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Food Processing & Agriculture

April 2010

## Industrial Development Bonds: An Old Financing Tool Can Help Companies Create New Growth

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It began back in the Great Depression, in the small town of Durant, Mississippi. People were hurting, jobs were scarce, and banks were failing. So Durant issued tax-exempt bonds for the construction of the Real Silk Hosiery Mill factory using the company's lease payments as security for the debt offering.

This was the first deployment of industrial development bonds (IDBs), municipal bonds that are similar to more conventional corporate bonds. IDB financing is initiated through a state or local government, such as Durant's, and allows a private user to benefit from the government's status as a tax-exempt entity and its ability to issue debt obligations at tax-exempt rates.

As the ultimate recipient of the bond proceeds, the private user benefits because the interest on the obligations is tax-exempt and therefore bears a lower interest rate than comparable taxable financing. For example,

depending on interest rate trends, IDBs may sell at rates far below prime on a variable interest rate basis, or two to four percentage points lower than taxable alternatives.

Fixed- and variable-rate IDBs, which are readily available in almost every state today, are typically issued through state or local industrial development bond issuers on a "conduit" basis, which means the issuer doesn't back or secure repayment of the bonds.

At a time when creating jobs is so crucial, raising capital remains so difficult, and strong companies are seeking the best and cheapest financing for expansion, IDBs continue to make a lot of sense. Unfortunately, very few companies are aware of IDB financing right now, even though both the private and public sectors sorely need it.

Structuring and closing IDB financings is often onerous and complicated. First, there are strict capital requirements, and companies need strong and solid financials to qualify.

Second, IDBs are generally for robust mid- to large-cap private companies in the food processing and manufacturing sector—and their "qualified expenditures" cannot precede the IDB approval date. This is a critical point,

since many companies find they're too far along in the project to make IDBs a viable financing alternative.

Third, the nature of the project that requires IDB financing is very important; public officials will carefully scrutinize what's being built, purchased, or installed to make sure it's economically beneficial.



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Fourth, companies that take advantage of IDB financing must be very prudent about their capital expenditures; in many cases there's an expenditure cap, and if it's violated, then the bonds are called.

Fifth, the IDB financing process can be bureaucratic. There are players involved at the county and state levels as well as from the finance world. The complexity increases because IDB financing falls under the federal government's Internal Revenue Code but is administered by the individual states, which depend on county commissioners in the approval and funding process.

To succeed with this multilayered IDB financing process and make the most of the

capital-raising opportunity, companies need to work with a team of experts that fully understand the various tax reporting issues—not just with a finance specialist. Advisors will look at a combination of “costs of financing and administration” during the bond amortization period, associated present value tax impact, and related up-front financing costs. Then they'll compare the IDB's effective interest rate cost to conventional financing alternatives, which allows a company to better estimate its true cost of capital and the short-, mid-, and long-term associated cash flow issues.

This process also includes a careful review of the company's capital expenditures over a six-year period, beginning three years from the IDB approval date to three years thereafter, to establish that the company won't violate the overall expenditure cap.

IDBs have traditionally been much cheaper than conventional financing, but the cost of this debt is clearly dependent on interest rates and economic cycles. In the 1970s, for example, we had extremely high interest rates and inflation, falling commodity prices, and rising operating costs. It was difficult for even good companies to secure financing. But for the companies that qualified, IDBs were a financial lifeline.

IDBs remained popular in the 1980s, but many companies choosing IDBs made the mistake of opting for fixed rates, which locked them in as interest rates declined and remained fairly low in the following two decades.

Companies using IDB financing today might want to consider a return to fixed rates, because it's hard to believe that the rock-bottom interest rates we're currently seeing will persist into later years. That said, the choice often depends on the amortization period for the financing, which can make the variable interest rate option a solid alternative.

Regardless of the financial forecast or projections, IDBs are an underused capital-raising tool, and they bear careful examination as companies seek growth and expansion in today's still-uncertain economy.

