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Bond Experts Raise Caution Flags on Detroit's $250M Anti-Blight Borrowing Plan.

Experts say municipal bonds with Detroit's high interest rates could charitably be called high yield for potential investors. Others might call them junk bonds.

Five years removed from bankruptcy, the city of Detroit is on a path to borrow a quarter-billion dollars to address the city's extensive blight problem in the middle of an economy destabilized by the ongoing coronavirus pandemic.

Despite the uncertain economy, the municipal bond market is humming and several experts say the city is likely to find investors for the approximately $250 million in bonds Mayor Mike Duggan wants to issue for blight removal.

But some see a range of potentially problematic issues — the city's history of financial struggles, the scandal-tainted demolition program and the possibility that the pandemic will sharply constrain city revenues.

Detroit also will have to pay an estimated $240 million in interest on the debt in addition to the amount of the high-yield bonds, according to a spokeswoman for the city.

"This deal looks like it has a lot of hair on it," Daniel Berger, senior market strategist for Refinitiv, a data and analytics firm that specializes in global financial markets, said, referring to risks and obstacles associated with the proposal.

Marilyn Cohen, who worked as an analyst and bond broker before founding Envision Capital Management in California more than 20 years ago, put it more bluntly.

"This to me looks like it's fraught with disaster," Cohen said. "Just because you have access to the money because it's cheap money doesn't mean you should grab it unless you have all your ducks in a row."

Duggan is plowing ahead, driven by the severity of the city's blight crisis and the job opportunities for Detroiters expected to be hired for demolition and rehab work. His plan — known as Proposal N, for neighborhoods — is headed for the Nov. 3 ballot for voters to decide. If approved, the city would issue up to $250 million in bonds to demolish an estimated 8,000 blighted homes and secure another 8,000 vacant houses so they can be more fully rehabbed.

The city has thoroughly considered the cost and affordability of the neighborhood improvement bonds, according to the city's finance and demolition departments. The bonds will be repaid through property taxes connected to the city's debt millage, which provides a more stable revenue stream than those more directly affected by the COVID-19 pandemic, such as taxes on casinos.

The city has projected it will lose about $194 million in general fund revenues in the current fiscal year, which began July 1. The projected losses represent about 18% of the previous year's general fund budget.

Property taxes that flow into the city’s general fund are expected to drop about 6%, or $7 million, this fiscal year compared with the previous year’s budgeted amount. The city is expecting income tax revenues to drop about 13%, or $150 million, from the start of the pandemic through June 2021.

Duggan acted quickly to address the pandemic-related budget crunch. He laid out a series of cuts in April to address the overall $348 million budget deficit the city projected through June 2021.

“In general, national experts are finding that the cities that rely more heavily on property taxes will not experience such an immediate collapse in their revenues from the coronavirus economic contraction,” city officials wrote in response to written questions from the Free Press. Detroit’s CFO”projected a recession scenario for this bond sale and found that even in the recession scenario projection, the city would be able to pay debt service without driving the debt millage rate above the current level,” officials wrote.

The answers provided through the city’s media relations department did not identify the specific city officials who compiled the answers.

Based on the city’s financial modeling, Detroit expects to issue a blend of 64% tax-exempt bonds and 36% taxable bonds that will be repaid over 30 years. The plan is to issue $175 million in bonds next year and $50 million in 2023, leaving room to issue another $25 million in bonds if the market conditions remain favorable, according to a city memo.

The city of Detroit anticipates interest rates on its new bonds to be between 3.64% and 6.58%. That’s significantly more expensive than borrowing by neighbors like Oakland County, armed with the highest possible bond rating. Long-term interest rates on AAA-rated government bonds currently are about 1.45%, according to Berger.

While elevated interest rates are not optimal for the city, they are expected to spur interest in the municipal market because higher interest rates mean higher yields for investors.

“Everybody’s grabbing for yield,” Cohen said.

But Cohen said she would advise her clients to put their money elsewhere.

The city’s recent history of managing demolitions — federal authorities investigated contracting irregularities, among other problems — raises questions about how the bond proceeds would be spent. Cohen said she also has doubts about the city’s ability to repay the debt because the rest of this year and 2021 could be a nightmare for cities’ balance sheets.

“Overall, I just worry about a repeat performance in some way, shape or form,” she said, referring to the city’s historic bankruptcy filing.

City leaders could inspire confidence in their plan if they tapped local businessman Dan Gilbert or someone else qualified in the private sector who could be involved in the city’s blight removal efforts, Cohen said.

Detroit businessman Dan Gilbert has studied Detroit blight and participated in a blight task force in 2014. One bond expert suggested city leaders tap his expertise to boost the city’s pitch to investors should voters approve Mayor Mike Duggan’s $250 million bond proposal.
Detroit businessman Dan Gilbert has studied Detroit blight and participated in a blight task force in 2014. One bond expert suggested city leaders tap his expertise to boost the city’s pitch to investors

should voters approve Mayor Mike Duggan's $250 million bond proposal. (Photo: Junfu Han, Detroit Free Press)

Gilbert has studied Detroit's blight problem. He was involved in a blight removal task force in 2014 and testified during the city's bankruptcy trial that year, saying, "I'd probably put myself in the top 1% in knowledge of blight in the city of Detroit."

In response to concerns about its demolition program, city officials said that a newly established demolition department has policies and procedures in place that have improved operations.

"With the creation of the new demolition department, we assessed existing processes, policies, and failures with the goal to create a more effective and efficient demolition program that meets or exceeds industry standards," city officials said.

Duggan needs a cash influx to continue fighting blight before more houses deteriorate past the point of saving. The federal funds that previously fueled the city's demolition efforts are used up.

Since its exit from bankruptcy in late 2014, Detroit has received several credit upgrades from ratings services. Moody's Investors Service in February rated a portion of the city's debt as Ba3, which is three levels below investment grade.

Municipal bonds with such high interest rates could charitably be called high yield, Berger said, while others would call them junk bonds.

Duggan's pitch to sell the plan to City Council and voters has focused on the need to solve Detroit's vast blight problem so that vacant, dilapidated homes no longer are part of everyday life for children in Detroit.

It's a compelling narrative to pitch to investors, but they will be more interested in details about the city's revenue streams and tax base, Berger said.

"It's quite a story and to explain it to bondholders, it's quite a job to do," Berger said. "Investors will get down to brass tacks and it's either 'Will they pay or won't they pay?' "

The city's current debt millage is 9 mills. If voters approve the bonds, the millage will remain at current levels because other debt will be paid off as the city takes on new debt. If the blight bonds are not issued, the millage will fall to 6 mills, according to an analysis of the proposal by the City Council's Legislative Policy Division.

For the average homeowner, that would be a difference of about $57 in annual property taxes, according to the analysis.

For the most part, the city is no longer under state oversight that was in place post-bankruptcy. However, debt issuance approval is one of the few remaining responsibilities of the state's Detroit Financial Review Commission, said state Treasury spokesman Ron Leix.

Ron Rose, a member of the commission, praised Duggan's blight removal efforts so far. Any problems that cropped up were the result of having to tear down so many homes, he said.

Rose said the city has done a spectacular job of financial planning since the bankruptcy, particularly with respect to its pension payments.

"They've put themselves in as good a position as any city could've done to meet those obligations," he said.

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by Joe Guillen

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