Bond Case Briefs

Municipal Finance Law Since 1971

California Private Placement Market May Be Pivoting.

PHOENIX – The relatively opaque private placement market, which has been very strong in California, may be slowing down after years of growth and shifting from a totally bank-dominated market to a more diverse range of purchasers, market participants believe.

The line between a private placement of municipal securities and a more traditional bank loan is sometimes fuzzy and full of ambiguity over disclosure, but issuers have turned increasingly to both techniques in recent years because of the relative simplicity of dealing with only one investor or lender.

The limited disclosure requirements that apply to non-public offerings of municipal bonds, particularly to loans, make it difficult to pin down exactly how big the multi-billion dollar market is nationally or in the Golden State. Observers described evolving practices in California.

Banks have been ramping up their muni holdings, with Federal Deposit Insurance Corporation data showing that bank holdings of municipal bonds have risen from just over $270 billion in June 2013 to about $325 billion in June this year.

Banks have been attracted to the strong performance munis have provided and the better risk profile attached to municipal securities compared to other kinds of debt.

Data provided by Thomson Reuters shows that private placements of munis totaled about $24 billion in 2014, with California accounting for some $4.4 billion of that total.

That was up from just $1.8 billion nationwide in 2005, of which $277 million were in California.

As of Nov. 4, Reuters data shows that neither the nation nor California are on pace to reach last year's levels, with California's activity slowing more.

Total private placement volume through Nov. 4 sat at $15.4 billion nationally and at $850 million in California.

Roger Davis, a partner at Orrick, Herrington & Sutcliffe in San Francisco, said he and other lawyers at his firm have been involved in California private placements, sometimes as counsel to the issuer and sometimes as counsel to the purchaser of the securities.

He said such deals occur as they traditionally have, with unrated or lower-rated credits, but have also broadened to include more types of transactions and include all sectors.

"They're occurring both where you would expect them to and replacing more traditional financing," Davis said. "We see it in the general government area, we see it in healthcare, we see it in K-12 education."

Davis said private placements have long been a bank-dominated market, but in his experience may be pivoting a bit away from that.

"It may be the case that there are somewhat fewer of those," Davis said of bank direct purchases.

He said that he has seen an increasing number of purchases made by hedge and infrastructure funds.

Davis said it's not clear from his perspective whether the direct placement market in California is losing steam.

"I can't say that it's shrinking or growing," he said. "They're still a material factor in the market. It's hard to tell how material a factor they are."

Several market participants discussed the California private placement market in at The Bond Buyer's California Public Finance Conference last month in San Francisco, saying the market may have peaked a year or two ago.

Those discussions also indicated that between 15 and 20 banks are consistently active with private placements in the state.

Dmitry Semenov, vice president and commercial relationship manager at Umpqua Bank in Roseville, Calif., said he has seen a number of smaller commercial banks getting involved in the private placement market over the last couple of years.

The new competition has given issuers more access to inexpensive borrowing, but it is unclear how long that will last, Semenov said.

"They're aggressive," Semenov said of the new market entrants, adding that he has seen some examples of very loose covenants and a potential lack of due diligence. "Lots of cheap money."

Semenov said that his bank is very active in the private placement market, totaling about $500 million in the last five years. Private placements are used for almost everything now, he said.

"At this point it covers pretty much the entire spectrum of issuers," Semenov said.

Some private placements are more of a one-off from banks who generally don't do them.

C.J. Johnson, chief financial officer at Mechanics Bank, a community bank in the San Francisco Bay Area, said his bank's recent decision to purchase $3 million of social impact bonds in a private placement was not a normal part of Mechanics' business.

In that deal, Richmond, Calif. is issuer of $3 million of bonds with a 0% coupon for the Richmond Community Foundation to use to acquire abandoned houses and sell them to qualified low-income homebuyers. The deal is risky, as Mechanics only gets its potential 10% annual return on its $3 million of the project is a success.

The bank gets credit under the Community Reinvestment Act, which encourages financial institutions to meet the credit needs of their communities. Regulators take a bank's CRA performance record into account when considering an institution's application for deposit facilities.

"I would say we're not really active in this market at all," Johnson said when asked about private placement activity. "It's a little bit of a one-off."

Johnson said the bank was motivated more by the local community angle, calling the situation "unique."

“We’re a community bank, and this is our community,” he said of Mechanics, which has three Richmond branches.

Regulators are in the midst of trying to bring clarity to the private placement sector, where there is significant confusion and controversy.

Issuers and banks are often unsure of whether an instrument is a loan or a security subject to Securities and Exchange Commission and Municipal Securities Rulemaking Board Rules, and broker-dealer groups have said repeatedly that some municipal advisors are acting improperly as placement agents soliciting banks to participate in these types of non-public transactions.

Analysts have called for more prompt voluntary disclosure by issuers of all their debts.

The Government Finance Officers Association executive board recently approved a best practice document recommending voluntary disclosure of information on direct placements, loans, and other credit arrangements with private lenders or commercial banks.

THE BOND BUYER

BY KYLE GLAZIER

NOV 5, 2015 1:30pm ET