New Plays In The Municipal Bond Market.

I note with interest that a variety of activities are going on in the municipal bond market that appear to be tied more to the lack of yields in the corporate and U.S. Treasurys markets combined with the games one can play in the less supervised municipal bond market. This has to do with some unique features of this market as well as the fact that many current distressed deals can be saved through the injection of additional funds, thereby salvaging a debt instrument carrying a 4% to 8% coupon of tax-free income for decades to come.

As students of municipal defaults for more than 30 years, I have seen any number of games that can and have been played with munis once they become distressed. To understand these games, one needs to be aware of a few things.

In times of low interest rates tax free municipal bonds with a high coupon rate are prized instrument. The fact that they may be tied to a dog of a project does not have to be an obstacle to reviving their fortunes. To the contrary, it drives their perceived value by current owners from par value to values of 30% to 60% of par. If you have deep pockets, you can tender for such bonds, buy up the issue and then give a loan to the project to remedy its financial woes. If successful, you end up with a project paying a tax-free yield of 4% to 8% for decades with a market value 20% to 50% above par and as much as 100% above cost.

I suspect two nursing home projects are underway on just such a course. They are the Cambria County PA Senior Choice project and the Florida Capital Trust Agency Beach House project. The two projects are not making public disclosure of why the interest payments are not being made or what remedies are under way. As a result, the bonds are trading in the 50 cents on the dollar range with heavy bond selling, something not usually seen.

A second point of interest about tax-free bonds is that they can be restructured as to coupon rate, maturity or the basic project for which they were originally issued. Hence, say you have a $17.5 million nursing home that's in distress. Let's say you manage to buy up 100% of the bonds at 66 cents on the dollar through various means including a bankruptcy filing and a public auction of the facility. Now you are left with a return of your 66 cents on the dollar investment and a worthless bond issue.

But wait, that worthless bond issue is a license to generate 6.5% tax free income until 2051. All that is needed is to have the issuing authority take this black mark off their record by allowing you to put as substitute collateral say, a building leased by the U.S. Post Office for the next 20 years. This may be a property you already own but which has been fully depreciated and now only generates taxable income.

Could the owners of the Canton Georgian Housing Authority Senior Living Bond for Provident Village have such a plan in mind? (Full disclosure, we were involved in such restructuring efforts back in the 1980s when those 'worthless bond instruments' carried double digit coupon rates.)

The above situations can be played out differently depending on the ownership of the bonds. Here, they are positives from the point of view of maybe salvaging a few from the large number of retirement facilities devastated by the Covid-19 pandemic. Left to only the trustees, such facilities have a poor record for recovery and end up hurting bondholders and occupants. What is not commendable here is that the process often works only by deception, withholding information from current bondholders and tax mitigation schemes that serve little purpose for the nation. Of course, I could be totally wrong and these investors have only the noblest of intentions, even making failed projects into green projects. But then, we've seen this movie before.

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