

Town of Federalsburg, Maryland

Comprehensive Financial Review – Executive Summary



January 2023



Background/Goals and Objectives

- Davenport & Company LLC (“Davenport”) was commissioned by the Town of Federalsburg, Maryland (the “Town”) to prepare a Comprehensive Financial Review for the Town.

- The goal of the Comprehensive Financial Review is to provide the Town’s key stakeholders – including senior staff, elected officials, and the public – with a perspective and overview of the Town’s financial related strengths and challenges.

- With the findings of the Comprehensive Financial Review in place the Town will be positioned to:
 - Understand, in greater depth, the financial pressures currently facing the General Fund and Water and Sewer Fund (“W&S Fund”), including recommendations on how to improve the fiscal health of these funds going forward;
 - Adopt / enhance policy guidelines that will serve as guideposts for key Town decision makers; and
 - Perform multi-year financial and capital planning.

- Contained herein is an Executive Summary of the Comprehensive Financial Review.



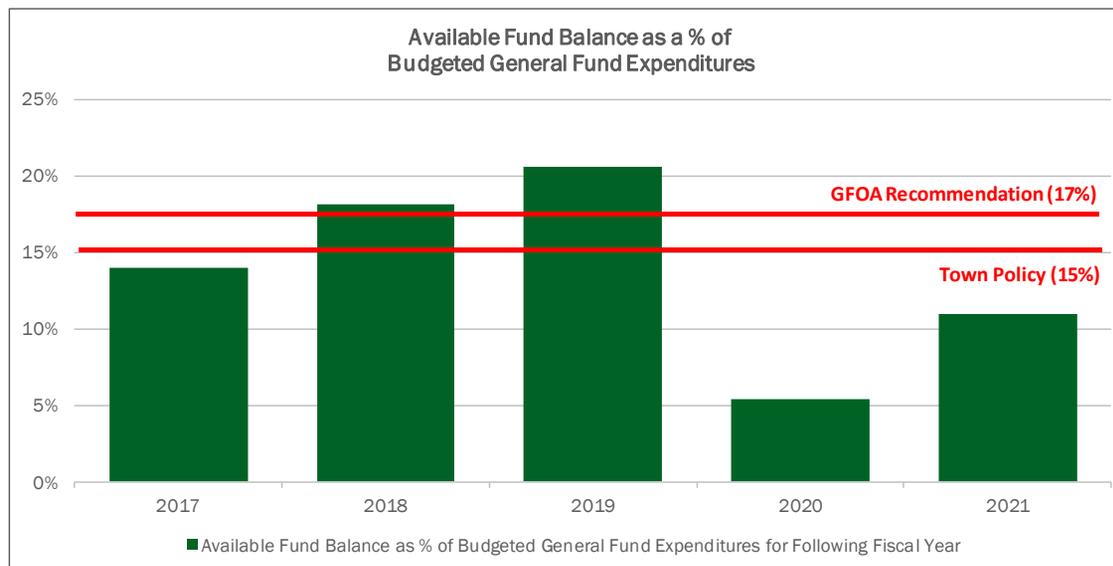
General Fund Summary





General Fund Summary – Fund Balance

- Fund Balance is an accumulation of surpluses of prior years and is therefore a finite resource.
 - A local government’s reserve position is arguably the most important metric for a local government, as a well-funded reserve can help offset any economic downturn or other one-time event.
 - Once reserves are exhausted, the Town would have to rely on external funding mechanisms to meet operating expenditures (i.e. short-term borrowing to meet operational needs such as payroll).
- The Town’s available General Fund balance has declined by 18.5% over the last five years to \$269,184 or 11% of budgeted General Fund expenditures for the following fiscal year.
 - This reduction in reserves was primarily due to an unbudgeted transfer to the W&S Fund in Fiscal Year 2020 since rates haven’t been increased since 2018. The Town also had another smaller unbudgeted transfer to the W&S Fund in Fiscal Year 2021, and **if these transfers continue, there will likely be additional negative impacts to the financial health of the General Fund.**
 - While the Town adopted a reserve policy in January 2021 to maintain a General Operating Contingency of at least 15% of General Fund expenditures of the following year’s General Fund annual operating and capital budgets, **the Town’s reserve position has remained below this policy in three of the last five years. In addition, the Town’s current 15% policy is still below the two months of operating expenditures (17%) that the Government Finance Officers Association (“GFOA”), which is considered the industry standard.**





General Fund Summary – Revenue and Expenditure Trends

- Property taxes, the most stable and reliable source of revenue, is the Town’s largest revenue source representing approximately 71% of total revenues as of Fiscal Year 2021, down from 75% in Fiscal Year 2017.
- While property taxes have only grown by 1.8% over the last five years, the Town’s two largest expenditures – community developments and public safety – have increased by 15.5% over the same time period.

Revenues	FY 2017	Percentage	FY 2021	Percentage
Property Taxes	\$1,845,955	75%	\$1,879,794	71%
Income Taxes	118,188	5%	176,235	7%
Licenses and Permits	71,568	3%	75,907	3%
Intergovernmental	173,659	7%	246,846	9%
Charges for Services	180,858	7%	183,043	7%
Note Receivable - Principal	48,024	2%	45,391	2%
Note Receivable - Interest	5,385	0%	2,935	0%
Miscellaneous	30,809	1%	51,960	2%
Total Revenues	\$2,474,446		\$2,662,111	

Expenditures	FY 2017	Percentage	FY 2021	Percentage
General government	\$483,822	19%	\$465,602	18%
Community development	930,476	37%	1,124,602	44%
Public safety	472,059	19%	495,207	19%
Public works	51,464	2%	15,002	1%
Social services	12,292	0%	15,110	1%
Parks and recreation	291,216	12%	230,791	9%
Debt service ¹	266,751	11%	210,869	8%
Total Expenditures	\$2,508,080		\$2,557,183	

- The Town has a history of budgeting relatively conservatively on both the revenue and expenditures side, including building in a contingency to offset any unexpected budgetary impacts.
- However, with expenditure growth continuing to outpace revenue growth this budgetary contingency has declined.
 - With this reduced contingency and continued transfers from the W&S Fund, there is a greater likelihood that reserves could potentially be needed to balance the budget if this trend continues.

	2022 Adopted Budget	2023 Adopted Budget	Inc (Dec) vs. 2022 Budget	Percentage Change
Revenues				
Property Taxes	\$1,907,206	\$1,973,743	\$66,537	3.5%
Income Taxes	90,000	90,000	0	0.0%
Highway User Revenue	140,054	153,951	13,897	9.9%
Other Taxes	1,000	1,000	0	0.0%
Licenses and Permits	35,515	20,350	(15,165)	-42.7%
Revenue from Other Agencies	51,390	47,390	(4,000)	-7.8%
Public Safety	77,000	77,000	0	0.0%
Sanitation and Waste Removal	179,000	200,120	21,120	11.8%
Recreation	3,170	3,170	0	0.0%
Fines and Forfeitures	100	100	0	0.0%
Miscellaneous Revenues	21,977	43,977	22,000	100.1%
Total Revenues	2,506,412	2,610,801	104,389	4.2%
Expenditures				
General Government	\$505,674	\$535,747	\$30,073	5.9%
Public Safety	1,159,520	1,232,673	73,153	6.3%
Public Works	668,888	708,158	39,270	5.9%
Recreation and Culture	20,800	23,800	3,000	14.4%
Economic Development	4,950	5,450	500	10.1%
Debt Service	63,317	63,317	0	0.0%
Miscellaneous	30,284	30,284	0	0.0%
Total Expenditures	\$2,453,433	\$2,599,429	\$145,996	6.0%
Operating Surplus (Deficit)	\$52,979	\$11,372		



General Fund Recommendations

- With limited revenue growth expected over the near-term, **the Town will have to either cut expenditures or raise revenues to ensure that the Town's healthy financial position is maintained and no additional draws on reserves occur.**
 - The Town has diligently worked to find efficiencies and cost savings related to General Fund expenditures. As a result, there may not be many options left to consider for reductions/cost savings and an increase in revenues (tax rate increase) may be required.

- While timing of future economic development projects is not known, Davenport believes it would be beneficial for the Town to develop a more long-term budget model to help proactively monitor the expected growth in revenues and expenditures and their impact on reserves.
 - This will allow the Town to explore budgetary options available to ensure a balanced budget is adopted without the use of reserves.
 - The budget model could be adjusted as needed as more detail on timing of upcoming economic development projects is known.

- Davenport would also propose expanding on the Town's current 15% reserve policy to provide some additional guidelines on how the reserve can be used, as well as replenished.
 - Once the Town meets its current 15% policy, the Town could consider adding an upper benchmark target of 17% to keep the policy in line with GFOA practices and provide added financial flexibility. The additional 2% could act as a budget stabilization reserve that would act as a first line of defense for any unanticipated revenue or expenditures fluctuations.
 - The 15% reserve policy should include additional language detailing what the funds could be used for (i.e. - extreme one-time events) and would require a majority/super-majority vote of Council before they could be utilized.
 - The 15% reserve policy should also include details on how this reserve would be replenished if it fell below the 15% target. This would include having Council establish a replenishment plan restoring the reserve to the 15% target within a three-year timeframe which is a GFOA/industry standard.



Water & Sewer Fund Summary



W&S Fund Summary – Revenue and Expenditure Trends

	Fiscal Year 2017	Fiscal Year 2018	Fiscal Year 2019	Fiscal Year 2020	Fiscal Year 2021
Operating Revenues					
Water service charges	\$428,956	\$367,955	\$406,872	\$414,555	\$395,544
Sewer service charges	1,087,432	1,025,085	1,080,165	1,079,223	1,035,151
Total Operating Revenues	\$1,516,388	\$1,393,040	\$1,487,037	\$1,493,778	\$1,430,695
Operating Expenses					
Water	\$128,241	\$193,953	\$189,583	\$157,915	\$319,370
Sewer	664,901	781,799	831,132	925,105	712,339
Depreciation and Amortization	662,248	666,046	660,531	659,552	664,173
Total Operating Expenses	\$1,455,390	\$1,641,798	\$1,681,246	\$1,742,572	\$1,695,882
Operating Income (Loss)	\$60,998	(\$248,758)	(\$194,209)	(\$248,794)	(\$265,187)
Nonoperating Revenues (Expenses)					
Intergovernmental revenues	\$0	\$0	\$0	\$35,100	\$1,699,321
Capital asset transferred from General Fund	-	-	-	-	23,131
Transfers in	65,046	(162,110)	3,186	78,308	214,354
Financial expense, net	(140,185)	(136,533)	(130,559)	(123,612)	(116,500)
Total Nonoperating Revenues (Expenses)	(\$75,139)	(\$298,643)	(\$127,373)	(\$10,204)	\$1,820,306
Change in Net Position	(\$14,141)	(\$547,401)	(\$321,582)	(\$258,998)	\$1,555,119
Net Position - Beginning of Year	\$12,211,238	\$12,197,097	\$11,649,696	\$11,328,114	\$11,069,116
Net Position - End of Year	\$12,197,097	\$11,649,696	\$11,328,114	\$11,069,116	\$12,624,235

- While the net position of the Water & Sewer Fund (“W&S Fund”) has increased by 3.5% over the last five years, this was primarily driven by the \$1.7 million in intergovernmental revenues received in fiscal year 2021.
 - When excluding the \$1.7 million, the net position of the W&S Fund would have declined 10.4%.
- Over the last five years, expenditures have grown at a significant 30.1%, while revenues have declined by 5.7%.
 - This has resulted in a significant decline in the W&S Fund’s cash position.
 - The last rate increase that was adopted was in fiscal year 2018.



Historical Water & Sewer Fund Performance vs. Budget

WATER FUND:

- Over the last five years, the Water Fund revenues have ended on average 5.1% under budget, while expenses ended under budget by an average of 18.8%. The Town's conservatism on the expenditure side has helped to offset revenue underperformance.

Water Operating Revenues				
	Budget	Actual	Variance (\$)	Variance (%)
2017	\$407,229	\$428,956	\$21,727	5.3%
2018	420,642	367,955	(52,687)	-12.5%
2019	413,143	406,872	(6,271)	-1.5%
2020	416,143	414,155	(1,988)	-0.5%
2021	473,499	395,544	(77,955)	-16.5%

Water Operating Expenses (Net of Depreciation)				
	Budget	Actual	Variance (\$)	Variance (%)
2017	\$169,304	\$128,241	(\$41,063)	-24.3%
2018	246,827	193,953	(52,874)	-21.4%
2019	217,151	189,583	(27,568)	-12.7%
2020	236,049	157,915	(78,134)	-33.1%
2021	327,861	319,370	(8,491)	-2.6%

SEWER FUND:

- Over the last five years, the Sewer Fund revenues have ended on averaged 18.9% under budget, while expenses ended over budget by an average of 13.2%. This has resulted in a net loss in the Sewer Fund during four of the last five fiscal years. Fiscal year 2021 was the only year in which the Sewer Fund was able to produce net income due to the one-time receipt of \$1.7 million in intergovernmental revenues.

Sewer Operating Revenues				
	Budget	Actual	Variance (\$)	Variance (%)
2017	\$1,325,424	\$1,087,432	(\$237,992)	-18.0%
2018	1,408,661	1,025,085	(383,576)	-27.2%
2019	1,324,000	1,080,165	(243,835)	-18.4%
2020	1,212,500	1,079,223	(133,277)	-11.0%
2021	1,295,603	1,035,151	(260,452)	-20.1%

Sewer Operating Expenses (Net of Depreciation)				
	Budget	Actual	Variance (\$)	Variance (%)
2017	\$597,719	\$664,901	\$67,182	11.2%
2018	642,357	781,799	139,442	21.7%
2019	732,709	831,132	98,423	13.4%
2020	772,376	925,105	152,729	19.8%
2021	714,281	712,339	(1,942)	-0.3%

Source: 2017-2021 Financial Statements.



Water & Sewer Fund FY 22 and 23 Budget Comparison

	2022 Adopted Budget	2023 Adopted Budget	Inc (Dec) vs. 2022 Budget	Percentage Change
Revenues				
Water	\$473,724	\$484,615	\$10,891	2.3%
Sewer	1,295,718	1,369,238	73,520	5.7%
Total Revenues	\$1,769,442	\$1,853,853	84,411	4.8%
Expenditures				
Water	\$479,165	\$497,946	\$18,781	3.9%
Sewer	1,269,429	1,213,082	(56,347)	-4.4%
Total Expenditures	\$1,748,594	\$1,711,028	(\$37,566)	-2.1%
Operating Surplus (Deficit)	\$20,848	\$142,825		

- Revenues are budgeted to increase by 4.8% between fiscal years 2022 and 2023 despite rates remaining flat.
 - As seen on the previous slide, both Water and Sewer revenues have historically ended under budget.
- Expenses are expected to decline by 2.1%, primarily driven by the sewer portion of the Fund.
 - However, sewer expenses have historically ended over budget.
- Positively, both the fiscal year 2022 and fiscal year 2023 budgets include an anticipated operating surplus that acts as a budgetary contingency. This contingency increased by 5.9x to \$142,825 in fiscal year 2023, providing additional flexibility to offset any changes to the budget.



W&S Fund Summary: Key Ratios

- The **Debt Service Coverage** ratio (Net Revenues divided by Total Annual Debt Service) measures the Town’s ability to meet its annual debt service requirements after all operational expenses.
- **Debt Service Coverage has declined since fiscal year 2017 to 0.74x, which means the W&S fund is not self-supporting (need at least 1.00x coverage).** This reduced coverage is being driven by a 44.8% reduction in net revenues as rates have remained unchanged. Debt Service has remained relatively consistent over the last five years.

	Fiscal Year 2017	Fiscal Year 2018	Fiscal Year 2019	Fiscal Year 2020	Fiscal Year 2021
Net Revenues	\$723,246	\$417,288	\$466,322	\$410,758	\$398,986
Total Debt Service	\$553,175	\$562,889	\$562,201	\$527,074	\$540,210
Debt Service Coverage Ratio	1.31	0.74	0.83	0.78	0.74

- **Days Cash on Hand** (“DCOH”) (Current unrestricted cash and liquid investments divided by operating expenditures minus depreciation, divided by 365) is a liquidity metric that gauges flexibility to pay near term obligations.
- **The Town’s Water & Sewer Fund cash position has declined significantly representing a very low seven DCOH as of fiscal year 2021. This cash position is well below the one (30 days) to three (90 days) month range recommended by the American Waterworks Association, Water Environment Federation, ICMA, and GFOA.**

	Fiscal Year 2017	Fiscal Year 2018	Fiscal Year 2019	Fiscal Year 2020	Fiscal Year 2021
Unrestricted cash and investments	\$ 539,145	\$ 263,303	\$ 173,967	\$53,987	\$ 20,777
Operating Expenses Less Depreciation	\$793,142	\$975,752	\$1,020,715	\$1,083,020	\$1,031,709
Cash Operating Expense Per Day	\$2,173	\$2,673	\$2,796	\$2,967	\$2,827
Days Cash on Hand	248	98	62	18	7

Source: 2017-2021 Financial Statements



W&S Fund Recommendations

- With the significant decline in the W&S Fund’s debt service coverage and cash position, it is strongly recommended that the Town consider hiring a third-party to conduct a full rate study.
 - This rate study would provide the Town with the necessary information about what rate increases would be required to bring the W&S Fund back to self-supporting status (1.00x debt service coverage).
 - If a rate study is not conducted and rates are not increased, the W&S Fund is likely to realize additional net losses resulting in further declines in the Fund’s net position.
 - Depending on the frequency and size of the annual net losses, the W&S Fund could potentially require additional financial assistance from the General Fund. The General Fund already made unbudgeted transfers to the W&S Fund in 2020 and 2021.
 - If these transfers continue, there will be added financial pressure on the General Fund, which isn’t currently meeting its own reserve policy.
- As recommended for the General Fund, Davenport believes that establishing a long-term budget model for the W&S Fund to help proactively monitor the expected growth in revenue and expenses, as well as determine what rate increases (if any) are potentially needed in any given fiscal year.
- Once the rate study is complete and a rate plan has been established, Davenport would recommend that the Town adopt additional financial policies related to the W&S Fund that will help to ensure a healthy financial position can be obtained and maintained going forward.
 - Establish a DCOH policy of 90 days as recommended by the industry to ensure the W&S Fund remains liquid and able to address any short-term budgetary issues.
 - To help manage current and future debt, Davenport would recommend establishing a Debt Service Coverage Requirement policy. While debt service coverage of 1.00x is considered self-supporting, adopting a slightly higher target of 1.20x would provide additional flexibility and be in line with industry standards.



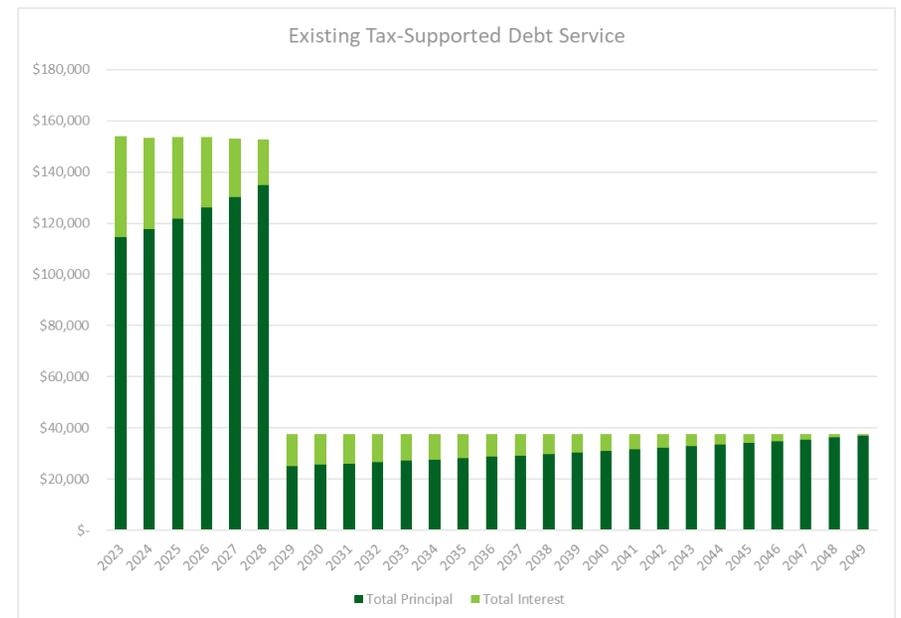
Debt and Capital Needs Summary



Existing Tax Supported Debt Service

- Below is an overview of the Town’s existing tax-supported Debt Service that is paid out of the General Fund.
- Current debt service for the General Fund is structured as declining debt service including 75% decline (approximately \$115,175) in fiscal year 2029.

Fiscal Year	Total Principal	Total Interest	Total Debt Service
2023	\$ 114,432	\$ 39,530	\$ 153,962
2024	117,614	35,810	153,424
2025	121,813	31,806	153,619
2026	126,025	27,466	153,491
2027	130,253	22,775	153,028
2028	134,995	17,811	152,806
2029	25,085	12,546	37,631
2030	25,574	12,057	37,631
2031	26,073	11,558	37,631
2032	26,581	11,050	37,631
2033	27,099	10,531	37,630
2034	27,627	10,003	37,630
2035	28,166	9,464	37,630
2036	28,715	8,915	37,630
2037	29,276	8,355	37,631
2038	29,847	7,784	37,631
2039	30,429	7,202	37,631
2040	31,021	6,609	37,630
2041	31,626	6,004	37,630
2042	32,243	5,387	37,630
2043	32,873	4,758	37,631
2044	33,514	4,117	37,631
2045	34,167	3,464	37,631
2046	34,833	2,797	37,630
2047	35,513	2,118	37,631
2048	36,204	1,426	37,630
2049	36,910	720	37,630
TOTAL	\$ 1,388,508	\$ 322,064	\$ 1,710,572



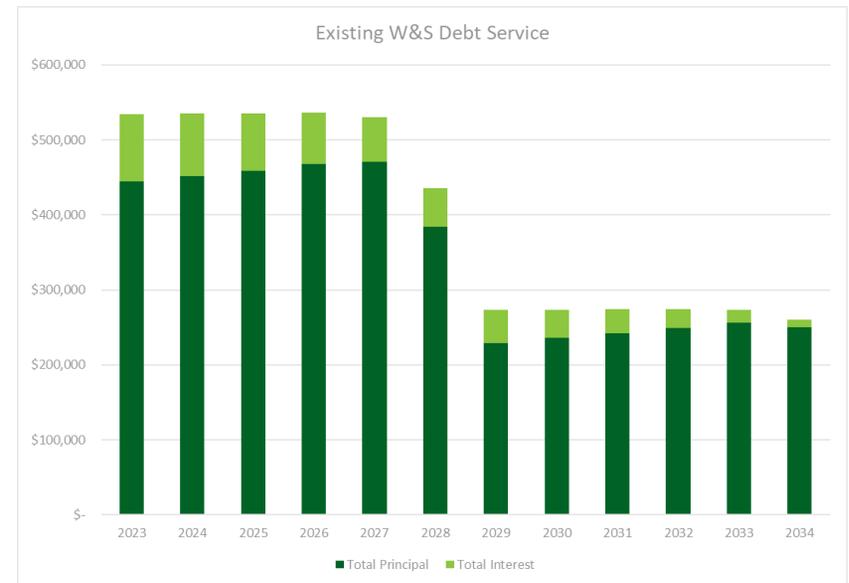
Source: 2021 Financial Statement; Debt Book.



Existing Water & Sewer Fund Debt Service

- Below is an overview of the Town’s existing debt service for the Water & Sewer Fund.
- Current debt service for the Water & Sewer Fund is structured with an overall decline including a \$95,115 decline in fiscal year 2028 and another \$162,334 decline in fiscal year 2029.

Fiscal Year	Total Principal	Total Interest	Total Debt Service
2023	\$ 444,137	\$ 90,413	\$ 534,550
2024	451,481	83,771	535,252
2025	458,359	77,023	535,382
2026	467,276	68,772	536,048
2027	470,362	60,058	530,420
2028	383,948	51,357	435,305
2029	229,126	43,845	272,971
2030	235,721	37,878	273,599
2031	242,323	31,608	273,931
2032	249,430	24,430	273,860
2033	256,545	17,011	273,556
2034	250,468	9,351	259,819
TOTAL	\$ 4,139,176	\$ 595,517	\$ 4,734,693

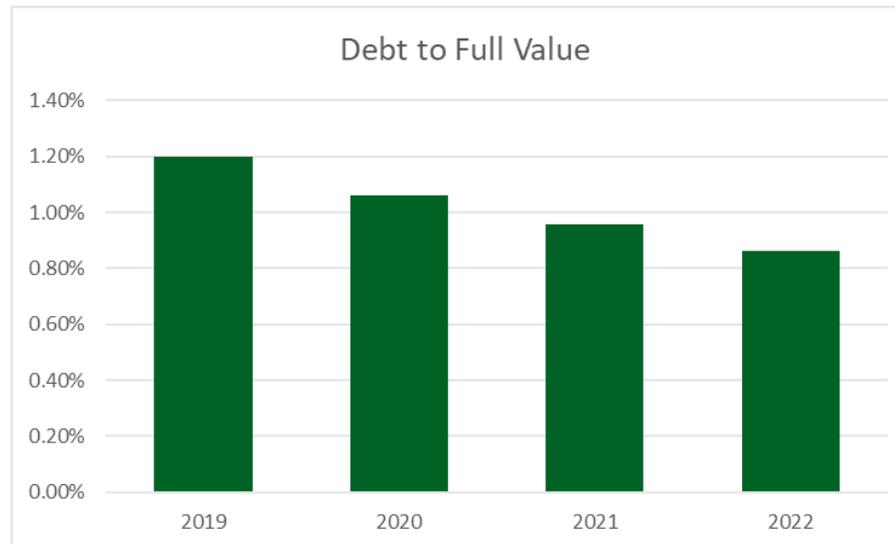




Key Debt Ratio: Historical Debt vs. Full Value

- Debt vs. Full Value is often referred to as a “Key Ratio” because it measures **Debt Capacity**, or the question of “Can I borrow this?”
 - The Town’s tax-supported Debt vs. Full Value has been declining as the Town’s outstanding debt has matured and no additional tax-supported debt has been issued.
 - To our knowledge, the Town does not currently maintain a Debt vs. Full Value policy, but Davenport would recommend one be established as it is a common policy adopted by similar local governments.
 - Davenport would recommend the Town adopt a policy of no more than 3% debt vs. full value, which is inline with industry practice and provides flexibility for future debt issuances, if needed.

Fiscal Year	Total Full Value	Tax-Supported Debt Outstanding	Debt vs. Full Value
2019	\$147,380,679	\$1,766,555	1.20%
2020	153,782,088	1,630,762	1.06%
2021	156,908,491	1,498,795	0.96%
2022	161,343,152	1,388,508	0.86%



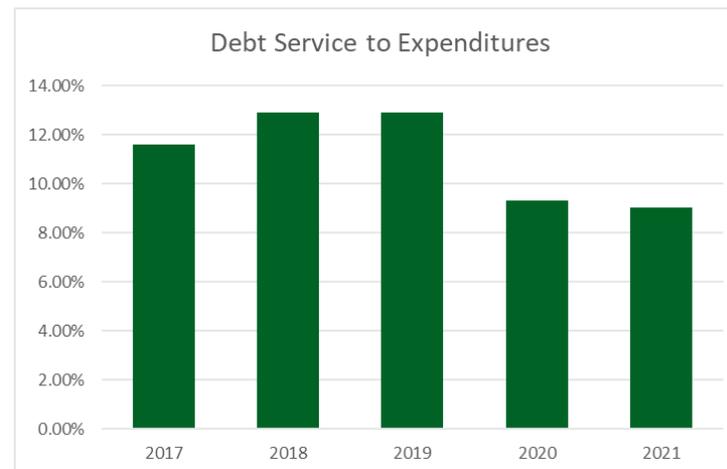
Source: 2019-2021 Financial Statements; Debt Book.



Key Debt Ratio: Debt Service vs. Expenditures

- Debt Service vs. Expenditures is often referred to as a “Key Ratio” because it measures **Debt Affordability** – “Can I afford this?”
- While this metric decreased in fiscal years 2020 and 2021, the Town is still near industry standard of 10%-12% of expenditures, providing the Town with limited flexibility for future capital needs.
- The Town does not currently maintain a policy on debt service to expenditures, but we would recommend that one be established as it is a common policy adopted by other similar governments.
 - Drafting the policy with a target of 10% and a ceiling of 12% would provide some flexibility for future needs, while still limiting the amount that could be issued to protect the financial health of the Town.

Fiscal Year	Debt Service	General Fund Expenditures	Debt Service to Expenditures
2017	\$291,216	\$2,508,080	11.61%
2018	314,718	2,439,958	12.90%
2019	321,119	2,492,530	12.88%
2020	235,422	2,533,789	9.29%
2021	230,791	2,557,183	9.03%



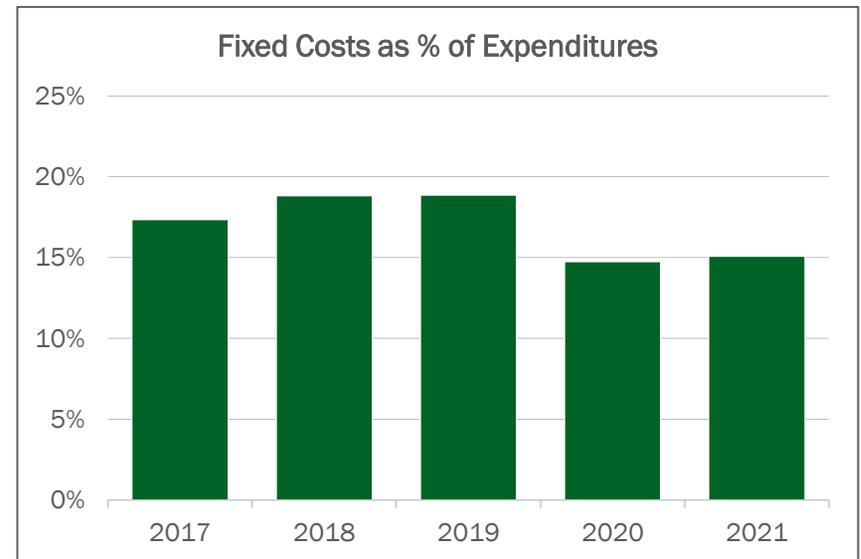
Source: 2017-2021 Financial Statements.



Key Debt Ratio: Fixed Cost Burden

- Fixed Cost Burden is emerging as a “Key Ratio” because it measures overall **Financial Flexibility**. It expands on debt service vs. expenditures to include the Town’s other long-term liabilities such a pension obligations. Positively, the Town does not offer Other Post-Employment Benefits (“OPEB”).
 - The higher the a local government's fixed costs, the less financial flexibility that government will have for other operating needs.
- The Town does not currently maintain a policy on total fixed costs, but the industry standard to maintain fixed costs below 25% of expenditures.
 - As you can see below, The Town’s fixed costs have declined since fiscal year 2017 due to reduced debt service costs and remain under the 25% threshold.
 - Davenport would recommend implementing the proposed policy for fixed costs not exceed 25% of General Fund expenditures.

Fiscal Year	Tax-Supported Debt Service	Pensions	Total Fixed Costs	General Fund Expenditures	Fixed Costs as % of Expenditures
2017	\$291,216	\$143,897	\$435,113	\$2,508,080	17.3%
2018	314,718	144,748	459,466	2,439,958	18.8%
2019	321,119	148,978	470,097	2,492,530	18.9%
2020	235,422	138,538	373,960	2,533,789	14.8%
2021	230,791	155,129	385,920	2,557,183	15.1%



Source: 2017-2021 Financial Statements.



Future Capital Needs

- While the Town has approximately \$2.6 million in projects included in the fiscal year 2023 budget, the Town does not have any plan to issue additional debt in the near-term.
 - Historically, funding of capital projects was driven by the receipt of state or federal funding.
- Projects included in the fiscal year 2023 budget will be cash-funded, including approximately \$1.7 million that will use a portion of the Town’s American Rescue Plan Act (“ARPA”) funds to finance these capital needs.



Debt and Capital Needs Recommendations

- To ensure that the Town maintains a healthy financial position both in the General Fund and W&S Fund, Davenport recommends that the Town consider adopting debt policies. These policies will provide benchmarks to guide the annual budget and capital planning process, ultimately protecting the Town from becoming overleveraged and causing financial stress. The proposed policies include:
 - Debt to Full Valuation policy of no greater than 3%;
 - Debt Service to Expenditure policy with a target of 10% and ceiling of 12%; and
 - Fixed Costs policy of no greater than 25%.

- In conjunction with the development of a long-term budget model, Davenport believes this model should also include a long-term Capital Improvement Plan (CIP).
 - This will allow the Town to determine what capital projects are outstanding and prioritize those projects in terms of need.
 - Reviewing the long-term budget forecast in conjunction with the CIP will provide a more comprehensive view of the Town's future financial challenges. This proactive approach will allow the Town time to discuss and manage these challenges with the goal of maintaining a healthy financial position in both the General Fund and W&S Fund.

- While the Town does not currently have any refunding opportunities (refinancing outstanding debt at a lower interest rate) based on current interest rates, Davenport will continue to monitor the Town's debt portfolio for any potential opportunities going forward.
 - Any debt service savings realized from future refundings could help provide budgetary relief.
 - Davenport will also monitor the ability for any potential debt restructuring (extending the original debt maturity to produce budgetary savings) as another way to produce annual budgetary savings.
 - While not guaranteed, the only restructuring candidate that the Town could consider is the \$2.016 million CDA Bonds of 2015. These bonds were originally issued with a 20-year amortization, the bonds could be extended and amortized over 30 years and still be within the useful lives of the assets originally financed.



Next Steps



Next Steps

- **January 2023**: Follow-up on any questions that the Council might have or would like to explore in more detail as a result of this presentation.
- **February 2023 – March 2023**: Develop a long-term budget model, along with multi-year Capital Improvement Plan to help proactively manage and protect the Town’s financial position.
- **April 2023**: Draft financial policies that would help support the ongoing fiscal health of the Town to be adopted by Council.

Disclaimer



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