TREASURY | PARTNERS

Trouble in the Tropics

How Puerto Rico's Bankruptcy Affects the Muni Market

May 30, 2017

Daniel Beniak, CFA
Associate Director
+1 917-286-2783
dbeniak@treasurypartners.com

Richard Saperstein
Managing Director/Principal
+1 917-286-2777
rsaperstein@treasurypartners.com

treasurypartners.com

Puerto Rico's prolonged economic and financial struggles, extraordinary buildup of debt, and ongoing battle with creditors led to what is an effective bankruptcy filing in US federal court. The island's filing is by far the largest bankruptcy case in municipal market history, marked by its inability to service a staggering $72 billion debt load. While this represents the beginning of a long and protracted restructuring process, it already has the makings of a watershed event in the typically understated – some would say "boring" – world of municipal bonds.

Below, we provide a brief summary of how Puerto Rico reached this unfortunate point, its current status in the bankruptcy process, and reactions from the broader market. We also review some of the likely long-term implications of this landmark case, and how we believe it will challenge longstanding assumptions on the creditworthiness of municipal bonds.

The Backstory

Puerto Rico's current financial situation is the result of decades of shortsighted fiscal decisions, market-enabled debt binges, severe economic depression, and headwinds stemming from its political status as an American territory.

Simply put, the Commonwealth of Puerto Rico is broke:

- It has a massive budget deficit and lacks market access to secure bridge financing.
- The major pension trust funds are nearly empty, threatening the sole income stream for a significant proportion of the island's population.
- Per capita indebtedness is nearly triple that of the highest state (Connecticut). Debt as a percentage of personal income dwarfs that of the highest state (Hawaii).[1]

Worse, Puerto Rico's battered economy appears far too weak to allow the government to "grow its way out of the problem":

- Puerto Rico's unemployment rate is currently 11.5%, with youth unemployment over 24%.[2]
- GNP (Gross National Product) has declined in 9 of the past 10 years.[3]
- Since 2010, average family personal income has decreased by 1.3% while inflation has increased nearly 6%.[3]
- Since an unusually large percentage of the Puerto Rican workforce is tied to the Commonwealth's government, austerity-related budget cuts would lead to more job and wage losses than a feeble private sector could reabsorb.
- Puerto Ricans are "voting with their feet" and moving to seek better economic opportunities, as the Commonwealth's population has shrunk by nearly 8.5% since 2010.[4]

1. Moody's Investors Service
2. US Bureau of Labor Statistics, Federal Reserve Bank of St. Louis
3. Puerto Rico Government Development Bank (Gross National Product and Average Family Personal Income in constant 1954 dollars)
4. US Census Bureau

Last year Congress established a federal oversight board over the Puerto Rican government. Among other powers such as the ability to approve budgets and capital projects, the board can approve debt restructuring negotiations and initiate a federal court case to forcibly reduce debt levels. The board took the latter bankruptcy-like step recently, and the beginning of this judicial process has now started.

Munis Holding Steady

The broader investment-grade municipal market has not suffered any contagion effects from Puerto Rico's woes. Most Puerto Rican credits, including the central government's General Obligations, were downgraded to junk status several years ago. In addition, many investors have long considered the island an outlier and do not associate its uniquely deep troubles with most municipal issuers (which we believe is correct). The narratives driving municipal market trends this year have focused on the potential for federal tax reform and Fed rate hikes, not developments in Puerto Rico.

The Real Story: Long Term Implications

Despite the muted impact thus far, we believe Puerto Rico's bankruptcy will serve as precedent for rethinking some of the bedrock assumptions of the municipal market. In particular:

- **The rules of the game can be changed.** Until Congress established an oversight board with restructuring powers, Puerto Rico did not have legal authority to declare bankruptcy or seek to forcibly reduce its debt load. Investors mistakenly relied on this, believing the Commonwealth couldn't legally attempt to impair their bonds.

  Needless to say, this was a naive assumption. There is always a threat that laws can creatively be changed if the circumstances are right. For example, holders of Puerto Rican General Obligation bonds – who depended on the Puerto Rican constitution's unequivocal guarantee of first payment priority – are about to learn this lesson the hard way. This segues into our next takeaway…

- **Which creditor is <u>really</u> senior?** Municipal bankruptcies have been (and remain) rare events, infrequent enough that we have little precedent to fall back upon. Historically, however, bondholders could count on having their covenants upheld to a reasonable degree, and their position in the creditor hierarchy generally respected.

  More recent trends have diverged from past experience. In the City of Detroit's landmark 2014 bankruptcy, for example, *General Obligation and other senior bondholders bore larger losses than city pensioners, who are usually understood to possess a legally subordinate claim. In January 2017, San Bernardino, CA's long-running bankruptcy concluded with the city's pension obligation bondholders receiving a settlement of 40 cents on the dollar while pensioners were untouched*. There is significant concern that a similar, bondholder-unfriendly situation is developing in the Puerto Rico proceedings. Despite seemingly strong legal protections, bondholders of distressed creditors have been at risk of effective subordination to more politically sympathetic stakeholders.

- **Politics matter.** The long, calm history of the municipal market has made it easy to forget that investing in a public entity under financial stress carries at least some degree of political risk. There are always two considerations when investing – ability <u>*and*</u> willingness to pay. The ability portion is more cut-and-dried, less open to interpretation, but willingness is more subjective and liable to erosion over time.

  Typically, municipal bondholders are seen as vital partners helping finance important civic projects. But when things go wrong and a stakeholder needs to draw the short straw, investors are exposed and should be sensitive to these potential outcomes.

Treasury Partners' View

The rarity of municipal bankruptcies means we have few historical examples, and as a result the ultimate outcome of the largest municipal bankruptcy in history will loom large. Although it won't set formal legal precedents, both investors and future distressed municipal issuers will surely draw lessons from Puerto Rico's experience.

We are concerned the longstanding "taboo" among issuers against municipal bankruptcy is fading. Previously, bankruptcy and bondholder impairments were considered so extreme and damaging to a municipality's long-term interests that they were hardly considered as real risks. Now, following Detroit's 2014 bankruptcy and the situation in Puerto Rico, issuers may consider it a more viable option to "wipe the slate clean." Moreover, in a corporate bankruptcy, creditors typically have the right to liquidate collateral to apply pressure and ensure fair recoveries. This is not the case in municipal bankruptcies – no judge would realistically allow bondholders to foreclose on courthouses or fire stations – which greatly increases a municipality's leverage over its creditors.

However, this is not to say we believe a "wave" of municipal bankruptcies appears imminent. The overwhelming majority of municipal issuers remain sound and committed to meeting their financial obligations to both citizens and creditors. Importantly, the financial troubles of Puerto Rico (and Detroit) were long-running and very visible – the danger was apparent for vigilant investors in advance of a bankruptcy filing. We don't anticipate any "surprising" future distressed municipal issuers, and believe that problem credits can be successfully identified and avoided.

As investors, we rely on solid, fundamental credit analysis and not just legal covenants. The quality and details of a bond issue's legal protections are important, but nothing trumps a strong balance sheet and solid operating financials. Solvency is the undisputed king – this includes consistent underlying financial performance and sustainable debt loads. If there is no significant visible fiscal stress, then the three troubling implications we've described here become irrelevant.

We have been, and continue to be, willing to invest in issuers facing "bad news" when our analysis indicates adequate financial strength and legal protections relative to the bond's yield. Conversely, we continue to avoid those issuers where we believe the financial performance and political realities are trending towards a dangerous situation for creditors.