Capital Markets and Investment Banking

Market Update

MAY 2018

Municipal Issuers Look to Preserve Flexibility After Prohibition on Tax-Exempt Advance Refundings

IN THIS ISSUE

Federal Reserve monetary tightening amidst a relatively low long-term rate environment has led to a flattening yield curve. Combined with federal tax code changes in December 2017, these dynamics are prompting municipal issuers to rethink refunding strategies and optional redemption features for new debt issuance as they attempt to maintain financial flexibility in a continuously changing regulatory and interest rate environment.

The Flattening Yield Curve

The fixed income market has experienced a pronounced "flattening" of the yield curve over the last two years. From April 1, 2016 to May 1, 2018, one-year rates for high-grade, tax-exempt municipal debt have increased by 120 basis points. During this same period, 30-year rates for high-grade tax-exempt debt have increased by only 41 basis points and remain near historic lows from a nominal perspective.

The increase in short-term rates can be attributed to many factors, but arguably the greatest driver is Federal Reserve monetary policy. The Federal Reserve began methodically increasing its Fed Funds Target Rate in December 2015 after holding the benchmark rate near zero for several years following the Great Recession. In addition, the U.S. Treasury has increased the issuance of shorter-term securities to fund expanding federal budget deficits. As a result, the increased supply has driven U.S. Treasury prices lower and yields higher.

With respect to municipal issuers, the flattening yield curve has improved refunding economics. Low long-term rates enable issuers to refinance debt and reduce borrowing costs. However, when issuers refinance debt prior to a redemption date, proceeds of the refunding issue are typically placed in escrow and invested in U.S. Treasury or federal agency securities. Additionally, federal income tax regulations make a distinction between "current" and "advance" refundings. Current refundings are completed within 90 days or less from the redemption date of the old bonds. In contrast, advance refundings are completed more than 90 days prior to the redemption date, and generally have longer escrow periods. The spread between the long-term rate on the new refunding bonds and the short-term reinvestment rate earned during the escrow period is called "negative arbitrage". Wide spreads and long escrow periods lead to excessive negative arbitrage and poor refunding economics for municipal issuers. Thus, the flattening yield curve has minimized the cost of negative arbitrage and prompted issuers to lock-in refinancing rates sooner rather than later.

Federal Tax Law Changes

The favorable yield curve environment that had been conducive to advance refundings came to an abrupt end in December 2017 with passage of the Tax Cuts and Jobs Act ("TCJA"). The TCJA eliminated tax-exempt "advance" refundings, effective immediately, and instituted many other tax code changes that will have a notable effect on the municipal bond market. These changes include: repeal of tax-credit bond programs including Qualified Zone Academy Bonds and Build America Bonds, among others; repeal of the alternative minimum tax for corporations (it remains for individuals); reduction of corporate and individual income tax brackets; and the capping of state and local tax ("SALT") deductions at $10,000.

Municipal Issuer Reactions – Refunding Techniques and Modified Call Options For New Issuance

The tax code changes established by the TCJA are prompting issuers to reassess debt management practices. Particularly, issuers are reviewing refunding techniques for outstanding tax-exempt bonds. Additionally, for new tax-exempt bond issuance, municipalities are studying the costs and benefits of modified call features that can provide greater flexibility for future debt restructuring.

In order to comply with the new prohibition on tax-exempt advance refundings, municipal issuers are considering alternative methods to lock in low refinancing rates today without running afoul of the rules. The most common techniques include taxable advance refundings, the use of forward settlement or rate cap products, open market repurchase programs, the use of Cinderella bonds that are issued as taxable, but convert to a lower tax-exempt rate at a future date and other derivate products such as swaps and swaptions. It should be noted that most, if not all, of these techniques are generally more costly than the tax-exempt advance refunding alternative available prior to passage of the TCJA.

Furthermore, for new tax-exempt debt, municipal issuers are re-examining the industry standard 10-year par call feature. Recently, in certain instances, municipal issuers have used shorter seven- or five-year par call features when the price concession is minimal. Issuers have also begun to test the market by adding make-whole call provisions to tax-exempt bonds that are also subject to the traditional 10-year par call. Similar to the make-whole call provisions that are commonplace in the corporate bond world (or tax credit bond market), the municipal make-whole call provision enables issuers to "current" refund bonds at *any time* prior to the standard par call date. The make-whole call premium is typically calculated as the greater of par, or the present value of remaining cash flow to the standard par call date (not final maturity) discounted at a predetermined spread to the applicable index.

The make-whole redemption is designed to be economically similar to tax-exempt advance refundings under the old tax code regime, where escrows were invested in U.S. Treasury securities to the par call date. However, one unique feature of the make-whole redemption is that it may produce better refunding results (i.e. greater savings for issuers) in certain interest rate environments compared to the standard 10-year par call. In addition, the receipt of a make-whole call premium (otherwise known as a capital gain) may create tax implications for certain investors.

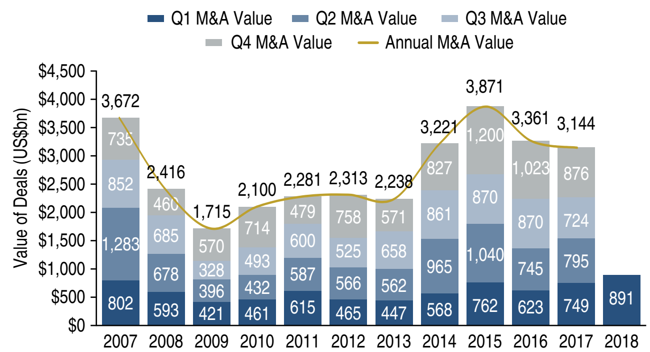
Time will tell if the shorter par call or municipal make-whole redemption become commonplace in the tax-exempt market. But the dearth of municipal supply during the first quarter of 2018 has given issuers better leverage to introduce new redemption features in their effort to retain flexibility under the new tax code.

Market Snapshot: Middle-Market Mergers & Acquisitions

Q1 2018 M&A Recap

- Global M&A deal value in Q1 2018 saw the strongest start to the year since 2001, as M&A activity has continued its sustained momentum over the past seven years.
- In Q1 2018, there were 14 “mega-deals” breaching the $10 billion mark, which drove the record total deal value.
- Overall, global M&A value increased 18% in Q1 2018 to $891 billion, while volume decreased 19% to 3,774 deals.

Quarterly Global M&A Comparison



Source: MergerMarket.

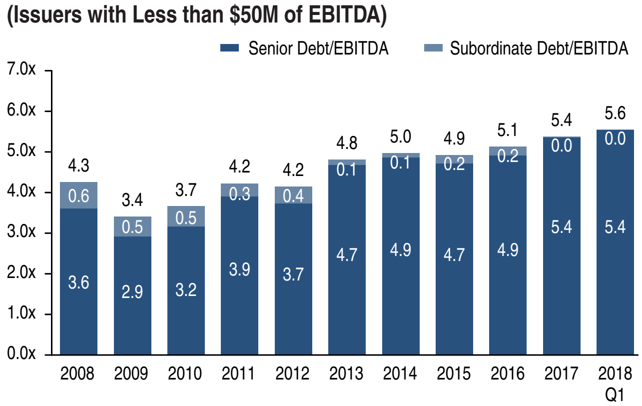
2018 Outlook

- Optimism in the outlook for global growth coupled with the need for private equity to put dry powder to work will continue to drive M&A activity in 2018.
- Cross-border activity will remain strong as dealmakers pursue strategies to expand geographically.
- A relatively favorable financing environment is supporting middle-market M&A activity.

Significant Opportunities Exist to Capitalize on the Favorable Financing Environment

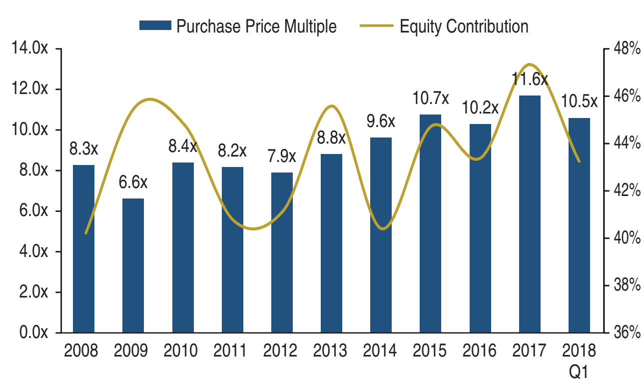
- Financial sponsor-driven acquisition multiples dipped slightly across the U.S. and Europe, averaging 10.5x EBITDA in Q1 2018. Equity contribution for middle-market LBOs averaged approximately 43% in Q1 2018.
- Total leverage in Q1 2018 for middle-market issuers with less than $50 million of EBITDA averaged 5.6x, up 0.2x from the 2017 average. Increasing debt capacity and aggressive behavior among leveraged lenders are supporting record valuations being paid by financial sponsors.
- Global private equity activity remains remarkably high. Q1 2018 saw 699 buyouts worth a total $114 billion, compared to the $90 billion and 782 of deals in Q1 2017, representing the highest dollar volume level since 2007.

Average Debt Multiples of Middle-Market LBO Loans (Issuers with Less than $50M of EBITDA)



Source: S&P Capital IQ LCD.

Average LBO Purchase Price Multiples



Source: S&P Capital IQ LCD.

Market Snapshot: Municipal Bonds

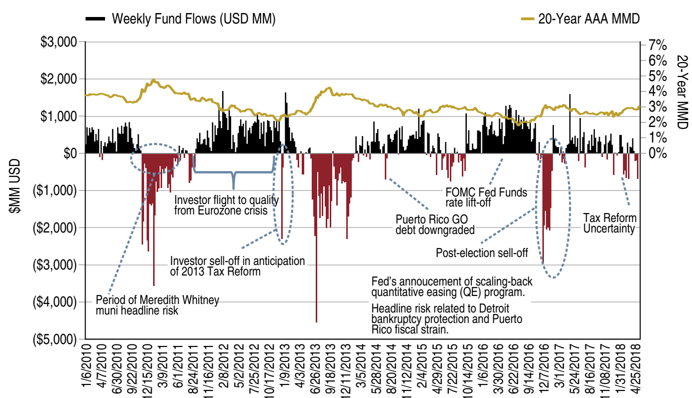
Municipal Bond Fund Flows and Municipal Market Data (MMD)

In the first few weeks of 2018, markets continued to suffer from the effects of tax reform. The beginning of 2018 saw a sharp increase in muni volatility and overall rate levels, with the 20- and 30-year AAA MMD experiencing rate increases of nearly 40 basis points in the month of January alone. However, the later part of the quarter brought an improved municipal market outlook to both issuers and bankers alike. Both tax-exempt and taxable yield curves flattened, which encouraged many issuers to go to market in search of obtaining more long-term debt. March's new issue supply came in at $25 billion, which was higher than both January and February, but still 23% below the pace of the previous year. This subdued primary issuance, along with a strong retail demand, continues to support the market and provides issuers with the opportunity to issue debt at surprisingly low levels.

March saw a target rate hike from the Federal Reserve to 1.75%, as well as increased expectations of a market sell-off from the combination of the Fed rate hike and tax season, but municipal bonds rallied later in the month. This was due to the Fed expressing that its preliminary estimate for three rate hikes in 2018 had remained unchanged. Also lowering rates in March was the announcement of U.S. tariffs on Chinese imports, which renewed fears of a trade war and inherently drove demand into the safety of municipal debt. Market conditions have driven both taxable and tax-exempt 20- and 30-year rates to around 3%, with ratios hovering just below 100%. This has reduced the benefit of tax-exemption for long-term issuances, and along with the elimination of tax-exempt advance refundings, has increased issuer interest in taxable debt. Mesirow has found that issuing debt on a taxable basis has resulted in lower issuer costs, as seen with recent issuances with the Cities of Carmel, Indiana; Hutto, Texas; New Britain, Connecticut; and Fishers, Indiana.

We continue to expect supply to normalize during the second quarter, as early-year calendar effects moderate and tax reform distortions subside. Overall, supply is still expected to be approximately 22% lower in 2018 than 2017. For 2018 and beyond, we recognize potential difficulties from more significant policy changes, including limitations on private activity bonds, curtailment of the state and local tax (SALT) deduction and the reduction in corporate tax rates. Additional market risks include fiscal stimulus, wage and price inflation and an expected three rate hikes from the Federal Reserve in 2018.

Municipal Bond Fund Flows and 20-Year MMD



As of the weekly reporting date of 4/25/2018
Source: EPFR Global Fund Flows and Allocations Data – All Muni Funds (Retail and Institutional Funds).

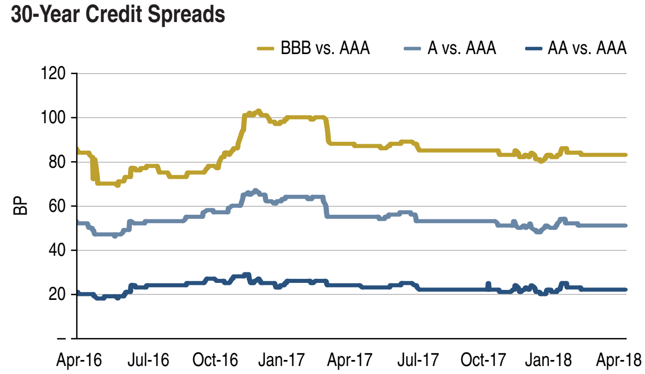
Trailing 16-Week Data

Muni Fund Reporting Date	Weekly Fund Flow ($MM USD)	20-Yr AAA MMD (%)
1/10/2018	496.06	2.61
1/17/2018	493.43	2.58
1/24/2018	179.17	2.68
1/31/2018	(573.40)	2.81
2/7/2018	(463.58)	2.83
2/14/2018	(661.28)	2.91
2/21/2018	286.54	2.93
2/28/2018	(689.07)	2.91
3/7/2018	178.11	2.92
3/14/2018	157.02	2.93
3/21/2018	405.04	2.93
3/28/2018	64.40	2.85
4/4/2018	(207.87)	2.84
4/11/2018	(187.72)	2.81
4/18/2018	(682.76)	2.84
4/25/2018	(2.27)	3.03

Credit Spreads

Fixed income markets continue to reflect the Fed's bias towards tightening rates, and the municipal yield curve continues to flatten accordingly. Credit spreads are tight, especially in some high-tax specialty state markets, including California and New York. Tax bill limits on SALT deductions are a powerful driver. Credit spreads have widened in several high-tax state markets, including Illinois, Connecticut, New Jersey and Pennsylvania, where there are concerns about structural fiscal imbalances at the state and local levels. There is some rotation among traditional institutional buyers as they adjust their investment strategies to the specific impacts under the new tax code.

30-Year Credit Spreads



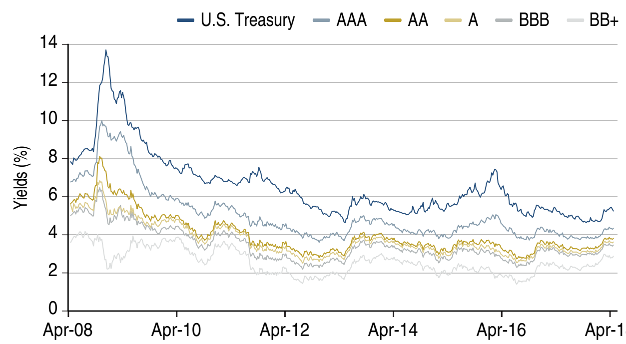
Source: The Municipal Market Monitor (TM3).

Market Snapshot: Corporate Debt and Infrastructure Finance

Corporate Debt Spreads – Finance Market Summary

- Yields on 10-year Treasuries crossed the 3% threshold for the first time in over four years in late-April after hovering just below it since February. 10-year Treasury rates have risen approximately 60 basis points year to date, a roughly 24% increase. The climb suggests investors are gaining confidence in economic growth and the prospects for an increase in inflation.
- Corporate spreads are following suit, with spreads to Treasuries widening slightly and yields increasing approximately 50 basis points across credit categories since the beginning of the year. Certain sectors, such as banking and insurance, have seen spreads widen more so than others, such as oil and REITS, which have seen more modest increases in spreads.

Historical Corporate Bond Yields – 10-Year Maturity



Data as of February 14, 2018.
Source: S&P Global Fixed Income Research.

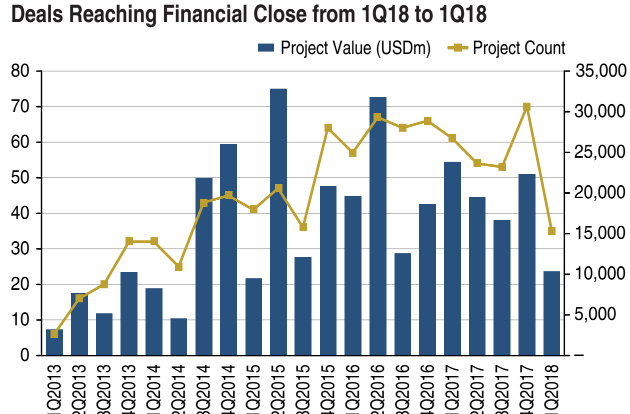
- The rise in the yield is happening amid the Federal Reserve's rate hikes. The Federal Reserve signaled intent to raise rates two more times this year and three times in 2019. This announcement is driving short-term yields higher, narrowing the spread between two-year and 10-year yields, and flattening the yield curve.
- Total corporate issuances in the first quarter of 2018 were 23.1% lower than issuances in the first quarter of 2017.[1] The reduction in issuances can be attributed to a combination of unprecedented levels of issuance in previous years, growing borrowing costs and a change in the tax code, which has made it cheaper for corporations to bring cash overseas back to the U.S.

1 SIFMA.

U.S. Infrastructure Market

- The first quarter of 2018 showed a slowing of U.S. project finance activity, with roughly $10 billion in infrastructure transactions reaching financial close. Brownfield transactions were most active, as 19 deals closed with an aggregate value of $7.8 billion. Brownfield and greenfield activity occurred predominately in the power and renewable energy sectors. High profile greenfield, transportation projects anticipated to reach financial close later this year include the LAX Automated People Mover.
- Trump's preliminary infrastructure plan released in February has stalled in Congress and will likely be put on hold until after the midterms. The plan proposed to provide $200 billion in federal funds which could lead to $1.5 trillion of new infrastructure investment. The plan shifts the burden onto states and local governments to identify new funding approaches to access the federal funding available and also to attract private investment.

Deals Reaching Financial Close from 1Q18 to 1Q18



Graph includes Greenfield, Brownfield and Refinancing transactions.
Source: Inframation.

Featured Mesirow Financial Deals

Gateway Casinos
& Entertainment

GATEWAY
CASINOS & ENTERTAINMENT LIMITED

Acquisition of Three Gateway Casinos & Entertainment Properties

Mesirow Financial successfully led the sale-leaseback for three Gateway Casinos & Entertainment Limited flagship properties valued in excess of CAD500 Million. With properties located in the Greater Vancouver Regional District, Gateway is one of the largest and most diversified gaming and entertainment companies in Canada. The acquired properties include the Grand Villa Casino Burnaby, Starlight Casino New Westminster and Cascades Casino Langley and are Gateway's three largest gaming properties in British Columbia. In each property, Gateway operates the casinos as a Service Provider to the British Columbia Lottery System, a "Crown Corporation" 100% owned by the Province of British Columbia. This was the Mesirow Realty Sale-Leaseback group's first cross-border transaction. The acquisition financing for this transaction was structured in collaboration with Mesirow Financial's Credit Tenant Lease (CTL) and Structured Debt group as well as Mesirow's Institutional Sales and Trading division. This transaction signifies the strong collaboration between our capital markets businesses and Mesirow's growing public-private partnership initiative. We continue to enhance our full-service platform in acquiring single-tenant properties, now internationally, complemented by our strong capabilities in debt placement.

TELEFONIX PDT™

has been acquired by

ASTRONICS
CORPORATION

— Sell-side Advisor —

M&A Sell-side Advisor to Telefonix PDT

Mesirow Financial acted as the exclusive financial advisor to Telefonix, Inc. and a related company, Product Development Technologies, LLC (together known as "Telefonix PDT"), on its sale to Astronics Corporation. Located in Waukegan and Lake Zurich, IL, Telefonix PDT is a full-service product design, development and manufacturing company that supplies advanced in-flight entertainment and connectivity equipment to the aerospace industry. Founded on the strength of its retractable cabling technology, Telefonix PDT has become a leader in technology development and execution for complex mechanical and electrical assemblies. The transaction represents another successful assignment completed by Mesirow Financial's Investment Banking group.

CITY OF HAMMOND, INDIANA
1884

City of Hammond, Indiana
$19,655,000
Special Taxing District
Refunding Bonds
Series 2018

— Sole Underwriter —

Sole Manager for the Sanitary District of the City of Hammond, Indiana

Mesirow Financial served as the sole underwriter for the $19,655,000 Special Taxing District Refunding Bonds, Series 2018 on behalf of the Sanitary District of the City of Hammond, Indiana ("the District"). The Series 2018 Bonds were issued to currently refund the District's outstanding Series 2006A, 2007B and 2010A Special Taxing District Bonds. The Series 2018 Bonds had an underlying rating of BBB and an insured rating of AA through Build America Mutual Company, as the cost-benefit analysis determined that utilizing bond insurance provided the District with economic benefit. Upon official engagement, Mesirow Financial assessed the estimated pricing levels based upon investor feedback for both a private placement and a public market offering in order to determine which distribution method was most advantageous to the District. Based upon the average life of the transaction, and Federal tax reform's effects on the private placement market, it was determined that distributing the Bonds through a public market offering was the most cost effective option for the District. Mesirow Financial worked with the District to evaluate several structures and call options designed to maximize savings in key years and to provide flexibility in the District's financial planning. Furthermore, Mesirow Financial's execution of this transaction allowed the District to achieve a net present value savings of $1.129 million, or approximately 5.32% of the refunded bonds.

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About Mesirow Financial

Mesirow Financial is an independent, employee-owned firm founded in 1937. As specialists in investment, risk management and advisory services, we are committed to helping our institutional, corporate and individual clients achieve their objectives. Our professionals are inspired by an entrepreneurial desire to develop tailored solutions designed to deliver measurable results. To learn more, please visit mesirowfinancial.com.

Contact Us

Dominick Mondi
President, Mesirow Financial
312.595.7133
dmondi@mesirowfinancial.com

Steve Jacobson
CTL and Structured Debt Products
312.595.7920
sjacobson@mesirowfinancial.com

Gerry Levin
Sale-Leaseback Capital
312.595.6070
glevin@mesirowfinancial.com

Brian Price
Investment Banking
312.595.6545
bprice@mesirowfinancial.com

Todd Waldrop
Public Finance
312.595.6242
twaldrop@mesirowfinancial.com

Bruce Young
Institutional Sales and Trading
312.595.6191
byoung@mesirowfinancial.com

Visit us online at mesirowfinancial.com

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