



# ISSUE BRIEFS

California Debt and Investment Advisory Commission

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## COMPETITIVE VERSUS NEGOTIATED SALE OF DEBT

*Deciding whether to go negotiated or competitive is the most important decision an issuer can make.*

*The Bond Buyer, April 8, 1991*

### INTRODUCTION

While one may quibble with the notion that the decision to sell debt through the negotiated or competitive process is “the most important decision an issuer can make,” this issue clearly represents one of the most controversial topics in public finance today. The controversy extends back to the mid-1970s, when more and more issuers began to select the negotiated method as the preferred way of selling bonds. This shift has been attributed to several factors, including the increasing utilization of revenue bonds instead of general obligation bonds; the volatile interest rate environment of the late 1970s and early 1980s; and the emergence of innovative financing options and products. The last factor is particularly relevant to California, where the restrictions imposed by Proposition 13 in 1978 led to the development of new financing techniques.

Most bond industry professionals would agree that neither the competitive sale nor the negotiated method of sale is ideal for *all* bond issues. The appropriate method of sale should be determined on a case-by-case basis after evaluating a number of factors related to the proposed financing, the issuer, and the bond market. The challenge for public issuers, then, is to properly identify how the relevant decision factors apply to their proposed bond issues. This

*Issue Brief* on the two principal methods of selling public debt is designed to help issuers conduct such a systematic evaluation of their proposed bond issues. It is intended to provide general guidelines for public issuers, particularly those who are infrequent participants in the bond market.

### COMPETITIVE UNDERWRITING

Competitive underwriting is the method of bond sale in which the issuer sells its bonds to the underwriter offering the lowest bid meeting the terms of the sale. In a competitive underwriting, the issuer, typically with a financial advisor or investment banker, conducts all the origination tasks necessary for the bond offering. These tasks include structuring the maturity schedule, preparing the official statement, verifying legal documents, obtaining a rating, securing credit enhancement, and timing the sale. The issuer then advertises the sale of the bonds in advance of the specified sale date through a Notice of Sale (NOS). The NOS contains relevant information on the proposed issue and the criteria by which the bonds will be awarded. At the specified date, time, and venue, the issuer opens all bids and awards the right to purchase the bonds to the underwriter with the best bid based on the criteria specified in the NOS.

## Advantages

*Competitive environment.* The issuer's ultimate goal in a financing is to protect the public's interest by obtaining the lowest possible interest cost. Consequently, the most compelling argument in favor of a competitive sale is that the competition among underwriters provides the incentive for keeping the effective interest cost as low as possible. Under the competitive bid process, market forces determine the price.

*Historically lower spreads.* While the gross underwriting spreads (management fee, expenses, underwriting fee, and takedown) between competitive and negotiated bond sales have been narrowing over the past decade, competitive underwriting is still generally viewed as the best means of reducing underwriting costs. While one may argue that equating spreads is an *apples versus oranges* comparison and that any advantage in spread should be weighed against other costs of the financing, data since 1982 indicate that competitive issues hold an edge in terms of lower underwriter fees paid on general obligation and revenue bond issues.

*Open process.* The other positive feature of competitive sale is that the issuer generally avoids allegations of unfairness or impropriety in the selection of the underwriter because the bonds are sold through a public auction.

## Disadvantages

*Risk premium.* Underwriters bidding on a competitive sale have no guarantee of being awarded the bonds. Thus, underwriters cannot be expected to conduct the same level of pre-sale marketing (canvassing prospective investors before the sale) as in a negotiated sale. To compensate for uncertainty about market demand, underwriters may include a hedge or a risk premium in their bids, which can show up either in the spread or the reoffering scale. The amount of the risk premium, however, should also be weighed against the total cost of the financing.

*Limited timing and structural flexibility.* An issuer's ability to make last-minute changes is limited by the competitive sale process. With regard to timing, competitive bidding entails a 15-day lag between the time documents are completed and the actual sale date, due to legal notice requirements. Hence, the issuer's ability to speed up the sale process, if necessary, is restricted. While a NOS can be structured to allow for postponement of a competitive sale and subsequent reoffering with a minimum of two days prior notice, the competitive sale process remains less flexible than its negotiated counterpart.

In addition, the competitive sale restricts the issuer's ability to adjust major structural features, such as final maturity and call provisions, to match the demand realized in the actual sale process. Again, while a properly structured NOS can increase the flexibility of a competitive sale by allowing for changes in the size of the issue (within certain parameters), principal maturity amounts, and the composition of serial versus term bonds, a negotiated sale still holds the advantage if flexibility in structuring is of paramount consideration.

*Minimum issuer control over underwriter selection and bond distribution.* In competitive underwriting, the bonds are sold to the underwriter submitting the best bid, based on the NOS criteria. The issuer exerts little influence over which underwriting firms actually purchase the bonds and how these bonds are ultimately distributed. For example, the issuer's ability to ensure that regional firms are included in the underwriting syndicate of a large issue, or that a portion of the bonds are sold to certain types of investors (e.g., retail or regional investors) is limited. In a competitive sale, market forces determine the distribution of the bonds. This lack of control, however, should only be disadvantageous to the extent that the issuer is interested in influencing the composition of the underwriting team or the distribution of the bonds.

## NEGOTIATED UNDERWRITING

In a negotiated sale, the terms of the purchase are subject to negotiation between the issuer and the underwriter. Whereas the issuer accepts or rejects the underwriter bids in a competitive sale, the issuer can and is expected to negotiate with the underwriter over the price of the bonds and the spread in a negotiated sale.

In a negotiated sale, underwriter selection is one of the first steps taken by the issuer. Because the issuer selects an underwriter without fully knowing the terms under which that underwriter is willing to purchase the bonds, the issuer's selection is based on other criteria, which generally include the underwriter's expertise, financial resources, compatibility, and experience. Once the underwriter is selected, both the underwriter and the issuer participate in the origination and the pricing of the issue. A financial advisor or another investment banking firm will often represent the issuer's interest in a negotiated sale.

### Advantages

*Assistance in originating the issue.* While the underwriter's primary role in a negotiated sale is as the purchaser of the issue, the underwriter can also assist the issuer in performing origination tasks such as preparing the official statement, making presentations to rating agencies, and obtaining credit enhancement – in essence, “one-stop shopping.” Some issuers, however, prefer to engage a financial advisor or another investment banking firm for assistance in a negotiated sale. In a competitive sale, the issuer performs the origination tasks or pays for these services separately.

*Effective pre-sale marketing.* Because the underwriter in a negotiated offering is assured the right to purchase the bonds, the underwriter can conduct more effective pre-sale marketing than in a competitive sale. By developing information about market demand for the bonds, the underwriter can reduce inventory risk, presumably leading to a lower risk premium in the pricing. Pre-sale marketing is especially

important for issuers who have not developed a reputation among investors or whose securities are not widely held among investors.

*Timely and structural flexibility.* Another advantage of negotiated underwriting is flexibility – the ability to sell the bonds at any time and to change the structure of the issue in response to changing conditions. Although the issuer may announce a negotiated sale date, this date is considered a target and can be changed if deemed necessary (because of a large supply of similar securities or unfavorable interest rate movements, for example). Similarly, negotiated underwriting allows the issuer the flexibility to adjust the structure of the issue up until the time of sale to meet either the issuer's or the investor's needs.

*Influence over underwriter selection and bond distribution.* In a negotiated sale, the issuer exercises more influence over underwriter selection and bond distribution. The choice of the underwriter in a negotiated sale is based on a variety of criteria which may target certain types of underwriting firms and establish distribution goals. Issuers trying to reach certain market sectors may be able to negotiate with the underwriter to allocate the bonds accordingly. Again, this type of control should only be relevant to issuers wishing to include certain firms in the underwriting syndicate or wanting to make sure that certain types of customers receive a portion of the bonds.

### Disadvantages

*Lack of competition in the pricing.* In a negotiated sale, the bond pricing is less subject to the rigors of competition, as the underwriter obtains the exclusive right to purchase the bonds in advance of the pricing. Unless the issuer is vigilant during the pricing, the interest rates may be structured to protect the profit margin of the underwriter, not to keep the issuer's borrowing costs as low as possible. Although some underwriters may exercise restraint in the pricing to protect their reputation and promote future business, issuers should take the responsibility to obtain market information on

comparable transactions at the time of the pricing.

*Elements of spread open to wide fluctuation.* While underwriters in a negotiated sale can provide an array of financial services which are in addition to the actual underwriting of the bonds, issuers should not lose sight of the fact that these services come at a price. Insofar as the cost of these services will be paid for as part of the underwriting spread (versus a flat fee), some issuers may not be fully aware of the compensation that is being provided for such services, or whether they actually need all the services being provided. Thus, the chance for wide fluctuations in spread between comparable deals is greater in a negotiated environment. The negotiated sale process demands increased scrutiny on the part of the issuer to keep spreads reasonable.

*Appearance of favoritism.* Because underwriter selection is based on quantitative *and* qualitative factors, negotiated sales can be subject to allegations of impropriety. Issuers must be prepared to defend their underwriter selection criteria, as well as their ultimate cost of borrowing, to avoid the appearance of impropriety.

## COMPETITIVE VERSUS NEGOTIATED: DECISION FACTORS

While it is impossible to develop a fail-safe formula to follow for making a decision on the appropriate method of sale, issuers can make informed decisions by conducting a systematic review of certain factors on a case-by-case basis. These factors can be classified under **issuer characteristics**, including *market familiarity, credit strength, and policy goals*; and **financing characteristics**, including *type of debt instrument, issue size, complexity of the issue, market conditions, and story bonds*.

### Issuer Characteristics

*Market familiarity.* Attracting sufficient investor and underwriter interest is critical to the

success of any bond issue. The frequent issuer is at an advantage in terms of attracting market interest insofar as the market is already familiar with its credit quality. Although the trend is toward greater disclosure for all issuers, generally, the market does not require as much information from frequent issuers as it does from infrequent market participants. Consequently, the infrequent issuer should consider the extent to which pre-sale marketing – which may be more effective under the negotiated sale – is necessary for the success of its bond sale.

*Credit strength.* Everything else being equal, the higher the credit quality of the issue and the issuer, the less likely there will be a need for negotiation. Because of the steady demand for high quality municipal bonds, issuers with a strong credit position can fare well in competitive bidding. Consequently, issuers should consider the competitive sale for issues rated A and above. Weak issuers may not attract sufficient market interest or induce competition and, consequently, may benefit from the more effective education process offered by the negotiated sale.

*Policy goals.* As noted earlier, issuers will find that the competitive bid process does not provide them much influence over the composition of the underwriting syndicate or the distribution of bonds. Moreover, some have argued that the competitive sale process screens out minority-owned, women-owned, or other small firms that do not have the resources to compete with more established underwriters.

In a negotiated sale, smaller firms will often have a better chance of being included in an underwriting syndicate, though there is no guarantee that smaller firms will be allocated bonds. To the extent that issuers believe that influencing the composition of the underwriting syndicate and the distribution of bonds are worthwhile policy objectives, they may be better served by the negotiated sale. When issuers choose a negotiated sale for these reasons, however, they should clearly specify the rationale and criteria for the selection of

underwriters and the allocation of bonds to avoid any appearance of impropriety.

### **Financing Characteristics**

*Type of debt instrument.* The market responds to familiar or well-known debt instruments and, likewise, tends to be apprehensive about innovations. An issuer using a relatively new debt instrument may have to familiarize the market with the security features of the instrument. The negotiated sale is invariably more conducive to this education process. However, insofar as the market has the ability to rapidly absorb information regarding new debt instruments, “innovative” instruments can quickly become mainstream. Thus, as the market becomes more familiar with a particular debt instrument, the need to educate market participants on the nuances of the instrument will diminish. Everything else being equal, more familiar instruments will be better suited to competitive sale.

*Issue size.* The size of the bond issue influences both the level of investor interest and the market’s ability to absorb the issue. The general rule is that if the issue is either too small or too large, the issuer should consider negotiating the sale. A very small issue will probably not attract any attention in the market without a concerted sales effort. A very large issue, on the other hand, may not easily be absorbed by the market. Therefore, effective pre-sale marketing activity – offered by the negotiated sale – becomes necessary.

*Complexity of the issue.* It is convention in the public finance industry that “plain vanilla” issues (i.e., those that are readily accepted and understood by underwriters and investors) lend themselves to the competitive bid process. Consequently, bonds which are structured to include features such as variable rates, put features, or interest rate swaps, may be more appropriate for negotiated sale.

*Market conditions.* During periods of interest rate stability, the need for flexibility in the timing of the sale is not particularly critical.

Conversely, the timing of the sale is very critical in an unstable or volatile market, especially when there is a need to bring an issue to the market in a few days. In such cases, the flexibility inherent in a negotiated sale can be indispensable. For example, refunding issues which are motivated by the desire to capture the savings offered by lower interest rates, and which may be susceptible to even minor fluctuations in market rates, may be better served by the timing flexibility offered by the negotiated sale.

*Story bonds.* In some cases, an issue faces market difficulties because it is associated with unusual events or conditions. For instance, issues linked to a previous default, litigation, or other adverse circumstances may be difficult to place. By the same token, issues or structures that are not familiar to the market may require added explanation. These issues are sometimes referred to as “story bonds,” because in order to develop sufficient market interest, the issuer has to “tell a story,” or explain why the bonds are actually sound investments. Issuers of story bonds, such as Mello-Roos bonds can benefit from the more effective pre-sale marketing opportunities offered by the negotiated sale. Nevertheless, bonds that may require an explanation, such as the bonds sold by the City of Los Angeles to finance a court-ordered judgement against the City, can be sold successfully in a competitive sale if the market is familiar with the issuer and the credit security is particularly strong.

### **ALTERNATIVE APPROACHES**

Issuers who find that the traditional approaches outlined in earlier sections do not completely meet their financing needs, may want to consider one or more of the alternative approaches described below.

**Conducting competitive bidding within the legal framework of a negotiated sale.** Issuers who prefer the competitive pricing environment offered by the competitive sale but, for one reason or another, can ill afford the 15-day

notice requirement, may want to consider an approach that offers both the flexibility of the negotiated sale and the competition in the pricing of the competitive sale. Under this approach, the issuer utilizes the legal framework of the negotiated sale, allowing the acceleration of the sale process. However, instead of negotiating the price and interest rate of the issue with just one underwriter, the issuer solicits bids from all interested underwriters and awards the right to purchase the bonds to the lowest bidder, thereby maintaining a competitive environment in the pricing. A disadvantage with this approach is that it does not provide the flexibility to make last minute or unanticipated changes in the structure of the issue.

**Infusing competition in the negotiated sale process.** More often than not, competition among underwriters produces lower costs and higher levels of service. Thus, it is important that issuers who plan to use the negotiated sale consider employing a competitive process for the selection of their underwriter. The use of a request for qualifications (RFQ) or request for proposals (RFP) to solicit interest requires potential underwriters to compete against one another on the basis of cost and services offered.

There are at least two ways the issuer can infuse competition into the underwriter selection process. One way is to establish an underwriting pool, similar to the one developed by the State Treasurer's Office, from which underwriters for all negotiated issues will be chosen. The issuer should select pool underwriters based on responses to an RFQ in order to determine those who are qualified to take the issuer's bond offerings to the market. Another method is to issue an RFP requiring interested underwriters to outline their proposals for taking specific bond offering to the market. Either way, issuers should consider the quality and level of service offered, not just costs, when selecting the underwriter.

**"Unbundling" financial services.** Issuers who do not need the full range of services offered by a financial advisor or investment banker, and who are concerned about costs, may want to

consider "unbundling" financial advisory services – hiring a financial advisor or investment banker only for certain portions of the sale. For example, in a negotiated sale, the issuer can hire a financial advisor or another investment banking firm to assist in the bond pricing, but not in preparing the bond documents. By splitting the services in this way, the issuer can lower the costs of financial advisory services, while receiving needed assistance on a particular element of the bond sale process.

## RECOMMENDATIONS

The following recommendations are intended to assist issuers not only in choosing an appropriate method of sale, but also in reducing issuance costs.

**Participate in all aspects of the bond issuance.** Issuers should never forget that it is their responsibility to protect the public trust by selling their bond issues at the lowest possible interest cost. The members of the financing team are merely agents of the issuer. Therefore, issuers should take an active part in all the decisions related to the sale of their bonds: the selection of the underwriting method; the selection of the financing team; the marketing of the bonds; and the investment of the bond proceeds. While not all issuers are experts in municipal finance, they should not be shy about asking their financing team members critical questions.

Moreover, it is important that issuers who choose the negotiated sale do not relegate the responsibility to obtain the best pricing for the issue to the underwriter. Personal and trustworthy relationships, notwithstanding, the underwriter's fiduciary responsibility ultimately lies with its investors. And because the investors' and the issuer's interests are not necessarily complementary, the responsibility for looking out for the issuer's interests during the pricing should remain with the issuer.

**Assess the level of demand for the issue.**

Naturally, a competitive sale will not be successful if it does not produce real competition. While as a technical matter, two bids are necessary to generate competition, three or more bids will generally ensure the issuer that the bid price of the bonds approximates the price of comparable securities being issued at the same time. (A notable exception is the State of California, which customarily receives only two bids on its general obligation bond sales and is still able to secure competitive prices for its bonds.) If the issuer determines that a competitive sale will generate only one bid, a negotiated sale may be preferable.

**Focus on the total cost of the financing.**

The spread is but one component of the total cost of the financing. While it is an important cost factor, concentrating negotiations on the spread at the expense of the interest rate pricing can prove counterproductive to the issuer's goal of keeping the total financing cost as low as possible. Conversely, focusing on the interest rates without considering other costs of borrowing, such as underwriter spread and financial advisory fees, can be equally deceiving. The key is to consider the total cost of financing when evaluating a particular debt issue.

**When in doubt, hire a financial advisor.**

Negotiated bond sales customarily require a greater deal of skill on the part of the issuer than competitive sales. In order to evaluate the financial terms offered by the underwriting syndicate, the issuer must be able to identify how the market is pricing similar transactions. An issuer lacking the expertise to undertake such an analysis negotiates from a position of weakness. In such cases, the issuer should consider hiring a financial advisor or another investment banking firm to assist in some or all aspects of the financing. Similarly, an issuer lacking the expertise to perform the origination tasks necessary to prepare an issue for competitive sale or to evaluate the bids once they are submitted, may also benefit from the services of a financial advisor or an investment banker.

**Evaluate the method of sale for every issue.**

It is very important that issuers evaluate the method of sale for each bond issue. Issuers should avoid becoming too comfortable with a particular approach. Each time an issuer comes to market, it should be with the knowledge that the method of sale has been thoroughly evaluated.