LPL RESEARCH

BOND MARKET PERSPECTIVES

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PUERTO RICO DEBT RESTRUCTURING

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KEY TAKEAWAYS

Following several defaults over the past two years, Puerto Rico filed for debt restructuring under Title III of the PROMESA act, a process similar to bankruptcy.

Puerto Rico's debt crisis has been years in the making and is not symptomatic of the broad municipal bond market. Title III does not apply to any state outside of Puerto Rico.

Although lower credit quality states should be monitored, signs of contagion have not materialized and appear unlikely.

Puerto Rico, a source of stress for municipal bondholders since at least 2013, is back in the news again. After years of recession and poor economic performance during which the territory racked up over $70 billion in debt, Puerto Rico submitted for Title III restructuring on May 3, 2017. This debt restructuring option is allowed under the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA), which was signed into law in 2016.

For most in the municipal bond market, the news was not surprising as Puerto Rico's fiscal issues were years in the making, and several factors played a role in the territory ultimately filing bankruptcy. Due to declining economic conditions and overleveraged borrowing in Puerto Rico, its inability to pay its bills is somewhat predictable. Although the government has tried to implement reforms, such as attempting to fix their pension issues and working aggressively to cut government spending, Puerto Rico's economy has not cooperated. The problems were exacerbated in July 2016 when the island defaulted on general obligation (GO) debt—bonds that were supposed to be guaranteed by Puerto Rico's constitution. Though Puerto Rico had defaulted on revenue bonds previously, the GO default was the first real sign that bankruptcy-like restructuring was on its way.

WHAT'S PRICED IN?

Market reaction to the recent filing has been mixed, with GO bonds seeing limited losses indicating that markets had largely priced in such an outcome. Puerto Rico Sales Tax Financing Corp (COFINA) bonds and Puerto Rico Electric Power Authority (PREPA) bonds did see larger losses in the wake of the filing, though much of this was just a reversal of gains that came following passage of PROMESA legislation in mid-2016.

- **GO debt:** Once thought to be guaranteed by Puerto Rico's government, but this changed after the 2016 default. Under Title III, GO bonds are likely to hold among the highest priority, but this remains to be seen, as the court may value senior-secured debt higher. After the Title III filing, debt due in 2035 traded at about 63 cents on the dollar as of May 8, 2017 [Figure 1].
- **COFINA:** These senior bonds are backed by sales-tax revenue and have recently traded higher than GO bonds. According to the deal offered to

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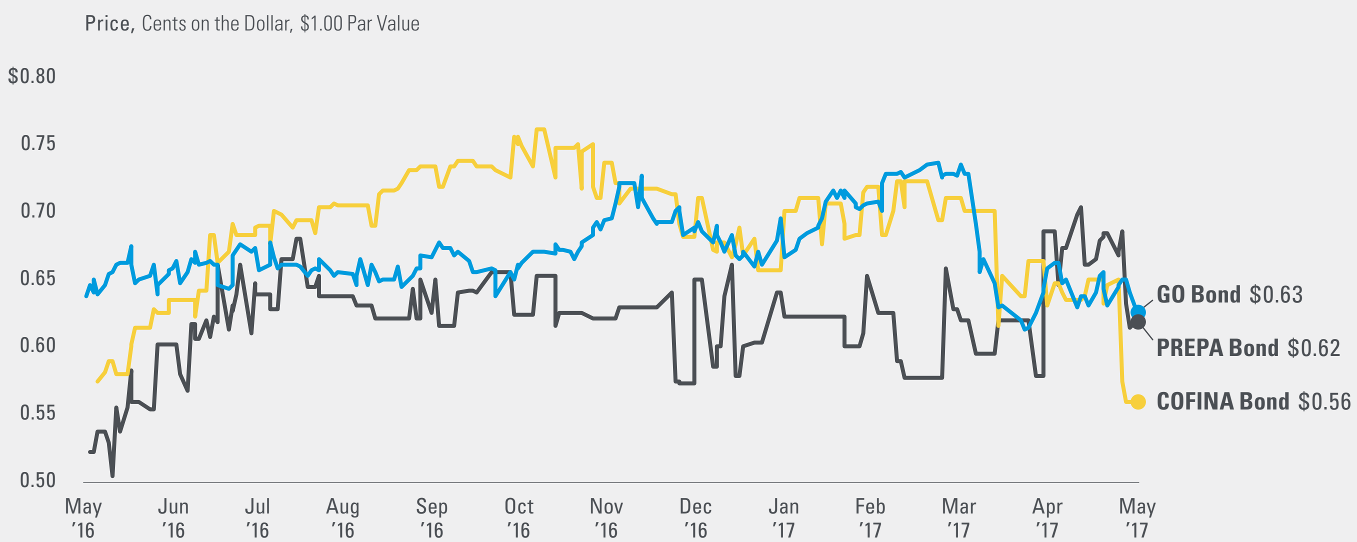
bondholders prior to filing for Title III, the government was willing to pay GO holders more than COFINA holders, prioritizing the GO debt ahead of COFINA. The power to prioritize bonds backed by a dedicated revenue stream like COFINA, ahead of the GO bonds, belongs to the court. After the filing, the prices subsequently dropped. Bonds due in 2040 sold for 56 cents on the dollar on May 8, 2017.

- PREPA: Essential service revenue bonds, such as those issued by PREPA, once held their value better than other bonds. PREPA bonds saw losses after the filing, but not as large as some other issues, with bonds due in 2042 selling for 62 cents on the dollar on May 8, 2017. Perhaps the lesson to be learned here is that essential revenue service bonds may hold their value better than other issues because power is a necessity.

Depending on the structure of the bonds (legal covenants or priority of payment), prices have ranged from the mid-$20s to mid-$80s ($100 is par). The low prices likely signal that the market had previously understood that par value may not be recouped. Normally, due to the government guarantee, GO bonds would be among the higher priced Puerto Rican bonds. However, following last summer's GO default, essential service power bonds are now trading a bit higher than the GO. Although it is difficult to draw conclusions from this, it does demonstrate that a well-diversified approach using essential service revenue bonds (especially in lower rated states) may be prudent.

1 **PRICE ACTION OF MAJOR PUERTO RICO BOND ISSUES OVER THE PAST YEAR**



Source: LPL Research, Bloomberg 05/08/17

CUSIPS referenced are 74514LE8 (GO Bond), 74529JNX (COFINA Bond), and 74526QZY (PREPA Bond).

Performance is historical and no guarantee of future results.

Par value is the nominal value of a bond, share of stock, or a coupon as indicated in writing on the document specified by charter.

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The issues illustrated are considered high yield/junk bonds. High yield/junk bonds (grade BB or below) are not investment grade securities, and are subject to higher interest rate, credit, and liquidity risks than those graded BBB and above. They generally should be part of a diversified portfolio for sophisticated investors.

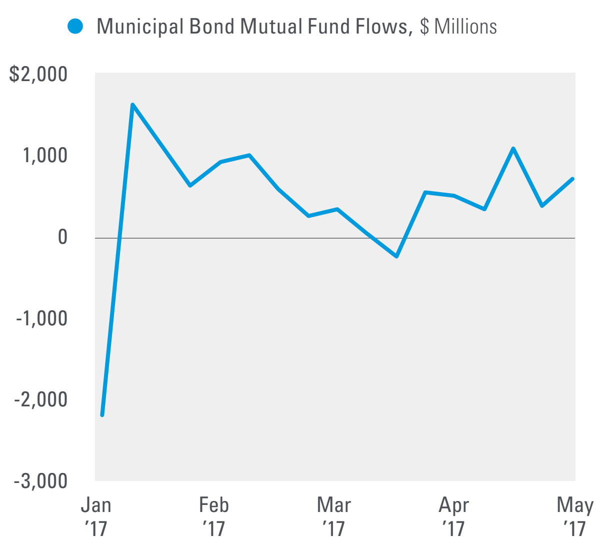
WILL PUERTO RICO SPILL OVER TO THE REST OF THE MUNICIPAL MARKET?

Since many highly rated states are growing their economies, Puerto Rico is not representative of the broader municipal bond market. Growing economies have led to better credit quality metrics and this is the primary reason why troubled municipal issuers are the exception and not the norm. Even though high-profile distressed bond issuers like New Jersey and Illinois may gather widespread attention, the number of municipal defaults still remains isolated.

So far, Puerto Rico has not impacted the broader municipal bond market and we don't expect the Title III filing to cause widespread concern. Most mutual funds have had time to digest Puerto Rico's debt and have reduced their exposure to uninsured holdings. The news surrounding Puerto Rico could lead to more scrutiny of other distressed issuers, though the debt and economic problems that Puerto Rico faces are more severe than those of any U.S. state.

Mutual fund flows can be used to gauge the fear of broader contagion. In 2013 and 2016, Puerto Rico distress corresponded with mutual fund outflows, followed by an extended period of weakness. However, flows have remained positive over the previous month [Figure 2], and only one small outflow was seen as Puerto Rico debt prices began to fall in March 2017. The lack of capital flight indicates that the market was on solid footing heading into the Title III filing. Though flows have showed little sign of distress, this is an area that we will continue watching in the near future as a gauge of how broader markets are reacting to developments surrounding Puerto Rico.

2 **MUNICIPAL BOND MUTUAL FUND FLOWS HAVE REMAINED POSITIVE OVER THE PAST MONTH**



Source: LPL Research, ICI, Bloomberg 05/08/17

Performance is historical and no guarantee of future results.

Investing in mutual funds involves risk, including possible loss of principal. Municipal Bond mutual fund's concentrated holdings will subject it to greater volatility than a fund that invests more broadly.

POTENTIAL RISKS

Puerto Rico isn't the only municipality struggling with fiscal difficulties. New Jersey and Illinois have also faced scrutiny in the past several years. New Jersey's state pension problem has been in focus since 2014. In addition to having the lowest pension funding level of any state, Illinois has been suffering a decrease in revenue as well. Puerto Rico's restructuring may cause investors to reassess the risks in these states, though unlike Puerto Rico where Congress was able to intervene because it was a territory, New Jersey and Illinois fall under states' rights and as such they can't be forced into restructuring. Both also have access to greater revenue inflows than Puerto Rico, so any comparisons are tenuous at best.

CONCLUSION

Puerto Rico, its citizens, and bondholders have a difficult road ahead. The island's debt restructuring period will most likely be prolonged and final resolution may take years. The good news for municipal investors is that the reaction in the broader municipal market has so far been muted, as Puerto Rico's issues have been years in the making and the Title III filing did not come as a surprise. That being said, with over $70 billion in debt, Puerto Rico's Title III filing could lead to the largest municipal restructuring the U.S. has ever faced (Detroit was the previous largest at $18 billion) and unknowns remain. The overall impact of this event may take time to develop, and with this in mind it may make sense for risk-averse investors to focus on higher quality municipal bonds to manage credit risk. ■

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