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Chicago Schools in Fiscal Limbo as Clash Builds Before Bond Sale.

Chicago's public schools are under fiscal siege as the political clash between the state's top Republicans and the city's Democratic mayor escalates, rattling investors as the nation's third-largest district struggles to avert insolvency.

The conflict over the fate of the school system threatens to force the Chicago Board of Education to pay a steep premium when it sells \$875 million of bonds on Wednesday. The deal comes a week after Republican Governor Bruce Rauner called for the state to take over the district and potentially authorize bankruptcy.

That idea was immediately rejected by Democrats in control of the legislature and Chicago Mayor Rahm Emanuel, who have unsuccessfully pushed for an influx of state aid.

The offering, one of the lowest-rated municipal bond sales in recent history, would have refinanced debt to put off interest payments. The pressure has been building on the school system, with Moody's Investors Service, Standard & Poor's and Fitch Ratings cutting its rating deeper into junk, the teachers union threatening to strike and a deficit that's projected to reach \$1 billion a year through 2020.

Securities due in 2044, the longest-dated tax-exempt portion of the deal, are being marketed at yields of 7.75 percent, according to four people familiar with the sale who requested anonymity before pricing. That's 5 percentage points above benchmark debt that matures in 29 years, according to Bloomberg data.

"All of this negativity ahead of the bond sale could increase the cost that the Chicago public school system has to pay to borrow money — and, in a worst case, they may not be able to issue all the debt that they had hoped to," said Paul Mansour, the head of municipal research at Conning, which oversees \$11 billion of state and local debt, including some of the board's securities. "They're getting hit on all sides as they're trying to bring this large deal to market, which is critical."

Chicago's schools are running out of cash after years of raiding reserves and shortchanging its pensions, which caused its annual payment to soar. An effort to rescue the schools has been caught in the financial and political crosscurrents of the city and Illinois, both of which are contending with their own fiscal strains.

Rauner, who is locked in an impasse with legislative Democrats that's left the state without a budget since the year started in July, has said he'll only help if Emanuel supports changes that the governor is pushing for, such as limits on unions. Emanuel has said Rauner's holding the schools hostage to the state budget stalemate, noting that Chicago's is the only district that pays the vast majority of its own pension costs. The board must pay \$676 million to its teachers' retirement fund by June 30.

Faced with such pressure, the district has suffered a slew of downgrades from Wall Street credit-rating companies. Moody's cut the district on Dec. 21 to B1, four steps below investment grade,

because of its dwindling cash. S&P dropped it to an equivalent B+ on Jan. 15. Four days later, Fitch lowered it to the same rank.

“This is a rescue financing,” said Matt Fabian, a partner at Concord, Massachusetts-based Municipal Market Analytics. “This is a restructuring of its debt. So absent this bond issue, there’s a serious chance that CPS could default.”

The sale of \$796 million of tax-exempt securities and \$79 million of taxable debt will fund capital projects, refinance variable-rate debt and pay off short-term loans used to cover fees on derivative trades that banks had the right to cancel after the district’s credit rating tumbled. The city was hit by the same penalties after Moody’s cut it to junk last year.

‘Breaking Point’

Forrest Claypool, the board’s chief executive officer, has faulted what he calls an inequitable school-funding system that’s helped push the district to the “financial breaking point.” While Illinois contributes about \$2,266 per student to teacher pensions in districts outside of Chicago, the city gets only \$31 per student, bond documents show. Chicago’s pension system was only 52 percent funded as of June 30.

Investors are demanding high yields to lend to the district. When it sold \$65 million of 3-month notes last month, it paid 3.25 percent, more than 10 times what’s demanded of top-rated borrowers.

The interest rates may be a draw for some, said Lyle Fitterer, head of tax-exempt fixed income at Wells Capital Management, which oversees \$39 billion of munis. He’s considering purchasing some Wednesday because he views the probability of bankruptcy as “almost zero.”

Illinois doesn’t allow localities to file for Chapter 9, and a proposal last year to allow that hasn’t advanced. The securities are backed by state aid revenue and a direct deposit of pledged taxes if that’s not enough, bond documents show.

“You have an entity that cannot file bankruptcy, does not want to file bankruptcy, and you’ve got a good management team in there,” said Fitterer, who holds some Chicago school debt. “For the right investors, it’s probably going to be a pretty attractive opportunity.”

Only the most speculative of buyers should consider the bonds, said Triet Nguyen, a managing director at New York-based NewOak Capital LLC.

“It feels so much worse, particularly against the backdrop of what’s going on at the state level,” Nguyen said. “A year ago, we certainly didn’t expect we were going to have this kind of gridlock at the state level. If it goes on much longer, it’s just going to make CPS’s problems that much worse.”

Bloomberg Business

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January 26, 2016 — 9:01 PM PST Updated on January 27, 2016 — 7:26 AM PST