

Bond Case Briefs

Municipal Finance Law Since 1971

Hedge Funds Fight to Save Puerto Rico Investments.

Hedge funds like Appaloosa Management, Paulson & Company and Blue Mountain Capital gathered in a conference room at the Barclays offices in Midtown Manhattan last September to talk about what was then the hottest trade: Puerto Rico.

An hour into the conversation, however, it became clear that if things started going bad, not everyone in the room was going to get along. Some had wagered on real estate, while others had bought up the debts of the central government and its troubled electric utility.

Those divisions intensify an increasingly contentious battle the hedge funds are beginning to wage to salvage an investment that, less than a year ago, looked like a sure thing.

This week's announcement by Gov. Alejandro García Padilla of Puerto Rico that the commonwealth may seek to delay debt payments has thrown the hedge funds' investment strategies into turmoil.

Even debts that appeared to be secure now seem in jeopardy, sending hedge funds and other investors scrambling to re-examine their legal rights and potential remedies should the government push for a restructuring.

A vast restructuring of the commonwealth's bonds could scare away more risk-averse investors from buying them for many years to come, causing major problems for the hedge funds.

"Those investors are not coming back," said Robert Donahue, a managing director at Municipal Market Analytics. "The hedge funds miscalculated and they are feeling the pain."

While some hedge fund managers say they were caught off guard by Governor García Padilla's call for a debt restructuring, they are not panicking, even as the price of some of their bond holdings has fallen 17 percent in the last two days.

They see the governor's announcement as more of an opening salvo in a negotiation rather than an indication of imminent and widespread defaults, particularly on debts that Puerto Rico's Constitution says must be repaid.

Some analysts say the governor's announcement may have been intended in part to drive down the value of the hedge funds' bonds so that the firms would be more willing to agree to concessions in order to minimize their losses.

"The Puerto Rico government has engaged in the creation of a crisis where there isn't one," said Hector Negroni, a principal at Fundamental Advisors, which owns Puerto Rico debt. "But I don't think they will ultimately flout the rule of law. At the end of the day, they need to borrow money again. And no one will lend them money if they break the Constitution."

Lending more money to Puerto Rico had been a major part of some hedge funds' strategy. They planned to allow the commonwealth to help fund its operations with borrowed money so it could take steps to jump-start the economy.

When Puerto Rico issued \$3.5 billion in general obligation bonds last March, a long list of hedge funds participated, including Paulson & Company and Och-Ziff Capital Management.

Paulson & Company immediately sold its approximately \$120 million holding, according to a person familiar with the firm's trading, and it was unclear whether the other hedge fund managers later sold their similarly sized positions.

The bonds were sold last March at about 93 cents on the dollar. On Tuesday, the bonds were trading as low as 64 cents, according to Municipal Market Analytics.

Many of the same hedge funds have been offering to lend the government as much as \$2.9 billion in a bond supported by a fuel tax. But the government has refused to negotiate a deal in recent months, hedge funds managers say.

Aides to Governor García Padilla said in an interview last week that they had not ruled out borrowing more money from hedge funds, but that they first needed to examine all their options, including a vast restructuring of current debts. The aides added that the initial deal terms were too onerous.

Some hedge funds had invested in Puerto Rico debt, expecting a restructuring all along. Firms like Blue Mountain Capital have bought up bonds owed by the Puerto Rico Electric Power Authority at steep discount. On Tuesday, the utility was close to a deal that would avert a default and possibly allow some of its creditors to eventually profit from their investments in its \$9 billion in debt.

Until this week, a restructuring of general obligation bonds, which carry a constitutional guarantee to repay, seemed like an impossibility, making the hedge funds' investment look bulletproof.

For the hedge funds, the idea was to lend the money at high interest rates, then flip the bonds to traditional municipal bond investors, like mutual funds, once the fiscal crisis on the island had passed. As part of that strategy, some of the hedge funds circulated research last summer arguing that Puerto Rico's problems were overstated.

But Governor García Padilla is now contending exactly the opposite, releasing a report by former officials at the International Monetary Fund and the World Bank that says that Puerto Rico's deficit is worse than it appears and that the commonwealth cannot solve its problems without restructuring its debts, possibly even its general obligation bonds.

Still, Puerto Rico's relationship with the hedge fund industry is complicated. At the same time the government is gearing up for a series of restructurings with hedge funds and other creditors, officials are courting investments in the broader economy.

Hedge funds have been among the few investors willing to take a chance that Puerto Rico can turn things around.

Puerto Rico's biggest hedge fund cheerleader in New York has been the billionaire John A. Paulson. Mr. Paulson told investors at an investment conference in San Juan last year that Puerto Rico's economy was turning a corner. He went as far as to predict it would be the Singapore of the Caribbean, referring to the Southeast Asian city-state that is considered the region's biggest economic success story.

Mr. Paulson bought up some of the island's most exclusive luxury hotels, including the St. Regis Bahia Beach Resort, the Condado Vanderbilt Hotel and the La Concha Renaissance hotel and tower.

And he has acted as a de facto liaison between the commonwealth and Wall Street.

Mr. Paulson recently suggested that Puerto Rico officials attend the hedge fund industry's biggest event of the year — the SkyBridge Alternatives Conference in Las Vegas, according to Alberto Bacó Bagué, Puerto Rico's secretary of economic development.

Mr. Paulson met with Mr. Bagué on the sidelines of the conference and helped arrange a meeting with James J. Murren, the chief executive of MGM Resorts, Mr. Bagué said.

"He is building a home, and he is validating our economic model with all his colleagues and friends and the investments that he has," Mr. Bagué said.

THE NEW YORK TIMES

By MICHAEL CORKERY and ALEXANDRA STEVENSON

JUNE 30, 2015

Copyright © 2024 Bond Case Briefs | bondcasebriefs.com