A Practitioner's Guide

Competitive v. Negotiated

How to Choose the Method of Sale for Tax-Exempt Bonds

To Effective Debt Management

Government Finance Officers Association

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COMPETITIVE v. NEGOTIATED

How to Choose the Method of Sale for Tax-Exempt Bonds

INTRODUCTION

One of the first decisions made by a state or local government in preparing to issue debt is the method of sale for its bonds. Bonds can be sold in one of three ways: through competitive bidding, negotiated sale, or private placement. The method of sale is an important factor in determining the overall cost of the financing, including both upfront issuance costs and debt service costs over the life of the bonds, and in ensuring public confidence in the sale process. Government entities must carefully evaluate which type of sale is likely to result in the lowest total financing costs for their jurisdictions while maintaining public trust.

Most bonds are sold through either a competitive or negotiated method of sale. Relatively few issues are sold through private placement. Private placement is a method of sale by which the issuer sells bonds directly to a limited number of sophisticated investors without a public offering. In 1993, only about 1 percent of the total volume of tax-exempt securities, or 3 percent of the number of issues, was privately placed. Since most issuers choose either the competitive or negotiated method of sale, this report will focus on these two options.

As measured by volume, the predominant method of sale for long-term, tax-exempt bonds in recent years has been negotiated sale. Eighty percent of the volume of long-term municipal bonds was sold using a negotiated sale in 1993. Focusing on general purpose issues, about 69 percent of the total volume of bonds, but only 53 percent of the number of issues, was sold by a negotiated sale.

CHARACTERISTICS OF A COMPETITIVE METHOD OF SALE

In a competitive method of sale, the issuer solicits bids from underwriting firms to purchase its bonds, and sells bonds to the firm or bond syndicate offering the lowest interest rate (or highest price) bid. With this method of sale, the issuer determines the size and other essential characteristics of the issue, prepares bond documents, obtains a rating, and completes all other necessary tasks for the issuance of the bonds prior to soliciting bids. A financial advisor and bond counsel are often employed to assist in these tasks. The issuer then publishes a Notice of Sale to advertise the sale of bonds. The Notice of Sale summarizes the terms and

conditions of the offering, describes the bidding requirements, and identifies the date and time of the sale. Underwriters submit their bids at the specified time for bid opening. Each bid takes into account both the interest rate paid to investors and the amount of compensation to the underwriting firm for selling the bonds.

Once bids are evaluated, the issuer awards the bonds to the firm submitting the lowest interest rate bid that meets all criteria specified in the Notice of Sale. The Notice of Sale will specify the method used to calculate the interest rate – usually either a net interest cost (NIC) or a true interest cost (TIC) method. The NIC is the average interest rate on bonds, and is calculated using the following formula:

$$\text{NIC} = \frac{\text{Total Coupon Interest Payments + Discount (less Premium)}}{\text{Number of Bond Years}}$$

The TIC method of calculation is preferred because it takes into account the time value of money. The TIC is the rate that, when used to discount total principal and interest payments over the life of the bonds, gives the amount of bond proceeds received by the issuer at the time of issuance.

In some jurisdictions, competitive sales are required by law. Issuers should consult with bond counsel in order to assure themselves that they are complying with all state and local statutes and other legal provisions related to method of sale.

CHARACTERISTICS OF A NEGOTIATED METHOD OF SALE

A negotiated sale involves a different process. In this case, an underwriting firm is selected well in advance of the proposed sale date before the issuer has full knowledge of the terms of the purchase. In the weeks prior to the sale, the issuer and the underwriter engage in discussions regarding the amount of compensation which will be paid by the issuer to sell the bonds to investors, to provide advice to the issuer on the characteristics of the offering, and to cover other costs. A final purchase price, reflecting the amount of compensation to the underwriters and the coupon interest rates at which the bonds will be offered, is negotiated at the time designated for sale of the bonds.

The issuer will usually select an underwriting firm (or firms) to take the lead role in marketing its bonds. This firm is known as the

senior managing underwriter. The senior managing underwriter will often take an active role in sizing and structuring the issue, and preparing bond documents. The issuer may also decide to delegate these responsibilities to its financial advisor and bond counsel, leaving the senior managing underwriter to work on marketing the securities to potential investors. The senior managing underwriter is also responsible for managing the activities of the bond syndicate -- that is, the underwriting firms making up the team that sells the bonds.

At the time bonds are to be sold, the underwriting syndicate meets to determine the interest rates at which various maturities will be offered. Upon approval by the issuer, the syndicate will approach investors to determine whether the bonds can be sold at these rates. Adjustments will be made as necessary until a final set of maturities and interest rates are reached reflecting the supply of and demand for bonds.

The underwriter also proposes an amount of compensation, known as underwriter's discount or gross spread. This amount compensates the underwriter's sales force for selling the bonds and the public finance staff for structuring the transaction. It also includes expenses incurred by the underwriter on behalf of the issuer, and may include a "risk" component to compensate members of the syndicate for incurring the risk that bonds may not get placed with investors at the stated coupon interest rates.

Once terms for the sale of the bonds have been reached, a bond purchase agreement is signed by the issuer, usually after approval by a legislative body. This generally occurs within one or two days of the sale date.

ADVANTAGES AND DISADVANTAGES OF A COMPETITIVE SALE

Competitive sales offer a number of benefits to issuers of tax-exempt debt, and should be given strong consideration in deciding which method of sale to use. There may, however, be circumstances in which these types of sales are not as advantageous relative to negotiated sales. The advantages and disadvantages of competitive bond sales are as follows:

Advantages

1. Competitive sales provide some assurance that bonds have been sold at the lowest interest rates given market conditions. Competition provides an incentive for each underwriter to submit the most aggressive bid at which it expects to be able to successfully market bonds to investors.

2. The amount of compensation paid by issuers to underwriting firms for selling the bonds, or gross spread, has historically been lower for competitive sales relative to negotiated sales. While the average gross spread differential for competitive and negotiated sales has narrowed in recent years, underwriting spreads for competitive sales were still $.81 per $1,000 bond less on average than for negotiated sales in 1993 based on data collected by the Securities Data Company. Part of this differential, of course, can be explained by the fact that negotiated transactions often have more complex structural or security features.

3. Competitive sales promote the appearance of an open, fair process. A growing concern of negotiated sales, whether real or apparent, is that underwriting firms may be awarded business to reward them for campaign contributions or for other political reasons. Competitive sales, if conducted properly, can remove the appearance of impropriety in the bond sale process.

Disadvantages

1. The issuer may have less flexibility with respect to the structure of the offering or the timing of the sale. Depending on state or local laws governing the issuance of bonds, the Notice of Sale advertising a competitive bond offering may need to be posted well before the sale date. In this case, the issuer is more limited in its ability to move the sale date in the event that market conditions make another date advantageous. The issuer may also have less flexibility in adjusting the structural features of the issue to respond to investor interest in certain maturities, call provisions, or other characteristics. In recent years, these concerns have been mitigated to some extent due to the growing acceptance of flexible terms in the Notice of Sale, as will be discussed in greater detail below.

2. Underwriters may build a "risk premium" into their bids to compensate for uncertainty in being able to sell bonds to investors at a particular interest rate. This occurs because underwriters have no assurance that they will receive bonds, and are thus unlikely to engage in extensive pre-sale marketing activities to determine the rates investors require for an issuer's bonds. A related concern stems from interest rate volatility found in the municipal market. If interest rates have increased in the interval between bid submission

and bond award, the underwriting firm's profits may be substantially reduced. The risk premium affords underwriters some protection from these uncertainties.

3. Issuers of bonds involving a complex financing or a weak or unknown credit may have difficulty in attracting bids. Again, the risk of being able to place the bonds with investors may limit underwriting firms' interest in bonds of these issuers, and can result in higher coupon bids by firms that choose to submit bids.

4. Issuers have less control in selecting the underwriting syndicate and determining the allocation of the bonds. Certain policy objectives, such as assuring local investors access to bonds, awarding bonds to local and regional firms, or meeting Disadvantaged Business Enterprise (DBE) policy goals, are more difficult to achieve with a competitive method of sale.

ADVANTAGES AND DISADVANTAGES OF A NEGOTIATED SALE

Negotiated sales also have both advantages and disadvantages, which are as follows:

Advantages

1. A greater incentive exists for an underwriter to engage in pre-sale marketing activities to assess investor interest in an issue, as well as demand for certain structures or maturities. For certain issuers, such as those experiencing financial difficulty or those contemplating a structure not well understood by investors, pre-sale marketing efforts may enhance investor demand for their securities. Issuers choosing to sell bonds through a negotiated sale should assure themselves that their underwriters develop and implement an effective marketing plan for the bonds.

2. An important advantage of a negotiated sale is its flexibility. The structure of the issue or timing of the sale can be adjusted as necessary to respond to changing market conditions. Hence, the issue can be designed to meet investor needs and generate cost savings for the issuer.

3. An issuer has greater control in allocating bonds to particular underwriting firms or ensuring that bonds are available to certain investor groups. While issuers can

achieve DBE or local preference goals using a competitive sale, it is often easier using a negotiated sale.

Disadvantages

1. An important policy objective in any public sector procurement of services is to maintain an open, fair process. Unfavorable publicity has been generated with respect to negotiated sales, charging that underwriting firms may at times be appointed based on the level of campaign contributions or for other political reasons. Negotiated sales are more likely to result in charges of favoritism, reducing public confidence in the bond sale process and in their government officials in general.

2. Negotiated sales require that issuers make a greater effort to remain informed of developments in the municipal market in order to ensure that bonds are priced at a favorable rate, and that underwriting spreads are reasonable. Most issuers do not have the resources to devote to monitoring the municipal market on an on-going basis, and are therefore likely to have difficulty in negotiating effectively with underwriters in either of these areas. Employing a good financial advisor can mitigate this risk.

FACTORS TO CONSIDER IN CHOOSING THE METHOD OF SALE

In preparing for the sale of bonds, the issuer must decide which method of sale is likely to result in the lowest costs for its debt and achieve other important policy objectives. This decision should be based on the characteristics of the issuer, market conditions, and the type of financing that is contemplated. It is important to note that a bond issue is not likely to meet all of the conditions that favor one method of sale over the other. For example, a highly rated issuer planning to sell bonds with characteristics that might otherwise favor a negotiated method of sale could find that a competitive sale would be equally beneficial. A primary objective in selecting the method of sale is to choose the one that will generate the most interest for the issuer's bonds among underwriters and, more importantly, investors.

Debt Structure

- **DETERMINE THE STRUCTURAL FEATURES OF THE BOND OFFERING.**

Before deciding on the method of sale, consider the nature of the securities to be offered, including complex structural features or

other special financing characteristics. The more familiar investors are with a debt instrument or structure of an offering, the less is the need for an enhanced marketing effort which is afforded through a negotiated method of sale to generate interest in the bonds. The following are examples of financing issues that should be evaluated.

- Is the debt widely understood and accepted by the public finance market?
- Is a complex or unique security provision or revenue stream being used to support repayment of the debt?
- Does the project generate cash flows that require a unique financing structure?
- Will the issue be combined with the use of innovative financing techniques, e.g., derivative products?
- Will the bonds be targeted to specific investor groups for which a specially designed structure might be beneficial?

"Plain vanilla" bond offerings -- that is, securities that are frequently issued and widely understood, such as general obligation bonds and commonly issued revenue bonds -- are readily accepted by the municipal market; little additional effort is needed to enhance investor understanding of these securities. Competitive sales can result in very favorable interest rates for these types of securities.

Bond offerings incorporating new financial instruments or complex structural features require a greater sales effort, and hence, a negotiated method of sale may be more beneficial. Issuers interested in placing bonds with specific investor groups may also benefit from a negotiated sale in order to develop a structure that meets the needs of these groups.

Credit Quality

- **REVIEW THE CREDIT HISTORY OR FACTORS THAT MAY AFFECT CREDIT QUALITY.**

Investors generally prefer bonds involving less risk, and therefore seek out high-quality issues. Therefore, a critical assessment of credit-related factors that may influence investor demand for the bonds is essential.

Among the questions to ask are:

- Has the jurisdiction experienced recurring difficulty in balancing its budget?

- Has the issuer been downgraded or placed on credit watch?

- Has the jurisdiction's financial outlook improved considerably since the last time its bonds were rated?

- Will the issue be non-rated?

For bonds rated "A " or better, a competitive method of sale can be very effective, all other conditions being equal. Negotiated sales may be advantageous when a jurisdiction's credit quality is low or rapidly deteriorating. Under these circumstances, issuers are likely to have difficulty in accessing the municipal market without additional pre-marketing efforts by the underwriter. Conversely, when an issuer's financial position has improved, but has not yet been acknowledged through a rating upgrade, a negotiated sale may be a effective means to educate investors of the positive development.

Issuer Characteristics

- **ASSESS THE IMPORTANCE OF OTHER ISSUER CHARACTERISTICS THAT MAY CONTRIBUTE TO INVESTOR DEMAND FOR THE BONDS.**

Investors are more likely to demand securities of issuers with an established history in the municipal market. They are more likely to be wary of purchasing bonds of issuers with whom they are unfamiliar or who are experiencing problems they do not fully understand. Questions on which to focus include:

- Is the jurisdiction a new or infrequent issuer?

- Is the issuer well-known and a regular participant in the market, and does it have a stable financial quality?

- Are there particular issues of concern to investors that can affect sale of the securities, e.g., pending litigation, previous default on the issuer's bonds, unfavorable court rulings, etc.?

- How favorably have prior issues been received in the municipal market?

- What is the size of the issue being contemplated?

Additional marketing efforts may be necessary for securities of infrequent issuers or issuers facing unusual problems. A negotiated sale may be more effective under such circumstances. Nevertheless, if bonds of such issuers are highly rated, a competitive sale may also work well.

The size of the issue may also influence the choice of sale method. Depending on market conditions and the type or credit quality of the issue, governmental entities contemplating a particularly large issue may want to consider a negotiated sale. Underwriters may perceive greater risk with an unusually large issue, because it may be more difficult to sell the entire issue. To the extent that a large portion of the bonds cannot be sold, the underwriter may incur a financial loss. Small issues can also be problematic in generating enough interest among underwriting firms to obtain competitive bids.

Market Conditions

- **EVALUATE MARKET CONDITIONS.**

Uncertainty in the municipal market can lead to significant interest rate volatility; thus, market conditions should be reviewed when deciding which method of sale is likely to be more cost effective. Market-related concerns include the following:

- Are there events creating market uncertainty, e.g., war or other national/international crisis, pending legislation, etc.?
- Is the Federal Reserve Board contemplating actions that may affect market conditions?
- Is a refunding issue being contemplated that depends both on interest rates in the municipal market and the U.S. Treasury market?
- Are other large issuers, issuers of similar credit quality, or issuers of similar types of securities (e.g., mass transit, wastewater treatment) coming to market in the same timeframe?

During periods of real or expected interest rate fluctuation, issuers may find that they are able to more favorably sell bonds using a negotiated method of sale. When interest rates are highly unstable, underwriters will be less certain of the rates at which they will be able to sell bonds to investors and make a reasonable profit. As discussed earlier, underwriting firms will often build a risk premium

into their bids for competitively sold bond issues to compensate for this uncertainty. This increases the cost for the issuer. Negotiated sales can be particularly advantageous when market conditions are volatile because issuers have greater flexibility to enter the market when interest rates are at a low point.

Another factor that may affect investor demand for an issuer's bonds is the number of competing issues in the market at the same time. As the volume of bonds being offered at a particular time increases, so too does difficulty of attracting investor attention with respect to any one issuer's bonds.

Policy Objectives

- **EXAMINE POLICY OBJECTIVES.**

Issuers often have certain policy objectives related to the sale and distribution of their bonds. Among the policy considerations to review are the following:

  - Are there particular targets for amounts of bonds allocated to DBE or local/regional firms?

  - Is there a desire to make bonds readily available to local or regional investors?

These goals may be met with either a competitive or negotiated method of sale. It is often easier to achieve them through the flexibility afforded by a negotiated sale. As discussed below, however, issuers should not rule out a competitive sale in order to meet policy objectives, as there are ways to address these policy goals with this method of sale.

Staff Experience

- **CONSIDER STAFF EXPERIENCE WITH BOND SALES.**

A negotiated sale can be very effective for issuers who remain abreast of market developments, and understand how their bonds trade relative to the market. Issuers need to determine the following:

  - Is sufficient time, expertise, or staff resources available to monitor the municipal market, how the jurisdiction's bonds are trading in the secondary market, and other factors affecting interest rates on municipal bonds?

  - Is sufficient time, expertise, or staff resources available to determine a fair level of compensation to underwriters?

Issuers will be in a position to negotiate more effectively with their underwriters, both with respect to the underwriting spread and yield on their bonds, if they have the resources to closely monitor the municipal market. They also need to be able to obtain information on the underwriting spreads of other issuers of comparable securities when negotiating the underwriter's spread. A good financial advisor can help an issuer in these negotiations, and is essential if the issuer does not have sufficient resources of its own to effectively negotiate with the underwriter.

EXPANDING YOUR OPTIONS WITH THE METHOD OF SALE

Thus far, the advantages and disadvantages of competitive and negotiated sales have been discussed, as well as conditions favoring one or the other method of sale. For competitive sales, the benefits achieved through competition, such as being able to justify that the bonds were sold at the lowest interest cost given the prevailing market conditions or demonstrating to the public that bond sale process was conducted fairly, must be weighed against reduced opportunities to generate investor interest in the securities. Conversely, issuers contemplating a negotiated sale know they have greater flexibility in structuring their offering or in developing a marketing plan to attract investors; yet, they also face the risk that their bond sale process may be open to charges of favoritism or that the price negotiated for the bonds may be lower than would have been obtained in a competitive offering. Regardless of the method of sale that is chosen, issuers need to look for opportunities to achieve greater flexibility, competition, and knowledge in order to obtain the lowest overall cost of debt financing.

Increasing Competition and Flexibility in a Competitive Sale

When choosing a competitive sale, issuers should make a deliberate effort to foster competition for their bonds in order to achieve a cost-effective sale. They may also be able to achieve greater structural flexibility, and hence, more favorable interest rates, in the way that they design the bidding process. The bidding process may also be designed to meet DBE or other policy objectives.

For competitively sold bonds, issuers want to generate enough interest in their bonds to encourage several underwriting firms to submit aggressive bids. Thus, issuers need to carefully consider the characteristics of the offering, credit quality, and other factors described above to assure themselves to the extent possible that underwriters will be willing to bid aggressively on their bonds.

Despite having a number of characteristics that might favor a negotiated sale, some issuers have been able to conduct a successful competitive bond sale by modifying the traditional competitive sale process. An issuer may be able to increase underwriter support for its bonds by issuing a Request for Qualifications to prescreen underwriting firms, to solicit their input on ways to structure the offering, and to obtain a commitment from firms to bid on their bonds in a competitive sale. This type of process has also been used by some issuers to obtain a commitment by underwriting firms to meet DBE goals. Issuers should develop an approach to their bond sale that will encourage maximum participation by underwriting firms.

Issuers utilizing a competitive method of sale can achieve some of the flexibility of the negotiated sale process through the Notice of Sale. For example, an issuer interested in retiring certain amounts of principal each year can increase flexibility in structuring the transaction by permitting underwriters to group various maturities into term bonds to meet investor demands, rather than requiring these maturities to be issued as serial bonds. The term bonds would have mandatory redemption provisions to conform to the issuer's objectives pertaining to retirement of the debt. Provisions in the Notice of Sale have also permitted issuers to make changes to the date or time of the bond sale. The Notice of Sale can also require that DBE participation goals for the sale be met. Bidders not meeting these goals (for example, through formation of a syndicate that includes DBE firms) would not be given further consideration.

Promoting Competition and Knowledge in a Negotiated Sale

As discussed above, there are times when a negotiated sale can be a more advantageous approach. The inherent flexibility and enhanced pre-sale marketing efforts afforded by this method of sale can stimulate greater investor demand, and increase the likelihood that bonds are structured to maximize investor interest and are sold at an opportune time. As a result, bonds can be sold at more favorable rates than if a competitive sale had been used. However, issuers must feel confident that the underwriting firms selected to market the bonds work aggressively on their behalf.

The capability of the underwriter in this respect can be better ascertained through use of a competitive selection process. Issuers should prepare and circulate a thorough Request for Proposals (RFP) to solicit qualified underwriting firms to serve as managing underwriter. The RFP is designed to gain an understanding of the experience of the firm and of the individuals who would work on

the account, the firm's financial position, its understanding of the financing needs of the jurisdiction, and other factors relevant to successful sale of the issuer's bonds. Using this process to select an underwriter will also instill greater public confidence in the selection process. The RFP can also be used to get an indication of the various components making up the underwriting spread. For example, issuers could ask for an estimate of the maximum gross spread that would be paid to the underwriter, including management fees and other expenses, as well as for an indication of the takedown (the amount of compensation for selling the bonds) based on criteria specified in the RFP.

In preparing for the sale, issuers need assurance that the costs they incur, both upfront fees paid to their financing team and long-term debt service costs, are reasonable given market conditions. While a carefully considered use of a competitive method of sale can alleviate concerns about the interest cost of the bonds, issuers using negotiated sales will be required to pay greater attention to market conditions to assure a fair price. They will also need sufficient information to be in a position to effectively negotiate the components of the gross spread with the underwriter. A financial advisor can be particularly helpful to an issuer during the pricing process, both in reviewing the interest rate scale proposed by the underwriter, and in providing information which can be used in negotiating the gross spread.

As the sale date for the bonds approaches, issuers should make a concerted effort to remain abreast of prevailing market conditions and their effect on interest rates, and how comparable issuers are being priced in the market. *The Bond Buyer*, a newspaper serving the municipal bond industry, is a good source of information on interest rates, bids and awards for competitive offerings, and prices for negotiated offerings. *The Bond Buyer* also publishes quarterly statistics, including trends in average gross spread. Financial advisors and underwriters have access to other databases containing valuable information for an issuer. Issuers should require their underwriters or financial advisors to provide market data and results of comparable sales both prior to the sale in order to negotiate more effectively during the pricing of the bonds, and after the sale in order to evaluate the outcome of the sale.

COMPETITIVE v. NEGOTIATED SALES:
Summary of Conditions Favoring Each Method of Sale

	CONDITIONS FAVORING A COMPETITIVE SALE	CONDITIONS FAVORING A NEGOTIATED SALE
DEBT STRUCTURE		
Pledged Revenues	General Obligation or Strong System Revenue	Project Supported Revenues
Security Structure (for Revenue Bonds)	Conventional Resolution and Cash Flow; Rate Covenant and Coverage	Unusual or Weak Covenants; Subordinated Debt
Debt Instrument	Traditional Serial and Term, Full Coupon Bonds	Use of Innovative Structuring, Derivative Products, Structure to Attract Particular Investors (e.g. Discount Bonds), etc.
CREDIT QUALITY		
Rating	'A' or better	Below Single 'A'
Outlook	Stable	Weak but Improving, or Under Stress
ISSUER CHARACTERISTICS		
Type of Organization	Broad-Based General Purpose Borrower	Special Purpose, Independent Authority
Frequency of Issuance	Regular Borrower in Public Market	New or Infrequent Issuer
Market Awareness	Active Secondary Market with Broad Investor Base	Little or No Institutional Awareness of Issuer; Historical Antipathy
Investor Comfort	Well-Known, Stable Issuer	Issuer Experiencing Significant Financial, Legal or Other Problems
MARKET CONDITIONS		
Interest Rates	Stable; Predictable Market	Volatile or Declining Market
Supply and Demand	Strong Investor Demand, Good Liquidity, Light Forward Calendar	Oversold Market, Heavy Supply
POLICY CONSIDERATIONS		
Participation in Sale of Bonds	Broad Market Participation Desired for Sale of Bonds	Desire to Direct Business to DBE or Local/Regional Firms
Stimulation of Investor Interest	Broad Market Participation Desired for Purchase of Bonds	Desire to Direct Business to Local/Regional Investors