

Synthetic Fixed Rate – Interest Rate Swaps

Variable Rate and Synthetic Fixed Rate Bonds. Since 2000, the use of variable rate and synthetic fixed rate debt has increased significantly. As endowment returns have struggled, borrowers have looked for ways to reduce their cost of capital. Variable rate bonds have the lowest possible interest rate in the tax-exempt marketplace. The variable rate has averaged 2.68% over the past ten years, 2.31% over the past year and is currently about 2.93%. Borrowers issuing variable rate bonds generally do so to obtain the lowest possible interest rate, or want the ability to prepay the bonds with 30-days notice without penalty.

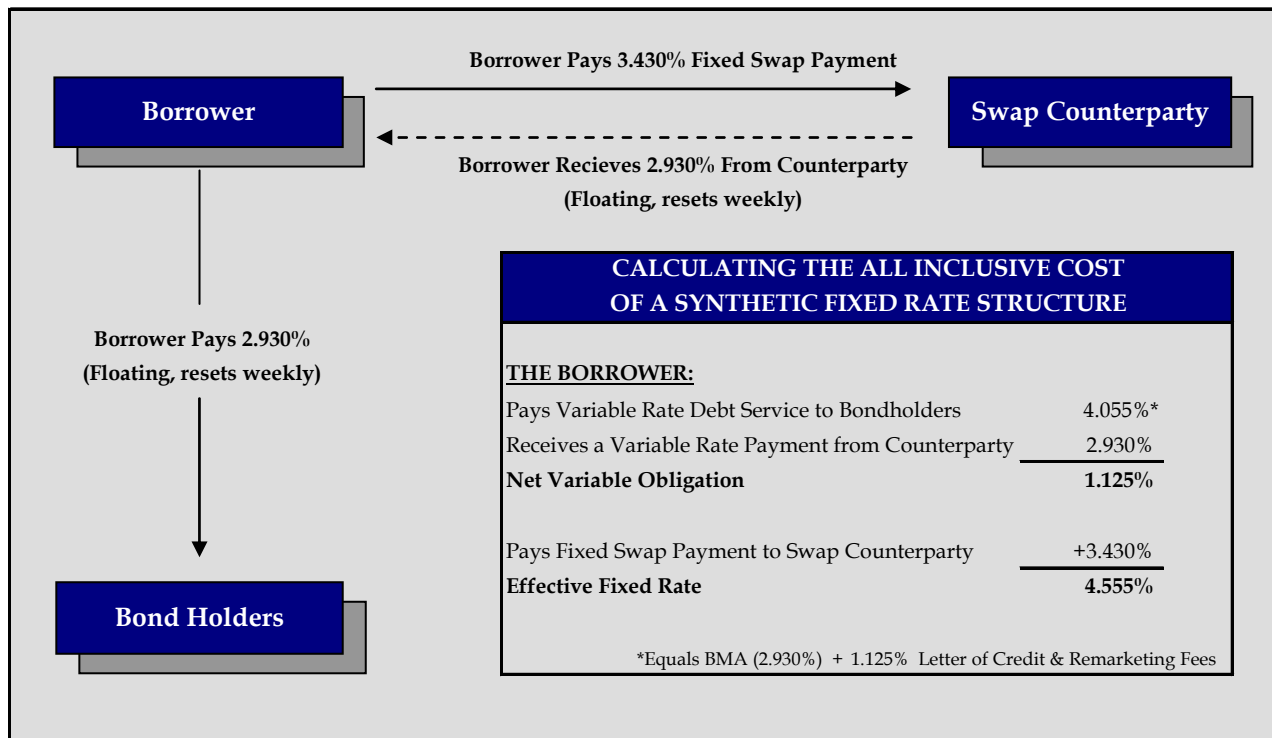
Synthetic fixed rate debt is created by issuing variable rate bonds and then entering into a separate variable-to-fixed rate interest rate swap agreement with a counterparty for all or a portion of the debt. The result is “synthetic fixed rate” debt. Since 2000, the majority of GKB’s independent school clients have utilized synthetic fixed rate debt. These institutions include Phillips Andover Academy, Palmer Trinity School, John Cooper School and many others.

It is important to note that some borrowers issue variable rate bonds (i.e. Stevenson School, Governor Dummer, Phillips Exeter, etc.) and remain entirely in variable rate mode. These borrowers periodically review the option to execute a variable-to-fixed rate interest rate swap if market conditions or interest rate outlooks change.

Overview of Synthetic Fixed Rate. Synthetic fixed rate is created when a borrower issues variable rate bonds then enters into a variable to fixed interest rate swap. The benefits of synthetic fixed rate are:

1. Significantly lower fixed rate than traditional rated bonds.
2. More flexibility to utilize a combination of variable rates with a range of fixed rates (i.e. some borrowers have combined 7-day variable rate with interest rate swaps from five to thirty years).
3. Greater prepayment flexibility than traditional fixed rate.

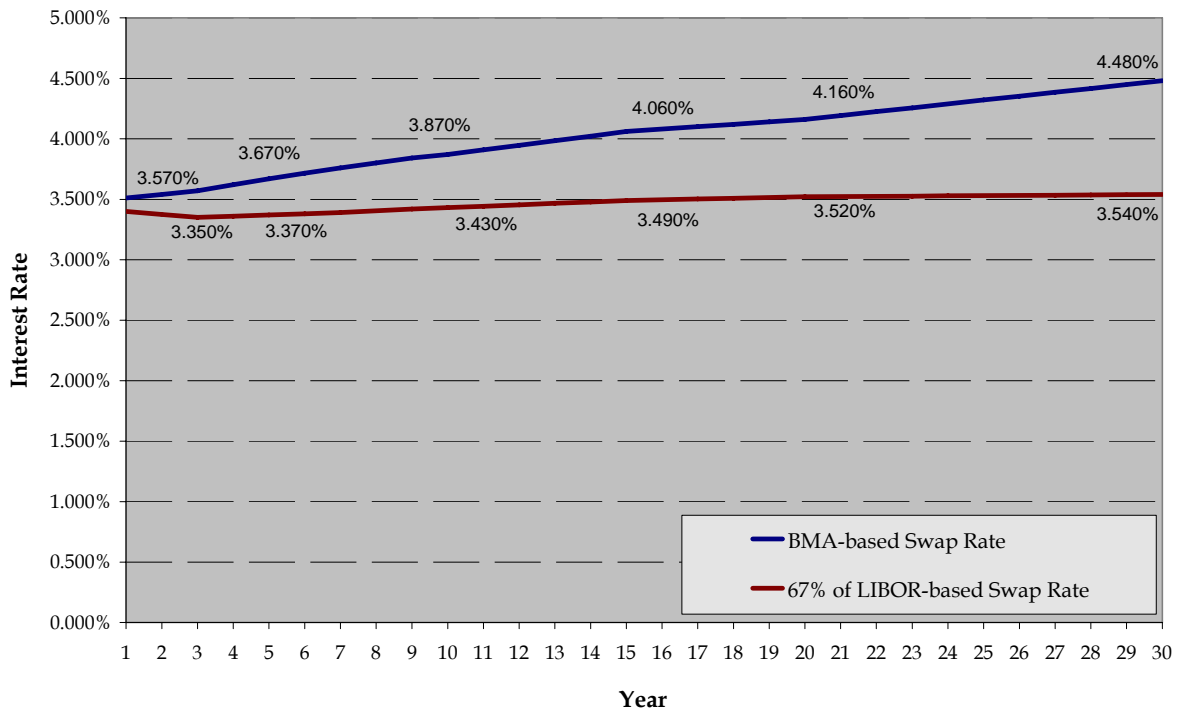
The following schematic illustrates the mechanics of an interest rate swap:



Interest Rate Swap Yield Curve. The School has the choice of utilizing either of two swap yield curves: (1) the 7-day Bond Market Association (BMA) index, or (2) 67% of LIBOR. The School can execute an interest rate swap along any point of the respective yield curves, one to thirty years. The vast majority of GKB’s independent school clients have utilized the 67% LIBOR swap curve.

The following graph illustrates the cost advantage of the 67% LIBOR-based interest rate swap compared to the BMA based interest rate swap.

THE YIELD CURVE
Comparison of Synthetic Fixed Rate Cost of Borrowing
(as of January 9, 2006)



Swap Documentation. The interest rate swap is a simple contract between the School and the swap counterparty. Documentation consists of the following:

1. Master ISDA Agreement. This is a boiler plate document used by all swap parties that defines terminology and certain conditions.
2. Schedule to the Agreement. This document is a short document that may modify some of the Master ISDA conditions.
3. Credit Annex. If any collateral is to be utilized by either party, this document outlines the mechanics of posting collateral.
4. Confirmation. This document outlines the key terms of the transaction

Over the past four years, George K. Baum & Company has devoted significant resources to developing and growing its swap expertise as interest rate swaps have become a widely-used financing tool in municipal finance. GKB has extensive experience in the competitive interest rate swap market and has recently created its own AA- rated derivatives subsidiary, GKB Financial Services Corporation (“FSC”), to act as principal in swap transactions.

Competitive Swap Market Experience

Over the past four years, GKB has acted as either swap advisor or bidding agent on behalf of over 60 clients in executing over 100 contracts with an aggregate notional amount exceeding \$3.0 billion.

Services that we provide when acting as swap agent include:

Structuring Advice: Determine the most attractive swap structure for the client with consideration for how the swap product fits within both the specific financing structure and the client’s overall outstanding debt portfolio.

Document Negotiation: Work with the client’s counsel to negotiate the legal documents that support the swap transaction to ensure fair and reasonable provisions are incorporated into the contract between the client and the swap provider.

Pricing Verification or Bid Solicitation: George K. Baum & Company can act as either swap advisor or bidding agent. In either role, GKB works on behalf of the client to confirm that the swap rate it locks in is a fair, reasonable and defensible rate – either by checking the pricing as an advisor or via a competitive bid process.

On-Going Swap Maintenance and Support: Monitor swap payment invoices and mark-to-market values to be sure they are accurate and interface with the swap provider to remedy any discrepancies or problems.

Negotiated Swap Market Experience

George K. Baum & Company now has the ability to negotiate interest rate swaps directly with our clients through GKB Financial Services Corporation (“FSC”). In the past six months, FSC has negotiated ten swap contracts with an aggregate notional amount exceeding \$340 million. More complicated transactions, involving multiple swaps or non-vanilla credit structures, typically benefit from the negotiation process because the client is able to customize the structure and to control the execution process.

Benefits of the negotiated process:

Structure Customization: The competitive swap process will typically generate the best price for standard, plain vanilla swap structures. When the client’s financing requires a more complicated structure or multiple swaps in one financing, the negotiated process helps the client as FSC can design a customized structure to achieve the goals of the financing.

Advance Document Negotiation: The negotiated process allows FSC and the client to negotiate swap documents prior to pricing any interest rate swap. FSC and the client negotiate the credit terms included in the swap document and agree on any unique provisions prior to locking the swap rate. Additionally, the client may have a target swap rate and negotiating the swap documents ahead of time allows the client to be ready to execute the swap as soon as its target is reached.

Efficient Swap Execution: The client can choose the day and time of pricing and execute the swap rate based on a phone call. The competitive process introduces more variables to executing the swap and may hinder the client’s financing schedule with complicated swap structures.