Bond Case Briefs

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Forewarned Is Forearmed: Tips And Pointers For Municipal Bond Workouts

I hate to be the bearer of bad news in these difficult times, but investors in high yield municipal bonds: brace yourself for defaults and bankruptcies. The Covid-19 pandemic has already compelled a spate of municipal bond defaults and at least one bankruptcy. More are coming. Don't say you weren't forewarned.

The good news is that forewarned is forearmed. If you find yourself face to face with a municipal bond workout, here are several factors to keep in mind.

Avoid a Bankruptcy Filing

Having gone through three bankruptcies, including testifying in Federal Bankruptcy Court, I draw on these experiences to offer this advice to borrowers and investors: avoid the bankruptcy option. Either Chapter 9 for municipalities or Chapter 11 for private entities (including nonprofits), bankruptcy is time consuming, expensive for all parties involved, often creates polarization when you need cooperation, and the results are usually not much better than had something been negotiated between the stakeholders. This is particularly true for Chapter 9 filings, where the case law is not well defined. You definitely don't want to be on the wrong end of setting precedent. Read this piece, *What 'Adult Entertainment,' Puerto Rico and Chapter 9 Bankruptcy Have In Common* for a well-detailed breakdown of the issues in Chapter 9 filings.

The Upside: If you absolutely cannot find any other alternative than a bankruptcy filing, strive to go to court with a "pre-pack" in hand. A pre-pack is a bankruptcy where all the issues are resolved and the path forward is clear. All you need is the judge's gavel for approval.

Essential Services

Project financings for hospitals, senior care, senior living projects, and public works utilities are generally attractive to investors because they are, or are perceived to be, more secure because they provide essential services to their community. They are "'too essential to fail."

But that becomes a double-edged sword in a workout. The fundamental economics of a single-purpose project can be an impediment. Essentiality of purpose can mean an inelasticity in demand. The community—be it defined by geography, demographics, or needs—still requires services. Water needs to flow, waste needs to be processed, electricity needs to be generated, patients need care. Operations have to be kept open, even if at a minimum. This limits budget flexibility. The only place for big savings may be in debt service, either reduced or deferred.

The Upside: The good news for bondholders is that essentiality of services still presents an economic safety-net. The financial issues bedeviling the borrower may be temporary (even if the 'temporary' time frame is counted in months or years). A resolution taking a long view (and why not, since the bondholder isn't getting paid in the interim anyway) can usually be found and with higher recovery.

Tax-Exempt Financing

Tax-exempt financing comes laden with regulations and restrictions, mostly from the U.S. tax code governing the "use of proceeds." This limits workout options. Original maturities can't be extended, a new debt structure might fall under reissuance rules, and the bonds can't be advance refunded. Moreover, the only capital source on the table is debt. Unlike the seemingly endless permutations of equity structures, debt can only be parsed so many ways.

The Upside: Even though capital options are restricted to debt in one form or another, there are still a few ways to restructure debt. For example, deferred payments are always popular because they give relief to the borrower but preserves principal and interest for the bondholder. Additionally, senior debt that is in default under the existing cash flow might offer some payment if bifurcated into a senior-subordinate security structure. Another alternative is a current refunding with taxable debt. Freed of code restrictions, it opens up operational doors precluded under tax-exempt bond rules. The trade-off between flexibility and the premium of taxable loan's higher rates is worth considering.

Fixed Assets

Sitting at the table of one workout I was involved in, a simple solution emerged—well, at least in my head: put the over-built project on wheels and roll it down the road to a better and bigger market. But alas, the facility wasn't on wheels. It was a very fixed asset. This highlights two problems bondholders and borrowers alike face with a fixed asset—immobility and illiquidity.

Most of the time, as much as you wish you could move a project, you just can't. Moreover, it's not just fixed in place. It's fixed in size. When a project is just too big for the market, it can be hard to shrink. An overbuilt continuing care retirement center or for-profit student housing can close wings or floors, but it rarely can be made physically smaller. There is no shrinkage. A special purpose or special design facility—think proton therapy projects—is bound equally by location and purpose. The fixed nature of the asset also defines its budget to large degree. Empty units still need to be heated and cooled, physical plant maintained.

The immobility, special purpose, and fixed size also limits liquidity. Yes, there are business brokers for CCRCs and college campuses—if supply and demand exist, a business will emerge to fill the niche. But given this is a small market with limited buyers and few comparable transactions, the bid-ask spread can be wide, particularly if the project hasn't worked as built. However, an appraisal based on the traditional discount present value of cash-flows won't work when there is no cash flowing. The appraisal valuation then turns to real estate value. That's a valuation mismatch. Bond values are based on payments from operating businesses, not underlying real estate. The underlying real estate value is usually considerably lower than a going-concern's value. Ouch.

The Upside: In some cases, particularly in senior living or housing, there may be some renovation or remodeling to reduce the number of units and right-size both the units and overall facility for the marketplace. The fees per unit may still remain unchanged—or have to be decreased—to attract residents, but better to have full occupancy at a lower rate than an empty facility at a higher one.

Another consideration is repurposing space for other types of revenue producing services. Acquisition by a national or regional service provider might provide an alternative as well. A new and better-known brand name on the entrance sign improves reputation immediately as well offers greater resources, both for services and management. None of these options are simple, but for bondholders, finding a solution generating some cash flow is better than no cash flow. For borrowers, the project keeps all or most of its original intent. Everyone still sorta wins.

Government Funding

When it comes to public projects, there is usually federal or state funding in the revenue mix—reimbursements, set fees, grants, revenue-sharing, loan guarantees, and so forth. While the fairly steady, if regulated, revenue stream is initially attractive for creditors, the strictures it imposes in a workout quickly makes it a yoke. In healthcare or senior services, the facility can be limited in the fees it charges or caps service payments. Revenue-sharing, grants, and loan guarantees apply more to secondary schools, including charter schools, and higher education institutions. Cuts in funding cannot be readily made up with higher taxes or higher tuition.

Problems can emerge if the organization has not been well run or, worse, if there is financial malfeasance. With those government funds almost inevitably comes a first and prior security lien in one form or another, priming whatever the bondholder thinks they are secured by in their well-crafted bond documents. For example, with health care providers, there are Medicare and Medicaid “claw-backs.” Miscategorized filings resulting in over-reimbursement can trigger a demand for the project to repay the overage. Discovering this during a workout can rent asunder any agreement between bondholder and borrower.

In higher education institutions, there is the risk of running afoul of Title 4 funding (federally backed student loan programs). These days, unacceptable student loan default rates can trigger a claw-back. Moreover, when a college or university closes, all of their federal funding has to be accounted for. If the school has poor management and weak administrative controls, this forensics exercise becomes a very time consuming and unavoidable process—which only drags out finding any solution. And this assumes no irregularities are found, which, inevitably, there are.

The Upside: If the bondholders suspect malfeasance or even simple ineptitude on the part of the borrower in causing the default, federal and state overseers can be powerful allies in compelling information disclosure. While understandably wary of government intervention (the jokey nostrum “‘we’re from the government and we’re here to help” can be all too real), it is a valid cudgel to wield if a borrower is dragging its feet on releasing information. The borrower may see it as a bluff, knowing most bondholders don’t want yet another stakeholder in the mix, but if a borrower is being particularly obstinate, the bondholders don’t have much to lose given they won’t get much by doing nothing.

Low Interest Rates

As any first year MBA learns, the cheaper the capital source, the higher the valuation. Think of it like a home mortgage. You can afford a lot more home at a 2% mortgage rate than you can at a 5% mortgage rate. Same as with a new project financed by municipal bonds. A project that didn’t work at a higher interest rate, suddenly, with the wave of a Harry Potter-esque magic wand of “Lowerus Raterus,” becomes tenable.

Well, tenable at least in spreadsheets and financial models. As the real-world kicks in, the magic fades and the borrower and bondholder alike come to discover a facility can be overleveraged just as much, if not more, with a lower interest rate as it can with a higher interest rate.

The workout problem in a low rate environment is that there isn’t a lot of flexibility. When a bond with an 8% coupon defaults, reducing the coupon to 4% can mean a material difference on the income statement, giving some breathing room for operations. But in a low interest rate environment, there isn’t much room to go if you are already near the floor. Negative rates aren’t really an option.

That leaves the only other financial lever—reducing, deferring or restructuring principal. The relationship between total debt service and principal reduction, regardless of the form it takes, is readily calculated. Whatever dollar-amount operations are needed for it to succeed, it's going to come out of principal.

The Upside: Even in a low inflation environment, the future value of principal loses value with every passing year. For bondholders, better to give in on principal and preserve what really matters: tax-exempt income in hand now. It may be cold comfort, but at least the effective rate on the remaining restructured bonds is going to be higher than the rate on the initial financing—and probably more accurately reflects the risk the bonds should have been valued on in the first place.

The Snarling Attorney

Unfortunately, in some workouts, a borrower opts to go the belligerent route. They retain a firm of litigious counsel—"lawyering-up," as the phrase goes. Usually this is initiated by a management with something to hide (the 'good-offense-is-good-defense' strategy), an over eager attorney (usually one not familiar with workouts or bankruptcy), or someone on the Board who read *Barbarians At The Gate* or watches too much *Shark Tank* and now wants to prove they can play the hard-nosed Wall Street game.

I've faced a few of these. It wastes a lot of time, money, and energy that otherwise might be used productively. Plus, it never works. But in a default, you're not getting people at their best. Emotions run high, the impulse to fight overwhelms reason. So, you have to deal with it.

Faced with this strategy, investors might quickly find the borrower using the essentiality of their purpose as leverage, portraying bondholders as greedy Wall Streeters trying to extract their pound of flesh from a this poor distressed nonprofit. Because of the demographics they serve, borrowers might also bring political pressure to bear as well. Knowing that investment firms generally don't want their brand and reputation besmirched, borrowers try to gain an upper negotiating hand by leveraging press and politics.

The Upside: Of course, bondholders are not without recourse. Big firms have deep pockets to fund protracted litigation is they so choose. Counter threats of forensic audits and suits against boards of directors for negligence in oversight have been known to level the playing field pretty quickly. After all, mud-raking and accusations of wrongdoing can go both ways. While institutions may briefly lose a little reputational luster, individuals can lose homes, savings, and livelihoods. But that usually only drags out the misery and, while bringing some short-term emotional satisfaction, does not generate much economic satisfaction.

Bondholders are urged to keep in mind they have another option a borrower does not: selling the bonds to a vulture fund. Yes, the vulture fund is going to pay a pennies-on-the-dollar-bo-tom-basement price. But ridding one's self of the aggravation of protracted dealings with a hostile and intransigent borrower may be worth the cost.

The borrower would be wise to keep this in mind before entering into any hostile strategy. A large, well-respected financial firm has the ability and resources to find a compromise for an outcome best for all stakeholders. On the other hand, a vulture fund generally doesn't care about borrowers' essential purposes or services. They don't care if they are dragged through the mud, having been down in the mud many times. All they want is profit. They know how to give twice as hard as they get and have no compunction about putting the borrower's reputation at risk. After all, the borrower is in default, already on shaky ground to start throwing stones. To mix metaphors.

Summary

For sure, Covid-19 is a “black swan” event, or at least one hopes so. But to dismiss it as once in a lifetime occurrence without learning some lessons would be foolish. No matter what the event, black-swan, market, or rate environment, the best protection against an unwanted financial outcome for both borrowers as builders and bondholders as lenders, is to have a clearly defined and quantified risk assessment methodology for project and investment, respectively. Be it a city council, nonprofit board, financial advisor or fund investment committee, this is the one strategy that continues to prove successful time and again in protecting the interests of all stakeholders. It is the core of being a fiduciary, to protecting and meeting the needs of clients, residents, patients, students, or whatever community you are serving.

And that’s what’s really essential.

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