry, *Dir. of Public Finance*
cterry@capitolpfg.com

Richard Alvarado, *Consultant*
ralvarado@capitolpfg.com

Jacque Kocer, *Consultant*
jkocer@capitolpfg.com

Stephanie Bell, *Project Coordinator*
sbell@capitolpfg.com

Kristina Bassett, *Administrative Assistant*
kbassett@capitolpfg.com



Sound advice has arrived . . .



School districts are finding themselves navigating through uncharted waters. But, it is not a time to panic. Over the past several decades, California has seen numerous financial calamities—the Orange County bankruptcy, the Richmond School District bankruptcy and the financial fall-out after 9/11. In all cases, there may have been short-term disruptions, but the municipal markets eventually got back on track and recovered to function in an orderly fashion. I expect that through a combination of government involvement and leadership from the business community, the municipal bond market will stabilize again.

In the mean time, I recommend school districts continue to hold their course. Understand your own financial situation (i.e., cash flow, budget) and resist temptations to halt progress. Sound financial planning can get you through this rough economic time and put you in a good position when the economy turns around.

-Jeffrey Small

Managing the Cash (Continued from Page 2)

The last straw (last draw)

Expansive deferrals of state revenues - A majority of a school district's revenues are distributed through monthly apportionments, and in the State cash flow crisis of the early 2000s, June apportionments were deferred to save the State money. During this time, the State implemented this deferral in order to push off expenditures into the next fiscal year. The newly-proposed three month deferral of prior year revenues has an actual impact on a school district's financial condition. For one quarter of a year, 10% of a district's general apportionments will be unavailable for district expenditures or for earning interest revenue. On a state-wide basis, this loss of interest revenue could approximate \$25 million dollars. Your cash flow loss comes at the State's cash flow gain. The Governor is proposing that the State borrow interest-free money from schools - from the current students of California.

Whether boom or bust, rapid changes in financial condition affect cash positions of local educational agencies. As 2008-09 approaches, districts will be confronted with the fallout from the real estate market, the credit crunch, and now the proposed State budget. It will be important not only to be realistic in analyzing these current trends when putting together next year's budget, but to openly evaluate the impact that local changes will have on the district's cash flow.

*-Jeffrey Small, Capitol PFG &
Terri Ryland, TRR School Business Consulting*