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Puerto Rico Crisis Spreads as Fewer Issuers Can Avoid Junk Fate.

As Puerto Rico's fiscal crisis reaches a tipping point, even some of the island's strongest borrowers with few or no ties to the government are finding themselves struggling to stave off a junk credit rating.

Standard & Poor's lowered almost $100 million of tax-exempt debt backed by Sistema Universitario Ana G. Mendez, a private non-profit college with multiple Puerto Rico campuses, to BB+ from BBB- last month. The cut, the first in over a decade, puts the bonds below investment grade, a blow to investors including OppenheimerFunds Inc., Massachusetts Financial Services Co. and Capital Group Cos.

Of the $70 billion in municipal bonds that Puerto Rico and its agencies issued, just $1.7 billion remains investment grade, data compiled by Bloomberg show. Much of the higher-rated debt is backed by private universities and hospitals with no direct government ties, while the tangled web of commonwealth borrowers is deep in junk status. The Ana G. Mendez downgrade shows that the island's economic stagnation and population loss is reaching corners of the Puerto Rican bond market still owned by investors who have otherwise fled.

"Even though they may be independent from the financial problems of the commonwealth, they're not independent of that economy, and that economy continues to contract," said Guy Davidson, who oversees $33 billion as director of municipal-fixed income in New York at AllianceBernstein Holding LP, which owns $3 million of Ana G. Mendez bonds. He wrote in an online posting last month that Puerto Rico debt wasn't yet a good investment.

Remaining Few

The largest portions of investment-grade bonds on the island include tobacco securities from the Children's Trust Fund, housing obligations backed by Fannie Mae and Ginnie Mae and debt from the Hospital Auxilio Mutuo Obligated Group, data compiled by Bloomberg show. Ana G. Mendez, named after the Puerto Rico-born educator, had been the fourth-biggest non-junk borrower before its downgrade.

Universidad Interamericana de Puerto Rico and Universidad Del Sagrado Corazon, rated A- and BBB- by S&P, respectively, have about $62 million of bonds outstanding, Bloomberg data show. Like Ana G. Mendez, the Puerto Rico Industrial, Tourist, Educational, Medical and Environmental Control Facilities Financing Authority issued the debt. They also have overlapping investors.

The biggest mutual-fund owners of Ana G. Mendez bonds reveal some typical Puerto Rico investors — OppenheimerFunds holds the most, with $32.6 million — and some unusual ones. Massachusetts Financial has a $22.7 million stake, second-highest, followed by Capital Group, USAA Investment Management Co., Franklin Resources Inc. and AllianceBernstein, Bloomberg data show.

The university system has three main campuses in Puerto Rico and another that's virtual, plus three centers in Florida, one in Maryland and one in Dallas. Its overall enrollment of about 40,000 in 2015 was flat relative to the prior year and a vast majority of its students were from Puerto Rico, according to S&P.

Building Reserves

"While management projects flat Puerto Rico enrollment in the foreseeable future, we believe enrollment could decline given Puerto Rico's weak economy and prolonged recession," S&P analysts Shivani Singh and Charlene Butterfield wrote in their report downgrading the university.

The system isn't planning any more bond sales or capital projects in the coming years, instead focusing on maintenance and building cash reserves, Alfonso Davila, vice president for financial affairs, said in a telephone interview. Students will receive the same services and education that they've always had, he said.

"The system will never default on its payments," Davila said. "People think Puerto Rico is not in a good condition, but the government is the one having the problems. We in the private sector are doing our best to improve the situation of the Puerto Ricans here and in the states."

Ana G. Mendez bonds maturing in March 2026 traded on April 1 at an average 86 cents on the dollar, to yield about 7 percent, data compiled by Bloomberg show. By comparison, an index of BBB rated revenue bonds due in 10 years yields 2.6 percent. Similar-dated Iowa Fertilizer Co. bonds rated BB- by S&P, used as a barometer for speculative grade munis, yield about 4.24 percent.

"The bonds offer attractive risk-adjusted spreads relative to other non-investment grade options," Geoffrey Schechter, a portfolio manager at Massachusetts Financial, said in an e-mailed statement.

Spokespeople for OppenheimerFunds, Capital Group and USAA declined to comment. Stacey Coleman, a spokeswoman for Franklin, said no one was available to discuss the holdings.

Tainted View

The Ana G. Mendez downgrade preceded a wave of moves by the commonwealth to address its fiscal strains. Governor Alejandro Garcia Padilla on April 6 signed a law that would allow him to halt payments on a wide swath of Puerto Rico bonds through January 2017. He declared an emergency period for its Government Development Bank on April 9. Two days later the island released a counterproposal to creditors to cut its obligations.

The securities are tainted by the association with Puerto Rico and trade as if they were rated four steps lower, Davidson said. He's not planning to sell his holdings, though he isn't looking to buy, either.

"The school is part of the future economic turnaround for Puerto Rico at some point," Davidson said. "I don't think you'd want to accumulate much until at least you can see a path to a more stable economy. In the next few months, we'll have anything but clarity."

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