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Upside in Puerto Rico Municipal Bonds.

Puerto Rico's new governor is intent on restructuring the island's debt.

The recent election of a new governor in Puerto Rico, and the formation of a powerful federal financial control board this summer, have resulted in some optimism about a bondholder-friendly restructuring of much of the island's $70 billion of debt.

The situation is still unsettled, but the new governor, Ricardo Rosselló, is viewed on Wall Street as a serious leader who wants to put the island on a stronger financial footing, bolster a weak economy, and work out a reasonable agreement with bondholders. Rosselló contrasts with the more combative outgoing governor, Alejandro García Padilla, who clashed with bondholder groups and then opted to default on $1 billion of debt-service payments on July 1.

Rosselló's election came after midyear, when President Barack Obama signed the Puerto Rico Oversight, Management, and Economic Stability Act, which created a seven-member control board with broad fiscal and debt-restructuring authority.

The benchmark Puerto Rico 8% general-obligation bond due in 2035 rallied after the Rosselló win, to about 72 cents on the dollar from 69 cents, but has since slipped back to about 69 cents. The market for Puerto Rico's senior sales-tax revenue bonds, known by their Spanish acronym Cofina, has been stronger, with long-term senior debt trading up to the low $70s from the high $60s in the summer, as Puerto Rico has continued to make payments to that debt.

Barron's was among the first to warn about Puerto Rico's growing financial troubles in a cover story more than three years ago ("Troubling Winds," Aug. 26, 2013).

Key future developments will be a new fiscal proposal from the incoming governor and recommendations from a task force about steps the U.S. government can take to ease Puerto Rico's financial burden.

Things should heat up in early 2017 because a stay on bondholder lawsuits ends in February—with a potential extension to around May 1. This means that a bond restructuring plan probably needs to be in place by then. There is apt to be considerable wrangling among different bondholder groups, and there is overall risk given Puerto Rico's fiscal, economic, and pension problems.

Against that backdrop, the general-obligation bonds, trading at less than 70 cents on the dollar, look like the best way to bet on a bondholder-friendly deal that could give GO holders a package worth 85 cents to 90 cents on the dollar.

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—Andrew Bary

November 26, 2016