Finance Division
PO Box 5915, Virginia Beach, VA 23471-0915
757.460.2261
hrsd.com

Internal Management Procedures Related to Tender Refundings

1.0 Background

Hampton Roads Sanitation District ("HRSD" or the "District") periodically refinances outstanding indebtedness to achieve debt service savings or to accomplish other compelling business objectives.

Following the elimination of municipal issuers' ability to advance refund bonds with tax-exempt refunding bonds in 2017, the municipal market adopted alternative refunding methods, including taxable advance refunding bonds, tax-exempt forward delivery bonds, and refunding bonds issued in conjunction with a tender. In recent years, tender refundings have become a more commonly used strategy to generate savings on bonds that cannot otherwise be refunded efficiently or in a timely manner.

In a tender for purchase, the issuer offers to buy back bonds at a price above their prevailing market value, funded with available cash or the proceeds of new bonds. Savings are measured by comparing the canceled debt service on the tendered bonds to the debt service on the new bonds.

A tender may allow the District to manage and optimize its debt portfolio in circumstances where a traditional refunding is unavailable or uneconomic — particularly where the target bonds are taxable (due to the low coupons), carry above-market coupons, or are not currently callable.

2.0 Purpose of Procedures

These procedures are intended to guide how the District will evaluate, price, and execute any tender. These procedures address the intended goals of a transaction, selection of the financing team, attributable costs, fair pricing, and determination of goal attainment.

These procedures supplement, and do not supersede, HRSD's Financial Policy. The provisions of the Financial Policy governing the refinancing of debt, escrow structuring, and the hiring of professionals continue to apply to any tender refunding. In the event of a conflict, the Financial Policy controls.

These procedures will be reviewed by the District prior to the launch of any tender offer, and updated as necessary to reflect changes in market practice, District policy, or personnel.

3.0 Evaluation Criteria

Articulation of Goals

Before a tender is presented to the HRSD Board of Commissioners (the Commission) for authorization, the District will clearly articulate the goals the transaction is intended to achieve — for example, debt service savings, elimination of restrictive covenants, or restructuring of debt service. The stated goals will be documented in the materials presented to the Commission and will govern the evaluation of the transaction at every subsequent stage.

Savings Standard

A tender will be evaluated as described in the “Refinancing of Debt” provisions within HRSD’s Financial Policy. Savings will be calculated net of all costs attributable to the tender. Because certain costs are payable whether or not the tender succeeds, the District will identify those costs separately before authorizing the transaction. Savings will be evaluated on the basis of conservative estimates of the tender participation rate, taking into account the identity and concentration of existing bondholders.

Preference for Combined Transactions

Given the complexity of tenders and the uncertainty of participation, the District prefers to combine any tender with the sale of new money bonds or a traditional refunding. Combining transactions spreads fixed costs over a larger issue and increases the likelihood that the District recovers the cost and staff time committed to the transaction. This preference is consistent with GFOA’s Best Practice, which recommends that issuers consider incurring the costs and work effort of a tender only in combination with new money or a traditional refunding. A standalone tender may be pursued where the Chief Financial Officer, in consultation with the Financial Advisor, determines that the expected benefit justifies the cost, and the Commission so authorizes.

4.0 Financing Team

A tender offer involves HRSD’s Finance Division, Bond Counsel, and Financial Advisor together with two participants whose roles are specific to tender transactions: one or more Dealer Managers and an Information and Tender Agent.

Dealer Manager

The Dealer Manager is a broker-dealer that acts as the District’s agent in conducting the tender offer. The Dealer Manager structures the tender and communicates with bondholders to market the offer, in the same manner that an underwriter structures and markets a bond sale. Where new bonds are issued to fund the purchase of tendered bonds, the broker-dealer serving as Dealer Manager will often also serve as senior managing underwriter of the new bonds.

Information and Tender Agent

The Information and Tender Agent performs the technical functions of the tender: interfacing with The Depository Trust Company (“DTC”), identifying and engaging with bondholders, distributing the Invitation to Tender and related materials to holders (including through DTC), and receiving and processing bonds tendered by holders.

Selection Standard

Because the skills required to price and manage a tender are not widely practiced, the District will engage a financing team with demonstrated, specific experience in tender refundings. This applies with particular force to the Dealer Manager and the Information and Tender Agent, which will be evaluated on tender experience rather than experience with routine bond financings.

5.0 Procedures for Executing a Tender

The following procedures outline the tender steps that differ from the District’s conventional capital market financings.

Voluntary EMMA Notice

The District may post a voluntary disclosure notice on the Electronic Municipal Market Access ("EMMA") website to alert the market to an anticipated tender offer. This allows the Dealer Manager to engage existing bondholders early in the process, in an effort to improve participation in the tender.

Dealer Manager Agreement

The Dealer Manager agrees to solicit tenders of the target bonds and to perform related customary services. The Dealer Manager Agreement sets forth:

- Compensation payable to the Dealer Manager. Reasonable expenses are typically payable whether or not the tender offer is successful;
- Deliverables required at launch, meaning the date the Invitation to Tender is released and disseminated to holders;
- Deliverables required at closing, when the tendered bonds are purchased;
- The circumstances under which the Dealer Manager's services may terminate; and
- Representations and warranties of the District similar to those in a bond purchase agreement.

Invitation to Tender

The Invitation to Tender is the document provided to existing bondholders that gives them the information necessary to decide whether to tender. Federal securities antifraud laws prohibit the District and other transaction participants from making material misstatements or omissions in connection with a tender offer, as with any debt financing.

The Invitation will generally address:

- The bonds subject to the offer, identified by series, maturity, and CUSIP number;
- The terms of the offer, the source of funds for payment, and whether the tender is conditioned on the successful issuance of new bonds;
- The expiration date, whether the offer may be extended, and whether and how a holder may withdraw a tender;
- The conditions to completion, including any minimum principal amount and the process for allocating among maturities if tenders exceed the amount the District will accept;
- The District's express reservation of the right to reject any and all tenders and to withdraw or modify the offer;
- The expected treatment of target bonds not tendered; and
- Updated information about the District material to a holder's decision, ordinarily satisfied by attaching the POS.

Launch

The launch of the tender offer is the dissemination of the Invitation to Tender to holders of the target bonds. The Dealer Manager Agreement is signed on the launch date, and the deliverables and opinions required at launch are delivered. The POS for any new bonds issued to fund the purchase is posted on the launch date and attached to the Invitation.

The launch of a tender is a listed event under Rule 15c2-12. The District will ensure that the Invitation to Tender is filed on EMMA concurrently with launch.

The offer period typically runs approximately ten business days; a shorter period may be arranged, generally at additional DTC cost. In setting its length, the District will consider with the Financial Advisor and the Dealer Manager the risk that market movement during the period materially affects the prices of the target bonds, and whether to reserve the ability to adjust offer prices. Where that ability is reserved, any adjustment is ordinarily made no less than three to five days before the close of the offer period.

Acceptance of Offers and Pricing

The period between launch and expiration is analogous to the marketing period between posting a POS and pricing. The Dealer Manager interacts with holders of the target bonds to market the tender. The Invitation will specify the expiration date by which holders must submit their tenders; the timing and procedure for withdrawing a tender; either the price to be paid for the target bonds or the method and date by which the price will be set and communicated; and the date on which tenders will be accepted.

New Bonds

Where the District funds the tender by issuing new bonds, the new bonds are offered and sold in a parallel process. Because the proceeds of the new bonds pay the purchase price of the target bonds, acceptance of tenders occurs in tandem with pricing of the new bonds. The transaction will be sequenced so that the refunding bonds are priced only after the set of tendered bonds is known and accepted, and the interval between those two milestones will be kept as short as practicable to limit market rate risk.

Closing

On the closing date of a tender, the District purchases the accepted target bonds and the original bonds are canceled. The tender payment typically occurs immediately following delivery of the new bonds.

6.0 Pricing the Tender

A tender involves both the sale of refunding bonds and the purchase of outstanding bonds. The purchase side requires analysis different from what the District undertakes for a conventional bond sale. Accordingly, before the tender is launched, the District's Finance team will work with its Financial Advisor and Dealer Manager to determine how the purchase price will be set.

Three pricing methodologies are generally used for municipal tenders:

- Fixed price — the District sets a target purchase price for each bond offered for tender, established at launch;
- Fixed spread — the District specifies a spread to a stated benchmark or index for each tender candidate, which translates into a purchase price determined by reference to that index on a stated date; and
- Modified Dutch auction — holders submit spread offers to a stated benchmark or index, which translate into a purchase price.

Different methodologies may be applied to different bonds within a single transaction, for example where the offer includes both taxable and tax-exempt tender candidates. The market continues to evolve in this area and there is no single correct approach; the District will assess the options with its Financial Advisor and Dealer Manager for each transaction.

Prior to launch, the District will:

- Review the pricing models with the Financial Advisor and the Dealer Manager, and confirm a common understanding of the data sources, the indices or benchmarks to be used, and why the recommended methodology was proposed;
- Review the criteria used to select the target bonds and the expected savings from each maturity proposed for tender;

- Establish the criteria for evaluating the fairness of the prices offered, including their relationship to recent secondary market trading levels; and
- Run sample tender pricing in advance, so staff are comfortable with the methodology before the time pressure of actual pricing.

7.0 Risks and Risk Mitigation

Uncertainty of Results

Because there is limited ability to communicate with investors before launch, the principal amount that will actually be tendered cannot be known when the offer is launched. Participation varies widely with the identity of the holders, market conditions, and the prices offered; rates from 10 percent to over 70 percent have been observed, and a working assumption of approximately 30 percent is common. The District will confirm before launch that the transaction remains worthwhile at a conservative participation level.

Uneven Debt Service Impact

Because participation can vary by maturity, a tender can produce cash flow savings that vary by fiscal year and create uneven changes in year-over-year debt service. Combining a tender with the issuance of new bonds allows the District to smooth these fluctuations and maintain a more stable debt service profile.

Varying Impact on Bondholders

A tender offer may affect bondholders differently: some holders may prefer to hold to maturity for the interest income, while others may prefer immediate cash or new bonds. This variation influences the participation rate and the success of the transaction. Because a poorly managed tender can damage bondholder relationships and the District's future market access, the District will conduct any tender with that consideration in mind.

Alternative Outcomes

The District may obtain a better economic result by waiting and refinancing the target bonds at their call date rather than proceeding with a tender. Bonds that are not callable are the strongest tender candidates for this reason. At the same time, future opportunities to refinance may not materialize, and the District will weigh the certainty of savings available today against the possibility of greater savings later.

Cost Risk

Tender transactions generally take longer and cost more to execute than conventional refundings, involve additional specialized participants and documentation, and require additional EMMA filings. Many of these costs are payable regardless of the outcome and regardless of how many bonds are tendered. The District's preference for combining tenders with other bond sales (Section 3.0) helps mitigate some of this risk.

Execution Risk

The District will ensure that the Invitation to Tender reserves the District's right to reject any and all tenders and to withdraw or modify the offer, and that the transaction documents provide appropriate opportunities to exit without penalty if market conditions become adverse or the refunding bonds are not sold.

8.0 Communication

Communicating Expected Results

The District will be careful in communicating the projected results of a tender, both internally and publicly, because results are uncertain until tenders are accepted. Projections will be based on a conservative participation assumption, will be presented as a range where practicable, and will not be framed in terms that assume the transaction will succeed.

Steven G. de Mik, CPA
Deputy General Manager/CFO