First Southwest Company

Role of the Underwriter in the Municipal Marketplace

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Financing Participants and Role

The coordinated efforts of a specialized group of professionals all working together is required to successfully issue debt

- Issuer
- Investor
- Bond Counsel
- Disclosure Counsel
- Financial Advisor
- Underwriter
- Underwriter's Counsel
- Credit Rating Agencies
- Trustee
- Credit Enhancement Provider
- Investment Advisor
- Non-Governmental Borrower

An underwriter is a firm, or group of firms, that purchases bonds directly from a bond issuer and resells them to investors. Underwriters are intermediaries between issuers and investors. Underwriters fill the void in the marketplace by purchasing whole bond issues and then reselling them, ideally for a profit, to investors.

Types of sale

Competitive Bid versus Negotiated Sale

The decision of how to market municipal bonds should be based on the characteristics of the issuer, the bond issue, and the market

- Competitive bidding is appropriate when the issuer is well known, good demand for the bonds is predicted, and the market is stable
- Negotiated sale is more appropriate when the issuer is less known, the market instrument is complex and less well understood by investors, and/or the market is less stable

Competitive Bid

- Issuer conducts all of the tasks necessary to offer bonds for sale, including:
  - Structuring the maturity schedule
  - Preparing the official statement
  - Verifying legal documents
  - Obtaining a bond rating
  - Securing credit enhancement
  - Timing the sale
  - Publication of notice of sale
  - Receiving bids
- Underwriters submit closed bids to the issuer on the day and time designated in the notice of sale. The bonds are awarded to the underwriter that have submitted the best bid (lowest true interest cost). No structural aspects of the bonds are changed regardless of the success or failure of the underwriter to sell the bonds. Any unsold bonds remain the responsibility of the underwriter

Negotiated Sale

- Underwriter is chosen prior to structuring the bond issue
- Underwriter may assist with determining what is to be financed, the method of financing and the financing structure
- Underwriter is chosen based on expertise, financial resources, compatibility, and experience
- After selected, the issuer and the underwriter begin the process of structuring the bond issue and the other origination tasks
- The underwriter markets the bonds to investors and develops an interest rate to be negotiated with the issuer
- The issuer often employs a financial advisor not associated with the underwriting firm to represent the issuer's interest in the process

The underwriting syndicate

Senior Managers, Co-Managers and Selling Group

The better qualified the syndicate to market the bonds, the lower the interest rate on the bonds

- Senior Manager
  - The syndicate's most important member. The senior manager commits its capital, negotiates the underwriting discount, interest rates, and yields on behalf of the syndicate and determines the distribution of the bonds
- Co-Managers
  - Co-managers are added to increase market penetration, and must also be willing to commit capital. Co-managers need to have the ability to reach markets that the senior manager cannot. Sinc e the number of co-managers will determine the risk and sales opportunity of each firm in the syndicate, care must be taken not the expand the number of co-managers to the point that participation will be diluted beyond reasonable commercial interest
- Selling Group Members
  - A selling group can balance the market penetration of the management team. A firm can be a member of a selling group without being a co-manager. A selling group member bears no liability and receives none of the management fee. The firm is compensated only from a pro-rata share of the takedown based on the number of bonds sold

Bond allocation process

The bonds are allocated to the management team and the selling group based upon the type of order

- Group Net Orders
  - Orders in which each member shares equally in the sale of the securities. Group net sales are done when a buyer wants to be assured that it will get the bonds requested. Because of the shared commission arrangement, group net orders are filled first
- Net Designated Orders (Priority Orders)
  - Are institutional orders whereby the buyer determines which firms will receive compensation for the sale. Institutions submit designated orders to increase the probability of receiving bonds. Normally rules are established prior to the sale stating that buyers must designate at lease three firms and that no one firm can receive more than 50% of the designation and both managers and selling group members can be designated (this is the industry standard)
- Member Orders
  - Orders whereby the selling firm receives 100% of the commission. Orders made by the selling group are filled last

Underwriter compensation

The Gross Spread

For both competitive and negotiated bids, the spread is made up of four seperate components

- Management Fee
  - Compensates the underwriters for their efforts in creating and implementing the financing structure. The amount is related to the complexity of the issue
- Underwriting Fee
  - Also known as the “risk” component, compensates the underwriter for the risk incurred by buying the entire issuance before it has received orders from investors for the bonds
- Takedown
  - The takedown is usually the largest part of the spread. It represents the discount at which the underwriter will buy or “takedown” the bonds from the underwriting account. The amount of takedown is related to how difficult the bond issue is the sell to investors
- Expenses
  - The issuer must also reimburse the underwriter for expenses incurred during the financing process. These expenses typically include, travel, underwriter’s counsel fees, bond association fees, DTC, and CUSIP

The underwriting process

Steps

Step 1: Preliminary Discussion
In a negotiated sale, the issuer starts preliminary discussions with the underwriter, bond counsel, and underwriter's counsel. In the competitive sale, the issuer consults with a financial advisor to arrange the bond sale instead of an underwriter

Step 2: Issuer adopts resolution stating intention to proceed with a bond financing
Underwriter is chosen. Bond counsel is employed. Preliminary draft of bond documentation are produced and reviewed by bond counsel and underwriter. Credit enhancement, if any, is coordinated

Step 3: Preliminary official statement drafted
A draft of the POS is produced and adjustments to the preliminary bond documents are received from the interested parties

Step 4: Public hearings

Step 5: Approvals
Issuer adopts bond resolution, bond purchase agreement is signed, final OS is distributed

Step 6: Closing
All documents are executed and delivered. Issuer delivers the bonds to the underwriter, and the underwriter transfers money to the trustee