Municipal Market Comments

ASCENT Investment Partners

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IN PARTNERSHIP WITH

The Market Impacts of Puerto Rico's Default

The Puerto Rico Public Finance Corporation (PFC) failed to make its scheduled Aug. 1, 2015 principal and interest payment, marking the first time the Commonwealth or one of its agencies has defaulted on a debt payment. The PFC has approximately $1 billion of outstanding bonds. Over the weekend, the PFC not only failed to pay $38 million of maturing principal, but also missed interest payment on its other outstanding debt.

The defaulted PFC bonds are not general obligations (G.O.s) of Puerto Rico, nor are they secured by a pledge of any specific stream of revenues or liens on any specific assets. Rather, they are backed by a pledge of the Commonwealth to appropriate funds in its annual budget to pay debt service. Without a legal pledge of specific taxes or revenues, holders of appropriation bonds generally have little recourse to seek recovery from the issuer if debt payments are not included in the budget.

This default does not directly impact the Commonwealth's G.O.s or its agencies' revenue bonds, some of which were paid as scheduled on August 1st. However, the deliberate failure of the Legislature to appropriate funds for debt service on the PFC bonds will taint all other Puerto Rico issuers. The default is widely viewed as a strategic move by the Commonwealth in the larger fight between the island and its creditors over the future of Puerto Rico's G.O. and tax-secured debt. Consequently, the default has already negatively affected the market for Puerto Rico's G.O. and agency bonds, hurting many investors in municipal bond mutual funds and ETFs.

On June 29, Puerto Rico Governor Alejandro Garcia Padilla made clear that he would seek to restructure the island's $72 billion of total government and agency debt. The Governor subsequently targeted Sept. 1 as the target date for his government to release a comprehensive debt restructuring plan. Since then, Puerto Rico and its largest creditors have been fighting privately and in the press over the extent of the Commonwealth's financial problems and the best path forward. Puerto Rico officials claim the PFC default proves the Commonwealth lacks the ability to pay its debt. Hedge fund investors counter that the island has the resources to pay all of its obligations in full. Ominously, Puerto Rico's situation has begun to take on many of the tones we saw in the Detroit bankruptcy, with the Governor setting the welfare of residents and support for social services in opposition to the payment of debt. Puerto Rico cannot access Chapter 11 bankruptcy unless the U.S. Congress passes a new law authorizing that route, so its only current options are either to negotiate a restructuring or to default and attempt to resolve the issues through litigation.

Ascent continues to view Puerto Rico debt as suitable only for sophisticated speculative investors. We reiterate our view that Puerto Rico cannot service all of its outstanding debt and that bondholders will face default in the near term, either through failure to pay or via a negotiated restructuring.

In a default or restructuring, the ultimate recovery value of any individual Puerto Rico bond will depend on a variety of specific details, including: each individual bond's legal structure; the source of revenues pledged for repayment; the presence or absence of bond insurance; and the security position of the bond relative to other obligations. At this point, it is impossible for investors outside the creditor negotiation process to know what realistic default recovery rates might be. We have seen default recovery estimates on G.O. bonds that range from nearly 100% (according to hedge fund investors) to as low as 60% (from Moody's). Recovery estimates for other Commonwealth issuers vary wildly, with some projected to be less than 30%. We expect that the Sept. 1 release of the Governor's restructuring plan will serve to reset the market's pricing expectations for many of these securities and formally start the Commonwealth's negotiated default.

According to Bloomberg estimates, approximately 31% of Puerto Rico's $72 billion in combined debt is held by hedge funds, 28% by individuals or institutions in Puerto Rico, and 14% held in U.S. municipal bond mutual funds. The rest of the bonds (27%) are held by individual investors, banks, insurance companies, international investors and other institutions. Bloomberg also estimates that approximately 50% of national municipal funds hold bonds issues by Puerto Rico or its agencies, though many of these bonds are also secured by municipal bond insurance. The fund families with the largest reported exposures include Oppenheimer, Franklin, and Nuveen. Virtually every high yield municipal fund has Puerto Rico holdings, as do many high grade and state-specific funds. As a result, many funds with Puerto Rico exposure have had to absorb significant losses over the past two years.

One additional consideration for municipal investors is the impact of a Puerto Rico default on the municipal bond insurers Assured Guaranty Corp. (AGM, rated A2/AA) and National Public Finance Guaranty Corp. (NPFG, rated A3/AA-). Both companies insure significant amounts of Puerto Rico G.O. and agency revenue bonds, and each has more than adequate capital to meet its payment obligations on Puerto Rico debt in the near term. However, if they recognize significant losses on their covered Puerto Rico policies, both AGM's and NPFG's credit ratings could come under pressure and market valuations of their bond insurance policies on all insured municipal bonds could suffer.

Although Puerto Rico bonds have been trading at distressed levels for over two years, the Governor's June comments pushed bond prices to new lows, with long-maturity Puerto Rico G.O. bonds dropping in price from around $73 to as low as $60 in late June. After recovering slightly through July, the looming default of the PFC bonds caused G.O. prices to drop again late last week, from the mid-$60s to around $60. Bonds issued by Puerto Rico's agencies vary widely in price, from close to par to as low as $40.

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With the market worried about default or restructuring, liquidity for smaller positions in Puerto Rico bonds has dried up, leaving many individual investors trapped or forced to sell at extremely distressed prices. Mutual funds and hedge funds may be able to negotiate selling their holdings in private transactions, but individual investors must get bids on their bonds in the municipal market to move out of positions. Since the island's bonds first came under pressure, liquidity for smaller blocks of Puerto Rico bonds has been poor. With the island's problems growing throughout 2015, individual investors now generally get no bids for their bonds or "throw-away" bids that might reflect pricing 10 points or more cheaper than the institutional market.

Puerto Rico's default again highlights the critical need for investors and advisors to properly evaluate the investor suitability of their bond and mutual fund purchases and perform periodic surveillance on the holdings in their portfolios. Since 2012, Ascent has viewed a Puerto Rico default as very likely and recommended investors sell Puerto Rico G.O. and agency bonds. Though it only became headline news over the past year, Puerto Rico's default has been years in the making. The Commonwealth has been in recession for a decade and its credit deterioration has been clear. Like Detroit, Puerto Rico's growing debt crisis was apparent and provided ample opportunity for investors to sell Puerto Rico bonds before they became distressed.

We will continue to follow events in Puerto Rico closely and update our commentary as developments warrant.

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