Puerto Rico And Bondholders Avert Disaster, Now What?

Puerto Rico successfully placed $3.5 Billion of tax-free debt this week in a well-received deal that buys the territory additional time to sort out its struggling finances. Yield-hungry investors were lured by the issue's robust 8.7% interest rate, which equates to over 16% on a taxable bond for top earners. The debt placement was critical for Puerto Rico to avoid a looming cash crisis stemming from debt maturities, and it provides up to a year and a half of liquidity according to David Chafey, Chairman of the Government Development Bank for Puerto Rico.

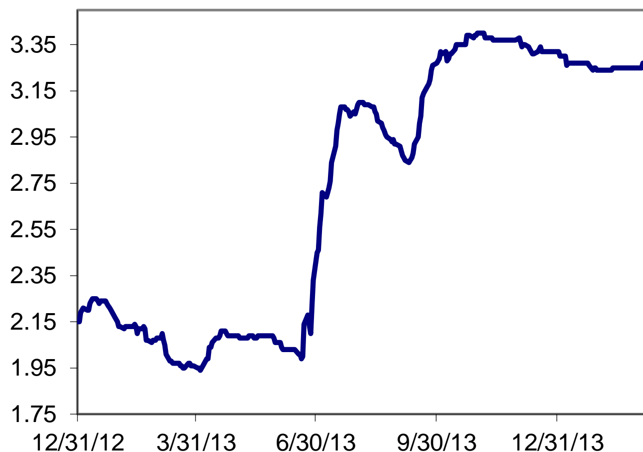

Fig. 1 Bloomberg 10-Year Puerto Rico Revenue Index spread versus Bloomberg 10-Year AAA GO Index since beginning of 2013.

Source: Bloomberg

So why did we avoid this opportunity to earn substantial yield? Simply put, the debt placement addresses the near-term liquidity crisis, but it does nothing to reverse the longer-term challenges plaguing the Commonwealth. Leadership has taken steps towards reform within the past year, but high unemployment, perennial deficits, and massively underfunded pensions remain considerable obstacles to fiscal stability. We view the risk/reward equation for Puerto Rico as better suited for equity investors rather than Municipal bondholders, who often take a "sleep at night" approach to their allocation.

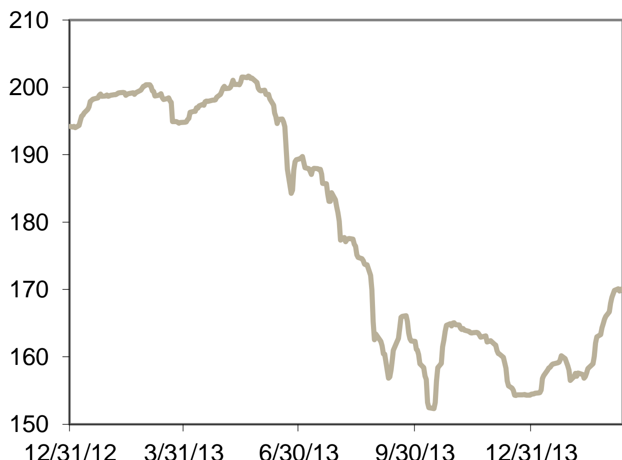

Fig. 2 The S&P Municipal Bond Puerto Rico Index declined roughly 20% in 2013, its worst year since its inception in 1999. Index valued at 100 on 1/31/99.

Source: Bloomberg

According to a Wall Street Journal report last week, Puerto Rico had engaged a financial restructuring firm in an advisory role. While this week's bond issuance suggests that restructuring will not be a 2014 event, we hardly take comfort in Mr. Chafey's outlook for 18 months of additional liquidity. We doubt Puerto Rico's problems will be resolved before the next liquidity squeeze comes.

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