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Not Your Grandfather's Municipal Market: Investors Eye Recovery Value.

Tainted from the Detroit bankruptcy and mired in the Puerto Rico debt crisis, investors are re-evaluating the former safe haven of the bond world, municipals, and emphasizing recovery values in their credit work.

Bonds that had what is known as an unlimited tax general obligation pledge once held the apex of security for muni investors as debt offering documents promised that a municipality would tax its citizens as much as needed in order to make good on its debt payments. Plummeting tax collection rates and a population exodus made this difficult for the Motor City, leading to its historic bankruptcy.

The Detroit case left holders of the unlimited tax GOs with a recovery of 74 cents on the dollar while retirees kept almost all of their benefits, inciting an about face in investor calculus. Now, lawmakers are pushing legislation to assure bondholders of the formerly sacred debt's “secured status” in bankruptcy.

California passed Senate Bill 222 into law this year, while Illinois' bankruptcy bill HB 4214 floats in the legislature. Michigan and Nebraska have legislation on the table promising investors a statutory lien on revenue sources. Meanwhile, investors embroiled in Puerto Rico's debt crisis are battling bankruptcy eligibility in and of itself.

Lawyers agree that the statutory lien could improve recovery values in a Chapter 9 bankruptcy, making bondholder claims secured. The feature helped bondholders in the Central Falls, Rhode Island case, although it was not litigated.

These legal developments may affect the bargaining power afforded to capital markets creditors in future bankruptcies, as they make lien protection unambiguous for bondholders, said Robert Christmas of Nixon Peabody.

And the market seems to agree. Detroit tested its market access in August for the first time since emerging from bankruptcy, coming to market with $245 million in debt, backed by a lien on income tax revenues. The formerly-insolvent city managed to woo investors with 4.5% yields, high for the A credit rating, but arguably low for a city that gave bondholders a haircut.

The successful issuance highlights an evolving approach to municipal investing. Investors are pricing in the statutory lien status, which is only relevant in a bankruptcy, noted William Bonawitz, director of research at PNC Capital Advisors.

Lower yields mean lower costs for borrowers, which leads some to argue that the legislation would be beneficial to cities and school districts nationwide. Others claim it creates an uneven playing field for creditors.

As muni players catch up to their corporate counterparts in the area of recovery analysis, they may hit a brick wall. There is little precedent to determine whether the new legalese will provide investors the security they hope for. Moreover, municipalities can't simply cease to exist.

If a judge is faced with deciding between funding the public safety and health requirements of a municipality or paying bondholders, the judge might favor tax-paying citizens, investors tell Debtwire.

Recovery analysis is distinctly different in public finance. Buyers of distressed corporate debt can walk away with equity in a company, while a municipality's biggest assets are its taxpaying citizens. There is no way to boost value so that investors walk away with a bigger piece of the pie.

Municipalities granting secured status to more and more bonded debt could reach a point where the revenue stream backing the bonds becomes diluted, and the value of the lien itself deteriorates, Bonawitz concluded.

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