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Buy Side

Issuers Structure Deals to Meet Retail Demand for Lower Coupons

By Christine Albano
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Municipal issuers have retail buyers in mind when they take a trip to the primary market to sell their tax-exempt bonds.

They say they have recently been delivering the 4%-or-less coupons that are in high demand by traditional buy-and-hold investors who have a growing appetite for cost-efficiency in the current low yield climate.

"We are giving investors the coupons they are looking for, hoping to increase the number of buyers interested and hoping to improve the pricing," Tim Rosnick, deputy controller of the Los Angeles, Calif., Unified School District told The Bond Buyer in an interview on Wednesday.

He said the district incorporated the preferred 4% coupons into two bond issues totaling $1.2 billion it sold earlier this month as a means of being flexible and accommodating of buyers' growing demand for sub-5% coupons.

The greater the demand, the lower the yields, which enhances cost savings, Rosnick said, as the district prepared to return to market with a competitive sale of $455 million refunding of GO dedicated unlimited ad valorem property tax bonds on Thursday.

While the deal is restricted from having zero coupon bonds or coupons higher than 6%, Rosnick said the structure will be at the discretion of the winning bidder.

"Other than the minimums and maximums, they have a great deal of flexibility in terms of coupons," he said. However, he said he expects 4% coupons to surface on some of maturities given the recent trend for the lower coupon product.

Retail demand for sub-5% couponing is increasing, other issuers and financial advisors confirmed.

"We are aware of retail demand and routinely look at alternative couponing structures," Jorge Rodriquez, managing director and head of public finance at Coastal Securities, said in an interview on Thursday.

As a co-financial advisor for the city of San Antonio earlier this month, Rodriguez said it made sense to structure some of the general improvement and refunding bonds and combination tax and revenue certificates of obligation from a $306.44 million sale with 4% coupons to benefit the hearty investor demand.

At the same time, that structure was advantageous for the city as some of the maturities with 4% coupons were oversubscribed – even though they were priced at a premium.

For instance, 4% coupons were structured in 2034, 2035, and 2036, to yield 2.43%, 2.48%, and 2.53% at the pricing.

Final decisions, according to Rodriguez, are often determined by a series of criteria, including investor demand, credit, size of the maturity, and yield to maturity calculations.

"All of those drive how you have to coupon it," he said.

Rodriguez said his firm consults with the underwriters to get price indications by maturity on a variety of coupon levels, including 3%, 4%, and 5%, and then chooses the coupons that will grab the most investor attention.

"You have to be able to move the bonds and also want to price them at the lowest possible kick to the issuers," he said.

Using lower coupons typically means a lower yield to maturity, which results in a lower cost to the issuer, Rodriguez said. For instance, structuring a maturity with a 4% coupon versus a 5% coupon may translate into 10 basis points of yield to maturity savings. That is very attractive for issuers selling a large transaction, Rodriguez said. On the city's recent deal, 5% coupon bonds due in 2033 had a yield to maturity of 2.996%, versus the 4% coupons due in 2034, which had a yield to maturity of 2.981%, according to Municipal Market Data.

New York City is also among issuers around the country aiming to please retail buyers with preferred couponing to meet their investment needs.

As a large and frequent issuer of municipal debt, New York City wants to keep abreast of the changing patterns of investor demand and try to meet that demand, according to the New York City Comptroller's office.

"Individual investors – who often live or work in our city – have always been important to the success of our bond sales," New York City Comptroller Scott M. Stringer told The Bond Buyer in a prepared statement. "We will continue to make a concerted effort to give individuals a fair chance to purchase bonds and invest in New York City's success."

The city recently drew substantial demand for 4% coupons that were included in its Aug. 2 GO sale of tax-exempt bonds totaling $800 million, according to data provided by the New York City comptroller's office.

The 4% coupons generated 51% of the $215 million taken during the two-day retail order period, while 37% were for the 5% coupons, and 12% were for the sub-4% coupons.

The strong demand for 4% coupons comes in response to the absolute low level of interest rates, the comptroller's office said. There is a particular effort by professional retail investors, such as money managers, financial advisors, and trust departments acting on behalf of individuals, to avoid the higher dollar prices associated with 5% coupons, which was the dominant coupon structure up until three to four months ago, the comptroller's office said.

On the city's GO sale, retail investors veered from recent buying patterns and participated in longer maturities in order to get higher yields – even if it meant accepting lower than the 5%

coupons they previously favored, an underwriter involved in the deal said after the pricing.

The retail crowd chased the 3% and 4% "handles" available in 2029 with a 2.07% yield and 2036 with a 2.78% yield. They even participated in the 2039 maturity, which had a split 3% and 4% coupon yielding 2.90% and 2.71%, respectively, he said.

"The market acceptability of sub 5% is becoming more and more prevalent," the underwriter added. "With absolute yields as low as they are people are sacrificing a little less coupon to pick up a little more yield to the call."

Since 5% coupons once dominated the market, retail investors also have an increased need for coupon diversify away from the previous market standard, the comptroller's office noted.

At the same time, the city benefits from having lower coupons, such as 4% coupons, which are priced as premiums to a call date with a slightly higher yield, and act as a natural hedge against rising interest rates versus the 5% coupons, the comptroller's office said.

Other issuers around the country are also tailoring their coupon structures for retail, while also achieving some cost savings of their own.

"The Connecticut State Treasurer's Office structures its bond sales to meet the preferences of a variety of investors and to strike a balance between current and future debt service costs for the general obligation program," Deputy State Treasurer Lawrence A. Wilson said in an email on Wednesday.

"We also are mindful that many retail customers prefer to purchase bonds with coupons of 4% or lower in order to avoid the higher prices associated with 5% coupons," he said. "Some institutional customers also prefer to purchase bonds with lower coupons," he added. "We structure our bond sales with a variety of coupons accordingly."

For instance, he said Connecticut's recent new issues have been structured with lower coupons to both accommodate retail investors' cost efficient strategy, as well as to manage the state's future debt costs.

"The lower coupons also allow us to balance current and future debt service costs, particularly for our general obligation bond program, for which premium must be used to cover near-term interest costs," Wilson explained. "Because of this, the budget impact of selling 5% coupon bonds at a premium is lower debt service in the short-term, but higher debt service in the future."

Therefore, selling lower coupon bonds for the GO program helps the state manage future debt costs, Wilson added.

For example, of the $250 million in tax-exempt GO bonds the state sold earlier this month via competitive bid at record low rates, he said $100 million, or 40%, of the bonds were assigned coupons of 4% or less by the winning bidder.

Additionally, when the state sold GOs back in May, of the $57 million in orders from retail investors during the retail order period, $29.1 million, or 51%, of those orders were for 4% or lower coupon structures, according to Wilson.

Of the total $501.4 million of bonds sold, $114.6 million, or 23%, of the bonds were sold with 4% or lower coupons to both retail and institutional investors, he added.

Wilson noted that Connecticut two decades ago was one of the first states to pioneer the now widely-used retail order period as a marketing technique and still gives its in-state residents priority status on bond issues.

Like Connecticut, New York City makes frequent use of retail order periods and makes an effort to offer a variety of coupons to their loyal, mom and pop investors, while also giving their orders preference over institutional orders when it comes to new issues, the comptroller's office said.
