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Bond Insurer MBIA Targeted by Short Sellers After Puerto Rico Hurricane.

Hedge funds are again betting against the company

Hedge funds are increasingly betting on whether bond insurer MBIA Inc. can survive heavy losses expected from Puerto Rico's bankruptcy in the wake of Hurricane Maria.

Short sellers have borrowed about 40% of the firm's stock since September, wagering that it will drop, while value investors Fine Capital Partners L.P. and EJF Capital LLC have taken the opposite side, buying millions of MBIA shares. Credit hedge funds like Mill Hill Capital LLC have bought credit default swaps, or CDSs, that gain value as the probability of an MBIA default rises.

Bond insurers charge premiums to companies and governments that issue bonds and agree to take over interest and principal payments if the borrowers default. That business model backfired during the financial crisis, when the insurers took billions of dollars in unexpected losses on mortgage bonds. Bets against MBIA became a lucrative trade among hedge-fund managers, most famously Bill Ackman.

MBIA recovered by focusing on insuring municipal bonds but defaults in that market have mounted, calling the firm's business into question once again. Bearish investors doubt the firm has set aside enough capital to cover likely payouts, especially now that Hurricane Maria has crippled Puerto Rico, where MBIA insured $3.4 billion of bonds.

"It's not something we've asked for or created," said MBIA's head of investor relations, Gregory Diamond, about the attention from hedge funds past and present. "We are here to operate our company as best we can and to satisfy our obligations."

Mill Hill founder David Meneret said he started buying MBIA CDS—derivatives that pay out if a bond defaults—before the hurricane struck because he believed the insurer was undercapitalized given its exposure to cash-strapped Puerto Rico and financially troubled states like Illinois and Connecticut.

"We didn't know when something bad was going to happen but with a company that has so much leverage, anything bad could be very damaging," Mr. Meneret said

By one measure, MBIA has done less to prepare for Puerto Rico-related losses than its competitors. MBIA's most recently reported loss reserves amount to about 10% of its exposure to Puerto Rico, compared with about 20% for Assured Guaranty Ltd. and about 40% for Ambac Financial Group Inc., according to data from S&P Global Market Intelligence.

The difference in reserves reflects the fact that most of the Puerto Rico bonds MBIA insured were issued by different entities and government agencies than the bonds insured by its competitors and the likelihood that recoveries will vary accordingly, Mr. Diamond said.

Puerto Rico owes investors about $70 billion of bonds and had begun restructuring the debt in court when Hurricane Maria struck in September, destroying much of the island's infrastructure and drastically reducing forecasts for how much bondholders will recover. Benchmark bond prices dropped to about 23 cents on the dollar from 60 cents as expectations of bondholder recoveries fell.

The net dollar amount of CDS contracts purchased on MBIA after the hurricane hit Puerto Rico increased by $267 million to $1.13 billion through Nov. 21, the most recent date for which data are available, according to data from the Depository Trust & Clearing Corporation. The percentage of MBIA stock sold short surged to 43% on Dec.19 from 14% in September, according to data from S&P Capital IQ.

Buyers of CDS have made large returns on their trade so far—prices of the derivatives have tripled since September, according to IHS Markit. Movement of the stock has been more erratic, falling about 40% to $6.22 in October from about $10 in early September, before rebounding to about $9 in November, when MBIA announced a $250 million share buyback. Shares closed at $7.49 Wednesday, and many of the recent short sales in MBIA stock were executed when the stock traded for $8 or more, implying a modest gain, according to data from the Depository Trust & Clearing Corporation.

Sunesis Capital LLC founder Manal Mehta, a longtime investor in MBIA, says the market is again underestimating the firm's resilience. The insurer will have decades to pay off the Puerto Rico bonds it insured, which is ample time for the island's economy to bounce back and for MBIA to recover money through litigation and debt restructurings, he says.

Some funds viewed the share drop as a buying opportunity. Fine Capital Partners L.P. and EJF Capital LLC have collectively bought about 5.6 million MBIA shares since the end of September, according to data from S&P Capital IQ. An official at Fine Capital declined to comment, while EJF couldn't be reached for comment.

The investor face-off reprises the debate over the viability of MBIA and other bond insurers that Mr. Ackman started in 2002, when he announced his short bet against the company.

The key to the bond-insurance business is reserving enough cash to cover losses from bond defaults, and to maintain a high enough credit rating to keep selling new policies. Mr. Ackman argued that MBIA had far too little capital relative to potential losses from the hundreds of billions of dollars the firm insured.

Fallout from the financial crisis forced regulators to intervene with two of the largest bond insurers—Ambac Financial Group Inc. and Financial Guaranty Insurance Co.—while others stopped writing new policies. MBIA's market capitalization dropped about 95% from precrisis levels and Mr. Ackman made about $1 billion from his trade.

Still, MBIA weathered the financial crisis by suing banks that structured the mortgage bonds it insured, and its stock recovered modestly, generating gains for hedge funds like GSO Capital Partners that bet the firm would survive.

That could happen again, Mr. Mehta says, forcing short sellers who borrowed MBIA stock to scramble to buy shares. "If you are short the stock and there's a positive piece of news, the stock will go vertical and you'll be caught with your pants down," he said.

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By Matt Wirz

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Write to Matt Wirz at matthieu.wirz@wsj.com