

Bond Case Briefs

Municipal Finance Law Since 1971

KKR Buying Wood-Pellet Bonds Shows High-Yield Lure: Bloomberg Muni Credit.

A Louisiana lumber town has become the crossroads for an unusual buyer and seller in the U.S. municipal market: private-equity firm KKR & Co. (KKR) and the world's biggest manufacturer of wood pellets.

A Louisiana public authority last month issued \$140 million of unrated bonds for German Pellets GmbH, which runs plants in Austria and Germany that make specialized wood pieces used for heating and power production. KKR's asset-management group bought the sale's \$95 million taxable portion, said Kristi Huller, a spokeswoman. The securities were priced to yield 12.2 percent, data compiled by Bloomberg show.

The deal shows the municipal market's growing reach beyond U.S. borders. In April, an Iowa agency sold a record amount of muni junk bonds for a fertilizer plant being built by Egypt's biggest publicly traded company. KKR, run by billionaires Henry Kravis and George Roberts, joins non-traditional buyers such as hedge funds that entered the market this year after Detroit's bankruptcy helped fuel the biggest losses since 2008.

"There's much more of an international component in the high-yield project-finance municipal market, and you're seeing different people come in," said Bill Black, who runs Invesco Ltd. (IVZ)'s \$5.7 billion high-yield muni fund from Downers Grove, Illinois. "Our business is becoming more broad and needs to be more sophisticated than perhaps it has been in the past."

Tougher Scrutiny

Junk-debt investors are used to scrutinizing bonds for industrial development, particularly those without a rating, because they represent the most defaults in the \$3.7 trillion municipal market. Local agencies issue the debt for companies, hospitals and nonprofits, which back the obligations.

The novelty of Louisiana's pellet plant made it tougher to analyze and drove yields higher, said Black, John Miller at Nuveen Asset Management and Dan Solender at Lord Abbett & Co., who oversee high-yield funds. Wismar-based German Pellets, a privately owned company, borrowed \$187 million in 2012 using bonds issued through a Texas agency for its first U.S. location, in Woodville, Texas.

The company's 334-acre site near Urania, Louisiana, will initially produce 500,000 metric tons (551,000 tons) of pellets a year, with a second phase of financing boosting output to about 1 million metric tons, offering documents show. The pieces will be delivered to a storage and loading facility 210 miles (338 kilometers) away in Port Arthur, Texas.

E.ON Agreement

The wood will be shipped mostly to European companies, including the U.K. subsidiary of E.ON SE. (EOAN) The utility, Germany's biggest, has agreed to buy about 480,000 metric tons of pellets

annually for five years starting in 2014, offering documents show.

The pellets are made from dried and densified sawdust, shavings or wood powder, according to the European Pellet Council, an industry group. Plant operators can burn the pieces, which are considered carbon-neutral, along with coal to comply with renewable-energy mandates.

In last month's bond sale, the \$45 million of debt due in July 2039 that's tax-free for individuals not subject to the federal Alternative Minimum Tax was priced to yield 10.5 percent, Bloomberg data show. That interest rate is almost double the 5.52 percent yield on benchmark BBB revenue debt.

About \$29 million of similar bonds were issued for the Louisiana plant in March, with a yield of 9.75 percent. The securities mature in August.

Experience Deficit

"It's definitely speculative and the yield reflects that, even more so than some of our traditional high-yield sectors," said Miller, co-head of fixed income at Nuveen, which oversees about \$90 billion in local debt. "People don't have a lot of experience around this sector."

The variable-rate bonds acquired by KKR mature in January 2020 and have an 11.5 percent interest rate tied to the London Interbank Offered Rate, adjusting quarterly, offering documents show.

As part of the terms, KKR Asset Management entered into an "equity contribution agreement" with German Pellets that promises that some cash from the subsidiary running the Texas facility will go toward redeeming the taxable bonds, according to sale documents.

New York-based KKR formed KKR Asset Management in 2004 to invest in stocks, bonds and credit strategies.

Predictable Revenue

KKR and its peers, which manage illiquid investments like private equity and real estate, have diversified since the U.S. financial crisis to grow their assets and tap more predictable revenue streams.

Huller, the KKR spokeswoman, declined to comment on the deal beyond the company's purchase.

Investors were more comfortable with the Louisiana offering given the history of the Texas project, Claudia Roehr, a spokeswoman for German Pellets, said in an e-mail. The yield was "in line with the relevant market level," she said.

"Seeing the current market demand, German Pellets can imagine to develop further projects," she said.

George Longo, who worked on the transaction as a managing director at Raymond James & Associates in New York, said he credits the company's project-finance banking team for the deal.

The plant will produce 80 permanent jobs around Urania, a town of about 1,300 people that was founded in the 1890s about 245 miles northwest of New Orleans in LaSalle Parish, said Martin Walke, vice president of economic development at the Louisiana Public Facilities Authority.

'Win-Win'

"Urania was established basically as a lumber town," he said in an interview. "This project fits right

into the core history of LaSalle Parish: It's lumber, it's a renewable resource and it helps the environment. We consider it a win-win."

Some borrowings for wood-pellet facilities have failed. The Colorado Housing and Finance Authority issued \$7 million of unrated debt in 2007 for Confluence Energy LLC, a manufacturer that planned to use wood from trees destroyed by beetles.

Confluence defaulted on the securities in 2009, and in 2011 the Internal Revenue Service examined the bonds for compliance with tax requirements, according to company filings. The debt maturing in April 2027 priced to yield 6.75 percent, Bloomberg data show.

The European Union has stepped up its goals for renewable energy. It wants to get 20 percent of its energy from renewable sources by 2020, the European Commission's website says. Those include wind, solar, hydro-electric and tidal power, as well as biomass, which is what the pellets are considered.

Drax Group Plc (DRX), operator of the U.K.'s largest coal-fired power station, said this year it is accelerating a plan to convert half of the plant to biomass.

Mandated Demand

Burning pellets releases carbon the trees would produce anyway when they decompose, preserving the carbon-neutral status. Offering documents for the Louisiana deal acknowledge demand is largely driven by government-imposed policies and incentives, and if those are taken away or a cheaper source of energy is found, the buyer base for pellets could "decrease significantly."

The Louisiana sale was worth buying for AllianceBernstein LP because of German Pellets' market share, said Dean Lewallen, a senior high-yield municipal credit analyst at the company, which oversees about \$31 billion in local debt.

"We'll definitely see more of these — the demand in Europe is increasing," he said. "And the U.S. has a lot of wood."

By Brian Chappatta Dec 19, 2013 6:28 AM PT

To contact the reporter on this story: Brian Chappatta in New York at bchappatta1@bloomberg.net

To contact the editor responsible for this story: Stephen Merelman at smerelman@bloomberg.net