PMA™ SECURITIES

UNDERSTANDING MUNICIPAL BONDS

How Municipal Bonds Are Sold in a Public Offering

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Municpal Bonds–Method of Sale

Many of us are familiar with municipal bonds, either as an issuer, an investor, or, for a much smaller number of us, a participant in the municipal bond industry. Generally speaking, the idea is simple. A unit of government needs to borrow money for any number of public purposes, and investors have the capital to lend to these governments in exchange for a rate of return. What is far less familiar to many is an understanding of the intricacies of the municipal bond market. As a result, PMA's Public Finance group has created the "Understanding Municipal Bonds" series to help educate our issuer clients on nuanced aspects of the bond market. In this edition, we provide insight on the method of sale options available to issuers when selling their bonds in the primary market (i.e., a public offering of municipal securities).

For a public offering, there are two methods of sale for municipal bonds: 1) **Competitive sale**, and 2) **Negotiated sale**. A competitive sale requires a financial advisor to post the bond issue on behalf of the issuer to an online portal where underwriters can electronically submit bids while competing for the bonds. In this auction-style platform, the underwriter that submits the best bid (lowest rate) is awarded the bond issue. The winning underwriter then re-offers the bonds to its network of investors. While an underwriter uses its own capital to initially purchase the bonds before re-offering them to investors, an underwriter itself is not considered an investor. Therefore, the underwriter's intention is not to hold the bonds for an extended period of time. Instead, an underwriter prefers to locate investors prior to, or as soon as possible after, the date of the bond sale.

It's important to understand the term "best bid." In a previous edition of our educational series, **found here**, we discussed the different ways the interest cost for a financing is measured. In a bond summary report, it's typical to see variations of the interest cost defined in the following ways: Net Interest Cost (NIC), True Interest Cost (TIC), All-inclusive Cost (AIC), and Arbitrage Yield (also known as the Bond Yield). For the sake of a competitive sale, the best bid is determined as that which provides the lowest TIC. The TIC takes into account the two items that the bidding underwriter can control: 1) the interest rates on the bonds, and 2) the Underwriter's Discount, which is best understood as the fee paid by the issuer to the underwriter to sell the bonds.

Competitive Sale–Open Auction

It's worth noting that in today's industry, there are two platforms on which an issuer can sell its bonds via a competitive sale. The first is an open-auction platform in which a bidding underwriter has the opportunity to improve its bid as many times as it would like. While the exact terms of the bids themselves remain anonymous to all underwriters, each underwriter can see the ranking of its own bid relative to competing bids. Therefore, the underwriter with the second best bid knows that it ranks second and can continuously submit better bids until it holds the top position. This bid competition continues until the predetermined timeframe for the auction expires, unless there is a new top-ranked bid within the last two minutes of the auction, in which case the auction is extended for another two minutes. Eventually, the underwriter that submits the bid with the lowest TIC for a full two minutes will be the winning bidder. See below for a sample bid summary in an open-auction competitive sale.

Sample Bid Summary–Open Auction

	Bidder	Firm	TIC	Time	Gross Interest	+ Discount/ (Premium)	Total Interest	Bid No.	Cumulative Improvement
1st	MORG-JJ	Morgan	1.597478%	11:04:50 am	$10,019,029.17	(6,505,488.38)	$3,513,540.79	5	0.015817%
2nd	JPMO-JM	JP Morgan	1.598785%	11:05:21 am	$10,019,029.17	(6,502,744.04)	$3,516,285.13	5	0.010298%
3rd	WACH-WI	Wells Fargo	1.601397%	11:01:47 am	$10,019,029.17	(6,497,256.95)	$3,521,772.22	2	0.003191%
4th	TDSE-JF	TD Securities	1.602057%	11:00:31 am	$10,019,029.17	(6,495,871.37)	$3,523,157.80	2	0.002568%
5th	PIPE-SC	Piper Jaffray	1.603348%	11:01:05 am	$10,019,029.17	(6,493,159.99)	$3,525,869.18	3	0.005836%
6th	JANN-MD	Janney	1.604398%	11:01:28 am	$10,019,029.17	(6,490,955.52)	$3,528,073.65	5	0.080321%
7th	FIFT-GK	Fifth Third	1.607473%	11:00:34 am	$10,019,029.17	(6,484,499.43)	$3,534,529.74	6	0.022647%
8th	MESI-MO	Mesirow	1.608603%	11:00:59 am	$10,019,029.17	(6,482,128.00)	$3,536,901.17	2	0.004506%
9th	HUTC-LJ	Hutchinson	1.623093%	11:01:40 am	$10,019,029.17	(6,451,723.70)	$3,567,305.47	2	0.004062%
10th	MERR-AM	Bank of Ameri	1.623811%	10:59:48 am	$10,019,029.17	(6,450,216.80)	$3,568,812.37	7	0.252321%
11th	ROBE-CG	Robert Baird	1.634861%	10:59:30 am	$10,019,029.17	(6,427,048.65)	$3,591,980.52	1	-
12th	UMBB-SM	UMB Bank	1.695142%	10:59:57 am	$10,019,029.17	(6,300,912.40)	$3,718,116.77	4	0.055173%
13th	CITI-ML	Citigroup	1.695355%	10:54:53 am	$10,019,029.17	(6,300,466.70)	$3,718,562.47	1	-
14th	KEYB-LC	KeyBanc	1.711164%	10:59:32 am	$10,019,029.17	(6,267,458.66)	$3,751,570.51	3	0.053947%

Source: MuniAuction 6/10/20

Competitive Sale–Closed Auction

The second type of competitive platform is the closed-auction in which each bidding underwriter can only submit one bid and does not know the bid's ranking throughout the bid window. Therefore, each underwriter is compelled to submit its best and final bid without knowing where the bid ranks. The timing is simpler as well, as each underwriter just needs to submit its best and final bid by a pre-determined time. See below for a sample of a summary of bids that occurred in a closed-auction competitive sale.

Sample Bid Summary–Closed Auction

Bid Award*	Bidder Name	TIC
☐	Robert W. Baird & Co., Inc.	1.834328
☐	Stifel, Nicolaus & Co., Inc.	1.873668
☐	The Baker Group	1.879313
☐	D.A. Davidson & Co.	1.880409
☐	FHN Financial Capital Markets	1.887002
☐	Raymond James & Associates, Inc.	1.904074
☐	Piper Sandler & Co	1.987159
☐	Northland Securities, Inc.	1.991662
☐	Bernardi Securities, Inc.	2.069373

Source: PARITY, i-Deal LLC, 6/4/20

Certain circumstances might justify using one platform over the other, so we encourage readers to consult your PMA Advisor when deciding which platform to use for a competitive bond sale.

Negotiated Sale

The negotiated sale process is quite different than a competitive sale. In a negotiated sale, the issuer pre-selects the underwriter, either through an existing relationship or a Request for Proposal (RFP) process. The advantage of this approach is that because the underwriter is engaged prior to the sale of the bonds, the underwriter's salespeople can take the time to pre-market the bonds to its network of investors and, in doing so, build investor interest in a targeted way that may not exist in a competitive sale. On the day of the bond sale, the underwriter solicits orders from its investors during the "order period" required to finalize the exact interest rates on the issuer's bonds. If soliciting retail investors or regional financial institutions are a priority for the issuer, then a targeted order period specific to the retail and regional investment community can be implemented, which is another benefit of the negotiated sale process. A disadvantage of the negotiated sale is that the issuer has limited the distribution of its bonds to a pre-selected underwriter or, in the case of a larger debt issue, more than one underwriter. When bonds are sold competitively, there is no limit to the number of underwriters and their unique distribution networks that can bid on an issuer's debt. Another disadvantage of the negotiated sale is that the issuer doesn't have the same level of information as the underwriter. However, the issuer can mitigate this imbalance by retaining a financial advisor to represent the issuer in negotiations with the underwriter. In fact, GFOA Best Practices **found here**, explicitly recommends that an issuer "hire a municipal advisor prior to the undertaking of a debt financing unless the issuer has sufficient in-house expertise and access to current bond market information."

It's also important to note that when municipal bonds are priced, they're often priced relative to the AAA Municipal Market Data (MMD) index, which is the most broadly utilized yield curve in the industry. The MMD changes on a daily, or even hourly, basis so comparing absolute rates from a bond sale occurring on one day to another bond sale occurring another day is not a fair, apples-to-apples comparison. In order to accommodate for a constantly changing MMD curve, the industry looks at the spread to MMD for each bond pricing. This spread, and not necessarily the absolute interest rate, determines how the investing community views the issuer's credit and determines how well or poorly a bond issue may have fared in a particular pricing. It's important to note that this type of comparative analysis done in a negotiated sale is not required in a competitive sale, because in the latter, the issuer knows it's likely receiving the best interest rates in a public offering.

Determining the best sale method and platform requires additional due diligence regarding the state of the municipal bond market, the credit rating of the issuer, and the structure and size of the particular bond issue in question. We recommend that PMA clients make this decision in collaboration with our PMA Public Finance team. For that, or any other questions, please contact any of PMA's Public Finance advisors below.

Next Edition Muni Bonds 101

Understanding Municipal Bonds

In our next edition, we'll shed further insight on the sale process with a discussion of the investors and the factors that impact the price of municipal bonds.

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