

BIG BANG IN PUBLIC FINANCE:

California government officials must have felt unwanted after several major investment bankers withdrew from the municipal-bond field. Fear not, bond issuers; plenty of bankers are clamoring for your business.

By LORI RAINERI

On Monday, Oct. 13, Salomon Inc., one of Wall Street's largest securities firms, closed its municipal finance department. The following day, Kidder, Peabody & Co. announced that it would cut 100 employees in its 280-member municipal bond group. Two weeks later, L. F. Rothschild decided to stop underwriting municipal bonds.

Earlier this year, employees of several other large firms endured reorganizations, transfers and dismissals in their public finance departments. Rumors persist that nearly every major Wall Street municipal operation faces cutbacks.

Government officials are asking why the major financiers in this country don't want to do business with them. The answer is that the major leaguers don't play in the minor leagues and never have.

Public finance is not as profitable as corporate finance for a large investment bank. With the same time and effort that it takes to put together a \$2 million assessment bond issue to finance street improvements, an investment bank can put together a \$100 million takeover bid for a corporate raider.

Because investment banks usually charge a percentage of the total financing (underwriting discount), larger financings mean larger profits. Furthermore, corporate clients are generally willing to pay their investment bankers more than public clients. Public finance can't compete with corporate finance at a large, diversified investment bank.

The profit disparity between corporate finance and public finance has been further aggravated by the Tax Reform Act of 1986. As most public officials are aware, the Act greatly reduced the volume of tax-exempt bond issues.

Furthermore, there was an artificial increase in tax-exempt volume immediately prior to the passage of the Act. Long-term tax-exempt issues ballooned from \$83.3 billion in 1983 and \$101.8 billion in 1984 to \$203.9 billion in 1985, as

public issuers rushed to beat anticipated tax law changes in the Act.

Consequently, many firms expanded their staffs to meet this temporary surge in the market. With the drop in volume to \$142.5 billion in 1986, the public finance industry had more people chasing less business. Public finance became much more competitive, and most firms were forced to reduce their underwriting discounts to maintain market share.

This resulted in suicidal price cuts, with underwriting discounts dropping from an average underwriting fee of 2.1 percent in 1985 to 1.5 percent in 1986. With such small returns available in the municipal market, it became an unattractive business for large Wall Street investment banks whose other operations are much more profitable.

Despite the recent retreat from public finance by some of the largest investment houses, most local government issuers in California will be unaffected. Many local agency bond issues are underwritten by investment banks which specialize in public finance or commercial banks, and these players are still very much in the game.

Typically, underwritings by the large Wall Street firms are for the largest public agencies in the country, such as the state of California and Los Angeles County. These are the public finance clients with the stature to command the attention of Wall Street.

For example, in 1986 Salomon underwrote 16 bond issues for only six California issuers totaling over \$2.4 billion. Six of these issues were for the Los Angeles County Industrial Development Authority, and five were for the Southern California Public Power Authority.

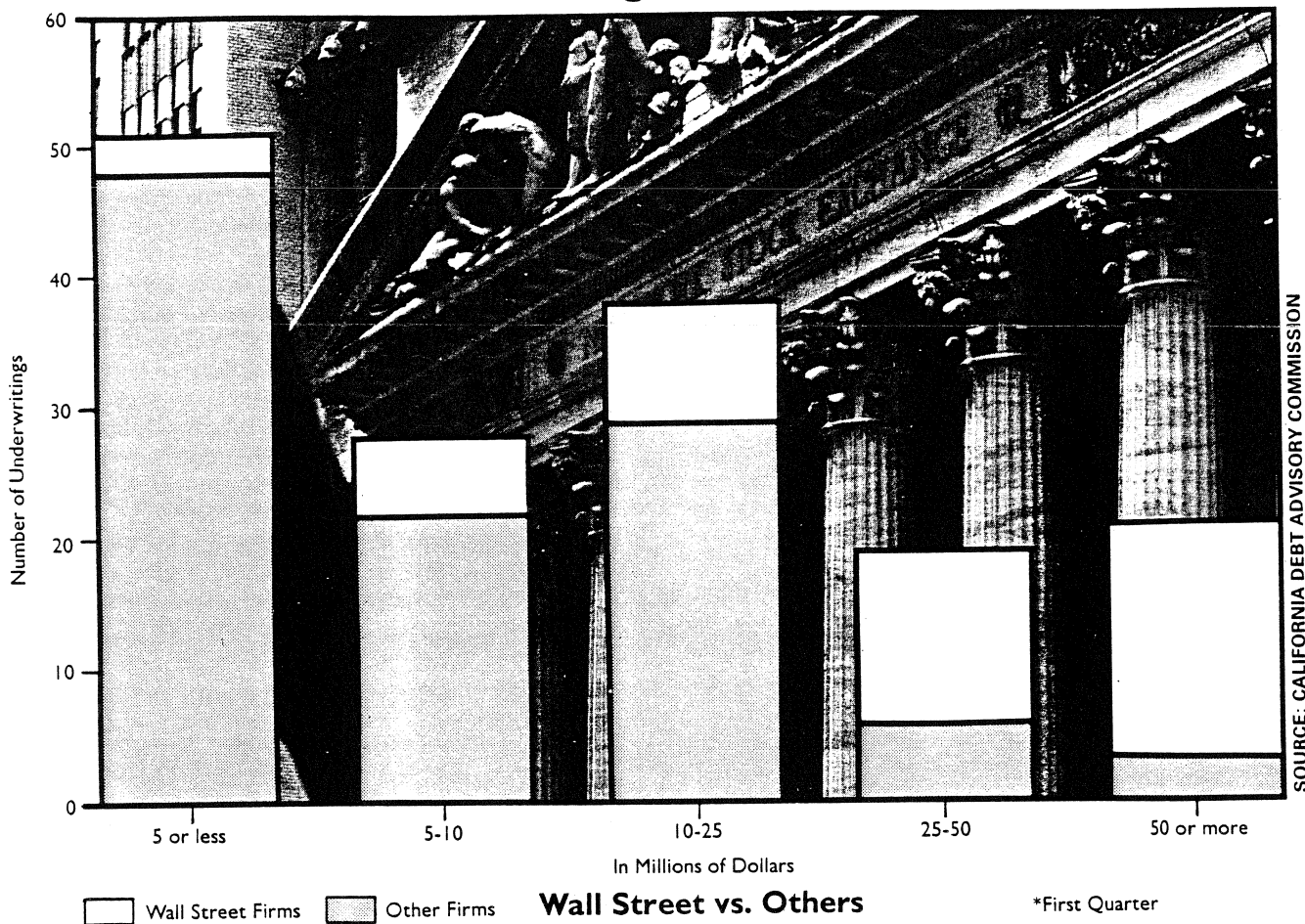
L. F. Rothschild's California underwritings totaled almost \$1 billion; but there were only seven bond issues, all for state agencies. Wall Street has traditionally not been involved in the low-margin business of local-government finance.

Clearly, the public finance industry has two distinct clienteles: large public agencies with large bond issuances and smaller local governments. During the first quarter of 1987, there were 157 negotiated underwritings totaling

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WHY WALL ST. SOUNDED RETREAT

1987 California Negotiated Underwritings*



over \$5 billion. About 75 percent (117) of these bond issues were under \$25 million. Thirteen, or 8 percent of these bond issues were for more than \$100 million. However, the 13 issues represented 60 percent of the total volume of \$5 billion.

Not only does public finance have two clienteles, but these clienteles are served by different types of investment bankers. As discussed previously, Wall Street investment banks typically underwrite large bond issues for large public agencies. Smaller governments in California are served by commercial banks and investment banks specializing in public finance.

Commercial banks and specialty investment banks generally have lower overhead and fewer competing business opportunities than Wall Street firms, and are therefore willing to underwrite at a level which is affordable for local governments. In the first quarter of 1987, Wall Street firms underwrote just 31 percent of the bond issues, almost all for the largest public agencies in California. Because these agencies

issue in much higher amounts than most local governments, these transactions represented 76.6 percent of the total volume. As can be seen in the chart, Wall Street firms have an almost insignificant market share for issuances under \$25 million, but dominate the market for transactions over \$50 million.

The absence of Wall Street firms from public finance will have little impact on most local government agencies in California because they weren't being served by Wall Street firms. The regional and specialty investment banks and commercial banks, which have been underwriting the vast majority of bond issues in California, remain in the public-finance business.

The large public agencies are losing some of their primary investment bankers. These agencies will now be forced to choose between those Wall Street firms remaining in the public-finance field and the California commercial banks and specialty investment banks which previously have specialized in relatively small issues. ■