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More M&A Seen Among Underwriters as Costs Increase.

LOS ANGELES – As underwriting fees on municipal bonds continue to decline and compliance costs rise, mergers and acquisitions offer firms a way to better manage these challenges.

The trend of lower underwriting spreads is nothing new, as underwriters have been dealing with declining fees since the 1980s. However, following the financial downturn, firms have been faced with the growing costs associated with an increase in rulemaking and regulation.

A handful of mergers and acquisitions among underwriting firms have been announced lately, including the recent acquisition of Los Angeles-based public finance investment banking boutique De La Rosa & Co. by Stifel Financial Corp., the parent company of Stifel, Nicolaus & Co.

“I think firms are trying to find ways to deal with the increased costs imposed by new regulatory and compliance requirements,” said Chris Mier, chief strategist and director of the analytical services division at Loop Capital Markets. “One way is through mergers, but there are others.”

Mier said greater costs from such requirements show up in the form of expensive compliance-related software, having to hire additional compliance and legal staff, outside legal counsel, and consulting costs, among others.

While the acquisition of De La Rosa & Co. will certainly help manage compliance costs, the decision to join Stifel was “a proactive one that reflected an optimism and belief in the strength of the California market,” according to the firm’s president, Ed De La Rosa.

After starting the company 25 years ago and growing it to become one of California’s top underwriters, De La Rosa said he began to notice that other competitors in the top ten were large global firms or publicly traded companies.

“We felt that if we were going to continue to grow in this market, and to gain more market share against these competitors, we needed to get our hands around more resources and more capital to offer to our clients,” he said.

De La Rosa, which focuses solely on the California market, ranked 11th among senior managers in the state in 2013, according to Thomson Reuters data.

Stifel, which acquired the eight-decade-old California municipal bond underwriting stalwart Stone & Youngberg LLC in 2011, ranked number seven.

About two years ago De La Rosa realized that his firm could not achieve its goals solely through organic growth, and began looking around for other opportunities. By the fall of 2013, he said his company had a number of offers to consider but Stifel was the best fit.

“We came to admire the amount of goodwill they’ve developed in California, because of their reputation for excellence in financial matters, for their creativity and for their ethics,” De La Rosa said of both Stone & Youngberg and Stifel professionals. “These are the same attributes we’ve

always aspired to, so it seemed that the combination of De La Rosa with Stifel and its California presence would be very powerful."

Of course, one advantage of combining resources with a larger firm is having more resources to help deal with some of the growing costs in the industry.

"It will be tremendously beneficial to have a larger compliance and legal department that covers the needs of all securities firms under the Stifel umbrella who can help with that — they can bring expertise and help spread the costs," De La Rosa said.

This is particularly important in the new regulatory environment because the burden is increasingly on the dealer to prove that they've complied with trading rules and due diligence rules, he said.

"All dealers have had to adopt policies and procedures and processes by which they monitor the activities of their professionals," De La Rosa said. "They've had to beef up the number of staff so they can demonstrate compliance when they get audited by [the Financial Industry Regulatory Authority] or the [Securities and Exchange Commission]."

To deal with falling underwriting spreads — which have been declining ever since De La Rosa started his company in 1989 — he said the smart market participants will always find a way to serve that market in the most economical way so they can operate profitably.

"We've always managed our costs and arrayed our resources so we could provide value-added service, ideas and products within the existing fee structure at the time," De La Rosa said. "That's been a big part of our recipe for success, and I expect that Stifel will help us to become even more efficient in this area."

Other movement among underwriting firms includes the acquisition, completed in July, by Minneapolis-based investment bank and asset management firm Piper Jaffray of Seattle-Northwest Securities Corporation, a Seattle firm with a homegrown focus on underwriting and advising on municipal bonds in the Northwest.

Piper Jaffray ranked 10th among senior managers in 2012, with 568 issues totaling $9.3 billion. Seattle-Northwest ranked 29th with 101 issues worth $1.8 billion. In 2013, Piper Jaffray moved up to the ninth spot with $11 billion in 624 issues.

In April 2012, Raymond James Financial, ranked 15th among senior managers in 2011, acquired Morgan Keegan, which held the ninth spot. The following year, Raymond James moved up to ninth place.

In a more recent move, M.R. Beal's founder, Bernard B. Beal shuttered the firm and moved, along with several employees from the company, to join Oakland, Calif.-based investment bank and financial services company Blaylock Robert Van LLC.

Beal will serve as chairman of Blaylock, and oversee the firm's municipal banking, underwriting, sales, and trading activities.

The firm has been renamed Blaylock Beal Van, LLC, pending regulatory approval.

M.R. Beal ranked 13th among co-managers with 218 issues totalling $47.4 billion in 2013. Blaylock was 40th, with 33 deals totaling $11 billion.

Among all senior managers, Beal ranked 35th, and Blaylock ranked 144th.

“One of the biggest costs of business right now for a firm is their legal and their compliance costs because regulators are putting more regulations on the board,” said Peter Stare, senior vice president at First Southwest. “There’s the Dodd-Frank Act that we all have to deal with, and the staff that you have to have to manage those things is constantly growing.”

Under Dodd-Frank, the Securities and Exchange Commission approved final rules that require municipal advisors to register with the commission if they provide advice to municipal entities on issuing bonds or other investment strategies.

The rule will affect financial advisory firms as well as many broker dealers involved in advisory work. It goes into effect on July 1.

Other regulations that firms are dealing with include a Volcker Rule that does not exempt tender option bonds, Basel III, which imposes new capital and liquidity rules on banks, and Rule G-17 of the Municipal Securities Rulemaking Board, which requires dealers to request issuers to acknowledge a receipt of disclosure.

Michael Decker, managing director and co-head of municipal securities at the Securities Industry and Financial Markets Association, said he hasn’t seen any hard data on industry-wide trends in compliance costs, but based on many anecdotal stories he’s heard from SIFMA members, there is no doubt that compliance costs are increasing across the board.

“When we talk to managers at firms about what keeps them up at night, it’s typical that the number one answer is costs of compliance and understanding and managing new regulations,” he said. “That is an overriding concern for managers of broker dealer firms.”

The new regulations generally impose record-keeping and documentation requirements and surveillance requirements, which require additional personnel, he said.

And there is also the possibility that a firm could be found in violation of any of the new provisions, in which case it could be subject to fines or limitations on its business. The costs associated with negotiating an enforcement action or responding to an enforcement action and the costs associated with managing the examination process are significant, he said.

“The spike in compliance costs probably affects small dealers more acutely because there’s a certain portion of costs that are fixed and they have to spread it a cross a smaller pool of revenue,” Decker said. “But it’s really an across-the-board issue, affecting big firms and small firms and it really is a very notable trend in the industry.”

A way that SIFMA tries to help the industry address these issues is through initiatives like model documentation, Decker said. This helps provide some standardization in terms of the documents the firms are using for compliance purposes and it also helps share the costs among firms of developing documentation and practices to help address compliance concerns.

“The trend of deregulation or light regulation of the industry is definitely past us,” Decker said. “The regulators are responding aggressively to the crisis and I think it’s likely that for the foreseeable future we’re going to see strong action by the regulators in terms of strengthening industry regulations.”

While the growing cost of compliance takes the spotlight in terms of major challenges facing the industry, it’s not the only one. Decker said that if he had to point to the second major challenge underwriters face, it would be risk management — managing a firm’s exposure and dealing with pressures whenever the market weakens.

“Costs are increasing for firms of all sizes,” said Mier. “Declining underwriting spreads and lower new issue volume put pressure on revenue. Everyone is being squeezed.”

The average fee state and local governments have paid underwriters on all bonds during 2013 to $4.92 from $5.56 the year before, according to Thomson Reuters data. That number was down from $5.65 in 2011 and $5.97 in 2010.

Spreads have come down almost 21% since peaking at $6.21 in 2009, after the economic downturn and global financial crisis, when deals were riskier to underwrite and fewer banks were competing for business.

Before that spreads had steadily declined from $5.73 in 2003 to $4.89 in 2008.

“Not only are spreads narrower but there’s less product to go around and that’s going to make for even more competition, which is going to compress spreads and compress rates further,” Stare said. “There are just not that many deals around anymore.”

Overall new issue supply was down 12.5% in 2013 to $334.6 billion from $382.4 billion in 2012, according to Thomson Reuters.

The decline was largely driven by a substantial drop in refunding deals as interest rates began to rise half-way through the year.

“There comes a point in time where your overhead just gets to be too much and you’ve got to look for other options, whether it be a strategic merger with another firm, or whether it calls for just closing the door,” Stare said.

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