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Chicago's Struggling Schools Made Wall Street \$110 Million From \$763 Million in Bonds.

J.P. Morgan, Nuveen invest in school board's bonds at big profit

The Chicago school system needed money—fast. Two Wall Street players saw an opportunity to invest.

J.P. Morgan Chase & Co. and Chicago-based Nuveen Asset Management have made realized and paper profits exceeding \$110 million on purchases this year of \$763 million in Chicago Public Schools bonds. The school system has said it needed the money to replenish its dwindling coffers before the new school year and to build and repair facilities.

The terms of the bond sales highlight the choices the school district faces after years of pension shortfalls and relying heavily on borrowing. The 397,000-student school district struggled to sell municipal bonds in February until Nuveen bought about one-third, and the district decided in July to borrow directly from J.P. Morgan for fear that investors might balk again, a spokeswoman for the Chicago Board of Education said.

"CPS did not have the luxury of waiting longer to demonstrate to the market that the progress we were making was real," said Ronald DeNard, the school district's senior vice president of finance, in an emailed statement about the bonds purchased in July by J.P. Morgan.

J.P. Morgan, the country's largest bank by assets, made a 9.5% profit on \$150 million in bonds it bought in July and sold in September, or 82% annualized. Nuveen, an investment firm managing \$160 billion, has bought \$613 million in bonds since February for a total return, including price gains and interest payments, of about 25%. That is almost 50% on an annualized basis, an especially large gain at a time of near-zero interest rates.

The school system's bonds are a favorite for John Miller, Nuveen's co-head of fixed income, who said the firm bought when the market feared a default, a concern he called overblown. "At the end of day, this school system is critically important to Chicago—to the whole country really," he said.

Its bonds are rated B3 by Moody's Investors Service and traded as low as 73 cents on the dollar in March before rebounding to about 90 cents in September. CPS said the bond sales facilitated much-needed fixes like lead abatement and classroom construction, though they increased the school system's already heavy debt load and its annual interest payments.

"We took a period of market risk on behalf of our client when they needed it most and the market has recognized their improved financial position," a J.P. Morgan spokeswoman said.

Chicago's school district operates on a budget of \$5.5 billion with a below-investment-grade, or junk, credit rating on nearly \$7 billion of bonds. Its teachers union is threatening to strike, in part, over proposed changes to its pension plan, which has a nearly \$10 billion funding gap. The school system's rainy-day fund is nearly empty and relies on short-term borrowing.

"J.P. Morgan and Nuveen are taking advantage of a distressed school district at the expense of our most vulnerable students," said Jackson Potter, staff coordinator at Chicago Teachers Union.

Nuveen held few Chicago Public School bonds in recent years but has been watching its prices closely since May 2015, when Moody's cut its credit ratings of the school board and the city of Chicago to junk.

The investment company, which now owns about \$806 million of the school district's bonds, dedicated an analyst to cover the district full time to better understand its capacity to increase revenue and the likelihood of a bankruptcy filing.

Prices of outstanding Chicago school bonds were hit in 2013 and 2015 after defaults by Detroit and Puerto Rico. Illinois Gov. Bruce Rauner called for a state takeover of the school system and for a potential bankruptcy filing over the past year and prices fell below 75 cents on the dollar.

Nuveen determined that the default risk was far lower than that implied by the bond prices. When J.P. Morgan was struggling to find buyers of \$725 million in bonds in February, the fund manager agreed to buy about 36% of the issue at about 84 cents on the dollar.

Mr. Miller continued buying after and now owns 60% of the bonds, making it the single largest investment in the \$15 billion Nuveen High Yield Municipal Bond Fund. Nuveen has made unrealized gains of about \$103.3 million on all the CPS bonds it owns, a company spokeswoman said.

Demand for Chicago Board of Education debt grew over the summer as investors gained confidence that the school board could plug much of its 2017 budget gap with budget cuts, state aid and new tax revenues. Market conditions also improved significantly, sending prices of municipal bonds with junk credit ratings up and pushing their yields down to about 4.6% in early July, a 17-year low, according to the S&P Municipal Bond High Yield Index.

Still, when the school district turned to J.P. Morgan for more money in July, it decided to sell the bonds directly to the bank to avoid the risk that investors would reject it. Instead, demand for the bonds rose throughout the summer, and J.P. Morgan sold all of the debt for a \$12 million profit in September, Wall Street Journal analysis of data from the Municipal Securities Rulemaking Board shows.

"You've gone from having maybe two to three people being interested in these deals to all of a sudden having 20 investors interested," said Mr. Miller of Nuveen.

J.P. Morgan committed to hold the \$150 million in bonds it purchased for about six weeks until the board of education prepared documentation allowing them to be sold to institutional investors.

The certainty J.P. Morgan provided came with a high price: The bank paid 91 cents on the dollar for the debt at a yield of 7.25%, much higher than the approximately 6% yield on the school board's outstanding bonds at the time. It sold the debt at prices as high as 102 cents on the dollar in early September and its trading profits, plus a \$1.2 million purchaser's fee, amount to the 9.5% return in six weeks.

J.P. Morgan has a longstanding relationship with Chicago Public Schools and is the top underwriter of its bonds over the past 10 years, according to data from Thomson Reuters. The bank views the school board as a high-priority client that it understands well and is willing to support its short- and long-term capital needs, the bank spokeswoman said.

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By MATT WIRZ and HEATHER GILLERS

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—Aaron Kuriloff
contributed to this article.

Write to Matt Wirz at matthieu.wirz@wsj.com and Heather Gillers at heather.gillers@wsj.com

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