16ROCK ASSET MANAGEMENT
www.16rock.com | info@16rock.com | (212) 332-1600

Summary

New opportunities have emerged in today's US municipal bond market for both issuers and investors. Municipal tender offers and exchange transactions, forward delivery bonds, convertible advance refunding bonds, and open market purchase operations are all examples worth reviewing. These transactions provide an economically accretive way for issuers and investors to monetize today's rate and relative value environment. Following the 2017 US Tax Cuts and Jobs Act much has changed in the US municipal bond market and so far, only the most sophisticated, flexible, and specialized market participants have benefited.

Eligibility

Following the 2017 US Tax Cuts and Jobs Act (TCJA) one of the most critical elements in the code was the elimination of the tax-exempt advance refunding option. Prior to TCJA, tax-exempt advance refunding activity represented nearly 20% of overall municipal bond issuance. It served as an important one-time benefit for issuers to issue new bonds, use the proceeds to pay off older bonds prior to the call date, and lower debt service costs for the issuer. It also served as a big win for investors by having their old bonds turned into a pre-refunded bond typically escrowed with treasury securities.

The eligibility of what can be refinanced is simple, it's the same as the refunding rules prior to TCJA with the major difference being that advance refunding of tax-exempt debt requires the use of taxable bond proceeds. An advance refunding applies to bonds callable more than 90 days prior to the first call, issued previously for new money or refunding purposes, barring any written barriers in the bond indenture, and generally provide economic savings to the issuer. By way of background, bonds refinanced less than 90 days to the first call are referred to as a current refunding, which were unaffected by TCJA.

Relative Value

Interest rates have shot up, prices have fallen, and relative value has fluctuated to a point where the economics align for issuers and investors to think outside the box. There are now opportunities for issuers to achieve the same advance refunding goals prior to TCJA just in a slightly more complex manner. In fact, there are more alternatives now given relative value of tax-exempt debt to taxable municipals. For example, this dynamic has shifted to a point where issuers are incentivized to tender eligible taxable debt and 'flip-back' this debt to tax-exempt. Example of eligible taxable debt include taxable advance refunding bonds of tax-exempt debt post TCJA where escrows have expired, new money taxable debt with a private letter ruling permit a change in tax status and Build America Bonds. In this case, issuers can also benefit from gaining an economical call feature as the taxable debt either had a make-whole call or a par call with low coupons resulting in a low probability of being exercised in the future.

The complexity of some of the new workaround transactions centers around timing, encouraging investors to accept certain terms (such as tender prices), securities law considerations, and fair dealing rules just to name a few. From an investor perspective, it presents an even better opportunity than in 2022 for tax loss harvesting. Tender offers provide additional benefits of monetizing performance at above market prices after accounting for tender premiums, but it takes a specialized focus and the right infrastructure to process these transactions.

Tender Offer and Exchange Transactions

In these transactions, issuers either repurchase outstanding bonds or exchange the outstanding bonds with new bonds. The offer to repurchase and/or exchange is typically based on a price above prevailing market levels, but close enough to provide required debt service savings. These transactions are most popular for both issuers and investors, but their success is dependent on the level of bondholder participation.

Forward Delivery Bonds

These bonds are priced today but aren't issued and settled until a date further in the future. They act as a hedge against interest rates for issuers since the price is set today and not a date in the future. They typically price at a concession to compensate investors for future delivery risks, including economic forecasts and credit risk. These transactions are less popular for investors given heavy demand in the municipal market on current income and risks to deliver in the future.

Convertible Advance Refunding Bonds

These so-called 'Cinderella' bond transactions are another option where an issuer sells a series of taxable advance refunding bonds that later convert to tax-exempt when legal and market conditions meet certain criteria. These bonds are typically sold directly to banks, rather than the public given the changing tax status over the life of the bonds, among other reasons.

Open Market Purchase Operation

We previously noted municipal issuers need to think outside the box as it relates to the FDIC liquidation of the SVB and Signature Bank portfolio in terms of buying back debt. The FDIC liquidation is just one example of secondary market supply and deep discount dollar price benefits offered to issuers. Like any of the other transactions mentioned here, there are rules and restrictions.

Conclusion

The elimination of the tax-exempt advance refunding option in TCJA coupled with today's rate and relative value environment is creating new opportunities. Issuers in select states deserve applause from their taxpayers for their use of these opportunistic financing approaches. Investors should also engage their portfolio management team and find reason to do the same.

About

16Rock is a full-service asset management firm specializing in U.S. Municipal Bonds with a global perspective. We cater to the modern needs of institutions and high-net-worth individuals around the world. Our passion is to help clients translate their desires and aspirations into sophisticated outcomes that exude order. Our team leverages decades of experience to construct highly curated portfolios. We offer tailored managed account solutions, transition management services, and through our alternative investment capabilities, products designed to deliver absolute return excellence.