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Junk Deals Derailed as High-Yield Muni Funds Pull in Less Cash.

The municipal-bond market is forcing high-yield borrowers to scrap their junk.

The Florida Development Finance Corp. this week postponed a $1.75 billion unrated bond sale for All Aboard Florida, a passenger railroad backed by Fortress Investment Group LLC, that underwriters have been marketing since August. A Texas agency has delayed pricing $1.4 billion of speculative debt for a methanol plant since releasing offering documents Oct. 19. And the Puerto Rico Aqueduct & Sewer Authority, struggling to access capital as the island staggers toward default, couldn't lure buyers even with yields of 10 percent.

The struggle to sell the munis mirrors the slowdown in the corporate-debt market for much of the year amid signs of a weakening Chinese economy and declining commodity prices. With speculation growing that the Federal Reserve will raise interest rates for the first time in nearly a decade and Puerto Rico's fiscal crisis escalating, the flow of money into funds that invest in the riskiest munis has slowed to $1.2 billion this year, compared with $8.8 billion in 2014, Lipper US Fund Flows data show.

"You're not seeing a tremendous amount of money coming in and really burning a hole in people's pockets," said Mark Paris, who runs a $7.3 billion high-yield muni fund from New York at Invesco Ltd. He said he or a colleague visited Florida and Texas to analyze the rail and methanol offerings, though he declined to say whether he'll buy the bonds. "Size is becoming an issue — you're not going to have every high-yield fund in these. There are only a certain amount of bonds funds can take."

Large junk-bond deals are rare in the $3.7 trillion municipal market, which is mostly made up of states, cities, counties and school districts at little risk of defaulting. Until Puerto Rico issued $3.5 billion of general obligations last year, the biggest speculative-grade deal was $1.2 billion.

There are only 12 open-end funds focused on high-yield munis that have more than $1 billion in assets, data compiled by Bloomberg show. Many have large stakes in investment-grade borrowers like California, which has had its credit rating raised repeatedly since the recession as its finances improved.

By contrast, All Aboard Florida's bonds are unrated, which is an indication they'd receive a junk rating. It's parent, Florida East Coast Industries, was ranked seven steps below investment grade by Standard & Poor's last year. The methanol-plant bonds for OCI N.V.'s Natgasoline LLC will probably have a rank three steps below investment grade, according to David Ambler, who analyzes high-yield munis at AllianceBernstein Holding LP in New York. The Puerto Rico agency, known as Prasa, has the third-lowest mark, Caa3, from Moody's Investors Service.

Size An Issue

"The biggest issue that's postponing these deals is just the absolute size of each one, and they're certainly speculative," said Mike Petty, manager of the $1.8 billion MainStay High Yield Municipal Bond Fund. "It'll be difficult to get that many bonds done within our space. The underwriters have been trying to get crossover interest as well."

With Puerto Rico veering toward default, some hedge funds and distressed-debt buyers may be leery of buying more high yield munis, said Invesco's Paris. Such investors, know as crossover buyers because they're not limited to specific markets the way mutual funds frequently are, hold as much as a third of the island's $70 billion of debt, according to Mikhail Foux at Barclays Plc. Puerto Rico's bonds have slumped more than 10 percent this year.

"There's a lack of crossover hedge fund buyers who can come in and take up the slack of what the tax-exempt buyers don't buy, and that's slowed down the order process," said Paris, whose fund has gained 3.8 percent this year, beating 93 percent of its high-yield peers. "I've been surprised at how long people have talked about these deals."

High-yield munis have delivered lackluster gains this year. They've returned 0.8 percent, about half what was seen in the broad municipal market, Barclays data show. That's partly because of Puerto Rico, whose bonds make up at least 25 percent of the index.

Gauging Risk

The offerings that have struggled to find buyers carry more risk than typical munis.

Puerto Rico's sewer agency, which shelved a $750 million sale, could be swept up in the commonwealth's debt restructuring, with Governor Alejandro Garcia Padilla seeking to persuade investors to accept less than they are owed. All Aboard Florida would be the first new privately run U.S. passenger railroad in more than a century, a project whose success will hinge on travelers' willingness to abandon their cars in favor the 235-mile (378-kilometer) train line running from Orlando to Miami. The methanol plant is an effort to break into a business dominated by foreign competitors.

All Aboard Florida spokeswoman Melissa Shuffield didn't return phone calls seeking comment. Omar Darwazah, a spokesman for OCI, didn't respond to a phone call and e-mail seeking comment.

With interest rates near generational lows and the Federal Reserve signaling it may end its almost seven-year policy of keeping borrowing costs close to zero, investors are rightfully slow to commit to new deals, said Jim Murphy, who manages T. Rowe Price's $3.3 billion high-yield fund from Baltimore.

"It's that much more important to be careful when spreads are tight and rates are low like the environment we're in," Murphy said. "People are being really careful and that's refreshing."

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by Brian Chappatta

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