Chicago Schools Slash High-Yielding 'Junk' Bond Deal.

CHICAGO — Chicago's troubled public school system on Wednesday had to slash the size of one of the biggest "junk" bond offerings the municipal market has seen in years and agree to pay interest costs rivaling Puerto Rico's in order to lure investors into the deal.

The Chicago Board of Education managed to sell only $725 million of an originally planned $795.5 million of tax-exempt bonds, and yields on the deal topped out at 8.5 percent, a massive premium relative to higher-rated debt sold in the U.S. municipal bond market and a clear indication of investors' view of the depths of the district's fiscal woes.

Wednesday's sale came a week after the school system had to pull the deal in its first attempt at an offering amid worry by investors that the district could end up in bankruptcy.

The nation's third-largest public school system has become dependent on borrowing to bolster its budget, which is sinking under escalating pension payments, despite credit ratings that have dropped into the "junk" level.

The 8.5 percent yield for bonds due in 2044 with a 7 percent coupon was slightly below the 8.727 yield for 21-year bonds in the municipal market's last big junk bond sale – a $3.5 billion Puerto Rico issue in March 2014.

But the school district's so-called credit spread over the market's benchmark triple-A scale was wider at 580 basis points versus 514 basis points for Puerto Rico in 2014, indicating investors are demanding a stiffer penalty from the Chicago Public Schools (CPS).

"It's a Puerto-Rico grade yield and clearly signals that the district is on an unsustainable path," said Matt Fabian, a partner at Municipal Market Analytics.

In contrast, a top-rated issuer's debt would yield only around 2.70 percent on Wednesday, according to Municipal Market Data's benchmark scale.

CPS officials said bond proceeds will reimburse the district's operating fund for out-of-pocket capital costs and free up $206 million by pushing out debt service payments. Portions of the deal to restructure variable-rate debt to fixed rate and finance-related interest rate swap termination fees were postponed.

"Along with the tough cuts announced yesterday and earlier this year, the sale of these bonds will produce sufficient proceeds to mitigate our cash flow challenges through the end of the fiscal year," said CPS Senior Vice President of Finance Ron DeNard in a statement.

Late on Tuesday, the district tried to assure prospective investors that revenue pledged to pay off the debt could continue to flow to them should the school district end up in bankruptcy court in the unlikely event the Democratic-controlled Illinois legislature would pass a Republican-sponsored bill permitting the move.

Republican Governor Bruce Rauner on Wednesday condemned the district's second attempt at borrowing, but denied trying to sabotage the system's bond issue by publicly advocating bankruptcy for CPS.

"The numbers don't lie," he told reporters. "CPS has been a financial disaster for years. The balance sheet is stunningly bad. Now they're looking at borrowing more money to cover operations."

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(Editing by Grant McCool and Matthew Lewis)