

# Bond Case Briefs

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## Don't Shrug Off Puerto Rico Risks.

***Now that the commonwealth has filed for court protection, investors in other municipal bonds could start to feel the pain.***

When Puerto Rico filed for court protection from creditors—the commonwealth’s own bankruptcy-like process created as part of the financial-rescue law passed last year—the market reaction wasn’t what you might have expected.

Some of Puerto Rico’s municipal bonds actually rose in value, and the broader muni market shrugged. Moody’s saw the filing as positive, in that it will simplify the process of negotiating separately with creditors. S&P Global Ratings saw no impact, partly because it already rates many of the bonds D for default, or close to that level.

It’s true that in some ways, not much has changed. Puerto Rico still owes a staggering \$74 billion in debt that it can’t pay and needs to restructure. “People see Puerto Rico as a one-off, although it is a big one-off,” says Mark Taylor, head of municipal research at Alpine Funds. Detroit’s 2013 bankruptcy, the second largest, was just \$18 billion in size.

But this isn’t the end of the story. A judge will decide how Puerto Rico’s many creditors will be treated. As the first bankruptcy under the new law, it could be precedent-setting and may eventually affect broader muni prices.

A key question is whether the general-obligation bonds, backed by Puerto Rico’s government, or the Cofina bonds, backed by sales taxes, will get preference in a restructuring. Already, investors have been betting that GO bonds will get preference over Cofinas, causing a downdraft in Cofina pricing. If Cofina’s dedicated sales-tax revenue stream isn’t validated, it could hurt similar bonds with their own revenue streams.

“If that lockbox system [of dedicated sales tax revenue] doesn’t really hold water,” says Taylor, “it could make investors more jaded” about this class of bonds.

John Miller, who heads municipal-bond investing at Nuveen Asset Management, believes any signs of favoritism based on earlier negotiations are irrelevant now that a judge will be calling the shots. But he thinks both types of bonds are due for more downside. The long-term financial plan certified by Puerto Rico’s financial-control board allows for debt repayment of only 24 cents on the dollar over the next 10 years. Puerto Rico’s GO and Cofina bonds trade between 58 and 65 cents on the dollar.

IF PUERTO RICO BONDHOLDERS suffer big losses, says Taylor, it could spill over into the rest of the muni market. He’s surprised how well prices have held up. “There is a lot of potentially unwarranted optimism in there,” he adds.

It’s too soon to know how it will shake out. Jim Murphy, a muni portfolio manager at T. Rowe Price, isn’t sure the accounting backing the control board’s projections is solid. “All these parties are about

to fight over the pie, but we don't even know how big the pie is," he says.

Another question Puerto Rico's bankruptcy is raising: Does it open the door for states to file for bankruptcy? Murphy's view: "It cracks the door a little bit."

That would clearly be a negative for state munis. But, cautions Richard Daskin of RSD Advisors, "the situation is developing and there are a lot of moving parts." He still likes insured Puerto Rico paper—since the insurance companies backing those bonds should be able to continue to pay—but warns that uninsured bonds are more like leveraged stocks than bonds. "They go in your risk bucket," he says.

Taylor thinks it will take two to three years to work through all these issues. The next key decision is for U.S. Supreme Court Chief Justice John Roberts to pick the district court judge who will preside over the case. When that selection is made, investors will try to handicap whether creditors or Puerto Rican citizens are likely to get preferential treatment.

"The judge is going to have a lot of sway because there is no precedent," says Daskin. And muni investors could be looking at a lot of red ink.

BARRON'S

By AMEY STONE

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