REPORT FROM

OFFICE OF THE CITY ADMINISTRATIVE OFFICER

Date: February 9, 2007

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Council File No. 06-2627
Council District:

To: The Mayor
The Council

From: Karen L. Sisson, Interim City Administrative Officer

Reference: Letter from Mayor, dated November 7, 2006, and letter from Councilman Jack Weiss, dated November 20, 2006

Subject: **Independent Review of Municipal Improvement Corporation of Los Angeles (MICLA) Lease Revenue Bonds, Series 2006-A (Police Headquarters Facility and Public Works Building) Financing**

SUMMARY

The City Administrative Officer (CAO) was requested by both the Mayor and Councilman Jack Weiss to prepare an Independent Review of the Municipal Improvement Corporation of Los Angeles Lease Revenue Bonds, Series 2006-A (Police Headquarters Facility and Public Works Building) (MICLA 2006-A) Financing. As the City had a qualified list of financial advisors approved by the Mayor and Council (C.F. 03-2637), the CAO chose Gardner Underwood and Bacon LLC (MBE) (Gardner) to prepare the study. The Independent Review is attached (Attachment A).

The MICLA 2006-A negotiated sale took place on November 30, 2006 and closed on December 14, 2006. The assignment to complete the study began on December 18, 2006 with a completion date of January 23, 2007. The MICLA 2006-A True Interest Cost (TIC) is 4.39% with the first debt service payment beginning in June 2006 for $2.6 million.

Gardner provided an independent review and analysis of the MICLA 2006-A pricing by analyzing the municipal market and its impact on the financing, analyzing comparable sales in the market, and reviewing the results of each of the four underwriting firms. Gardner also analyzed the success of the City's reason for a negotiated sale, which was the inclusion of smaller local and regional firms, specifically, how the inclusion of these firms impacted the City's financing, and analyzed the distribution of compensation to determine if the City achieved its desired goal.

Gardner did not discuss the merits and drawbacks of a negotiated versus a competitive sale nor included its views on a preferred method of sale. The Mayor and Council have requested a report on new policies for the use of negotiated and competitive sales. The CAO will discuss those issues in a future report.

Market Analysis

Gardner concluded that the City's negotiated sale of the MICLA 2006-A bonds was successful as evidenced by lower yields compared to similar California issues priced that week. Gardner stated that most of the success was due to the execution of the underwriting team, a slightly higher underwriter discount resulting in more attention and aggressive selling by the underwriting firms, and the following:

- **An advantageous market, declining to some of the lowest interest rates of the year.** Both weak economic indicators and declining interest rates combined to lower interest rates for the City. The changing market conditions at the time of pricing were crucial to the lower yields. The market and economy moved in the City's favor, which would have produced the lower yields regardless if the bonds were sold on a negotiated or a competitive basis.

- **Movement of pricing from November 29 to November 30, 2006.** Since many large issuers sold bonds that week, the one-day move allowed for fewer competing issues. The senior manager's decision resulted in stronger results. It is easier to change dates with a negotiated sale, as a competitive sale would have required 24 hour notice making it harder for last minute adjustments.

- **Extensive pre-marketing and a retail order period by underwriters.** The pre-marketing made investors more aware of this sale and resulted in the participation of over 26 institutional investors. In addition, the retail order period the day before the sale brought in investors less sensitive to pricing. The combination of institutional competition and the retail order period gave the City significantly lower yields. This diversification of investors is not typically attained in a competitive sale.

- **Strong demand for the City's bonds.** The City benefited from strong investor demand for its bonds resulting in lower yields. On some maturities, the City was oversubscribed nearly two times. This resulted in re-pricing the bonds and lowering them by two to four basis points, depending on the maturity date. The demand was independent of the sale method, although more investors were targeted using a negotiated sale.

- **Structure of bonds saved the City money.** The ability of the senior manager to split various maturities (bifurcate) into two separate coupons and yields produced lower costs by appealing to different investors with different preferences. In one maturity, the senior manager trifurcated a maturity for a specific investor. Otherwise, this maturity would not have had enough orders. According to the senior manager, this saved the City $4.9 million in debt service payments over the life of the bonds. This specialized structure may not have occurred under a competitive sale.

City Goal of Smaller Firm Participation

The negotiated sale allowed the City to meet its policy goal of smaller and local firm participation through the group net designation for institutional sales. Group net designation means that the liability taken on by a firm, say 30%, is the amount of compensation received. For the retail order period, the firms received compensation based on the orders sold to their retail clients. The chart below reflects both institutional and retail sales combined.

	City Goal	Fee*	Total Fee Paid*	Retail Orders	Institutional Orders	Total Orders	Bonds Allotted
De La Rosa & Co.	30%	38%	$426,263	78%	82%	66%	85%
Seibert Brandford Shank & Co.	30%	26%	$286,300	0%	16%	20%	10%
Merrill Lynch	20%	19%	$213,050	11%	2%	12%	3%
Lehman Brothers	20%	17%	$195,875	11%	0%	2%	2%

*Represents both Institutional and Retail Sales combined.

Debriefing Comments

After the sale, the CAO had a series of debriefing meetings with each underwriter and the financial advisors. Below are the comments from those debriefings, as reported by Gardner:

- Three of the four underwriters believed that the negotiated sale went well and the City achieved the lowest cost. One firm mentioned that the City should continue to use competitive sale, to achieve the lowest cost.

- The majority of the retail orders were filled by the senior manager who is not traditionally known as a leading California retail firm. This was due in part to the expanded definition of retail to include individual investors, investment advisors and bank trust departments with no order over $1 million. Both Merrill Lynch and Lehman performed well as co-managers during the retail order period.

- One firm suggested that the senior manager should have started the order period at market opening, 6:00 a.m., versus 7:30 a.m. PST.

- One party observed that it took longer than normal for the senior manager to calculate the final numbers. It was unclear if this was due to the complexity of the financing, the limited experience with large issues or the differing software program between the financial advisor reviewing the numbers and the senior manager.

- One underwriter was concerned that the senior manager was not a national firm with the capital to solely underwrite the bonds. As the City had allocated 30% of the liability to the senior manager, this was not an issue as this would have been the maximum liability. The firm's capital was sufficient.

Gardner's Conclusions

Overall, Gardner concluded that the City received "excellent results using the negotiated sale method for this specific transaction." Gardner's conclusions are as follows:

- Given the changing market conditions at the time of pricing and the senior manager taking advantage of certain aspects of a negotiated sale, in the market that day and for the MICLA 2006-A transaction, the City received better results using a negotiated method of sale.

- Despite this financing's success, the benefits of negotiated sale can not be generalized. If rates and/or the economy had moved in the opposite direction, the underwriters may have had difficulty absorbing the downturn and could have resulted in higher rates than a competitive method of sale.

- Regardless of the timing and market conditions, the negotiated sale process did allow the City to achieve its public policy goal of smaller local and regional firm participation, which the City had not achieved with competitive sales.

- The method of sale should be carefully determined on a deal-by-deal basis.

CAO's Observations

The CAO agrees with Gardner's conclusion that the City received excellent results in the MICLA 2006-A financing as evidenced by the low TIC of 4.33% for 30 year bonds. The last financing the City did was the Solid Waste Resources Revenue Bonds, Series 2006-A for a TIC of 4.21% for 18 year bonds in September 2006. Gardner mentions that the pre-marketing allowed for many of the bonds to be oversubscribed. This can also be attributed to the City's high credit rating and demand for the City's bonds by investors. The City's success from this negotiated sale can be repeated with a process that will allow for the best syndicate for that particular type of bond. The CAO is currently developing policies on the Negotiated and Competitive Methods of Sale as well as a Request for Qualifications for underwriters with specific criteria that will allow for the best syndicate in a negotiated deal.

RECOMMENDATIONS

That the Council:

1. Receives and files the Independent Review of the Municipal Improvement Corporation of Los Angeles Lease Revenue Bonds, Series 2006-A (Police Headquarters Facility and Public Works Building) Financing.

2. Instruct the City Administrative Officer to use the Independent Review of the Municipal Improvement Corporation of Los Angeles Lease Revenue Bonds, Series 2006-A (Police Headquarters Facility and Public Works Building) Financing as a reference in developing the City's Negotiated and Competitive Bond Sale policies.

FISCAL IMPACT STATEMENT

There is no impact on the General Fund as a result of filing the Independent Review of the Municipal Improvement Corporation of Los Angeles Lease Revenue Bonds, Series 2006-A (Police Headquarters Facility and Public Works Building) (MICLA 2006-A) Financing. This report is in compliance with the City's Financial Policies.

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Attachment

Attachment A

January 19, 2007

Ms. Natalie Brill
Debt Administration
City Administrative Office
City of Los Angeles
200 N. Main Street Suite 1500
Los Angeles, CA 90012-4137

RE: $448,595,000 Municipal Lease Revenue Bonds, Series 2006A (Police Headquarters Facility and Public Works Building)

Dear Natalie,

Enclosed please find our independent analysis of the pricing for the above-referenced financing. We have attached a summary pricing analysis that provides an overview of our findings and a PowerPoint presentation that contains background information and referenced material.

Please feel free to contact me with any comments or if you need further clarification on any information. We appreciate working with the City on this assignment and hope to continue our relationship in the future.

Sincerely,

Lisa A. Smith
Principal

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Summary Pricing Analysis
$448,595,000
Municipal Improvement Corporation of Los Angeles
Lease Revenue Bonds, Series 2006A
(Police Headquarters Facility and Public Works Building)

Background

The City of Los Angeles (the "City"), through its Municipal Improvement Corporation of Los Angeles ("MICLA"), priced $448,595,000 in lease revenue bonds on November 30, 2006. The bonds were issued to provide funds for the construction and completion of the new police headquarters facility and the acquisition and renovation of a public works building. The proceeds of the sale were also used to retire outstanding commercial paper used for both facilities. Over the past decade, the City has predominately sold lease revenue bonds on a competitive basis, but chose to utilize a negotiated sale for this transaction.

In conjunction with this pricing and the use of the negotiated sales process, the Mayor and the City Council requested an evaluation of this bond financing by an independent financial advisor. Gardner, Underwood & Bacon LLC ("GUB") was hired to provide this independent analysis.

GUB's goal is to provide an objective, third party review of the municipal market during the week of pricing and based upon this market information determine if the City received a fair pricing. We have focused on analyzing this transaction as it relates to similar financings priced in the marketplace during the same week. We have not included in this analysis a general overview of the merits and drawbacks of a negotiated versus a competitive sale, nor have we included our views of a preferred method of sale.

Basis of Analysis

The City's overall goal for the selected financing team was to attain the lowest cost financing. GUB analyzed many factors to determine the success of the financing. The most effective and predominant measure is to compare a financing's yield spread to the Municipal Market Data ("MMD") index. MMD is a composite index of tax-exempt, long term, AAA-rated State general obligation bond yields.

Many variables impact a financing's yield spread to MMD. As such, we not only analyzed the changes in the municipal market and its impact on the financing, but we also analyzed comparable sales in the marketplace, the breakdown of sales by investor type and the marketing results of each underwriting firm. Additionally, we analyzed the catalyst for and the success of the City's predominant reason to have a negotiated sale; the inclusion of local and regional firms and how their inclusion impacted the City's financing. Also included in this analysis is the distribution of compensation to determine if the City's desired percentage goals were met.

Analysis of Financing

Based on market data and industry comparables, the City had successful results from the sale of its MICLA's $448,595,000 Lease Revenue Bonds, Series 2006A.

These results are evidenced by the lower yield spread to MMD as compared to similar California issues priced during the week. Overall, the City's financing outperformed all of the other large financings issued in the market for that week. The most direct comparison that illustrates the City's success is the County of Los Angeles' lease revenue financing that priced on November 29, 2006. Overall, on an adjusted basis to account for changes in daily interest rates, the City's MICLA financing had lower spreads to MMD in almost every maturity as compared to the County's transaction. Most of this success is attributed to the execution of the underwriting team. Another perceived factor is the slightly higher underwriter discount paid in the City's transaction that resulted in more attention and aggressive selling by the underwriting firms resulting in lower overall costs on the financing.

We have highlighted below the various factors that contributed to the success of the financing. It is important to note that some of these factors were a direct result of a negotiated sale and controlled by the underwriting team while others were interest rate driven and a direct result of the market. Interest rate changes can not be timed and though they had a positive impact on this specific transaction, they could have just as easily moved in the opposite direction and negatively impacted the financing.

-Advantageous market movement during the week

During the week of pricing, major market indices (10 and 30 Year Treasuries and MMD) declined to some of the lowest rates for the year. Economic indicators for the week also came out weaker than expected. The City benefited from the declining interest rates and weakening economy by achieving lower interest rates on its bonds. As an example, MMD fell four to eight basis points during the week of pricing which directly lowered the yields for this financing. This market impact would have lowered yields if the bonds were sold either on a negotiated or competitive basis.

-Movement of pricing day

The movement of the pricing from November 29, 2006 to November 30, 2006 allowed the City to issue bonds on a day in the market with fewer competing issues. Sales volume of long term bonds for the week was over $13 billion with California issues representing $3 billion. The senior manager chose to price the MICLA financing at the end of that week after the majority of the larger California transactions had priced. Typically, it is easier to change pricing dates in negotiated sales as there are no requirements or restrictions. Though it can be done, changing the pricing date for a competitive sale requires a minimum 24 hour notice making it much harder to make last minute adjustments due to market changes.

-Extensive pre-marketing and retail order period by underwriters

Premarketing by the underwriting team made the investor market aware of the transaction ahead of time resulting in strong participation from over 26 institutional investors on the transaction. In addition, to further lower yields, a retail only order period was held on November 29th for the 2008-2017 maturities. Retail investors tend to be less price sensitive than

institutional investors which translates to lower yields to the City. Incorporating the retail order period in the financing provided the City with significant economic benefit. This diversification of the investor base could not typically be attained in a competitive sale.

-Strong demand for City's bonds resulted in a re-pricing

Strong investor demand for the City's debt contributed in lowering the interest rates. The pricing was so successful that it was nearly two times oversubscribed resulting in a re-pricing of the institutional as well as retail orders. Interest rates were reduced up to four basis points for the retail targeted bonds and one to two basis points for the longer maturities.

-Restructuring and bifurcation of bond coupons (and trifurcation for one maturity) during the pricing saved the City money

The ability of the senior manager to offer two separate coupons and yields on various maturities allowed for the City to obtain orders from different investors desiring different preferences. This ensured placement of bonds and lower yields. In addition, the senior manager even trifurcated one maturity to tailor it for a specific investor. If this had not occurred, there would not have been enough orders to fill this maturity. Per the senior manager, the bifurcation of bonds saved the City $4.9 million over the life of the financing. Similar conversations and requests by investors would be difficult to accomplish in a competitive sale.

Historical Analysis

In order to thoroughly analyze the success of the transaction, GUB wanted to not only compare the financing's yield spread to MMD to other current comparable financings, but also to other historical MICLA transactions. Our goal was to determine if there is a discernible difference between the yield spread of this negotiated transaction to the prior competitively sold transactions.

GUB gathered and analyzed pricing data and yields on all MICLA transactions over the past five years to determine if there has been any consistent spread to MMD or pricing trend that the City received. Our initial analysis showed that the yield spread to MMD varied among all of the issues. We segregated these historical transactions by maturity, by par amount and by issue type (real property or bond transactions considered to have an "essential" purpose by the marketplace versus equipment financings) and still found no consistent trend or spread. As a result, we were unable to quantify how selling this transaction on a negotiated basis impacted the City's yield spread to MMD.

Distribution of Bonds

The financing was almost two times oversubscribed with $768,888,000 orders for $448,595,000 in bonds. The distribution of bonds by investor type was as follows:

$353,450,000 in institutional orders (79%)
70,885,000 in retail orders (16%)
24,260,000 in member orders (5%)

Results of Underwriting Team

Overall, the underwriting team performed well as evidenced by the low yields the City received on the financing. In addition, the City's use of a designation policy that incorporated group net designation for institutional sales allowed the City to distribute the economics of the transaction for the institutionally placed bonds in accordance with its desired percentages. A breakdown of the designation policy is as follows:

Manager	Liability %	Liability
De La Rosa & Co.	30.00%	$134,578,500
Siebert Brandford Shank & Co.	30.00%	$134,578,500
Merrill Lynch	20.00%	$89,719,000
Lehman Brothers	20.00%	$89,719,000
Total	**100.00%**	**$448,595,000**

The ability to guarantee the distribution of compensation, which could not be achieved under a competitive sale, insured that the City's public policy goals were met. Listed below is a brief synopsis of each firm's performance:

De La Rosa & Co. – The senior manager received 38% of all fees for the financing ($426,263) mainly due to their strong participation in the retail order period. DLR received 78% of all retail orders, 82% of all institutional (group net) orders and 7% of all member orders. Their strong marketing represented 66% of total orders. DJR was allotted 85% of all bonds.

Siebert, Brandford Shank & Co. – Not a retail firm, SBS, focused its efforts on institutional orders. They generated 16% of all institutional (group net) orders and 47% of all member orders. SBS performed particularly well in the 2027-2037 maturities helping to ensure a successful underwriting. They contributed to 20% of all orders and were allotted 10% of all bonds. SBS' total compensation was $286,300 or 26%.

Merrill Lynch – Merrill Lynch is a strong retail firm that had 11% of all retail orders. Additionally, ML had one order representing 2% of all institutional (group net) orders and 5% of all member orders. Overall, ML performed well as a co-manager generating 12% of all orders and being allotted 3% of all bonds. Their compensation was $213,050 or 19% of the total.

Lehman Brothers – Lehman used its strong retail network and solely focused on this market segment to represent 11% of all retail orders. Their performance solely in the retail market segment resulted in generating 1% of all orders and being allotted 2% of all bonds. This translated to $195,875 or 17% of total compensation.

Comments/Suggestions

After the pricing concluded, City staff and the transactional financial advisors held debriefing calls with all members of the underwriting team. Listed below are some of the comments and/or suggestions stated on those calls.

1. Three of the underwriters felt that the negotiated sale process went well and that the City achieved the lowest cost of financing for the day. One firm mentioned that they preferred the City continue to use the competitive sale method for future financings.

2. The majority of the transaction's retail orders were predominately filled by the senior manager, a firm not typically known in the industry to be a strong California retail firm. The use of an expanded definition of a retail investor (to include individual investors as well as investment advisors and bank trust departments with no order over $1 million) allowed for this strong showing. Both Merrill Lynch and Lehman also performed well as co-managers during the retail order period.

3. One underwriter felt that the senior manager could have started the order period at market opening versus 7:30 am pst to take advantage of early market activity.

4. One party observed that it took longer than normal to receive final number runs from the senior manager. It was unclear if this was due to the complexity of the financing, the senior manager's limited experience and/or capability with this size transaction or the differing financial software programs between the financial advisor and the senior manager.

5. One underwriting firm mentioned their concern that the senior manager was not a national firm nor did it have the capital to solely underwrite the transaction. Having a strong capital base and being a national firm is relevant in a competitive sale because the underwriter typically does not have bona fide orders and under SEC guidelines, in conjunction with members of its syndicate, is required to have sufficient capital to underwrite the entire transaction. Whereas in a negotiated sale, an underwriting syndicate does not typically underwrite a financing unless at least 65-70% of a transaction has been sold with bona fide orders. These bona fide orders place the total liability of unsold balances at 30-35% and therefore allow the senior manager to underwrite with less capital. For example, a firm with $5 million of capital can underwrite over $70 million of long term bonds. In the City's transaction, assuming a 35% unsold balance would be $157,008,250 and the senior manager's 30% underwriting liability would be $47,102,475. The senior manager would have had sufficient capital to underwrite the bonds and, in fact, based on their 30% liability they could have underwritten the issue with more than a 50% unsold balance.

<u>Designation of Bonds to BlackRock</u>

There was concern by all parties over the designation of bonds to BlackRock, a fund 49% owned by Merrill Lynch. As such, per their internal policy Merrill Lynch can not be designated any bonds that BlackRock buys. Not knowing this internal policy, De La Rosa & Co. filled the BlackRock order on a group net basis which allowed Merrill Lynch to be compensated. After allotments were made, Merrill Lynch realized this mistake and adjustments to the allotments and compensation had to be made. All parties were unclear how this lack of communication between the two firms occurred. Despite the difficulty, all parties in conjunction with underwriter's

counsel, determined an appropriate resolution in accordance with the Agreement Among Underwriters. Corrections were made so that Merrill Lynch would not be compensated for any bonds allocated to BlackRock with De La Rosa taking over their share. In return, De La Rosa would allocate compensation from other maturities to make Merrill Lynch whole. To date, all parties have signed a letter acknowledging and agreeing to these changes. This did not impact the City or the financing, though City Staff was concerned that they were unaware of this issue until the debriefing calls and would like to have known about the situation when it initially occurred.

Conclusion

Overall, the City received excellent results using the negotiated sale method for this specific transaction. As stated above, several reasons contributed to these strong results including the following:

1. The changing market conditions at the time of pricing were crucial to the lower yields. The market and economy moved in the City's favor to generate a low cost financing.

2. The City benefited by strong demand by investors for the City's bonds.

3. The senior manager's decision to move the pricing day to one with fewer competing California issues.

4. The senior manager's ability to take advantage of certain attributes inherent to a negotiated sale to lower yields including:
   a. Extensive premarketing and the use of a retail order period;
   b. The ability to reprice the issue to further lower yields after it was oversubscribed;
   c. The bifurcation and trifurcation of specific maturities to meet certain investors' preferences.

5. And finally, the City's underwriting team consisted of strong local and regional firms with different market strengths as well as large national firms to ensure strong retail investor participation.

Despite the success of this transaction, it is important to note that the benefits of a negotiated sale *should not* be generalized. If the interest rate market had moved in the opposite direction, the underwriting team may have had difficulty absorbing a downturn and the financing may have resulted in yields higher than what could have been achieved with a competitive sale. Regardless of market conditions and the timing of the financing, the negotiated sales process allowed the City to achieve its public policy goals of local and regional firm participation which is something the City has been unable to achieve using the competitive sale method.