Bond Case Briefs

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With Soaring Demand Come Weaker Assurances for U.S. Municipal Investors.

NEW YORK — In July, investors gobbled up $1 billion of bonds from a financially-strapped Catholic hospital system in Illinois called Presence Health Network, even though it offered few contractual guarantees debt buyers typically require.

The deal, rated just above junk status, is emblematic of a fever that has swept the $3.7 trillion U.S. municipal bond market: yield-chasing investors not only piling into riskier debt, but also increasingly willing to accept less protection in the event of a default.

Some portfolio managers say it has been a decade since they have seen such a strong seller's market.

"It's reminiscent of right before the Great Recession, where there was a long period where high-yield rates were low and demand was high," said William Black, senior portfolio manager for the City National Rochdale Municipal High Income Fund.

Low and negative sovereign interest rates have contributed to a scramble for relatively higher yielding U.S. municipal debt. Foreign buyers now hold more muni bonds than ever, U.S. Federal Reserve data show.

Overall, investors have poured nearly $10 billion into high-yield municipal bond funds so far this year, according to data from Lipper, a Thomson Reuters unit. That is more than any other full year in nearly the last quarter century except 2006, which had $10.1 billion of inflows. (Graphic: http://tmsnrt.rs/2dylqFl)

Taking advantage of the seemingly insatiable demand, some borrowers are offering weaker or fewer guarantees, so-called covenants, such as debt reserve funds and debt service coverage ratios.

Because they are based on many factors, credit ratings alone may not reflect the quality of covenants, so some investors may be taking on greater risks than they realize.

Such "covenant light" bonds were harder to offload after the market tumbled in late 2008, while investors who held them saw valuations swing wildly because of infrequent trading and huge price gaps, analysts said.

"Some funds got just clubbed. That was frankly very traumatic for a lot of investors, and fund managers too," said Joseph Krist, partner at the Brooklyn-based public finance consulting firm Court Street Group.

In a default, workouts are harder. Covenant light bondholders have fewer tools to intervene, for example by requiring issuers to hire turnaround professionals or take other corrective action earlier. They also risk deeper losses in bankruptcy than those with greater protection.

HEALTHCARE AND CHARTER SCHOOLS

Sectors such as healthcare, charter schools, and senior living facilities tend to be more prevalent covenant light issuers, in part because they may struggle more to generate consistent operating margins.

Hospitals and charter schools issued 44 percent and 76 percent more debt by par amount so far this year, respectively, compared with 2015, Thomson Reuters data show. Senior living facility issuance rose 6 percent.

They come in other sectors too. The city of San Antonio, Texas, sold AA-rated junior lien water system bonds on Thursday without a reserve fund – a fact disclosed in the title of the bond documents.

But many covenant light deals are unrated or speculative grade. Issuers have sold more than 400 percent more bonds rated junk at BB and BB- by S&P Global Ratings so far this year than last year, Thomson Reuters data show.

One such example is Summit Academy North, a junk-rated Michigan charter school that missed deadlines for annual financial data in four of the last five fiscal years, according to bond disclosures.

Summit sold $22.5 million of refunding bonds on Aug. 31 with a cash on hand liquidity threshold of just 30 days, a very low level for the sector.

Even so, the top yield was just 4.75 percent on 2035 bonds – a rate that an investment-grade borrower would have likely offered only a couple of years ago.

“I cannot believe some of the deals that are getting done in the muni market right now – without a mortgage, low debt service reserve fund,” Mark Paris, head of municipal portfolio management at fund manager Invesco, said at a recent event.

Some funds say they have little choice but accept fewer safeguards in order to put clients’ cash to work.

“Money is coming in to the point where people have to buy something,” said one market professional who declined to be named.

Institutional investors have pushed back by demanding greater liquidity covenants, said Mark Taylor, a portfolio manager and head of high-yield research at Alpine Woods Capital Investors.

By September, he had a stack of rejected deals in his office that was four-feet tall, Taylor said. Nonetheless, the deals he has turned down are getting picked up by others.

“There is a plethora of deals coming to market that people probably would have rejected nine months ago.”

By REUTERS

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