Bond Case Briefs

Municipal Finance Law Since 1971

Puerto Rico's Argentina-Like Debt Gambit Comes With a Big Catch.

Puerto Rico is turning to a novel, yet increasingly popular, approach to lighten its crippling $70 billion debt load.

Pioneered by Argentina in the mid-2000s, and used by Greece and Ukraine in debt restructurings in recent years, the proposal is part of a plan to cut the island's obligations by 46 percent and avert a default that would be the biggest of its kind. The novel part is a sweetener — in the form of "Growth Bonds" — that could potentially help creditors get all their money back.

But there's a catch: the bonds only pay out if Puerto Rico can collect enough taxes over the next 35 years. And for the commonwealth, that's a big if.

While it worked in Argentina because the commodities boom helped the nation quickly recover from its fiscal crisis, Puerto Rico faces a very different set of circumstances. Not only has the economy contracted in the past decade, its prospects remain bleak. That's raising questions about whether the offer is credible enough to win over bondholders as they kick off negotiations over how to restructure its debt.

"It's hard to see any meaningful economic growth coming out of Puerto Rico in the foreseeable future," said Matt Fabian, a partner at Municipal Market Analytics, a research firm based in Concord, Massachusetts.

"Those securities would essentially have no value. The most likely outcome is that they never receive a payment."

The stakes are high. After years of borrowing to fix budget shortfalls, Puerto Rico warned creditors that it may stop debt-service payments if it fails to renegotiate its debt before May 1, when a $422 million Government Development Bank payment comes due. Two commonwealth authorities have already defaulted on payments to investors.

Puerto Rico's proposal, announced on Monday, would reduce its obligations to $26.5 billion from $49.2 billion. Bondholders would swap their securities for new notes that delay principal and interest payments.

The plan consists of two types of securities: so-called Base Bonds that begin paying interest in 2018 and the aforementioned growth bonds, which repay principal after 10 years only if Puerto Rico's revenue collections surpass targeted levels. Creditors have a chance to recoup all of their money if revenue growth exceeds the estimated annual rate of inflation.

Puerto Rico estimates it will begin repaying the growth bonds in 2029, if the island's economy begins to grow at 2.5 percent by 2022, according to the restructuring plan. That might be an optimistic assumption.

"It's difficult to come up with economic scenarios where Puerto Rico grows at 2.5 percent in the near future," said Orlando Sotomayor, a professor of economics at the University of Puerto Rico. "All economic fundamentals point in the opposite direction and include declining population, workforce participation, reduced investment, and education."

The proposal also doesn't detail how the commonwealth will support its largest pension fund, which owes current and future retirees $30.2 billion — a big question mark for Lyle Fitterer, the head of tax-exempt debt at Wells Capital Management, which oversees $39 billion of municipal bonds, including Puerto Rico securities.

"That's a big unknown," Fitterer said. "That obviously will impact bondholders' ability to get paid back."

Upside Potential

Growth bonds aren't entirely new to the $3.7 trillion municipal-bond market. Many housing or community development-projects are financed with tax-exempt securities that are repaid based on future increases in property taxes or assessment fees.

Greece and Ukraine have sold similar securities to help restructure their debt. Last year, Ukraine included so-called GDP-linked warrants, whose payouts are tied to economic growth hurdles. The benefit for the issuer is that payments aren't made until economic growth can support them. For bondholders, they offer the potential for bigger profits once the borrower gets back on its feet.

"The upside of the growth bonds is directly in line with the economic recovery of the commonwealth," Barbara Morgan, a spokeswoman who represents the Government Development Bank at SKDKnickerbocker in New York, said in an e-mail. "Without a willingness from all parties to invest in solutions that move the island's economy down that path, no one wins."

Still, the securities can be notoriously hard to value. And for issuers, it's questionable whether they're worth it because of how big a liability they can become over time. When Argentina initially issued the GDP warrants in its 2005 debt swap after defaulting on $95 billion in 2001, the securities were deeply discounted by some investors who were skeptical of the country's growth prospects.

As the economy grew, the warrants created a larger-than-anticipated debt payment for Argentina. It's paid investors about $10 billion since 2005. And the country could potentially be on the hook until 2035 — when the warrants finally mature.

"It really depends individually on each country and each security that you look at," said Siobhan Morden, the head of Latin American fixed-income strategy at Nomura Holdings Inc.

Bloomberg Business

by Michelle Kaske

February 2, 2016 — 9:01 PM PST Updated on February 3, 2016 — 5:54 AM PST