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Lowest-Rated State Now Has \$573 Million of AAA Bonds to Issue.

Illinois's next big bond deal sounds like a municipal-market oxymoron: the worst-rated state in the nation is offering more than half a billion dollars of AAA debt.

The \$573 million of securities the state plans to sell Thursday are secured by a stream of sales-tax revenue that's diverted to investors, earning the deal the highest ranking from S&P Global Ratings. That's seven steps above the state's general-obligation debt, which is backed only by the government's guaranty to pay what it owes.

"We expect the state of Illinois's sales-tax bonds to fare better than the state of Illinois's GO bonds, primarily due to the substantial support from the designated sales tax," said Richard Ciccarone, the Chicago-based president of Merritt Research Services LLC, which analyzes municipal finances. "However, they will suffer. It will extract a higher borrowing penalty than would normally be expected for such a high-rated bond issue because of the chronic financial pressures."

Governor Bruce Rauner, a Republican, and the Democratic-led legislature only recently emerged from a record-long fight over the budget, agreeing on June 30 to a six-month plan that will avert a shutdown through the end of the year. Without revenue increases or deep spending cuts needed to eliminate the government's deficit, Illinois is still on track to end the fiscal year at least \$5.5 billion in the red and even the top-rated debt has a negative outlook from S&P — indicating it's not immune to a downgrade.

The political discord has cast ripples throughout Illinois, leaving universities and other municipal borrowers there with more downgrades in the second quarter from Moody's Investors Service than those in any other U.S. state. Illinois's rating was slashed to Baa2, two levels above junk, the lowest Moody's has graded a state since 1992. Moody's isn't rating Thursday's deal.

Despite the fiscal strain, Illinois has continued to pay investors on time and its law provides for "an irrevocable and continuing appropriation" for bonds, according to disclosure documents for the sale. The primary source of payment for Thursday's deal is a share of Illinois's 6.25 percent sales tax, which provides even more security.

"It's one of the strongest revenue streams that the state has," said Dennis Derby, a money manager in Menomonee Falls, Wisconsin, at Wells Fargo Asset Management, which holds Illinois bonds among its \$39 billion of municipal debt and may buy Thursday's deal. "It'll be interesting to see where these price. Almost every issuer in the state of Illinois has some type of issuance penalty."

While investors demand yields on Illinois bonds that are higher than any of the other 19 states tracked by Bloomberg, the interest penalty has fallen since the stopgap budget was passed. Illinois's 10-year debt yields about 3.1 percent, or 1.7 percentage point more than benchmark securities, according to data compiled by Bloomberg. That gap was 1.9 percentage point on June 30.

The agreement between Rauner and Democrats failed to eliminate the deficits that were left after

temporary tax hikes expired last year. And Rauner wants his agenda, including curbs on labor unions and property taxes, to come with any budget fix — something Democrats have steadfastly resisted.

With municipal-market interest rates holding near the lowest in more than half a century, the political turmoil is likely to prove a draw to investors looking for higher yields, said Dan Heckman, a senior fixed-income strategist in Kansas City at U.S. Bank Wealth Management, which oversees \$133 billion and may buy some of the AAA securities. He said the yields will likely be higher than other top-rated bonds.

“There’s been a real lack of quality issuance in Illinois,” Heckman said. “There’s a lot of pent-up demand. You’ll see that if it’s priced right.”

Catherine Kelly, a spokeswoman for Rauner, declined to comment on speculation about how the bonds will be priced.

It won’t be the last chance for buyers looking for highly rated Illinois debt. The Illinois Finance Authority plans to sell \$500 million of bonds next week for the state’s clean-water program, which makes loans to local governments for projects. The grade from S&P and Fitch Ratings? AAA.

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