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Muni-Bond Funds Burned Chasing Yield With Wood-Pellet Bankruptcy.

Wood pellets are made to be burned. It turns out a Louisiana facility that was built to make the pieces for power plants is doing the same to municipal-bond investors.

Invesco Ltd., Waddell & Reed Financial Inc. and AllianceBernstein Holding LP are among buyers left in limbo after Louisiana Pellets Inc., a subsidiary of the world's biggest pellet maker in Germany, filed for Chapter 11 bankruptcy last month. After selling almost $300 million in municipal debt since 2013, it defaulted on some taxable bonds on Jan. 1 because its facility in a small lumber town struggled to ramp up output to the levels projected in initial offering documents.

The project is the latest example of the risks associated with chasing yield in the portion of the $3.7 trillion municipal market that finances industrial-development projects, the segment most prone to default.

Investors have had few opportunities to buy recently and a lot of money to work with: High-yield muni funds saw inflows in 94 of the 116 weeks since the start of 2014, Lipper US Fund Flows data show.

The wave of cash means "you have people jumping over themselves chasing incremental yield," said John Bonnell, a fund manager who oversees about $10 billion of state and local-government debt at USAA Investment Management Co. in San Antonio. "There used to be a saying way back when: If something couldn't get financed in the bank market or the corporate market or the equity market, it would get done in the muni market."

Local authorities often issue debt for companies, hospitals and nonprofits, which back the obligations. While they often work with well-established borrowers, so-called conduits since 2014 have financed — or tried to finance — speculative projects including a sewage-to-fertilizer plant, a new home for USA Basketball and a methanol plant near Texas's Gulf Coast that's seeking to challenge foreign producers that dominate the business.

A Louisiana public authority issued $140 million of debt in November 2013 on behalf of the pellet company, which built a facility in Urania, a lumber town of 1,300 about 245 miles (394 kilometers) northwest of New Orleans. Investors extracted a steep price to compensate for the risk: Partially tax-exempt securities due in 2039 paid 10.5 percent interest, or 6.4 percentage points more than AAA munis, according to data compiled by Bloomberg. Subsequent rounds of financing came through private placements in 2014 and 2015, the data show.

The pellets are made from wood residues like sawdust or shavings that are then dried and compacted.

Electricity producers burn the pieces, which are considered carbon-neutral, along with coal to comply with renewable-energy mandates.

Facing adverse weather and construction setbacks, the facility failed to meet production expectations. A sharp decline in the price of traditional energy sources like oil and natural gas added financial strain to the parent company, Wismar-based German Pellets, which declared insolvency overseas last month.

Bondholders' View

Invesco is the largest holder of Louisiana Pellets debt, with about $89 million in its funds as of Dec. 31, data compiled by Bloomberg show. The next biggest owner is Waddell & Reed, with $22.5 million, then AllianceBernstein with $18.5 million, the data show.

Claudia Röhr, a German Pellets spokeswoman, didn't respond to an e-mail seeking comment on its plans for the Louisiana facility or the options available to repay bondholders.

"The quickness of this project coming under scrutiny and into trouble is concerning to us, but it's why you run a diverse portfolio," said Mark Paris, who runs Invesco's $7.7 billion high-yield muni fund from New York. "This is one of those situations where as a bondholder, we're going to be working out the situation with the borrower. It's probably not something we are going to try and sell out of."

Michael Walls, who manages the $869 million Waddell & Reed Advisors Municipal High Income Fund, declined to comment, citing restrictions from being part of a group that agreed not to publicly discuss certain details of the project. The Louisiana Pellets bonds due in 2039 with a 10.5 percent interest rate are the second-largest holding in the fund.

"We believe that eventually the first phase of this plant can operate successfully — and have a new owner — but it is way too soon to know about expanding beyond that," Dean Lewallen, a senior high-yield municipal credit analyst at AllianceBernstein, said in an e-mail. "The near-term focus is to get it operating again."

German Pellets began financing the plant in late 2013 when oil was still selling for about $100 for a barrel, compared with $40 now. Natural gas prices have been cut in half over the period.

'Very Vauable'

The plant was supposed to produce 500,000 metric tons of pellets annually by operating at about 87 percent of capacity, according to offering documents from the 2013 sale. Instead, in the second half of 2015, it produced just 101,000.

German Pellets also borrowed $187 million in 2012 through a development agency in Sanger, Texas, for its first U.S. location, in Woodville, Texas. Invesco is the largest holder of those securities as well, with $39.6 million, Bloomberg data show.

Unlike its Louisiana counterpart, the Texas plant is operating as expected, producing more in three months than the Urania facility did in twice the time.

"We believe there is a very strong international demand for the product, and we expect these plants to be very valuable," said Paris, the fund manager for Invesco. "They're the largest, they're new, and we expect them to be very valuable assets."

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