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Hedge Funds That Flocked to Puerto Rico Bonds Face Long Road Out.

- **Debt restructuring likely to wind up in court, analysts say**
- **Bonds trade below recovery rates suggested by Moody's ratings**

Hedge funds first starting buying Puerto Rico debt in the summer of 2013 because they liked what they saw: A government that was paying high, tax-free yields that couldn't go bankrupt.

Nearly four years later, the Caribbean island has defaulted on most of its bonds and Governor Ricardo Rossello, who took office in January, says it can pay less than a quarter of what's owed over the next decade, assuming he can slash the budget and increase the island's revenue. Some of the securities are trading near record lows. And, thanks to the U.S. Congress, Puerto Rico and its federal overseers can use bankruptcy-like proceedings to have some of its $70 billion debt written off in court, something investors once assumed it couldn't ever do.

"It's been a really long trade," said David Tawil, president and co-founder of Maglan Capital LP, who bought Puerto Rico bonds in 2013 but has since sold them. "I don't think when they first got into this they bargained for this type of length of trade. There's been a lot more twists and turns and not to any substantial progress point between then and now."

Puerto Rico investors holding general-obligation bonds and sales-tax debt and insurance companies are negotiating through mediation on a restructuring deal, the largest ever in the $3.8 trillion municipal-bond market. There isn't much time: The commonwealth faces a fresh hurdle on May 1, when a temporary hold that's sheltered it from the impact of creditor lawsuits is set to expire. If Puerto Rico fails to strike a deal with its creditors or gets bogged down in a legal morass, it can seek to reduce its obligations through a court — an avenue that analysts say looks increasingly likely.

"We're at the very beginning of a process that will likely take years," said Matt Fabian, partner at Concord, Massachusetts-based Municipal Market Analytics Inc.

Hedge funds, which hold about one-third of Puerto Rico's debt, started buying in 2013, after the island's long-running recession and unremitting budget shortfalls caused other investors to flee. The distressed-debt buyers scooped up the bonds as traditional municipal-bond investors dumped their holdings and prices fell. An index of Puerto Rico bonds plunged nearly 10 percent in August 2013, the biggest monthly decline since the index's inception in 1999.

The size of Puerto Rico's outstanding debt made it easy to take large positions and the discounted value left open the chance of a price rebound — dangling an opportunity for speculative gains rarely seen in the municipal market, where few borrowers default. Distressed debt was scarce at that time and the island's bonds were one of the few places to buy cheap securities, Tawil said.

"This was the first real distressed opportunity in U.S. municipals," Tawil said. "It's a gigantic capital structure so all of the big distressed guys can go ahead and look at this and say 'I could put a couple hundred million to work here, no problem."'

Hedge funds wagered that investors would ultimately allow the island to push out maturities if the commonwealth did its part to cut the government's spending, Tawil said. Instead, by 2015, Puerto Rico started defaulting on bonds to avoid potentially devastating budget cuts.

"There's just not enough money," Fabian said. "We have a basic problem of where do municipal-bond payments fit as far as the priority of payment? GO and Cofina believe that they're at the top and the board believes they're at the bottom."

While Puerto Rico's debts include a web of obligations sold by different government entities with various repayment pledges, investors are now fighting over an average $787 million that Rossello says he has each year to pay principal and interest over the next decade. One key issue is what will receive a better recovery — the $12.5 billion of general obligations or the $17.3 billion of sales-tax bonds.

Puerto Rico's constitution states the island's general obligations are to be paid before other expenses, while sales-tax bonds have a claim on that revenue before the commonwealth can use it for other expenses. The government hasn't missed payments on its sales-tax bonds.

Moody's Investors Service estimates the general obligations and senior Cofinas, which get first claim on the sales-tax receipts, will receive 65 cents to 80 cents on the dollar in a restructuring deal. MMA's Fabian doubts the recovery rates will be that high because Puerto Rico's outcome is unpredictable. Securities with even weaker repayment pledges may receive less than 10 cents on the dollar, he said.

Some bonds are trading below the projected recovery rates. General obligations with an 8 percent coupon and maturing in 2035, the island's most-actively traded, fell to as little as an average 61.8 cents on the dollar on March 30, the lowest since they were first sold in 2014 at 93 cents, data compiled by Bloomberg show. The debt traded at an average 63.1 cents on Friday.

Cofinas with 6.05 percent coupon and maturing in 2036 traded at an average 60.8 cents Friday after falling to 58.7 cents on April 12, the lowest in nearly a year, Bloomberg data show.

Analysts say Puerto Rico's debt crisis will ultimately be resolved in court, given the long odds of convincing creditors — some of whom have already taken opposing sides in lawsuits — to voluntarily accept steep losses, despite whatever legal claims they have on the government's cash.

"It's hard to see how mediation could succeed theoretically," Fabian said. "There are fundamental points like the constitutional prioritization of GOs and the purported segregation of Cofina that need a court to decide their staying power."

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