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Chicago Schools Double Bond Sale as Rates Head Higher.

- **Board of Education sold $561 million of G.O. refunding bonds**
- **Demand for yield, rate hike outlook seen as reason for change**

The Chicago Board of Education doubled the size of its bond sale Thursday to $561 million amid signs of strong demand for the junk-rated district's high-yielding securities.

The offering, which was initially planned for next week until officials moved it up, is the first this year for the nation's third-largest school district and was increased from the $260 million initially scheduled. Because of its chronic fiscal strains, the system's uninsured bonds carried yields that were 1.93 percentage point to 2.24 percentage points more than top-rated securities, with debt backed by Assured Guaranty Municipal Corp. offered for as much as 1.35 percentage point over the benchmark, according to a repricing note sent to an investor.

The acceleration of the district's bond sale came after yields rose this week amid concern that the Federal Reserve may raise interest rates more aggressively than previously anticipated.

"There's a consensus that on the horizon there's not a lot of yield coming, and so buyers are certainly putting their money to work," Adam Buchanan, senior vice president of municipal sales and trading at Ziegler Capital Markets Group in Chicago, said in a telephone interview. "For an institution that needs capital in a rising interest rate environment, you want to raise as many dollars as you can at this cost of capital — it could be more expensive down the road."

High-yield bonds have been one of the few bright spots in the municipal market this year, delivering returns of 1.9 percent despite the losses posted by most securities, according to Bloomberg Barclays indexes. Prices on the Chicago district's debt have rallied over the last year, reflecting the significant step-up in state aid for a system that had long been in fiscal crisis largely due to its escalating pension bills.

This month, the most-actively traded Chicago Board of Education debt traded at an average price of $1 at a 4.96 percent yield, compared to 79.6 cents at a 7.3 percent yield in May 2017, according to data compiled by Bloomberg.

In August, lawmakers and Governor Bruce Rauner overhauled Illinois's school funding formula, making the state pick up the normal cost of Chicago's teacher pensions, a major expense for the cash-strapped district. That change, along with a hike in other state aid and property taxes, means Chicago schools have an additional $444 million of revenues, according to bond documents.

The state now covers $221 million of normal pension costs for Chicago schools and provides an additional $93 million in other state funding, according to bond documents. The district also enacted a $130 million property-tax levy for pensions, according to an online presentation to investors.

"CPS is on the hook for a lot less of their pension burden than they have in the past, and there's a number of other funding sources that are offsetting that risk," said Dennis Derby, a portfolio manager at Wells Fargo Asset Management, which holds $39 billion of municipal debt, including

Chicago school bonds. His firm is considering buying Thursday’s deal. “The market reception is significantly better than it was two years ago because there’s less uncertainty tied to funding going forward.”

It’s a more positive story than a year ago, but still there’s a lot of pension debt to fund, said Dan Solender, head of municipal investments at Lord Abbett & Co., which holds $20 billion of state and local debt, including some issued by district. The Chicago teachers’ pension fund is about 50 percent funded, leaving an unfunded liability of about $10.9 billion, according to bond documents.

“They’re telling an improving story,” Solender said in a telephone interview. “They still have a lot to do to really improve themselves to get out of the below investment grade category.”

Another risk is the board’s reliance on the fiscally-stressed state of Illinois that faces ongoing political squabbles over its budget. Rauner, a Republican who is facing re-election this year, proposed a spending plan in February that ends the state’s pension pickup of CPS’s normal pension costs. Democrats have resisted Rauner’s plan, and it remains to be seen what budget, if any, Illinois leaders will approve for the year that starts July 1.

In April, S&P Global Ratings revised its outlook on the board to positive from stable, citing the jump in state aid, but the board is still rated B, five steps below investment grade, partly due to its “extremely weak liquidity,” according to S&P.

There’s no question that this year is different for the board. Ending the school year early, canceling summer school and slashing school spending were all floated as options for the district in 2017 as it struggled to make its June 30 pension payment.

“A large part of it is the credit outlook for CPS is substantially better than it was even just a year ago,” Derby of Wells said. “And management has done a commendable job in getting their message across to investors.”

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