Bond Case Briefs

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Junk Cities Across U.S. Earn Ratings Revival by Fixing Blunders.

(Bloomberg) — The $3.5 trillion municipal market's fallen angels are rising again.

U.S. localities that failed to pay investors or got swept up in costly development projects have seen their prospects brighten after sinking to junk. While names such as Harrison, Menasha and Vadnais Heights may not resonate with most Americans, they gained infamy among bond investors after stumbling into fiscal peril.

They're among communities getting a boost from almost six years of economic growth: Moody's Investors Service's upgrades outpaced downgrades last quarter for the first time since 2008.

"It's not for us to keep these places in the penalty box," said Alfred Medioli, a Moody's analyst in New York. "They don't have major economic issues. There's new management in place, so presumably they wouldn't be making the same mistake of underwriting projects that they couldn't pay for."

In the past seven months, Moody's raised Harrison, which had struggled with debt tied to the New Jersey home of Major League Soccer's Red Bulls, to Baa3, one step above junk; and elevated Menasha, Wisconsin, and Vadnais Heights, Minnesota, to Baa2, one level higher. The upgrades are rebuilding trust between investors and the localities, which got burned by backstopping debt for commercial or sports-related development projects.

Menasha's Mishap

Menasha, 100 miles (161 kilometers) north of Milwaukee, got a three-step increase from Moody's in January. The community of about 17,600 hasn't had a grade that high since 2009, when it fell to junk for failing to appropriate funds to pay debt backing a distressed steam plant. Investors ended up getting 75 percent of what they were promised.

"It wasn't a dollar-for-dollar payback, and I know that's one of the things that Moody's didn't like and the reason they didn't want to go back to investment grade," said Peggy Steeno, the treasurer.

Steeno took the post in 2013 and said she highlighted to Moody's how the locality has moved past its struggles. The sale of the plant last year stabilized its finances, Moody's said.

"Appropriating is critical," she said. "I would never issue bonds without making sure the appropriation was there and the proper steps were in place."

Downgrade Debacle

About 280 miles west, in the Minneapolis suburb of Vadnais Heights, officials in 2012 refused to appropriate funds for a youth sports complex that didn't meet projections and left the city on the hook for debt. Its rating plunged to junk after it formerly carried the third-best investment grade.

Last year, holders of senior-lien lease bonds backing the sports center recovered 45 percent of what they were owed after the surrounding county bought the facility, Moody's said in a report. Without the complex burdening its finances, the community earned a two-level upgrade from Moody's in October.

"We will certainly consider past experience when evaluating future projects," Kevin Watson, the city administrator, said in an e-mail.

The credit rebound may encourage other localities to consider walking away from lease or appropriation debt, said Tom McLoughlin, head of muni fixed-income in New York at UBS Wealth Management Americas, which oversees about $85 billion in munis.

'Penalty Box'

"Their time in the penalty box appears to be shorter," McLoughlin said. "It increases our concern about local-government general-fund obligations and whether they deserve a big place in individual investor portfolios."

Standard & Poor's also sees signs of strength from once-downtrodden municipalities, known as fallen angels when they lose their investment-grade ranks.

This month, S&P revised the outlook to positive on Central Falls, the formerly bankrupt Rhode Island city rated two steps below investment grade. In February, it put a positive outlook on Moberly, Missouri, which in 2011 opted not to make payments on $39 million of bonds that a local authority sold to lure an artificial-sweetener plant project that collapsed.

Moberly "has other appropriation debt that they've budgeted on time," said John Sauter, an S&P analyst in Chicago. "The real mover that's different now is that they've gotten to the point where they've adopted a new debt policy."

Moberly Moves

Moberly in December created an economic-development commission that would use an independent third-party to vet companies, according to S&P, which says it's holding off on an upgrade because the policies haven't been tested.

There are exceptions to the revival, as some municipalities grapple with more than just failed projects. About 50 localities are rated below investment grade, or 0.5 percent of those rated by Moody's, Medioli said.

Atlantic City, New Jersey, for one, became a fallen angel in July. The gambling center is confronting a downward economic spiral as casinos expand in neighboring states.

Moody's said in a report Thursday that Atlantic City may default on its bonds. Its emergency manager released a report this week that proposed debt deferrals as one solution.

Moody's also cut Wayne County, Michigan, home of Detroit, three steps to speculative grade last month after its county executive warned of a "financial Armageddon" in 2016 unless it reduces a projected $70 million deficit.

The lesson for localities is that choosing to not pay for debt tied to development may prove a better option than appropriating and straining their finances, said Howard Cure, director of municipal credit research in New York for Evercore Wealth Management LLC, which oversees $5.7 billion.

That means investors shouldn't expect lasting punishment for governments reneging on obligations.

"If they can explain why they didn't pay for a particular series of debt, but continue to pay for their other series, the rating agencies are willing to eventually forgive and forget what they did," Cure said.

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March 25, 2015

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