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Puerto Rico Rides Muni-Bond Rally to Bankruptcy Deal.

Creditors owed roughly $11.7 billion agreed to settle with Puerto Rico, expecting that its court-supervised bankruptcy is nearing an end

Puerto Rico moved closer to resolving the largest municipal-debt default in U.S. history as creditors owed $11.7 billion coalesced around a settlement, the most Wall Street support yet amassed for a restructuring of the territory's core public debts.

Creditors agreed to cut $18.8 billion in general obligation debt by around three-fifths to $7.4 billion, wagering that booming market demand for risky municipal debt will help generate profits for them while easing Puerto Rico's exit from bankruptcy.

The proposed settlement released Tuesday would lower Puerto Rico's interest payments to bondholders to levels that its financial supervisors believe it can support after years of population loss and economic decline.

"We achieved a fair, sustainable, and consensual agreement that puts Puerto Rico on a path to recovery and is an important tool to lift the weight of bankruptcy from the people and businesses of Puerto Rico," said David Skeel, chairman of the financial oversight board that steered negotiations.

Some bonds covered by the deal have gained value in recent months, buoyed by fixed-income investors' appetite for high-yielding municipal debt and expectations that Puerto Rico's court-supervised bankruptcy is nearing its end. The agreement marks the culmination of months of private talks between finance officials and creditors to assess the long-term damage to key economic sectors like tourism and hospitality stemming from Covid-19.

Emerging from bankruptcy will remove the uncertainty hanging over Puerto Rico about how much legacy debt will need to be repaid and on what terms, Mr. Skeel said.

Investment firms that participate would exchange their claims for a mix of $7 billion in cash, $7.4 billion in restructured bonds and tradable securities known as contingent value instruments that only pay out if sales-tax collections exceed certain projections. Large bondholders including GoldenTree Asset Management LP and Autonomy Capital are backing the settlement, along with bond guarantors Assured Guaranty Ltd. and MBIA Inc.

A sustained rally in high-yield municipal bonds, including Puerto Rico's, helped to ease the deal, according to bondholders and advisers involved in negotiations. Yield-hungry investors have been drawn to risky municipal bonds in part due to the U.S. Federal Reserve's commitment to ultralow rates, which make fixed-income returns hard to find.

Expectations that federal support for Puerto Rico will increase with the White House and both houses of Congress under Democratic control are also fueling the rally in debt from the territory, according to analysts and investors. The S&P Municipal Bond Puerto Rico Index has returned 5.65% over the past year even after a post-pandemic selloff, outperforming other baskets of risky municipals maintained by S&P Dow Jones Indices.

The stronger the market demand for Puerto Rico bonds, the more the restructured debt will be worth, the less of it that needs to be issued to compensate bondholders, and the stronger the incentive for them to sign on to a settlement.

“It’s been a seller’s market, so any municipal bond that’s out there is gobbled up, much less a municipal bond that’s going to have a little bit of extra yield,” said Tom Kozlik, head of municipal strategy and credit at HilltopSecurities Inc. “It’s going to be very well accepted.”

While Puerto Rico debt was largely held before its bankruptcy by traditional municipal holders and individual investors, many bonds migrated over time into the hands of hedge funds that bought at depressed prices in hopes of profiting from a deal.

Any restructuring requires approval from the federal judge overseeing Puerto Rico’s bankruptcy case and still faces obstacles, including objections by Gov. Pedro Pierluisi and other elected leaders to reducing pension benefits of public employees.

The agreement was finalized under the oversight board that has been supervising Puerto Rico’s finances since the territory defaulted. Former President Donald Trump in his final months in office overhauled the board’s membership, installing several of his own selections at a critical juncture in the restructuring.

Justin Peterson, a Trump appointee and former bondholder adviser who joined the board in October, called the settlement a “significant milestone in ending bankruptcy for the people of Puerto Rico” that “would not have been possible without the flexibility of creditors in reaching a deal.”

Not all bonds covered by the settlement are being treated equally, with fixed recoveries ranging from as high as 80.3 cents on the dollar to 67.7 cents for Puerto Rico’s last sale of debt before its default, a $3.5 billion issuance in 2014.

The lower recoveries on some bonds reflect arguments by the board that Puerto Rico breached constitutional ceilings on debt in 2012, rendering subsequent bonds invalid and worthless, which bondholders denied.

The settlement, if approved, would end the legal battles that have raged since Puerto Rico filed for bankruptcy in 2017, costing taxpayers in the territory more than $858 million in fees and expenses for lawyers, bankers and other professionals as of last month. Some rulings stemming from that litigation have undermined longtime assumptions among investors about the safety of some types of municipal bonds, although Puerto Rico’s struggles have been viewed in some quarters as an isolated incident within the typically staid tax-exempt market.

The bankruptcy came after years of heavy borrowing and service cutbacks in Puerto Rico that affected everything from schools to electricity service and pushed many residents, who are U.S. citizens, to depart for the mainland, sapping the tax base and squeezing budgets. The territory’s financial troubles have strained its relationship with Washington and slowed the release of federal aid following the devastating 2017 hurricane season.

Efforts toward an economic revival in Puerto Rico have also been complicated by corruption allegations against public officials and political turmoil stemming from a former governor’s forced resignation in 2019 as well as more recent earthquakes and the continued fallout from the coronavirus pandemic.

Bond recoveries under the settlement are somewhat lower than what some creditors agreed to receive before the pandemic, reflecting the resulting financial hit to Puerto Rico, ratings firm Moody's Investors Service said.

The board said it expects to file a debt-adjustment plan incorporating the deal in federal court next month. Creditors will have the chance to vote before it can be approved.

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By Andrew Scurria

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