Puerto Rico Bonds Seen Cheapening as Record Restructuring Looms.

(Bloomberg) — Puerto Rico's power utility is moving toward a record restructuring of its $8.6 billion debt load. For high-yield municipal investors, the move may be a trigger to add the junk-rated commonwealth's bonds.

The Electric Power Authority, called Prepa, is poised to reduce its obligations this year through negotiations with creditors. Such an agreement may cheapen Puerto Rico securities, which already trade at distressed levels, while clarifying how the commonwealth and its agencies may tackle $73 billion of debt, said John Miller, co-head of fixed income at Nuveen Asset Management. The company runs the biggest high-yield muni fund.

Signs of interest from mutual funds would be welcome news for the struggling U.S. territory, which has relied on buying by hedge funds. Traditional purchasers stepped back as the risk grew: 54 percent of muni mutual funds hold Puerto Rico bonds this year, down from 77 percent in October 2013, according to Morningstar Inc. Puerto Rico's securities are widely held because they're tax-free nationwide.

"There will be opportunities," said Miller, who helps manage $100 billion of munis in Chicago. "We're not there yet because nothing's been restructured and we don't know who is going to take the hits here."

'Dry Powder'

Nuveen reduced its allocation about two years ago, Miller said. Its $10.8 billion High Yield Municipal Bond Fund, the largest of its kind, didn't hold any Puerto Rico as of Feb. 28, down from a 1.8 percent allocation on June 30, 2011, data compiled by Bloomberg show.

The firm has room to add commonwealth debt in its muni funds, Miller said.

"All of these funds have dry powder in their below-investment-grade buckets," Miller said. "That's another reason why we want to follow it closely and try to identify an opportunity."

Debt of Puerto Rico has earned about 0.1 percent this year, compared with 0.8 percent for the entire municipal market, according to S&P Dow Jones Indices.

Some commonwealth debt has been gaining. Prepa bonds maturing in July 2040 traded Thursday at an average of 52.6 cents on the dollar, up from about 50 cents at the start of 2015.

Borrowing History

The island was cut to junk a year ago because of its history of borrowing to balance budgets. The territory and its localities have more debt than all but two states: California and New York. Its economy has struggled to grow every year since 2006, and its population shrank by 7 percent in the past decade to 3.5 million, according to Census data.

Governor Alejandro Garcia Padilla’s administration is trying to avoid defaulting on Puerto Rico’s $13 billion of general obligations. Legislators passed a law allowing some public corporations to ask investors to take a loss, which might ease their financial strains and free them from relying on the island’s general fund. A federal judge threw the measure out, although the island has appealed.

As a result, there’s no road map for agencies seeking to reduce debt, and Puerto Rico localities can’t file for Chapter 9 bankruptcy protection. That leaves investors guessing how large potential losses may be.

Puerto Rico’s general obligations may be at risk: there’s a high probability that the island will default on the securities in the next two years, Moody’s Investors Service said in a Feb. 19 report.

Commonwealth lawmakers this week filed a bill that would allow Puerto Rico to default on its general obligations.

“The credit-negative discussions, regardless of whether they culminate in enacted legislation, signal the rising likelihood of consolidated debt restructuring that affects not only public corporations, but also the central government’s general obligation and other tax-backed securities,” Ted Hampton, a Moody’s analyst in New York, wrote in a report Thursday.

Zero Sum

“At some point there’s going to be a buying opportunity,” said Peter Hayes, who helps manage $116 billion as head of munis at New York-based BlackRock Inc. “It will probably be an attempt at some type of restructuring, but will it be just in the public corporations or will it be in the general obligations? It remains to be seen.”

BlackRock’s $538 million High Yield Municipal Fund had 0.9 percent of assets in Puerto Rico as of Jan. 31, Bloomberg data show. While that’s up from zero a year ago, the allocation was about 6 percent in July 2012, Bloomberg data show.

Prepa may fail to pay of about $400 million of principal and interest due July 1, Moody’s said in a March 16 report.

The utility in August signed an agreement with creditors to extend bank loans through March 31. In return, the agency promised to file a debt-restructuring plan, which it has failed to do. The utility, bondholders, bond insurers and banks are discussing an extension. Moody’s estimates a recovery rate of 65 percent to 80 percent if Prepa defaults. It would be a historic restructuring for a municipal issuer.

The Government Development Bank, which handles Puerto Rico’s debt sales, declined to comment through David Millar, a New York-based spokesman.

Entry Point

Puerto Rico has proven volatile, so investors may not have to wait for a restructuring to buy.

General obligations sold in March 2014 at 93 cents rose to an average of 96.6 cents that month, then fell to 81.9 cents Feb. 9. The debt traded Thursday at about 84.1 cents.

“You can effectively exit and re-enter at will,” said Jason Diefenthaler, who helps manage Wasmer

Schroeder’s $80.5 million High Yield Municipal Fund, which directs about 6 percent to commonwealth debt. “There’s always a way to get involved with Puerto Rico.”

Some investors already added as yields reached 10 percent, equivalent to a taxable 16.6 percent for top earners.

MacKay Shields LLC in New York boosted its holdings to $247 million in its four MainStay muni mutual funds as of Dec. 31, or about 10 percent of assets, up from 0.2 percent in October 2013, according to Morningstar.
The Puerto Rico bonds are insured, according to MacKay Shields.

Inaugural Year

In the inaugural year for Wasmer Schroeder’s High Yield Municipal Fund, Puerto Rico accounted for as much as 9.2 percent of assets in November. That allocation is now about 6 percent, all insured, said Diefenthaler, who helps manage $5.1 billion of munis at the Naples, Florida-based firm.

The fund, which debuted on March 31, can direct as much as 10 percent to Puerto Rico, Diefenthaler said.
“If we can opportunistically add more insured paper, I would be all over that,” he said. “The Puerto Rico name itself detracts from the value of that insurance in the secondary market, so there’s opportunity to pick up yield.”

by Michelle Kaske

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To contact the reporter on this story: Michelle Kaske in New York at mkaske@bloomberg.net

To contact the editors responsible for this story: Stephen Merelman at smerelman@bloomberg.net Mark Tannenbaum, William Selway

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