FUNDAMENTALS OF DEBT FINANCING

Marketing and Pricing an Issue

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ESTABLISHING CONTEXT

- Understand what motivates the players
- Beware of “conventional wisdom”
- The law of accumulation – a series of small, positioning moves adds up over time to big differences
- The “asymmetry” of information during the process
- Determine what your “bottom line” will be and what you’ll do if you don’t get it

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DIFFERENCES IN MARKETING APPROACH

- Competitive sales:
  - Occurs only in limited fashion by underwriter before the sale
  - Is "open-ended" ("If we buy it, will you come?)
  - Requires certain easily identifiable features in the issue
  - Rarely focuses on a single investor group –usually broad base
- Negotiated issues:
  - Should start well in advance of the offering
  - Often oriented toward specific investor groups or types
  - Customizable
  - Needs to be managed by the issuer carefully so that it produces the "best" sale, not the "only" sale – more later!

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RESPONSIBILITY VARIES

- Competitive sales:
  - ✓ Marketing is mostly up to you, the financial advisor, others
- Negotiated sales:
  - ✓ Marketing is mostly up to the underwriter or syndicate

<u>Regardless of type of sale, someone must do it!</u>

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THE ROLE OF THE UNDERWRITER

- Buys at wholesale
- Sells at retail

That's it – hard to get any fancier.

*The underwriter is the only one in the room with two customers – **you and someone else . . . .***

> *That doesn't mean you're being "cheated," but it does mean you should understand the dynamics, namely: the underwriter's point of view is going to be informed by both your needs and desires as well as those of the investor*

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THE PRICING PROCESS

- Develop your marketing plan well in advance
  - ✓ Make sure that it targets the “right” audience
- Know what the market will accept & what it is looking for
  - ✓ Yields, coupons, supply, demand, etc.
- Compare the “right” things
  - ✓ Don’t overlook secondary trading as an indicator
  - ✓ Who else will be in the market?
  - ✓ Use benchmarks cautiously – things are often not comparable
- If a negotiated sale, <u>be prepared to negotiate!</u>

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THE BASICS OF PRICING

- The higher the yield (for a fixed interest rate) the lower the price for that bond, and vice-versa . . . .
- Once interest rates are established, they remain constant – usually for the life of the loan (we are not considering variable rate borrowings here)
- Buyers seek to protect themselves from adverse changes in the value (read: price) of their investments; that means that they will always seek to buy at the lowest price (highest yield)
  - ✓ This is particularly true in institutional offerings

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WHY YIELD MATTERS MORE THAN SPREAD

- Establishing a “maximum” underwriting spread is not the same as negotiating your overall cost
  - ✓ What matters to investors is yield; therefore a sale at a higher yield is an easier sale, and the commission (paid from spread) should reflect that
- Negotiating the spread is the most over-rated measure of success
- What matters is your overall cost
  - ✓ Sometimes, you’ll get lower rates if you offer more spread
  - ✓ That requires an understanding of the distribution system and its incentives
- You pay spread once – at the time of the sale – but you pay interest for the life of the loan
- Bottom line: If you “save” thousands of dollars on the spread, but end up paying tens of thousands more in interest, you lose!

THERE ARE VARIOUS "PRICES"

- Primary (bid) price:
  - ✓ The price paid by the wholesaler (the underwriter) to you (the issuer)
- Retail offering price:
  - ✓ Price paid by the final investor to the broker/dealer
- Concession price:
  - ✓ Price paid by a broker/dealer who is not the originating underwriter
- Sometimes it's hard to "see" the "real" price that is being paid

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WHAT IS A SYNDICATE

- A collection of underwriters joined together for the purpose of attenuating market risk
  - ✓ Used less often of late, but perhaps may re-emerge
- Involves a "book-running" manager
  - ✓ Someone to organize and direct the underwriting and pricing efforts
  - ✓ This affects bragging rights of the broker/dealer as well as her profits
- Selling groups are not the same thing
- Can an underwriter act alone instead of in a syndicate?
  - ✓ Of course, and they often do

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AN EXAMPLE OF PROFIT ALLOCATION

Issuer offers bonds to the underwriter, and		
↓	*The issuers cost of money is now fixed*	
Underwriter (or syndicate) buys the bonds from issuer; then	*Underwriter is now "at risk" to market changes in interest rates*	
↓		
Member "takes down" bonds, and	*The syndicate makes the "underwriting spread" (the difference between the price paid to the issuer and the "bona-fide offering price" less any concessions or allowances*	
↓		
Member either sells bonds or . . . . →	(a) to a permanent investor	*Member makes full commission*
(b) To another dealer (a "non-member") who then		
↓		
Sells the bonds to a permanent investor	*Member and non-member split the commission*	

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BASIC TRUTHS ABOUT THE MARKETS

- Markets are always uncertain
  - ✓ If they weren't, we could come in early, buy the right thing and then go home for the day and play golf or listen to the "Stones"
- Markets exist to measure and price that uncertainty
  - ✓ Markets function best when the risks are most visible and the rewards are subject to reasonable estimation – your job is to make that process as orderly as possible
- Uncertainty brings a negative bias to the market – whether for bonds, houses, oil, toxic loan assets, whatever
- Understand this and you will "own" the world!!!

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UNCERTAINTY PRODUCES NEGATIVE BIAS

- First, there's "marginal" pricing
  - ✓ If there are 100 shs of IBM for sale, and there is a visible order to buy 100 IBM then the price of IBM can be easily determined
  - ✓ But, if there are 1,000 Ford for sale, and orders for only 800 Ford exist, then it is likely that a lower price will result for the remaining 200 shs of Ford
- Therefore, it can be argued that "only" 200 shares affected the price of all 1,000 shares
- That's marginal pricing and it also applies to the sale of your bonds!

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BUYERS & SELLERS

- There are fundamental difference between buyers and sellers:
  - ✓ Buyers choose when to buy – they have time on their side
  - ✓ Sellers usually don't have the luxury of time – there is a project to be built, an expenditure that must be made, a council meeting deadline that must be met, etc.; in short, something needs to happen, usually sooner rather than later.
- As a seller, your mission is doing something else – this is incidental to your organization's reason for being – the players in the market know that and act on it.
- So, what will your "bottom line" be?

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UNCERTAINTY PRODUCES THESE RESULTS

- Uncertainty causes markets to trade lower
  - ✓ lower prices = higher yields
- The investor has the luxury of time and you don't
- So, in a pinch, they simply "wait you out" until your need becomes acute or the uncertainty diminishes
- So, ... Doesn't it stand to reason that a greater number of buyers will probably influence your results in a positive way?

BASIC TRUTHS ABOUT BUYERS

- Institutional buyers:
  - ✓ Buy in large size, make decisions quickly, and are very price sensitive
- Retail buyers:
  - ✓ Buy in smaller size, take a long time to make decisions and are not as price sensitive
- Accessing them is not as easy as it looks . . .
  - ✓ You must have the right "product"
  - ✓ You need the "right" level of uncertainty to avoid the exercise of the luxury of time
  - ✓ You must know who they are and why they buy
    - FEATURES AND BENEFITS MATTER!!!

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WHAT SORT OF OFFERING WORKS?

- Retail buyers favor bonds that are easier to understand or which are more common, such as . . . .
  - ✓ Los Angeles Department of Water and Power
  - ✓ State of California (in better times!)
  - ✓ General obligation bonds
  - ✓ Simple (or no) call features and other embedded "goodies"
- Institutional buyers favor bonds that reward risk taking with appropriate returns
  - ✓ "fancy" call features – couponing strategies – sinking funds
  - ✓ More obscure credits: tobacco bonds, pension obligation bonds

THE MARKETING PLAN

- Do it early!
- Write it down!
- Make it consistent with the type of sale you've selected!
- Communicate your expectations with some emphasis!
- Give it the appropriate amount of time!
- Stay involved!

IDENTIFYING MARKET TRENDS

- Technical factors:
  - ✓ Supply and demand
    - Forward supply
    - Inventory of unsold bonds
  - ✓ Regional or quality imbalances
    - It's an "A" rated world
  - ✓ Size
    - Small issues reach the market differently than large ones – remember marginal pricing can be your friend too!
- Fundamental factors:
  - ✓ Economic climate
  - ✓ Interest rates and monetary policy
  - ✓ What is the trend?
  - ✓ What is really relevant?

SOURCES OF INFORMATION

- Bloomberg: www.bloomberg.com
  - Go to: http://www.bloomberg.com/markets/rates/index.html"rates and bonds"
  - displays both U. S. Treasuries and national, "Aaa"/"AAA"/"AAA" municipal "spots" (rates for 5, 10, 20 & 30 year maturities)
- EMMA: http://emma.msrb.org/default.aspx
  - No subscription required; available to all
  - Also furnishes market volume overview, trade ticker, search, and much more
- Wall Street Journal: www.wsj.com
  - http://online.wsj.com/mdc/public/page/2_3021-bondyield.html?mod=topnav_2_3024
- Thomson Reuters: www.TM3.com
  - Subscription required
- Municipal Market Advisors: www.mma-reasearch.com
  - Subscription required

GATHER YOUR DATA

- Do some detective work:
  - ✓ Look at your last sale and compare it to:
    - Where the benchmarks were at the time
    - Where comparable issuers were selling bonds
- Make a projection of what the ranges for your issue "ought" to be
- Beware of the appearance of precision in illustrations furnished by the underwriting community

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THE COMPETITION

OFFERING:	$39,000,000	$132,145,000	$57,000,000	$5,000,000
ISSUER:	NEW TOWN LEASE	BIG RIVER POWER DISTRICT	URBAN SCHOOL DISTRICT	RURAL SCHOOL DISTRICT
RATING /DUE	INSURED	A-1/A+/A+	AA2/AA/NR	INSURED
2016	3.75	4.10	3.20	4.75
2017	3.95	4.30	3.45	5.00
2018	4.15	4.50	3.65	5.25
2019	4.35	4.70	3.85	5.55
2020	4.65	4.90	4.05	5.80
2021	4.85	5.05	4.25	5.95
2022	5.05	5.20	4.40	6.10
OPTION:	10/1/19 @ 100	4/1/19 @ 100	NON-CALLABLE	NON-CALLABLE
NOTES:	CENTRAL VALLEY	LEASE	COMMUNITY COLLEGE	NORTH COAST

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YOUR ISSUE

	OFFERING:	$32,500,000
ISSUER:		YOUR BONDS
DUE	PAR AMOUNTS	"AA2"/"AA"/"AA"
2016	2,300,000	3.60
2017	2,900,000	3.85
2018	3,600,000	4.10
2019	4,400,000	4.25
2020	5,300,000	4.50
2021	6,400,000	4.70
2022	7,600,000	4.75
OPTION:		8/1/18 @ 102
NOTES:		TIC = 4.50%

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RECEIVING THE BID

- What information is critical?
  - ✓ In other words, what is the minimum you must know?
- What information is relevant?
  - ✓ What will help you refine your views?
- Do you care if the underwriter loses money?
  - ✓ Yes. Both the underwriting community and the investor base are looking for an offering that is “well-placed” and maintains a stable price for the near-term

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YOUR ISSUE & RESULTS

	Offering:	$32,500,000	Preliminary Orders	Comments	Final Pricing
Issuer:		Your Bonds			
Due	Par Amounts	"Aa2"/"AA"/"AA"	Order Amounts		
2016	2,300,000	3.60	1,850,000	½ retail; ½ hedge fund	3.50
2017	2,900,000	3.85	All	"all-or-none" with '18s	3.75
2018	3,600,000	4.10	All	"all-or-none" with '17s	3.95
2019	4,400,000	4.25	2,900,000	Stocked by non-member	4.25
2020	5,300,000	4.50	5,000,000	Three mutual funds	4.45
2021	6,400,000	4.70	All	Insurance company	4.65
2022	7,600,000	4.75	500,000	Underwriter's family	4.80
Option:		8/1/18 @ 102			8/1/18 @ 100
Notes:		TIC = 4.50%			TIC = 4.46%

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HOW DID YOU DO?

- Original scale produced TIC of 4.50%
  - ✓ Total interest cost of **$48,097,300**
- Negotiated result produced TIC of 4.46%
  - ✓ Total interest cost of **$47,991,250**
- You saved your stakeholders **$106,050** by negotiating price – could it have been better?
- That requires further observation

WHAT HAPPENS NEXT?

- You care a great deal about whether liquidity develops
  - ✓ A happy investor is your best prospect for the next sale
  - ✓ Don't forget your continuing disclosure obligation and investor relations outreach
- Feedback and "post-mortem" is very useful, but must remain incontext
  - ✓ MSRB trade data as a starting point
  - ✓ Recognize that marginal pricing is probably at work
    - Trick is to leave as little "on the table" as possible and still produce an orderly result
- Let's look at some examples . . . .

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AFTERMARKET RESULTS

	AMOUNT:	PRICE/YIELD	TYPE	COMMENTS
11:30 AM	2,600,000	4.80	D2C	THIS TRADE IS AT THE REVISED, NEGOTIATED PRICE
1:42 PM	700,000	4.70	C2D	WHO'S DOING THE SELLING? WHY? JUST TWO HOURS LATER?
1:44 PM	700,000	4.65	D2C	WHY DIDN'T THIS CUSTOMER BUY AT THE ESTABLISHED PRICE?
2:02 PM	425,000	4.70	C2D	IS THIS THE SAME "CUSTOMER" AS 11:30 AM?
2:06 PM	425,000	4.65	D2C	CONNECTED TO PREVIOUS TRADE OF $700,000?
3:20 PM	300,000	4.70	D2D	COMPARE THIS PRICE TO THE <u>ORIGINAL</u> PROPOSAL ON PAGE 24
3:22 PM	300,000	4.65	D2C	SEE A PATTERN YET?
3:45 PM	1,175,000	4.70	C2D	THIS ONE <u>MIGHT</u> BE THE "MARGINAL PRICING" AT WORK
3:48 PM	1,175,000	4.65	D2C	

CONCLUSION:

If these trades are the result of "under-pricing," this issuer may have left as much as $35,000 on the table on just these four paired trades!

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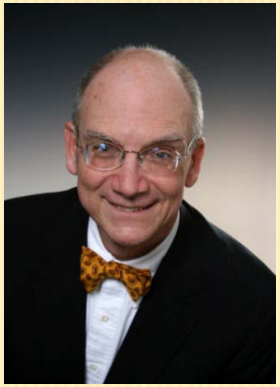
QUESTIONS?

THE SPEAKER



Tim Schaefer is the founder of Magis Advisors, an independent public finance consulting firm in Orange County, California. He has practiced in the financial advisory business in California for twenty years with both national and regional firms before founding Magis in 2008. Tim has more than 40 years experience in the municipal securities industry, including emphasis on development driven finance: enterprise revenue bonds; lease and lease revenue bonds for parking projects; redevelopment contributions for economic development; and, Mello-Roos and assessment bonds used to fund public infrastructure. Prior to entering the financial advisory field, Tim managed the national municipal trading desk at Chemical Bank in New York City. He also managed the Public Finance Division of Bank of America in San Francisco.

He served more than twenty years on the Technical Assistance Committee to the California Debt and Investment Advisory Commission (including three terms as its chairman) and three years as a private sector advisor to the Standing Committee on Governmental Debt of the Government Finance Officers Association of the United States and Canada. Recently, he served on a National League of Cities' task force investigating substitute mechanisms for municipal bond credit substitutions as a consequence of the collapse of the major municipal bond insurers in early 2008. He is a co-author of the *California Public Funds Investment Primer*, published in 2006 and has authored a number of articles on the field of municipal finance. He is a frequent speaker before groups such as CDIAC, the League of California Cities, CSMFO and others.

Tim holds the designation of Certified Independent Public Finance Advisor awarded by the National Association of Independent Public Finance Advisors. He is a member of the California Society of Municipal Analysts (a component organization of the National Federation of Municipal Analysts), the Risk Management Association, the Government Finance Officers Association, and the International City Management Association . He is also a registered investment advisor representative.