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Chicago Schools Pay Bigger Bond-Market Penalty Than Puerto Rico.

If municipal-debt investors want further evidence that Chicago's schools are in financial distress, its \$725 million bond deal this week is all the proof they need.

After delaying the sale when some investors balked, the district issued 7 percent debt for as little as 84 cents on the dollar, signaling that investors have doubts they'll be repaid in full. No municipal borrower — not even cash-strapped Puerto Rico — has had to offer such a steep discount on a bond deal of that magnitude since at least the 2008 financial crisis, data compiled by Bloomberg show.

"The only time you're going to see this big of a discount is when it's a distressed situation," said Burt Mulford, a manager of tax-exempt funds in St. Petersburg, Florida, at Eagle Asset Management, which oversees \$2.5 billion of munis. He said he didn't buy the bonds. "The ultimate buyers want to minimize the pain if it stops paying interest, so if they have the bonds at a discount, that would help offset that."

The nation's third-largest district, with almost 400,000 students, is on the brink of insolvency after years of skipping pension payments, drawing down reserves and borrowing to cover operating costs, pushing its \$6 billion of outstanding debt deeper into junk. While Mayor Rahm Emanuel, a Democrat, has pushed for more aid, Republican Governor Bruce Rauner has called for a state takeover and changing the law so the district could file for bankruptcy.

The district's ability to access the market Wednesday showed there's some optimism that it will be able to deal with its fiscal strains. The proceeds provided an injection of cash that will help it pay off maturing debt and reduce the near-term strain on its budget. It has a debt-service payment due on Feb. 15, which officials said will be made.

"We're buying time to fix the system," Forrest Claypool, the district's chief executive officer, said during a Feb. 3 interview on "Chicago Tonight," a public television show. When asked whether the district can go back to Wall Street to borrow again, Claypool said he didn't know.

The discounted price on the securities increased the yields — which measure the return after interest payments based on the full face value — to as much as 8.5 percent, about 5.8 percentage points more than top-rated securities. That gap was half a percentage point more than Puerto Rico paid in March 2014, when it sold \$3.5 billion of bonds in a last-ditch attempt to stave off insolvency. The island's bonds have since slipped from 93 cents on the dollar to about 70 cents as it edges closer toward defaulting on the government-guaranteed debt.

With distressed debt, buyers tend to focus more prices because of the risk that interest or principal payments won't be made.

The Chicago Board of Education's sale price indicates that investors burned by Puerto Rico have learned a lesson. They're demanding more to lend to highly indebted issuers that rely on a steady stream of borrowed money, said Alan Schankel, a managing director at Janney Montgomery Scott,

and Richard Ciccarone, the president of Merritt Research Services, which tracks municipal finance.

Jessica Francisco, a spokeswoman for JPMorgan Chase & Co., a main underwriter on the deal, declined to comment. Emily Bittner, a spokeswoman for the schools, declined to comment.

Landmark Deal

No state or local government has managed to issue so much debt with credit ratings as low as Chicago's schools, Bloomberg data show. Puerto Rico had a BB+ rating from Standard & Poor's, three steps higher than the district's B+, when it last borrowed almost two years ago. Even Jefferson County, Alabama, had an investment grade upon emerging from bankruptcy in 2013, when it issued 6.5 percent sewer debt due in 2053 at 95 cents on the dollar.

Illinois law doesn't allow Chicago's schools to file for bankruptcy, which gives investors some confidence that what they're owed won't be written down in federal court. Democrats who control the legislature dismissed Rauner's push to allow for Chapter 9 as dead on arrival. Emanuel has enacted a record property-tax increase and sought to reassure the bond market that the city's finances are on the mend.

Investors in the Chicago deal probably bought with the expectation that state and city officials will take steps to put the school district on more stable financial footing, said Dan Solender, head of municipals in Jersey City, New Jersey for Lord Abbett & Co., which holds Chicago school bonds among its \$17 billion of debt. He declined to say whether he bought at this week's sale.

If it eventually wins higher credit ratings, the school system could refinance the long-term debt in 10 years by triggering call provisions that allow it to buy back the securities. At that point, investors would get repaid \$100 for every \$84 they invested.

And if the district veers towards the bankruptcy route endorsed by Rauner, bondholders won't have lent it as much money as they would have last week, when underwriters initially tried to sell \$875 million of debt.

"It really tells us the market is starting to think about how distressed credits trade," said Neil Klein, senior managing director in New York at Carret Asset Management, which oversees \$750 million of munis and declined to buy the Chicago debt.

"There's not as much concern about the ultimate yield to maturity you're achieving. They're looking at dollar price," he said. "That's very different than your traditional municipal bond buyer, who makes assumptions that bonds will pay until maturity."

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