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‘Weird’ Muni Bond for Virginia Tire Recycler Offers Juicy Yield, No Risk.

- **Escrow bonds with mandatory put preserve tax-exempt allocation**
- **Structure delivers ‘free lunch, dinner and dessert’ for buyer**

Municipal bonds can often seem like the quirky cousins within the $53 trillion US fixed-income market. But sometimes being a little weird pays.

Consider the $65 million in environmental improvement revenue bonds sold last week by the Southampton County, Virginia, Industrial Development Authority for a new tire-recycling project. The facility, to be located at a logistics center in the southeastern portion of the state on the border with North Carolina, will “demanufacture” car and light truck tires into scrap steel, solid fuel, liquid fuel and syngas, according to the preliminary official statement to the bonds. A private company, PRTI, is running the project and will be the ultimate borrower.

Resource recovery has a spotty record in the municipal bond market. Of the $57 billion in municipals in distress or default, $1.86 billion was used to finance resource recovery, according to data compiled by Bloomberg. But investors in the bonds sold last week don’t need to worry about that risk because recycling isn’t repaying the bonds.

And that’s where the quirkiness comes in.

The debt was sold only to preserve the private-activity bond allocation made by the commonwealth of Virginia that will allow PRTI to use relatively low-cost tax-exempt financing to build the facility. The use of tax-exempt financing to benefit private companies – offered by municipalities to boost local economies — is capped by the federal government and expires if it’s unused in a given year.

So the new bonds are a sort of placeholder. The money raised in the debt offering will be invested in US Treasury securities and put into an escrow account, and the bonds are subject to a mandatory tender next June. At that point PRTI will come to market with new bonds and use the proceeds of that issue to build the new facility in Virginia.

The bonds, rated Aaa by Moody’s Investors Service, were priced at par — or 100 cents on the dollar — with a 4.88% coupon on Nov. 6. At the time, top-rated municipal bonds maturing in a year were yielding 3.54%, according to the Bloomberg BVAL yield curve. So investors picked up more than 1.25 percentage point in extra yield, basically just because of the eccentricities of the municipal market.

And as it says right on the cover of the bond offering documents, “The Bonds are being offered only to investors who, in making their investment decision, rely solely on the Government Obligations and any cash on deposit in the Mandatory Tender Account, and not on the credit of the company or the feasibility of the Project.” So virtually no credit risk, though the bonds are subject to the alternative minimum tax.

‘Wabi-Sabi’

These kinds of deals, used by borrowers looking to preserve their private-activity bond allocations in advance of remarketing to final investors, are relatively unusual. Bloomberg doesn’t track annual sales of such deals on a separate basis, but anecdotal evidence suggests they come up a few times a month.

For investors, “bonds with this type of structure are the muni equivalent of wabi-sabi,” Nicholos Venditti, senior portfolio manager at Allspring Global Investments, LLC, in an email, referring to the Japanese art of finding beauty in imperfection. He continued, “Any time investors can find beauty in the weird, or in this case, excess return in the weird they should jump at those opportunities. All it takes is some extra work and a slightly different perspective.”

Eric Kazatsky of Bloomberg Intelligence concurred, saying that private activity bonds subject to the alternative minimum tax like these already offer a yield premium that’s like “the proverbial free lunch,” because so few investors have to pay the AMT. Add to that the escrow and put structure embedded in the Virginia debt issue, and it’s like “free lunch, dinner and dessert,” he said.

Chris Hare, chief executive officer of PRTI, said in a telephone interview that the company already has a facility operating in Franklinton, North Carolina, and is working to make sure its process is “industrially scaled.” He can save the assurances for the next set of investors.

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