

PROVIDING DIRECTION
PRODUCING RESULTS

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Death of the Bond Market?

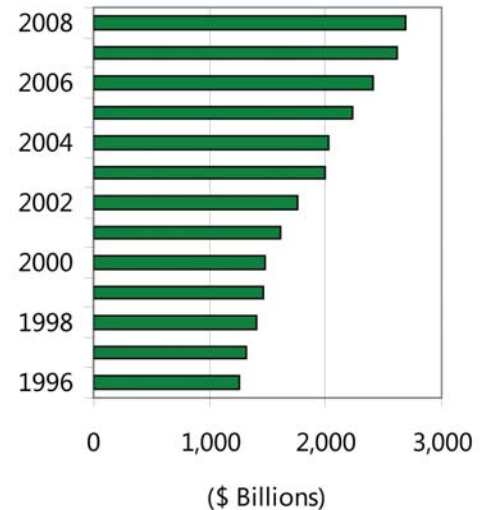
It seems like people's pessimism about the economy affects their perceptions of the municipal bond market. A surprising number of people have the belief that interest rates are not attractive or there is no market for their bonds. This news on the "death" of the bond market is greatly exaggerated. 2009 has become a year full of opportunity for the issuers of municipal bonds. In this article, we take a closer look at market conditions through a conversation with Tom Bartzen, Northland Securities head municipal bond trader and the Chairman of our Board of Directors.

Q: We hear lots of stories about the inability of businesses to borrow money. What is the situation for local governments?

Tom Bartzen: We have seen a strong and steady investor appetite for municipal bonds. According to SIFMA (Securities Industry and Financial Markets Association) the total amount of outstanding municipal bonds grew by almost 3% in 2008. While the rate of growth slowed (outstanding bonds increased by an average of

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Outstanding Municipal Bonds



Data from Securities Industry and Financial Markets Association

BABs - The Devil is in the Details

By now, you have probably heard about Build America Bonds (BABs). The American Recovery and Reinvestment Act of 2009 created BABs as a means of lowering the cost of state and local government debt. The concept is simple. Issuers of tax-exempt bonds for governmental purposes may switch to taxable bonds and choose to receive direct federal reimbursement for 35% of the interest expense or provide a 35% tax credit to investors. However, like many things, the devil is in the details. Let's take a close look at the nuances of structuring and issuing Build America Bonds.

Why Do They Work?

BABs produce lower cost debt when the spread between taxable and tax-exempt interest rates is narrow enough that the 35%

reimbursement drops interest expense below the tax-exempt level. Under current market conditions, the BAB direct reimbursement payment produces lower interest expense for bonds maturing in 2013 and later. Issuers must understand that these results vary depending on the constantly changing relationship between tax-exempt and taxable interest rates. The economics of BABs also vary due to market conditions, type of debt and creditworthiness of the issuer.

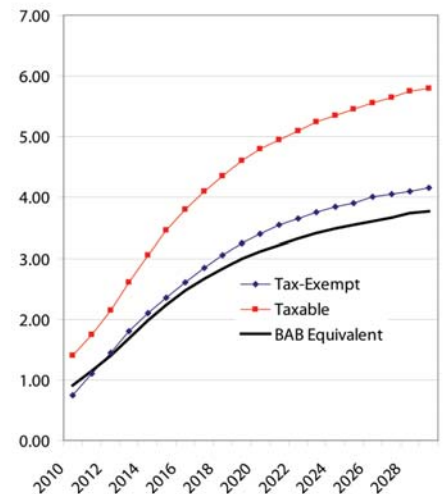
While the potential savings are enticing, there is more to consider before you issue BABs.

Cost of Issuance Cap

Not more than two percent (2%) of the bond proceeds can be used for costs of issuance. Costs included in this calculation include financial advisor fees, underwriter's discount,

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Average Rates (May 28, 2009)



Data compiled by Northland Securities, Inc.

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bond counsel fees, rating agency fees, and paying agent fees. If costs exceed the 2% cap, then issuers must use money other than bond proceeds to pay these expenses.

This restriction may reduce the appeal for smaller issues. The 2% cap on a \$1,000,000 bond issue limits costs of issuance to \$20,000. With a discount of \$10/\$1,000 (on a typical long-term issue), only \$10,000 is left for all other issuance expenses. This cap becomes less of a factor with larger issues.

In evaluating the use of BABs:

- Do the math on costs of issuance. Make sure that you know that costs will be under the 2% cap or what amount you will be asked to pay out of pocket.
- Include all out of pocket costs in your calculations of savings from BABs.
- Look out for premiums. Bonds reoffered at premiums create underwriter's compensation that must be included in the 2% costs of issuance calculations. In competitive sales, limits on premiums can be set. A negotiated sale creates more flexibility in using premiums to sell the bonds while keeping within the 2% cap.

Refunding

BABs cannot be issued to refund existing debt. Issuers also need to understand the nuances of a potential refunding of BABs. Under the current program, BABs cannot be issued to refund BABs. The use of BABs for any refunding is prohibited and the ability to issue BABs expires on December 31, 2010.

However, issuers can use tax-exempt bonds to refund BABs. It is important to work closely with bond counsel in the issuance of BABs to retain the ability to undertake a tax-exempt refunding of the issue. The alternative to issuing tax-exempt refunding bonds would be to leave in place the original BABs issue (to retain the federal reimbursement) or to refund with non-BAB taxable bonds.

Getting Your Payment

To receive the federal reimbursement payment, issuers must submit the new 8038-CP form at least 45, but not more than 90, days prior to each interest payment date. It is not clear if all paying agents will take on the responsibility of sending the semi-annual requests for reimbursement. Northland Trust is evaluating options for ensuring timely filing and flow of funds over the life of the bonds. At a minimum, our service will include assistance with

completing the forms and a filing reminder notification.

Structure

BABs provide some intriguing structuring opportunities. The federal reimbursement is based on interest expense, not total debt service. Since most bonds have larger interest expenses in the early years, the impact of the federal payment will be greater in these years.

Assume that you structure bonds to produce level annual debt service with tax-exempt rates. If this maturity schedule is used for BABs, the level annual payment will not be achieved. With greater interest expense in early years of the bond issue, the federal interest reimbursement is larger in these years. The result is ascending annual payments.

This situation illustrates an additional savings element of BABs – the ability to accelerate debt repayment. The reduction in interest expense creates the opportunity to pay additional principal in the earlier years and still stay within debt repayment constraints.

Another option may be two series of bonds. The early maturities would be sold as tax-exempt. The second series would consist of the later year's maturities where BABs produce lower interest expense. Bifurcating the issue in this manner allows the issuer to take advantage of the best rates over the life of the bonds. The merits of this approach and the optimal structure can best be determined at the time of sale.

Sale Process

Structuring the sale process is a critical step in the use of BABs. The merits of BABs depend on the relationship between tax-exempt and taxable interest rates. Today, the market favors the use of BABs for many bond issues. Market conditions will change over time and can change between the date setting the sale and the date bids to purchase the bonds are received. Flexibility to respond to changing markets will be a key to capturing the best results.

Regardless of the sale process, the structure of terms for the offering should match your best judgment on the final form of the bonds. Why structure and offer bonds as tax-exempt when BABs are likely to produce the lowest interest costs? This approach should minimize the changes between initial offering and final sale. The result should be a simplified sale process and bonds more attractive to potential purchasers.

A negotiated sale is well suited to the flexibility needed to find the least cost debt solution. With a negotiated sale:

- The issuer decides whether to issue BABs or tax-exempt bonds based on the conditions at the time of sale. This decision is not dependent on receiving a bid for your preferred option.
- The issue can be more easily adjusted to match maturity schedules with existing market conditions to maintain the integrity of issuer plans for debt management. These adjustments may mean moving principal within a maturity schedule or moving principal between two series of tax-exempt and taxable bonds.
- The issuer can test the sensitivity of call features, seeking the earliest call date that does not affect interest rates.
- The issuer has greater capacity to avoid bad days in the market. Rather than reject bids, a negotiated sale is easily postponed and rescheduled on short notice.

The traditional competitive sale method lacks the ability to evaluate options at the time of sale. This method requires the issuer to make a decision about the use of taxable BABs weeks prior to the actual sale date. While recent tax-exempt sales can be used to evaluate a BABs bid, the issuer must postpone the sale or reject bids if tax-exempt bonds work better at the time of sale.

BABs have led to the use of a competitive sale process that seeks bids on bonds both as taxable BABs and as tax-exempt. The terms for recent sales request (but do not require) that underwriters submit bids for both taxable and tax-exempt rates. This approach creates the potential to choose between BABs and tax-exempt at the time of sale. The experience of recent sales shows that the evaluation of options is occurring outside of the bidding process. Underwriters are assessing the options before bidding and only submitting one type of bid. For most recent sales, this process results in all taxable and no tax-exempt bids. In this case, the issuer could assume that the "market" has determined that taxable BABs are better or could look for recent tax-exempt sales for contrasting rates. What will you do if this investigation shows that tax-exempt rates actually produce lower interest costs? As with any competitive sale, the issuer reserves the right to reject bids.

Most competitive sales retain the ability to adjust the structure based on the low bid. The

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Carbon Footprints

Prospects for “cap and trade” legislation carbon emissions reductions are fairly high. It is anticipated that possibly by the end of this session of Congress, the U.S. may have some form of system in place, achieving one of the new Administration’s campaign pledges to play a role in the “global warming” effect. Whether one embraces the concept of global warming or not, controls are coming. The first controls will likely be applied to the electrical generation industry, likely then to be followed by the next greatest offenders: the trucks, buses and autos we use to get to work or transport our goods to market or children to school. The last step may well include controls applicable to government.

If you are not an emitter of carbon, do not work for an emitter, do not transact business or trade with an emitter, you probably will be held harmless from the potential impacts of

new legislation. But who among us is not an “emitter?”

Odds are, though, few of us will escape the carbon assessment and ultimate costs of offsetting our contribution to air quality and its broader impacts. Probably, some day very soon, business, industry, institutions and government will be discussing with their auditors the new line items on their financial statements recognizing the financial impacts of their “carbon footprints.” (One ton of carbon emitted equates to one carbon credit.)

A pick-up truck emits roughly two pounds of carbon dioxide for every gallon of gas it consumes. That means driving just 15,000 miles a year at 15 miles to the gallon produces 14 tons of carbon!

Mayors of cities throughout the Midwest are conducting their own “carbon footprint calculations” and broadly outlining new

“sustainability plans,” ordinances and other CO2 reduction efforts. These initiatives may not only produce positive environmental impacts, but also create valuable jobs and economic development activity. Burnsville, Minneapolis, St. Paul, Philadelphia, Baltimore, San Francisco and numerous communities in between are assessing the size of their carbon “feet” and measuring the expense of undertaking a broad set of initiatives against the “Thunderdome” of no initiative at all.

On the way to school the other morning my 7 year old asked, “Is this truck a big ‘spitter’ of carbon?” I replied, “NO! Trucks don’t spit!” under my breath, I said, “they emit.”

Read Judy Purmans’ [Tracking Your Carbon Footprint](#), a good place to begin to organize your thoughts, www.thepurmangroup.com. Check the volume of CO2 your vehicle “spits” at: www.fueleconomy.gov.

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8.8%/year from 2005 to 2007) this change reflects the overall economic downturn rather than the inability to bring bonds to market. We tend to forget that municipal debt grew by just 2.0% in 2004 and 1.6% in 2000.

Q: We all use interest rates as a measuring stick for market conditions. How have interest rates for tax-exempt bonds changed in recent months?

Bartzen: The BBI (Bond Buyer’s 20-Year G.O. Index) on the week of April 20 (2009) hit 4.57% - that is only 54 basis points off of the 50-year low for rates.

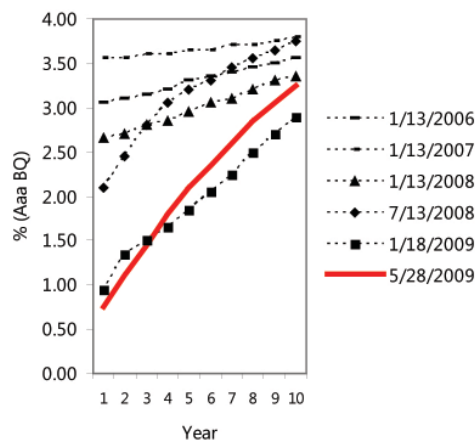
Current conditions are amazingly favorable, but trends are also extremely volatile. On May 22, 2008 the 20-Year BBI was 4.52%, on October 16, 2008 it was 6.01 and 4.57% on April 23, 2009. Can you say rollercoaster?

An important factor in the current market is a steep yield curve. The one-year rate is under 1%, but rises rapidly. The coupon on principal maturing in ten years exceeds 3%.

Q: Recent federal legislation made several changes affecting issuers of municipal bonds. What are the impacts of these changes?

Bartzen: Expansion of the BQ cap (bank-qualified bonds) from \$10 million to \$30 million served to put more supply in the face

Comparison of Short Term Interest Rates



Data compiled by Northland Securities, Inc.

of a declining market of buyers (decline in total number of banks).

The spread in the BQ vs. non-BQ bonds has contracted from 100+ basis points to 20 basis points or less (no difference in 1 to 10-year maturities and up to 20 basis points on the long end).

The Federal Stimulus package has given a two year issuance exception for the AMT (alternative minimum tax) provision for private

activity bonds. AMT bonds have been the orphan of the bond market as more and more taxpayers have fallen into the AMT tax category. In addition, traditional buyers of bonds subject to AMT, such as mutual funds and insurance companies, have avoided the sector. The ability to issue private activity bonds without the AMT stigma should bring new life to cities trying to use public/ private partnerships to create jobs or build new infrastructure in their communities.

One of the most interesting and important changes is the growth in taxable bonds driven by the issuance of Build America Bonds. While taxable bonds have been around for more than two decades, limited volumes have left the market undeveloped. Build America Bonds promise to greatly expand the number and variety of taxable municipal bonds in the market. At the same time, investors are attracted to the security of municipal bonds with the higher returns of taxable debt. This demand should produce lower long term interest rates. Low taxable interest rates combined with the 35% federal interest expense reimbursement will make Build America Bonds a desirable option for many local government capital projects.

Making Opportunities

Francis Bacon said “A wise man makes more opportunities than he finds.” Are you waiting for opportunities to fall into your lap or are you out looking for them? Good financial planning allows you to anticipate challenges and position yourself to capture opportunities. You chart a course rather than react to current events. A proactive approach to local government finance has never been more important. The elements of financial planning are unique to each community. Here are some factors to consider:

Growth

A plan should be based on an understanding of the implications of growth. Growth creates many of the revenue building blocks of city government. Growth creates property valuation. The amount of taxable property value determines the tax rate needed to fund services and debt. Growth produces consumers of government services and payers of user fees. The recent economic downturn shows the challenge in predicting future growth. Growth turned into a stalled economy in the blink of an eye. A financial management planning process cannot provide an accurate forecast of future growth. It can, however, help you understand the financial implications of alternative rates and forms of growth.

Services

The financial challenges facing local government encourages creativity in the delivery of municipal services. A financial management planning process can be used to forecast future service needs and to test alternative approaches to service delivery.

TIF Districts

Tax increment financing (TIF) districts present two important financial resources: community development funding and new tax base. A periodic review of all TIF districts ensures that existing obligations can be met. Even with current statutory constraints, TIF districts

may have the capacity to help address new community development issues.

Expiring TIF districts can be a significant economic resource. At decertification, excess funds are redistributed to local taxing jurisdictions. Property value formerly captured by the TIF district is freed for general taxation. How will you use these new resources?

Debt

Existing debt places demands on revenues. As debt is retired, these revenues are available for other uses. New debt could be added without increasing revenues or additional may be shifted into operating budgets. Some types of debt, such as improvement bonds, may leave balances in debt service funds that can be used for other purposes.

As interest rates change over time, there is an opportunity to refinance existing debt. Each issue of tax-exempt bonds is eligible for a single advance refunding. While we cannot predict future market conditions, we can explore possibilities. Setting criteria for refundings helps to avoid reacting to (or missing) market opportunities.

A financial planning process provides an opportunity to learn about new debt options. This information helps policy makers and staff plan for future capital improvements.

Capital Improvements

Investments in infrastructure, facilities and equipment are the largest expenditures made by local governments. A capital improvements plan (CIP) is an essential financial management tool. The CIP projects capital investments over a five to ten year period and creates a feasible funding plan. A financial planning process can explore alternative combinations of annual revenues, fund balances and debt. The process seeks to find the funding plan that makes needed improvements with the least impact to local residents and taxpayers.

Fees

In general, it is important to ensure that user charges are set at a level that equitably distributes service costs and maintains long-term financial viability. Rather than take the one-year view provided by annual budgets, financial planning looks five (or more) years into the future. This long view is essential to managing the need to increase fees and to anticipate changes in annual revenues. A financial management planning process can examine both the financial and the statutory compliance aspects of current fee structures.

Process

The key to a successful financial management plan is the process. The process creates the opportunity to develop a shared understanding of the needs and opportunities facing your community, explore alternatives for meeting these needs (there is rarely a single right answer), understand the implications of funding alternatives, and build the consensus needed to take action. Ideally, a planning process involves a series of 1-2 hour interactive workshops. The workshops are used to convey findings and recommendations on key topics, to facilitate discussion and to receive guidance. The process becomes a balancing act between the need to complete the process in a timely manner and the time available for participation in extra meetings.



It is easy to find reasons not to undertake financial planning. Too many issues cannot be predicted. We have done fine without a plan. We are too busy with other, more pressing issues. For many organizations, there is a grain of truth in each of these statements. The larger truth is that the new opportunities we find and the problems we avoid are the real keys to managing financial resources in challenging times.

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issuer must take care not to reserve so much flexibility that the bonds become less attractive to a bidder. What am I buying – taxable or tax-exempt? How many bonds are available in any year? How many bonds are not subject to prepayment? When do these questions get answered? In a marketplace with fewer buyers, issuers should be wary of excessive bidding complexities. Complexity often creates higher interest rates. At some point, it is easier for an underwriter to pass and bid on another issue.

Conclusion

Issuers should evaluate the use of Build America Bonds for every governmental purpose, new money bond issue over the next 18 months. The larger and longer the issue, the greater the potential for interest expense reduction by issuing BABs. Capturing the real benefits of BABs requires more than picking the BABs option and selling the bonds. Take time to explore the structuring and sale options that

create the lowest debt costs and meet your overall debt management objectives. Watch for more BABs news. It is an evolving part of public finance.

The information in this newsletter is based on sources believed to be reliable, but does not purport to be complete and is not warranted by Northland Securities, Inc.