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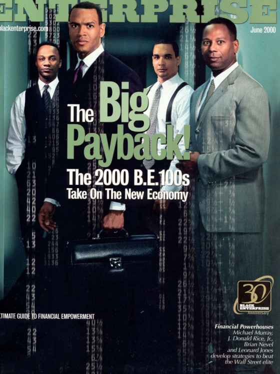

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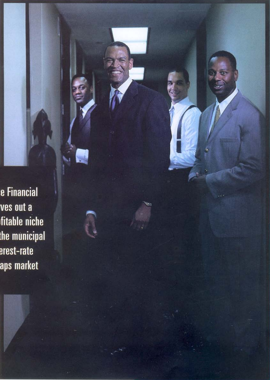

Rice Financial carves out a profitable niche in the municipal interest-rate swaps market

Rocket Scientists With Attitude

By Ivan Cintrón and Kimberly Lanise Seals

PHOTOGRAPHED BY WILLIAM RICHARDS

AS A COMPETITOR FOR MUNICIPAL DERIVATIVES DEALS, J. Donald Rice Jr., president of Rice Financial Products Co., wants to beat the big boys at their own game and on his terms.

For Rice, 41, it's meant building his firm into an operation specializing in municipal interest-rate swaps, one of several types of securities known as derivatives.

A derivative is a financial instrument whose value depends on the characteristics of an underlying asset or instrument, and includes such securities as futures and options. In the case of Rice Financial, founded in 1994, that value is based on the difference between interest rates as in a fixed-rate to floating-rate swap.

Like some other African American-owned financial services firms, in fields ranging from investment banking to asset management, New York City-based Rice Financial wants to be judged solely as a derivatives expert and not as a minority enterprise.

"We are recognized for the nature of our transactions, not because we are an African American-owned firm. We do this one thing and we do it well," asserts Rice, a 14-year veteran in the securities industry. "We're able to provide in the swap market the same level of expertise as other [majority-owned] firms."

That knowledge base means that Rice Financial is in head-to-head competition with the municipal derivatives operations of such Wall Street titans as Merrill Lynch & Co., Rice's former employer, and Goldman, Sachs & Co. Since opening its doors nearly six years ago, Rice Financial has executed well over $5 billion in derivatives transactions.

"We're one of fewer than 10 investment banks that have a significant presence in the municipal derivatives market and the only firm that is not a major money-center bank," notes Rice from his office on the 52nd floor in the World Trade Center.

FROM ROCKET SCIENTIST TO ENTREPRENEUR

Before striking out on his own, Rice, originally from Hot Springs, Arkansas, was a founding member of Merrill Lynch's municipal derivatives products group, joining the brokerage and investment banking powerhouse in 1985. He structured such deals as a $300 million floating-to-fixed interest rate swap for a District of Columbia General Obligation refunding bond issue, a complicated transaction involving the refunding of more than 200 separate loan obligations; and a $148 million floating-to-fixed rate swap for the City of Philadelphia, the first done by a major city government, in 1990. Rice also did a stint at Bankers Trust in its derivatives department.

But Rice—and later, his future colleagues—began to chafe under the bureaucracy of large investment banks, where introducing an innovative new financial instrument would become bogged down by procedural issues.

"If you come up with a new product, it goes to a new product committee, then another committee, then it's three weeks later before it comes out," says Rice. "If it's successful, a lot of other people take credit, but if it fails, you get the blame."

The science of structuring derivatives and other related securities is often referred to as financial engineering. And Rice's education—a B.S. in engineering from Kettering University and an M.B.A. with distinction from Harvard Business School—helped shape his career as an architect of complex securities transactions.

Like most engineers, Rice, when asked to define derivatives in general and the basic concept of a fixed-to-floating interest-rate swap in particular, literally draws a picture of the transaction on a napkin—his engineering background coming into play, he says. In simple terms, an interest-rate swap is much like refinancing a home mortgage, only on a much more complicated level, he says.

"Suppose you know someone, your neighbor, and [he or she] says, 'You pay my floating-rate mortgage payments and I'll pay the fixed-rate payments,'" explains Rice. What the firm does is serve as an intermediary, matching clients who want to exchange fixed-rate payments for floating-rate payments.

In the hypothetical example above, "you don't know your neighbor. We give you the floating payments, you give us the fixed, and we find someone else to match the fixed-rate payments," Rice says.

As the intermediary among the parties involved in interest-rate-swap transactions, Rice Financial serves as the principal and counterparty, not the agent. That means the firm executes the contract itself, putting its own capital on the line, resulting in potentially greater profits for the firm.

BRAIN TRUST

While the firm is named after the tall, confident Rice, he often calls upon other members of his team—his inner circle of rocket scientists, if you will—to describe his firm's operations and the details of past swap transactions. Several of them cut their teeth either in derivatives or in public finance.

The firm's two other early partners, Michael Murray, 33, and Brian Nevel, 29, both Howard University alumni, served stints at Merrill's municipal financial engineering desk. Their educational backgrounds in high-tech fields helped prepare them for the derivatives market: Murray earned a B.S. in computer systems engineering; Nevel received a B.B.A. in actuarial science.

Currently, Murray, in the securities industry for 10 years, heads up Rice Financial's structuring and modeling efforts, performing quantitative analysis and hedging transactions. Before joining Rice Financial, he led the financial engineering group at Merrill Lynch's municipal markets division, where he reviewed all of its major quantitative analysis, designed Merrill's bond financing models and supervised training of all new recruits. While at Merrill, Murray structured several billion dollars of the firm's senior managed tax-exempt debt issues, including a $1.1 billion New Jersey State Authority financing.

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—J. Donald Rice Jr.

And Nevel, the third member of Rice Financial's technical triumvirate, is responsible for the design and execution of interest-rate swaps and other municipal derivatives. He joined Rice Financial shortly after its founding six years ago from Merrill Lynch, where he served in its public finance group. Nevel, in the securities industry for seven years, structured a number of complex municipal financings totaling more than $1 billion while at Merrill, including lease appropriation, capital appreciation and derivative securities. He was also responsible for developing new financial products for municipal clients and trained new analysts and associates in debt-structuring techniques.

When Rice, Murray and Nevel meet with clients, they often sketch out the details of a potential transaction on a blackboard, just as they do in the office. In essence, they try to break down a complicated deal into its component parts to demonstrate to clients how it will benefit them.

BUILDING BY BUYING

In the municipal market, relationships with state and local officials are crucial to winning investment banking deals. To that end, and as part of its overall strategy to pump up its core derivatives business, last November Rice Financial acquired the municipal bond underwriting business of Philadelphia-based Pryor, Counts & Co. (No. 15 on the BE INVESTMENT BANKS list) for an undisclosed sum (see, "Rice Is on the Move . . . Again," Newspoints, February 2000). Rice Financial then folded it into Houston-based Apex Securities (No. 4 on the 1999 BE INVESTMENT BANKS list), renaming the unit Apex Pryor Securities. Rice Financial purchased broker-dealer Apex

Securities in June 1998. Terms of that deal also weren't revealed.

The new firm will continue to underwrite general municipal bond deals, and the combination of the two should push Apex Pryor higher into the municipal underwriting rankings, from about 25th to 15th, says Rice. Apex Pryor Securities' geographical coverage now includes the Northeast, complementing the formerly Southwestern clientele of the broker-dealer unit.

Apex Pryor Securities' underwriting capabilities helped Rice Financial win new clients.

Rice explains that the Pryor deal, and the Apex transaction before it, strengthened the firm's core derivatives business by expanding the client base it can pitch its interest- rate products to—municipalities and other local entities accustomed to executing "plain vanilla" municipal bond transactions.

"Municipalities tend to base their financing decisions on who their underwriters are. The underwriters bring their clients different ideas to get their financing needs done," says Rice. "We're looking to take these bond relationships and move them toward derivatives relationships."

"Municipalities are more conservative by nature. To take an exotic product to a treasurer or finance executive, you have to show superior knowledge of the product and be able to answer any and all questions," adds Murray.

LEVERAGING CLIENT RELATIONSHIPS

With the addition of Apex Pryor's underwriting capabilities, Rice Financial also relies on its top investment bankers to help persuade clients to add municipal derivatives to their financing menu.

For example, Leonard Jones, 39, managing director and head of Apex Pryor's investment banking division, is actively involved in structuring several kinds of municipal bond transactions. These deals include new money issues, current and advanced refundings (transactions involving replacing higher-interest bonds with lower-interest ones), and interest-rate swaps.

Jones' 14 years of experience includes commercial and investment banking deals in the U.S., Africa and Latin America. He was a vice president at Morgan Stanley & Co. (now Morgan Stanley Dean Witter) and at Smith Barney Inc. (now Salomon Smith Barney).

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—Michael Murray

And Rodney Ellis, 46, managing director and founder of Apex Securities, has contacts in municipal government through several elected and appointed positions. These relationships have helped Rice Financial win new derivatives business. Currently serving as a Texas state senator, Ellis was recently appointed acting governor for a day while Gov. George W. Bush and Lt. Gov. Rick Perry were outside the state. Other posts he's held include assistant to U.S. Congressman Mickey Leland and legislative assistant to former Lt. Gov. Bill Hobby. Ellis remains active in Apex Pryor's investment banking decisions.

As for future deals, Rice Financial is eyeing the State of California as ripe for an interest-rate swap deal, although other municipalities in the Golden State have done similar issues. Recently, California passed a law allowing the state to issue variable-rate debt for the first time, an opportunity for Rice Financial's brand of fiscal engineering.

Of course, it hasn't always been easy for Rice Financial to hawk its wares, especially back in 1994. Derivatives got a bad name then after Orange County, California, suffered losses of nearly $2 billion in its investment pool, leading to the county filing for bankruptcy because of leveraged investments in certain securities, including interest rate-based derivatives to

Rice Financial's trio of rocket scientists often draw diagrams of complicated interest-rate swaps on a blackboard. Rodney Ellis's (right) connections made it easier for Rice Financial to pitch derivatives to cautious municipalities.

hedge its risk. County Treasurer Robert Citron was accused of failing to disclose the highly leveraged nature of some of the securities in the county's investment pool.

Citron eventually pleaded guilty to six felony counts in 1995. Orange County sued several Wall Street firms, most notably Merrill Lynch, the county's financial advisor. Merrill Lynch settled out of court with the county and other local agencies for $437 million in 1998.

SIGNIFICANT FIRSTS IN DERIVATIVES

Rice Financial has carved out an enviable position in the municipal derivatives market as a pioneer in structuring first-of-its kind deals before its larger Wall Street competitors. Due to the nature of the derivatives market, however, it's difficult to determine the exact number of deals. Municipal derivatives transactions are a private and generally unregulated sector of the tax-exempt market.

For example, the firm executed a $140 million interest-rate swap for Dade County, Florida, the first floating-to-floating interest-rate swap of its kind, back in 1997. The deal reportedly lowered Dade County's borrowing costs to less than 3% and provided more than $20 million of cash-flow savings over the life of the deal.

In another deal in 1995, Rice Financial helped bring the Raiders football team back to Oakland. The Oakland-Alameda County Coliseum Authority wanted to finance improvements that were being made to the Raiders' stadium. But the city couldn't borrow in the tax-exempt market for stadium repairs and the rates in the taxable market were too high for a cost-efficient transaction. Rice Financial effectively converted $140 million of the commercial paper to a fixed rate using a floating-to-fixed interest-rate swap structure, saving the city $13 million to $16 million in additional debt service.

Despite the fact that Rice Financial was negotiating the idea of doing a derivatives deal right around the time the Orange County scandal broke, it managed to win the transaction.

More recently, Rice, along with Goldman Sachs, won a portion of a forward interest rate swap on $200 million of outstanding bonds issued to finance the construction of Denver International Airport. Merrill Lynch also won a piece of that deal.

"We looked at their debt service and came up with some technical advice and kept proposing ideas every two months or so. Then they stepped us up," says Jones. Rice Financial snagged that deal nine months after Apex Pryor began serving as a senior swap advisor to the city.

The firm has also been growing internally as Rice has hired a number of veteran municipal bond bankers from a variety of disciplines. For example, Peter Barbera, a former principal with Alex. Brown & Sons, was tapped to head Apex Pryor's sales, underwriting, and trading desk. The underwriting firm also added Philip Smith, a former Smith Barney analyst, who is responsible for much of the firm's quantitative analysis.

When Rice isn't building up his business, fending off competitors and developing highly technical instruments, he takes to the sky, ironically, to relax. He flies small planes from local airports in New Jersey, one of his favorite pastimes. "When you're up there you never think about work or anything else," he says.

And in the world of derivatives rocket science, there are always new paths to travel. He adds, "There's a saying in aviation, 'The runway behind you doesn't do you any good at all.'"

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—J. Donald Rice Jr