

IDBs – An Oft Neglected Financing Tool

By Martin Walke

I work in Economic Development but for an entity which serves as a conduit issuer of tax-exempt bonds on behalf of the State of Louisiana. In my role as Vice President of Economic and Program Development for the Louisiana Public Facilities Authority (LPFA), I work with prospects on finding the most appropriate and least expensive financing available for their project. While most of the LPFA's clientele are not-for-profit corporations (hospitals, universities, educational facilities, foundations, etc.), we also have the ability to aid taxable corporations by utilizing Industrial Development Bonds (IDBs) to finance qualified capital projects. IDBs are an excellent financial aid tool to use in economic development but are seldom used in Louisiana perhaps due to a lack of understanding. They can save a company up to millions of dollars on its cost of capital over the term of the financing.

An IDB is a tax-exempt Private Activity Bond issued by a state or local governmental entity (i.e., a Local Industrial Development Board or the LPFA) on behalf of manufacturing facilities to finance certain qualified capital projects. The corporation (borrower) benefits by using the governmental entity's (issuer's) tax-exempt status and its ability to issue debt obligations (bonds) at tax-exempt rates. Typically, the interest rate on IDBs is 25-30% below Prime on a variable interest rate basis or 2-4 percentage points lower than taxable alternatives. If the borrower procured a loan directly from a bank or other financial institution, the lender would be required to record the interest earned on the loan as taxable income. For example, if the lender's corporate tax rate is 35% (the US Federal Corporate tax rate for 2010); their interest rate will take into consideration a mark up of at least 35% over their own cost of capital in order to

generate a net profit. When an underwriter (banker) makes a tax-exempt loan, it needs only to determine a fee they will charge for its services since there is no taxable profit in the interest rate. The borrower may also choose to finance utilizing a fixed rate of interest on the bonds if they are uncomfortable with the interest rate fluctuation risk associated with the variable rate option.

Federal law imposes a limit, or cap, on the amount of tax-exempt Private Activity Bonds that can be issued in Louisiana by the LPFA or any other issuer of bonds. This limit is known as the Louisiana State Volume Cap or Private Activity Bond Volume Cap. Tax-exempt bonds are subject to the Louisiana State Volume Cap with the exception of qualified veterans' mortgage bonds; qualified 501(c)(3) bonds; bonds issued as exempt facility bonds for solid waste disposal, pollution control projects, airports, docks and wharves, hydroelectric generating facilities, and local providers of water or natural gas; and a portion of bonds issued to finance high speed intercity rail facilities. The Louisiana State Volume Cap is computed and adjusted annually by multiplying the number of residents in the State by an amount set forth in Federal Law. The Governor of Louisiana must issue an Executive Order granting a bond issue an allocation from Louisiana's State Volume Cap prior to the issuance of the bonds in order for the interest on the bonds to be tax-exempt. In the past, the general allocation of Louisiana's volume cap has been 50% for housing, 25% for student loans, 20% for IDBs, and 5% for exempt facilities. Specific allocations for IDBs are based upon job creation and investment.

The Internal Revenue Code permits the issuance of qualified small issues for manufacturers which are defined as companies that assemble, fabricate, manufacture, or process a product for resale. A "manufacturing facility" is defined as a facility used in the manufacturing or

production of tangible personal property. The definition includes processing which results in a change in the condition of such personal property such as refining.

The maximum amount allowable by current tax law of a tax-exempt IDB is \$10 million per company, per public jurisdiction. However, this amount comes with certain limitations as enumerated in the tax code. The capital expenditures for a manufacturing company that receives tax-exempt financing cannot exceed \$20 million during a six year period including the three years prior to and three years following the issuance of the bonds, including the amount of the bond issue being contemplated. Furthermore, the company may not exceed \$40 million in tax-exempt bonds, in aggregate, for all locations.

Proceeds of an IDB can be used for any of the following purposes: building and equipment; machinery and furnishings; land and landscaping; costs of issuance up to 2% of the total bond proceeds; and cost of architects, engineers, surveyors, attorneys and permits in limited amounts. Costs of issuance include underwriter's fee, bond counsel, printing of offering documents and bonds, trustee's fees, issuer's fee (for example, the LPFA charges a \$500 application fee and \$500 per million, less the application fee) and publication cost to advertise a TEFRA (Tax Equity and Fiscal Responsibility Act of 1982) hearing on the project in the local newspaper.

A TEFRA hearing is mandated by the IRS to provide a reasonable opportunity for interested individuals to express their views, either orally or in writing, on the issuance of bonds and the nature of the improvements on projects for which the bond funds will be allocated. The TEFRA notice of public hearing must be published in the daily newspaper of largest circulation in both the project's and issuing authority's location at least 14 days prior to the hearing date. In

the case of the LPFA, our TEFRA hearings are always held at the offices of the LPFA and must be held prior to LPFA Board of Trustee approval of the project. Minutes of the TEFRA hearing are available following the hearing and include any materials and/or written comments provided by members of the public.

Further restrictions on the use of IDB proceeds require that 95% of the tax-exempt proceeds must be used for the defined IDB project. No more than 25% of the bond proceeds may be used for land costs. If bond proceeds are being used to purchase a used building, at least 15% of the total bond amount must be used to renovate the facility. While the bond term can be structured for up to 30 years, the maturity of the bonds cannot exceed 120% of the estimated useful life of the assets being financed.

An existing Louisiana company that has international sales and has utilized subcontractors in China to manufacture numerous components of its product line recently used IDBs to fund its expansion in Louisiana. With recent economic developments in China coupled with the advancement of robotics, the company's leadership considered expanding its operations here in Louisiana to have greater quality control and to increase production management by hiring additional employees at home. The company has worked extensively with officials at the University of Louisiana-Lafayette (ULL) to customize the robotics required for their manufacturing process. Due to its crucial part in the manufacturing process, it was critical to know the size and weight of the robotics prior to the design of the building. The next step was to meet with an architect to design a new building to be constructed adjacent to their existing facility in an industrial park. Once the architect's design was completed, it was estimated that the total cost of the new building, robotics, furnishings and cost of issuance were just over \$8

million. Given this, the company clearly met the “manufacturing” test and the fact that the company had no more than \$20 million in capital expenditures the past three years and did not expect to have any additional capital expenditures in the coming three years, the \$8 million total clearly qualified it for a small manufacturer’s IDB and access to the tax-exempt bond market to finance this venture. An additional bonus in the company’s favor was its excellent, long-standing relationship with its commercial bank, JP Morgan Chase. As a valued customer, JP Morgan Chase agreed to serve as underwriter for the transaction and also agreed to purchase 100% of the bonds to be held on its own books. Purchasing all of the bonds decreased the underwriter’s fee for the transaction since it was not necessary to pay a commission to any public finance brokers who would have marketed the bonds to prospective buyers. While this particular transaction has yet to close, all indications show that the company will save over \$1.35 million on its cost of capital on an \$8 million loan (\$8,000,000 @ 4.75%, 20 year term with an issuance cost of \$500,000 versus \$8,000,000 @ 6.4125%, 20 year term). The project will allow the company to maintain greater control over its manufacturing process by decreasing its dependency on offshore subcontractors, increase quality control, decrease its manufacturing costs over time and increase its Louisiana workforce by nine full time employees.

Economic developers have many tools at their disposal to entice companies to expand or relocate in their jurisdiction. One of the most important components to consider in the entire package of inducements is the cost of capital. If you are able to show a company’s management how it can expand its business and save millions of dollars in interest over and above all of the other inducement tools you’ve personalized for them, your chances of winning its confidence and its business expands exponentially. In addition to the benefit derived by the company, the local community in which the manufacturing entity is located receives an economic benefit in the

form of a net positive impact to the local tax base generated from the job creation or job retention associated with the expansion. Therefore, I encourage any economic developer to not overlook the utilization of this key tool. It's handy and your knowledge of it may very well separate you from your competition and help you win the business.