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Capital Appreciation Bonds May Pressure School Districts

The issuance of capital appreciation bonds (CABs) is fairly common in municipal finance, particularly for issuers in rapidly growing areas. Fitch views reliance on CABs with concern, as they can materially weaken an issuer's debt profile.

The primary feature of CABs is that both interest and principal payments are deferred until maturity. For rapidly growing areas, the primary appeal is that needed capital improvements can be funded immediately, but the repayment burden is shared with the larger future population. In addition, by delaying repayment, CABs provide a financing vehicle when tax rate or debt level restrictions would prevent issuance of current interest bonds.

CABs slow overall debt amortization and most are not callable, potentially constraining debt capacity for decades to come. Furthermore, in return for receiving no periodic interest payments, investors demand a higher yield. The higher yield, coupled with the longer repayment period, results in higher total debt costs for every dollar generated for projects compared to current interest bonds. As a result of these drawbacks, some issuers may find their tax rate capacity insufficient to meet subsequent capital demands.

Since school districts tend to have large capital needs, especially when enrollment increases rapidly, school districts in rapidly growing states like California, Texas, and Florida have utilized this tool often. For districts with pressing capital needs that lack tax rate flexibility to issue traditional current interest bonds or seek taxpayer equity by deferring principal repayment to the future taxpayers, CABs can be an effective tool. However, reliance on CABs can present unique risks, and issuers could face materially weakened debt profiles as a result.

Fitch believes promised tax rates or legal "tax rate expectations test requirements" at issuance, coupled with enrollment growth, followed by stagnant or falling assessed valuations, are the primary drivers for increased CAB issuance for school districts in California and Texas in recent years. Regardless of the expected tax rates, once general obligation bonds are issued (whether CABs or current interest bonds), the issuer is obligated to increase the levy to repay the bonds.

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