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Puerto Rico's $72 Billion Mess Reunites Lehman Foes.

Some of the same distressed-debt buyers that started battling seven years ago over the remains of Lehman Brothers Holdings Inc. are now girding for a rematch over the U.S. territory's $72 billion of debt. That's likely to pit investors such as Fir Tree Partners — among firms that snapped up $4.5 billion of bonds the island has to pay before other obligations — against creditors including Angelo Gordon & Co. and Knighthead Capital Management. Those firms are part of a group that owns a majority of the more than $8 billion of borrowings by the U.S. territory's power agency.

The conflict is heating up after the Puerto Rico Electric Power Authority, known as Prepa, met with the financial adviser to its creditors Monday to restart talks toward a restructuring that may ask bondholders to take a loss or wait longer to be repaid. Hedge funds now hold as much as 30 percent of the obligations of Puerto Rico and its agencies, Barclays Plc municipal-debt strategist Mikhail Foux estimates.

"It's extremely disorderly and nasty," said Joseph Rosenblum, director of municipal-credit research at AllianceBernstein Holding LP. This "messy approach to trying to resolve something with no clear structure or guidance doesn't give a bondholder any kind of confidence," he said.

Few Opportunities

The reason so much hedge-fund money is riding on the island is simple: an increasing number of distressed-debt funds are chasing a declining number of opportunities. Little wreckage remains from the 2008 financial crisis, and six years of central-bank stimulus has kept tomorrow's bankrupt companies flush with cash.

Two of the biggest borrowers that teetered after the financial crisis, Energy Future Holdings Corp., the Texas power producer formerly known as TXU Corp., and the main operating unit of Caesars Entertainment Corp., are now in the hands of bankruptcy judges.

The face value of bonds in Bank of America Merrill Lynch's U.S. Distressed High Yield Index of corporate securities has declined to $104.6 billion from as high as $644.1 billion at the height of the 2008 financial crisis.

New Funds

At the same time, hedge-fund managers began trading in 24 new distressed-credit funds last year, the highest number since 2010, according to data provider Preqin. Five have started this year, with total assets growing to $150.3 billion.

"There are not any obvious large distressed situations, such as a Caesars or a Lehman Brothers or TXU, coming down the pike," said Stephen Ketchum, chief executive officer of the $6.5 billion hedge-fund firm Sound Point Capital Management, among investors in the island. "We were comparing Puerto Rico to some of the worst sovereign-debt situations in history and it just didn't make sense to us, especially since Puerto Rico is a U.S. territory."

Prices on Puerto Rico’s general-obligation bonds plunged to as low as 55 cents on the dollar last July, data compiled by Bloomberg show. They’ve since rebounded to about 68 cents. Bonds sold by Prepa reached 33 cents a year ago, and have since climbed to 56.

Offering a Chance

While the hedge funds are teeing up for a fight, their money is giving the territory a chance at getting out of its mess as traditional buyers like mutual funds flee.

“The capital from the distressed funds has given the current government at least a chance to enact the agenda and balance the budget in the short term,” said Aaron Rosen, a principal at Archview Investment Group, a Stamford, Connecticut-based hedge-fund that manages about $900 million and invests in some smaller Puerto Rico agencies.

Each of the funds is wagering in one way or another that Puerto Rico and its public agencies can raise revenue and cut costs before the Government Development Bank, lender to the commonwealth and municipalities, runs through its cash.

Angelo Gordon, Knighthead, D.E. Shaw & Co. and units of Goldman Sachs Group Inc. are among 11 firms that agreed to delay a default on nearly $5 billion of Prepa’s debt until Thursday. In a restructuring plan presented to creditors Monday, the power agency said it can’t support its debt service through existing cash flow and recommended at least $2.3 billion of investment to modernize operations and restore its finances.

Bondholders said the proposal is a basis for further talks, while calling some aspects “unworkable.”

‘Constructive Solution’

“While elements of the plan were positive from our perspective, there were also aspects that were unworkable and will require further negotiation,” Stephen Spencer, a managing director at adviser Houlihan Lokey, said in an e-mailed statement.

Knighthead’s Tom Wagner said in a statement that the firm continues to “believe that a constructive solution can be found that will result in Prepa receiving the capital funding needed to modernize its infrastructure” in a way that provides “more reliable service to consumers.”

Representatives for Angelo Gordon, D.E. Shaw and Goldman Sachs declined to comment.

Familiar Foes

During Lehman’s bankruptcy, Angelo Gordon, Knighthead, D.E. Shaw and Goldman were among investors that railed against a restructuring plan advocated by a group of creditors led in part by Fir Tree and Canyon Capital Partners, court records show.

Fir Tree, the New York-based investment firm founded by Jeffrey Tannenbaum, aligned with Monarch Alternative Capital and Stone Lion Capital Partners in other parts of the Lehman bankruptcy, the records show.

Fir Tree is now helping to lead a group of 35 firms that mostly own general obligation bonds. That also includes Monarch and Stone Lion. Canyon is also in the group, according to two people with knowledge of the matter.

Representatives for Monarch and Stone Lion didn’t respond to telephone and e-mail messages.

Spokesmen for Canyon and Fir Tree declined to comment.

If the commonwealth can't come to an agreement with that group on a planned sale of $2.9 billion of new debt backed by oil taxes, the GDB will run out of money by Sept. 30, according to the commonwealth's latest quarterly filing on May 7.

"We just blew the whistle of the first quarter of what will be a full game in Puerto Rico," Michael Lipsky, a partner at MatlinPatterson Global Advisers, said in an interview at his New York office. Matlin, which manages $7.2 billion, is invested across Puerto Rico debt, Lipsky said. "The cadence will quicken."

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