Detroit Seeks Water-Bond Sellers to Escape Default: Muni Credit.

Detroit's water and sewer department is set to find out today if it will succeed in striking a deal with bondholders to avert a possible default.

The Detroit Water and Sewerage Department is giving investors until 5 p.m. Detroit time to decide whether to sell back $5.2 billion of bonds. The move is part of a plan by the system to borrow through new securities with lower interest rates, using the savings to bolster the finances of the bankrupt city.

The proposal would allow bondholders to part with their securities at a known price — in most cases 100 cents on the dollar or more — rather than risk losses in federal bankruptcy court. Emergency Manager Kevyn Orr would win sought-after savings for the Motor City if investors agree to the deal, which may help the city win court approval of its plan to cut debt and exit bankruptcy.

"The goals are all sort of intertwined with each other, and we think it has a win-win concept behind it," said John Miller, the co-head of fixed income in Chicago at Nuveen Asset Management, which oversees $92 billion of munis. He said the company plans to sell back some Detroit water debt. "The city would get some benefits, bondholders would get some benefits and the users of the system would also get some benefits."

Puzzle Pieces

Water and sewer bondholders are among the final pieces of the bankruptcy puzzle for Detroit, which has reached agreements with general-obligation investors and pensioners after 13 months under court protection.

Under the offer, each individual water and sewer bond can be resold at a given price. If enough are sold back, the Michigan Finance Authority will issue new debt with lower interest rates to purchase the tendered securities.

While Orr hasn't sought to force the department's bondholders to write down what they're owed, his plan for emerging from bankruptcy would cut the interest rates on some securities or eliminate provisions that protect investors from being forced to resell bonds before they mature. The plan led the three biggest credit raters to lower their ratings on the bonds to junk.

Tossing Junk

The success of the repurchase plan is no sure thing: Standard & Poor's rates the water and sewer securities CCC, eight levels below investment grade. If the buyback goes through, the department's finance team says it'll request investment grades on the new bonds because they won't be affected by the bankruptcy proceedings. Without a higher rank, the city may not be able to borrow at a low enough rate to complete the refinancing.

About $1.4 billion of the $5.2 billion of debt has been tendered as of 11 a.m. Detroit time, according to an online tally from Bondholder Communications Group LLC. The Michigan Finance Authority, which may begin pricing the new water and sewer securities on Aug. 26, released two sets of offering documents yesterday that total 1,136 pages and left the deal size blank.

Citigroup Inc., the lead underwriter on the bond deals, said in a presentation to Detroit's board of water commissioners this month that the success of the tender offer should earn back investment grades for the system. Yet "there can be no assurance as to this outcome," and the grades could fall to D, representing default, in the tender process.

Default Tightrope

The water department's financing team "will stress to the rating agencies that the Tender Offer is voluntary and not 'distressed,'" according to the presentation, which said grades should be released Aug. 25, the day before the deal prices. A least one bond insurer will back some of the new securities, according to offering documents.

Even if the refinancing is successful, some investors would still be accepting less than they would eventually be paid. Research firm Municipal Market Advisors, which keeps its own tally of muni failures, said if the utility doesn't make all scheduled principal and interest payments, it would fit its default definition.

"The city is hoping to avoid the characterization of its DWSD restructuring as a default by having bondholders agree to be defaulted upon," according to the MMA report. The plan is "attempting to walk a very technical line in rating agency definitions of 'default' and 'distressed exchange.'"

Sewer Savings

Fitch Ratings won't consider the tender offer a distressed exchange, the New York-based ratings company said today in a report.

Moody's Investors Service declined to comment, said Thomas Lemmon, a company spokesman. Scott Garrigan, an S&P analyst in Chicago, said he will gauge the rating effect and whether it should be considered a distressed exchange once the tender is finalized.

Offering documents don't list ratings. As recently as July 2013, S&P rated senior-lien water and sewer bonds A+, the fifth-best investment grade and 13 steps above the current rank.

"If they're extricated from the bankruptcy, they become the original credit they were, and in some ways stronger because they lowered their debt service costs," said Tom Metzold, co-director of municipal investments at Eaton Vance Management, which oversees $24 billion in local debt, including Detroit water and sewer bonds. He said he may sell some back.

The system's outstanding bonds with the highest interest rate mature in July 2033, data compiled by Bloomberg show. The $150 million in debt has a 7.5 percent coupon, meaning the city pays $11.25 million to investors annually. Lowering the rate to 5 percent, for example, would curb payments by $3.75 million a year.

119 Cents

More than 75 percent of those high-cost securities have been tendered. Investors were enticed with a repurchase price of 119.1 cents on the dollar, the highest offer of any debt, according to a report from Wells Fargo Advisors. The bonds, backed by Assured Guaranty Municipal Corp., hadn't traded that high since March 2013, Bloomberg data show.

“The city buying back these bonds in a way that is voluntary is in a sense like bidding your bond out on the open market because you don’t want to deal with it anymore,” said Patrick Stoffel, a municipal analyst at Wells Fargo in St. Louis. “It speeds along potentially the whole trial because it seems like there would be quite a few legal challenges to the city trying to impair bonds through bankruptcy.”

Water and sewer bondholders balked at the prospect of being impaired in bankruptcy because their payments are backed by a secure revenue stream from the utility, rather than a full faith and credit promise like general obligations.

The water department’s tender offer takes a cram down off the table and averts what could have been an undesirable example of impairing bondholders in bankruptcy, Nuveen’s Miller said.

“From a precedent perspective, maintaining the sanctity of the special revenue pledge is a good thing,” Miller said. “Separate and apart from that, it’s also good to have the asset out of bankruptcy. We’re positively predisposed towards the whole macro plan.”

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