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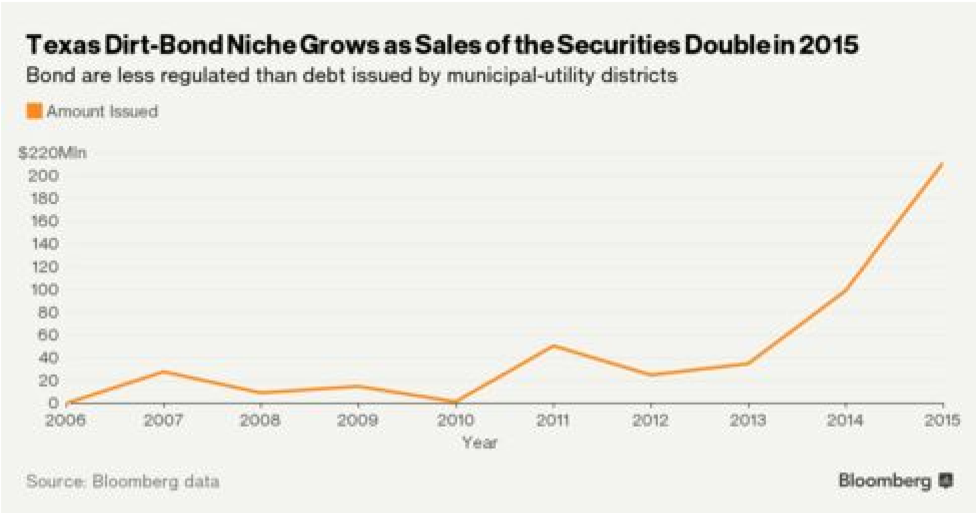
Texas `Dirt' Bonds Make Comeback With Fewer Investor Protections.

Westlake, Texas, carved out a special district to borrow $26.2 million last year for a developer to lay the groundwork for a "European style village" with residential villas, hotels and a wedding chapel around an 8.3-acre lake.

The debt for the new community some 35 miles (56 kilometers) northwest of Dallas is part of a small but growing niche of the $9 billion Texas dirt-bond market that's not bound by regulations that since the 1980s have protected buyers from the risks of a property-market crash. A record $211 million was raised last year by selling the public-improvement district debt, which allows developers to borrow before a project begins, making them akin to the securities issued in other states that defaulted during the last real estate crash.

"The risk to bondholders would be higher" in a housing-market rout, said Lisa Washburn, a managing director for Municipal Market Analytics in Concord, Massachusetts.

Following an influx of new residents that caused the population to swell by more than 1,000 a day, Texas's local governments have been stepping up sales of municipal bonds that help transform vacant tracts into newly-minted homes and commercial developments. The flood of debt has paid for water lines, roads, parks and other infrastructure needed to keep up with the booming Texas economy, which has started to cool as the drop in oil prices ripples through the energy industry.



The real estate district bonds are paid off by a property tax, which is covered by residents after they move in. That can pose a risk to investors if the houses sit vacant, the developer doesn't complete the project or it can't meet the tax bills until they're sold.

Most of the bonds issued for such developments in Texas have been through municipal-utility districts, which have faced heightened regulations since the housing crash of the 1980s pushed many to default. The 800 districts are regulated by the Texas Commission on Environmental Quality, require that developers make minimum investments before bonds can be sold, and have broad power to levy property taxes.

That’s provided security to bondholders. None of those districts missed debt-service payments in 2012 or 2016, years when Florida and Colorado borrowers had defaults rates from 1 percent to 15 percent, according to Municipal Market Analytics.

The public-improvement district bonds, which raise money for the same purposes, aren’t covered by those regulations. And their use has been on the rise: While only about $500 million have been issued since the structure was authorized by Texas lawmakers in the 1980s, $311 million of that was in the past two years. About a dozen districts sold them in 2015.

The securities tend to have lower credit ratings than their more heavily regulated counterparts or no ratings at all. While more than 60 percent of municipal-utility districts are in Moody’s Investors Service’s single-A rating category, most of the public-improvement district debt sold last year wasn’t ranked, according to Bloomberg data. Borrowers frequently forgo ratings if they’re unlikely to qualify for an investment grade.

Many public-improvement bonds issued last year were for suburbs ringing the Dallas-Fort Worth area, where rapid job growth has been driving housing starts and price gains to the highest level in a decade.

Shrinking Inventory

That area’s real estate market has been resilient despite the oil industry’s contraction. Last year, the inventory of houses for sale shrank 9 percent in north Texas after declining about 12 percent the year before, according to North Texas Real Estate Information Systems. In November, Dallas home prices were up 9.4 percent from a year earlier, according to the S&P/Case-Shiller index.

In Westlake, where Fidelity Investments is the largest employer with more than 5,000 workers, developers of the 85-acre Solana Public Improvement District are using the proceeds of the January 2015 sale for infrastructure needed to build homes and commercial buildings. That initial work will be done by August, said Sarah Dodd, spokeswoman for Centurion American Development Group, a developer.

When finished in a decade, Westlake Entrada, as it’s known, is slated to include 322 single-family villas and condos at prices ranging from $360,000 to $995,000, according to bond documents. Plans also include two hotels, restaurants, retail and office sites and an amphitheater, chapel and events center.

Dodd, the spokeswoman, said the risk to bondholders is mitigated by a “stringent” review of proposed districts by the local-government officials that establish them. “Due diligence is very comprehensive,” she said.

The arrangement allows the development to be built in a “way that doesn’t burden existing taxpayers,” said Amanda DeGan, Westlake’s assistant town manager.

The securities have offered high yields at a time when interest rates are holding near half-century lows. In November, the Jackson Ridge Public Improvement District in Aubrey, north of Dallas, sold $10.2 million of unrated bonds maturing in 2040 at a yield of 8.25 percent, more than twice as much as top-rated bonds. The Bayside Public Improvement District in Rowlett, another suburb of the city, is scheduled to sell $13.5 million of the debt next week.

The debt lets cities and counties to fund development without the cost. But some investors are hesitant to take on the risk that they may not be repaid if the housing market doesn't hold up.

"It's a legal structure that's not dependable," said Doug Benton, senior municipal credit manager for Cavanal Hill Investment Management, which manages about $6 billion. The firm doesn't invest in public improvement district bonds. "The pledge is weaker."

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