



BEST PRACTICE

Pricing Bonds in a Negotiated Sale (1996, 2000, and 2010)

Note: This Best Practice (BP) is one of a group of five relating to the sale of bonds. These five BPs should be read and considered in conjunction with each other because of the interaction of the processes to which they apply. The five BPs are:

Selecting and Managing the Method of Sale of State and Local Government Bonds
Selecting Financial Advisors
Selecting Bond Counsel
Selecting Underwriters for Negotiated Bond Sales
Pricing Bonds in a Negotiated Sale

Background. One of the most important outcomes of the sale of bonds, the cost of borrowing, is established through the pricing process. Unlike a competitive sale, bond pricing in a negotiated sale requires a much greater degree of issuer involvement. The issuer negotiates both the yield on the bonds and the underwriters' compensation (also called underwriter discount or gross spread), which includes the takedown (or sales commission), management fee, underwriting risk, and expenses. An issuer's success in negotiating the price of its bonds depends on its ability and willingness to devote sufficient time to understanding the market and the historical performance of its bonds.

Recommendation. The Government Finance Officers Association (GFOA) recommends that state and local government issuers strive for the best balance between the yield for each maturity and the takedown to achieve the lowest overall cost of financing. The following actions by issuers are recommended to improve the pricing process:

1. Communicate to the underwriter specific goals to be achieved in the pricing of bonds and expectations regarding the roles of each member of the financing team, including the issuer and an independent financial advisor employed to assist in the pricing process. Identify the issuer representative who has authority to make key decisions and be available throughout the pricing process.
2. Take steps during the underwriter selection process and prior to final pricing to manage the compensation to underwriters by
 - including a provision in the request for proposal that requires respondents to indicate the range of costs for each component of compensation and specify an expected maximum for each,
 - setting a cap on fees and expenses, and
 - obtaining and reviewing information on each component of underwriters' compensation for other recent similar sales.
3. Develop an understanding of prevailing market conditions, evaluate key economic and financial indicators, and assess how these indicators likely will affect the timing and outcome of the pricing. Obtain a pricing book from the underwriter and/or the financial advisor which would include the following information:
 - the supply and expected demand for municipal bonds;
 - the release of key economic indicators, actual or anticipated actions by regulatory or political bodies, and other factors that might affect the capital markets;
 - the interest rates and current market yields of recently priced and outstanding bonds with similar characteristics;

- the interest rates and interest rate indices for bonds with similar characteristics provided by independent services that track pricing performance; and
 - the historic benchmark index data for the bond issue being sold and for other bond issues being sold.
4. Issuers should be aware they have an important role in determining how bonds will be allocated among syndicate members and ultimate investors. Issuers should consider order priority and the designation policies in reviewing the preliminary pricing wire and the Agreement Among Underwriters prior to the sale. To a large extent the designation policy controls the distribution of underwriter compensation among the syndicate members.
 5. Work with the underwriter to develop an appropriate premarketing effort to gauge and build investor interest. In consultation with outside professionals (e.g., financial advisor, underwriter, pricing consultant), consider providing for retail orders either through a separate retail order period or by identifying certain maturities as retail priorities. If doing a retail order period, issuers should take measures to establish the legitimacy of the retail orders such as limiting order size and disclosure of zip code designation.
 6. Request that the senior managing underwriter propose a consensus pricing scale on the day prior to the pricing that represents the individual views of the members of the underwriting syndicate and obtain a number of interest rate scales from other syndicate members.
 7. Evaluate carefully whether structural features, such as call features and original issue discount, that impact the true interest cost (TIC) of a bond offering, but limit future flexibility in managing the debt portfolio, will result in greater overall borrowing costs.
 8. During the marketing of the bonds, the issuer should have sufficient current market information and be in close contact with the lead underwriter. Consider repricing at lower interest rates at the end of the order period, giving consideration to order flow and order volumes.
 9. The issuer should review the proposed allotments of the bonds to ensure achievement of the issuer's objectives.
 10. Evaluate the bond sale after its completion to assess the level of up-front costs of issuance, including whether the underwriters' compensation was fair given the level of effort and market conditions; and the pricing of the bonds, both in terms of the overall TIC and on a maturity-by-maturity basis.
 11. Develop a database with information on each issue sold with regard to pricing performance, including the types of bonds sold (general obligation or revenue bonds), credit rating, maturities, yield and takedown by maturity, and the TIC.

References

- *Pricing Bonds in a Negotiated Sale: How to Manage the Process*, J.B. Kurish, GFOA, 1994.
- GFOA Best Practice, "Selecting and Managing the Method of Sale of State and Local Government Bonds," 2008.
- GFOA Best Practice, "Selecting Financial Advisors," 2008.
- GFOA Best Practice, "Selecting Underwriters for Negotiated Bond Sales," 2008.
- GFOA Best Practice, "Selecting Bond Counsel," 2008.

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