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Why Taxable Bonds are a Muni Market Fixture, Not a Fad.

AUSTIN — At 30% of issuance so far in 2020, taxable munis are here to stay and will continue to be a force in the municipal market unless tax law changes or rates rise dramatically.

Taxable issuance ballooned to about $70.5 billion in 2019, by far the highest level outside the two years Build America Bonds were sold, 2009 and 2010.

That amount represented nearly 18% of the muni market'stotal 2019 issuance.

Members of the taxable bond panel at The Bond Buyer's Texas Public Finance Conference this week were unanimous in saying taxable issuance totals will grow further and represent an even larger piece of the overall issuance pie in 2020 and beyond.

From a broadened buyer base that includes larger institutional and international investors, but extends to direct retail and separately managed accounts, taxable demand has dramatically changed the municipal market starting in the second half of 2019.

Tom Ryan, head of municipal bond valuations at Refinitiv, noted that instead of typical crossover buyers, the market now has "crossover issuers" because they can truly take advantage of both markets in this rate environment.

Dan Bingham, head of institutional markets at Build America Mutual, said the taxable issuance boom has attracted a much larger investor base, including a growing number of institutional and international buyers.

Bingham said that in the BABs era, the investor base was broadened but when the program expired, the market went back to very limited issuance of taxables.

"With that said, we are even seeing smaller issuers selling taxable deals," he said. "Ultimately, we are seeing a much healthier environment" for all issuers.

The prospect that smaller issuers can access direct retail and SMA accounts engaged with the yield pick-up that can be found in the taxable space, is compelling, he said.

"Larger deals, recognizable names, index eligible deals — you've got a lot of institutional accounts that are much more apt to participate in this market," Bingham said. "International accounts are participating in the municipal market to a level we haven't seen before."

Low absolute rates across the globe are helping.

As the percentage of taxable deals relative to the total market continues to expand, they are becoming easier to understand from an international investor perspective, given some of the protections that are provided in the offering documents.

Investors are "looking for anything they can pick up spread," Bingham said.

The supply/demand mismatch, tremendous cash coming into the market via tax-exempt mutual fund inflows and compressed spreads on the tax-exempt side of the market are leading to a perfect environment for issuers to take advantage of the taxable market, Patricia McGrorry, managing director at Ramirez & Co., said.

“Across the curve there are buyers for every credit and every credit spectrum,” she said. There are definitely different buyers for those smaller deals and different liquidity requirements, but “there’s always a spread for everything.” While she said that smaller issuers might face some concessions for a taxable deal less than, say, $25 million, it depends on the market conditions, such as what other taxable deals are being priced on a given day among other factors.

And the traditional municipal 10-year call is making the leap into the taxable space.

Panelists noted that prior to the recent market conditions, investors would charge at least a 35 to 40 basis point premium on a taxable 10-year callable deal. Today, the cost of the call is about 18 to 22 basis points. “That has changed pretty meaningfully,” Bingham said.

McGrorry said the investor perception has changed and that “if you build it, they will come.” The 10-year call option that many taxable municipal deals use is less of a deterrent in the current market than a few years ago.

Investors are “going to have to buy it if they want to participate. The penalty is credit specific and name by name recognition, and the 10-year call penalty will be less.

Ryan noted that while the global demand is strong, it is “surprising to me that taxable investors aren’t penalizing issuers more.”

With that, Ryan said issuers could even test the market with a seven-year call. In this market, investors are thinking, “do I actually care about the call option?”

Having more optionality is better for issuers and they should “call their bankers.”

Bingham noted there are three ways of dealing with the lack of exempt advanced refundings: access it through a forward-delivery deal, a taxable refunding, or waiting.

“The value of savings today are too strong to wait,” he said.

Barbara League, partner at law firm Orrick, Herrington & Sutcliffe, noted that she is seeing more inquiries into different structures to take advantage of low rates. Aside from issuing taxable bonds to refund exempts, she is seeing more forward-delivery bonds, certain swap structures, tender rights.

“How can we recreate what we lost? The best way we can recreate is to bring back what we lost,” but that does not seem to be a likely scenario, she said.

One area that the participants agreed was that taxable issuance has pressured the exempt market significantly but that threats to removing the exemption at the federal level should not be considered.

Shannon Albert, Senior Director, Treasury & Assistant Treasurer at San Antonio’s municipal CPS Energy, said even outside of the current taxable environment, “there is always that risk.”

As a utility that issues a lot of tax-exempt debt, she said market participants have an obligation to do “everything we can to educate our legislators” on the exemption. “We use taxable as a tool in our toolbox. We look at strategically to see what the most makes sense," and there are multiple considerations to how she plans her bonding program.

"Issuing taxable debt sometimes is a better choice for us," however, the exemption is integral to her debt portfolio. The exemption provides significant savings over long periods of time and will cost communities largely if it were to be taken away.

"I feel like we have an obligation to give [lawmakers] a hard time," she said.

By Lynne Funk

BY SOURCEMEDIA | MUNICIPAL | 02/27/20 03:01 PM EST

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