CALIFORNIA DEBT AND INVESTMENT ADVISORY COMMISSION

FUNDAMENTALS OF DEBT FINANCING

Marketing and Pricing an Issue

Outline of presentation by:

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ESTABLISHING CONTEXT

- Once you've arrived at the pricing, you are not building a project – you are selling something!
- Understand what motivates the players
- Beware of "conventional wisdom"
- The law of accumulation
- The "asymmetry" of information
- Know your "bottom line" and what you'll do if you don't get it

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RESPONSIBILITY VARIES

- Competitive sales:
  - ✓ Marketing is mostly up to you
- Negotiated sales:
  - ✓ Marketing is mostly up to the underwriter

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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
- 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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THE ROLE OF THE UNDERWRITER

- Buys at wholesale price
- Sells at retail price
  - ✓ 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
    - The underwriter's point of view is going to be informed by both your needs and desires and those of the investor
- The riddle of the real estate brokers who sell their own homes

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THE PRICING PROCESS

- Develop a marketing plan
  - ✓ Make sure that it reaches out to the “right” audience
- Know what the market will accept
  - ✓ Yields, coupons, supply, demand, etc.
- Compare the “right” things
  - ✓ Don’t overlook secondary trading as an indicator of what “might” happen
  - ✓ Who else is in the market?
  - ✓ Use benchmarks cautiously
- If a negotiated sale, then be prepared to negotiate!

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THE DIFFERENCE BETWEEN YIELD & SPREAD

- Establishing a “maximum” underwriting spread is not the same as negotiating your price
  - ✓ 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!

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PRICES AND YIELDS MOVE INVERSELY

- 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

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

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
- 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!!!

UNCERTAINTY PRODUCES NEGATIVE BIAS

- First, there's "marginal" pricing
  - ✓ If there are 100 "x" for sale, and there is a visible order to buy 100 "x" then the price of "x" can be easily determined
  - ✓ But, if there are 1,000 "x" for sale, and orders for only 800 "x" exist, then it is likely that a lower price (<u>higher yields</u>) will result for the remaining 200 "x"
- Therefore, it can be argued that "only" 200 "x" affected the price of all 1,000 "x"
- That's marginal pricing and it is very important to you when you go to sell bonds!

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BUYERS & SELLERS

- The 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.; <u>in short, something needs to happen, usually sooner rather than later.</u>
- As a seller, your organization's mission is doing something else – this is incidental to the organization's reason for being – the players in the market know that and act on it.
- So, what <u>is</u> your "bottom line?"

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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?

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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!!!

WHAT SORT OF OFFERING WORKS?

- Retail buyers favor bonds that are easier to understand or which are more common
  - ✓ Los Angeles Department of Water and Power
  - ✓ State of California
  - ✓ 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

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THE MARKETING PLAN

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

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SOURCES OF INFORMATION

- Wall Street Journal: www.wsj.com
  - "markets" then, "market data" then, "bond rates & credit markets" then, "bond yields" then "range of municipal yield curve scales – select the general credit quality of your issue
- Bloomberg: www.bloomberg.com
  - "rates and bonds" displays both U. S. Treasuries and national, "Aaa"/"AAA"/"AAA" municipal "spots" (rates for 5, 10, 20 & 30 year maturities)
- Thomson Reuters: www.TM3.com
  - Subscription required
- Municipal Market Advisors: www.mma-reasearch.com
  - Subscription required

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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

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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:	Inland empire	lease	Community college	Central valley

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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

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WHAT HAPPENS NEXT?

- Feedback and "post-mortem" is very useful
  - ✓ 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
- 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

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QUESTIONS?

THE SPEAKER

Tim Schaefer is the founder of Magis Advisors, a new 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, the GFOA, and the California Association of Counties.

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.