California's Zombie Agencies Beat Rally as Mass Defaults Averted.

Since California shut down 400 authorities that redeveloped blighted neighborhoods, the $30 billion of bonds left behind have rallied as local governments defied speculation about widespread defaults.

Debt from the agencies returned 42 percent in the four years that ended Aug. 31, almost double the overall municipal market and beating the 28 percent for California tax-exempt bonds, according to an analysis by Nuveen Asset Management. Only two cities have missed payments on the securities since Governor Jerry Brown shuttered the agencies in early 2012 to help close the state's budget shortfall.

The bonds, which are financed with local property taxes, have benefited from an orderly payment process overseen by the state and surging real estate prices. The assessed value of California properties increased 4.4 percent to $4.8 trillion in the year ended June 2014, exceeding the peak reached in 2009 before the full impact of the housing-market crash rippled through local tax rolls.

"Whenever there's noise, there's often opportunity," said Stephen Candido, senior research analyst in Chicago at Nuveen, which holds the debt among its $230 billion of assets. "The market is often fearful. We were more focused on the long-term upside, knowing from early on that repaying these bonds would be a priority."

Brown and his fellow Democrats in the legislature abolished the agencies to redirect about $1 billion of their funds to schools, which eased the financial pressure on the state in the aftermath of the recession.

Some consultants to cities warned at the time that they may be unable to cover the agencies' debt bills. In 2012 Moody's Investors Service downgraded $11.6 billion of the securities to junk, citing uncertainty about whether localities would renege on the obligations.

While San Bernardino, a city of 215,000 east of Los Angeles, said the burden contributed to its 2012 bankruptcy, elsewhere the impact has been more limited. The only cities that have missed bond payments are Riverbank, near Modesto with $15.4 million of the debt, and Monrovia east of Los Angeles, which has $11.75 million, according to Municipal Market Analytics in Concord, Massachusetts.

Legacy Debts

Municipalities once used the agencies to borrow for projects that improved blighted areas. A portion of the real-estate taxes that resulted were used to pay off the bonds. Since the agencies were closed, local governments have been required to outline their obligations every six months to the state Finance Department, which has the authority to require them to prioritize payments to bondholders.

The process has gone smoothly, said H.D. Palmer, a spokesman for the department.

The outcome contrasts with investors' initial concerns, said Matt Fabian, an analyst with Municipal Market Advisers.

"RDAs are performing better in the market because much of the uncertainty about the sector's transition has gone away," Fabian said by e-mail. "Plus the turmoil in the last few years likely shook loose a fair bit of the retail owner base, leaving the bonds in institutional hands, implying a bit more trading and liquidity than most municipal sectors."

Bonds Gain

The $85 million of San Jose redevelopment agency bonds maturing in 2030 traded Tuesday for an average price of $1.04 on the dollar, up from 77 cents in December 2011. That reduced the yield to 2.1 percent from 6.4 percent. Bonds sold by Stockton's authority, which come due in 2036, traded Wednesday for 100 cents on the dollar, up from 87 cents in late 2011.

Moody's no longer takes a dim view of the sector, said Robert Azrin, a senior analyst for the company. The median rating for California redevelopment debt is Baa1, three ranks above junk, he said.

"At the time, they were valid concerns, but with each year that's passed, we've seen that these payment schedules have gone smoothly," Azrin said. "With the passage of time, a lot of the risks we identified haven't come to fruition."

Many redevelopment bonds may also be refinanced in the next couple of years as securities issued in 2006 and 2007 reach their 10-year calls, which allow the local governments to pay them off early at face value, said Candido, the Nuveen analyst. He said he expects the bonds to remain popular among investors because governments have been meeting their obligations.

"Here we are in 2015 and they're finally addressing the concerns of investors," he said.

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