PRNewswire

A Municipal Market Year in Review: The Days of Easy Money and Simple Approaches are Behind Us

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SACRAMENTO, Calif., Nov. 21 /PRNewswire/ -- This past year has brought significant market turmoil. But, arguably, the bankruptcy of "Bond King", Lehman Brothers, on September 15, will be seen as the turning point for easy bond market access by school districts and other government issuers.

(Photo: http://www.newscom.com/cgi-bin/prnh/20081121/LAF506-a) (Photo: http://www.newscom.com/cgi-bin/prnh/20081121/LAF506-b) (Photo: http://www.newscom.com/cgi-bin/prnh/20081121/LAF506-c)

Since 1998, government bond issuers have enjoyed favorable borrowing conditions when issuing municipal bonds, selling approximately $4.1 trillion worth. Long term interest rates on AAA rated bonds have ranged from a low of 4% to a high of 6%. These low interest rates were made possible through bond insurance and an overwhelming demand from institutional buyers.

The Downturn Begins ...

The municipal market first took a turn for the worse on November 5, 2007, when credit rating agency Fitch Ratings announced that they would reassess AAA rated municipal bond insurers due to their exposure to defaults from the subprime mortgage fiasco. Only bond insurers Assured Guaranty and FSA were anticipated to retain their AAA status.

Days after the Fitch announcement, the credit rating agency Moody's Investors Service followed Fitch with a similar announcement. AMBAC was the first to be downgraded with other downgrades soon to follow. Without a plethora of AAA bond insurers, the days of easy market access would be numbered.

Variable Markets Destabilize

The variable and auction rate markets were the first segments to destabilize after downgrades of the AAA bond insurers. Like homeowners caught with upward moving variable rate mortgages, municipalities found themselves having to refinance variable rate debt as interest rates quickly rose. Plus, many liquidity providers, who were responsible for supporting the market for these securities, began to lose capital due to mortgage losses.

Unfortunately, many investment banks and "sophisticated" financial advisors encouraged school districts and other government agencies to issue variable rate debt on the premise that their interest rates would be lower than fixed rate debt. But, as liquidity began to dry up, many issuers found their variable rate debt was not re-marketable to investors or liquidity providers. Consequently, many issuers were left paying the maximum interest rate (in many cases 12%) until the debt could be refinanced.

The once steady municipal market suddenly became unstable with school districts and other government issuers scrambling to refinance billions of dollars of variable rate debt while institutional investors began scrambling to liquidate positions in order to raise capital.

Some Issuers Make Adjustments

In early 2008, a California County Office of Education competitively sold an uninsured, vanilla Certificate of Participation. This standard issuance garnered only two competitive bids and had a true interest cost of approximately 5.80%. After witnessing the poor execution of this competitive sale, Capitol Public Finance Group (Capitol PFG) began adjusting our method of marketing debt in order to keep pace with the evolving credit crisis.

One important adjustment was to expand the use of negotiated sales, particularly for debt issues that were not clear cut, high grade, municipal securities. Examples included nonrated notes, bonds with maturities of up to 40 years, capital appreciation bonds, and taxable bonds. Although these bond structures have traditionally posed problems for successful competitive sales (i.e., sales achieving at least three bids), with the current market, negotiated sales became a more effective marketing solution in terms of cost effectiveness, market timing, and financing terms.

This was particularly evident beginning in March of 2008, after the collapse of the Wall Street investment bank Bear Stearns. Investment banks like Bear Stearns became constrained in their ability to bid on new bonds as their ability to leverage bond purchases evaporated. Uninsured bond offerings were hurt the most by the fall off of investment banks' diminished capacity to obtain capital necessary to maintain competitive underwriting operations.

In the years leading up to this collapse of Wall Street, hedge funds and investment banks were able to borrow at low short term rates and purchase new long term bonds using financial leverage. This technique made the competitive bond market efficient since firms were able to sell millions of dollars of bonds to a single investor with a single phone call.

Under the easy money market conditions, financial advisors could simply tout their market prowess when recommending competitive sales for virtually all types of debt. But in the current bond market, competitive sales face potentially higher interest rates and higher underwriting compensation with the risk that the bonds cannot be sold to institutional buyers, especially without bond insurance. Failure to recognize these changes in the marketplace left many government agencies, unbeknownst to them, with poorly executed bond sales (2 bids or fewer).

The Rise of Underwriters with a Retail Client Base

It became relatively obvious early in 2008 that the most efficient bond sales would occur the old fashion way -- using firms that had a large retail client base. After analyzing the bond trading, distribution and marketing capacities of many of the investment banking and underwriting firms, it was clear that well established western regional firms, such as M.L. Stern & Co. (now Southwest Securities, a subsidiary of SWS Group, Inc. (NYSE: SWS)), were ideally positioned to underwrite bonds at more competitive interest rates than their counterparts.

Traditional investment banks historically relied on firms like Southwest Securities to assist in their bond underwritings by purchasing and reoffering bonds to their retail clients. Now, with many of the large investment banks short on cash and without the depth of institutional investors, regional firms were poised to bring substantial transactions to market.

Southwest Securities first demonstrated their marketing power to us in June of 2008 when they were able to assist a once financially troubled school district with the sale of $34.3 million, 40 year Certificates of Participation at a true interest rate of approximately 5.01%. This successful transaction paved the way for Capitol PFG to utilize Southwest Securities for several major negotiated bond financings, including a $78.3 million revenue bond issuance, which was awarded The Bond Buyer's Far West Deal of the Year in November 2008.

The Municipal Market Re-prices to Higher Interest Rates

Despite unprecedented efforts by the government to unclog the credit markets after the September 15 bankruptcy of Lehman Brothers, the municipal market re-priced to higher levels. The three month LIBOR rate, a key borrowing rate for credit markets, rose from 2.6% prior to the Lehman bankruptcy to over 4.6% in mid October. During this time, tax-exempt interest rates also increased as capital needed to support the municipal market became scarce. Institutional investors who relied on borrowing in the short term market to finance long term investments found that capital was either non-existent or too expensive to take new positions or hold existing ones.

Institutional liquidations in the secondary market resulted in a decline in the value of bonds, which pushed bond yields to levels not seen in nearly a generation. Municipal bond issuers found themselves competing with institutions for investors who were able to purchase high yielding bonds sold under desperate conditions.

Despite the difficult market conditions, on September 24, Capitol PFG took the controversial step of bringing a $23.7 million Certificate of Participation to market while the anticipated federal bailout was under consideration. It was clear to us that the market was not experiencing a one-time event that could be avoided by rescheduling the bond sale. Under the guidance of the Southwest Securities underwriting and banking team, we successfully priced the 40 year issue at a true interest cost of 5.72%.

Although the LIBOR rate has recovered to pre-Lehman bankruptcy levels, to our surprise, demand for municipal bonds is less than it was prior to September 15. The market was able to withstand the meltdown of the bond insurers, but not the bankruptcy of Lehman Brothers.

Latest Developments ...

Notwithstanding the current market outlook, we are seeing two encouraging developments:

(1) The drop in LIBOR may eventually enable leveraged buyers to absorb market supply as they profit from purchasing higher yielding bonds. We believe leveraged buyers will be necessary in order for the market to continue to absorb the upcoming annual supply of municipal, corporate, and household paper that is essential for the economy to function as we currently know it. (2) There is positive movement regarding bond insurers. Warren Buffet's Berkshire Hathaway has insured a few issues in California. Bond insurers are rumored to be in talks to access funds under the Federal Troubled Asset Relief Program (TARP), which may result in a restoration of their AAA credit rating. Plus, Municipal Infrastructure Assurance Corp., a new bond insurer, is expected to enter the market in late 2008. Finally, on November 11, Assured Guaranty announced that it will acquire FSA. This acquisition is contingent on confirmation that the transaction will not have a negative impact on the credit ratings of either bond insurer. Although this acquisition will reduce competition, market participants hope that the consolidation will help stabilize Assured Guaranty's AAA credit rating by the three major credit rating agencies.

Unfortunately, the municipal bond insurers are not out of the woods. For the last two months or so, Moody's Investors Service was expected to release a re-evaluation of bond insurers. Downgrades to FSA or Assured Guaranty would be a severe blow to the ability to borrow at insured AAA interest rates.

Outlook for the Future

Although interest rates are higher now than they were over the last ten years, essential governmental projects will continue to be financed. But, it will become increasingly difficult for the market to absorb the existing supply of bonds and find buyers for bonds that come to market during the next year.

With a contracting economy, and declining revenues, municipal issuers will have to make more of an effort to maintain a strong credit profile to access the markets as strong underlying issuer credit ratings will become increasingly important. Going forward, municipal issuers will see greater interest rate spreads between high investment grade and less creditworthy investment and non-investment grade debt.

Finally, as long as the economy remains gloomy, issuers and their advisors will be forced to take a more sophisticated approach than what they are accustomed to, in order to have well executed bond sales in the current volatile and evolving bond market.

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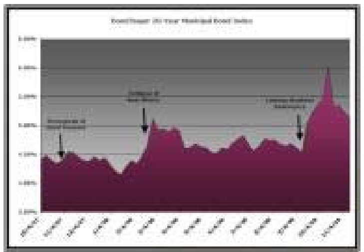

Chart 3: Bond Buyer 20-Year Municipal Bond Index. (PRNewsFoto/Capitol Public Finance Group, LLC)

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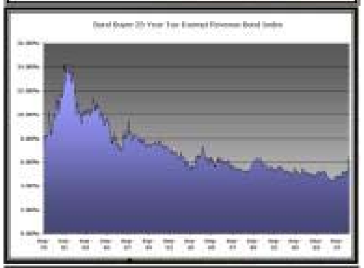

Chart 2: Bond Buyer 25-Year Tax-Exempt Revenue Bond Index.(PRNewsFoto/Capitol Public Finance Group, LLC)

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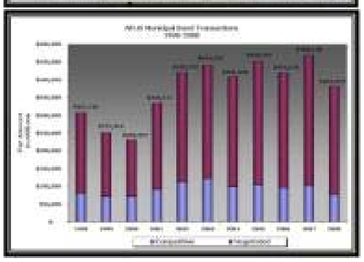

Chart 1: All US Municipal Bond Transactions 1998-2008. (PRNewsFoto/Capitol Public Finance Group, LLC)

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