

This week’s news regarding Puerto Rico Electric Power Authority (PREPA) has been another stark reminder for municipal bond investors. PREPA is the island’s main utility provider of electricity which entered bankruptcy in 2017 with over \$8b in outstanding debt. The bankruptcy court ruled on Monday bondholders would only have claim to less than 30% of the outstanding debt while investors previously expected around 70% based on prior agreements with the Federal Oversight Management Board. The U.S. District Judge on Wednesday rejected a claim to reconsider an appeal by bondholders, both events sent bonds prices falling sharply.

Puerto Rico was struggling with a weak economy for years even before a devastating hurricane and a default on billions of dollars in debt. Puerto Rico’s fiscal problems has roots dating back to 1996 with the repeal of a corporate tax break known as Section 936 that sparked an exodus from the island. Section 936 was enacted in 1976 and allowed US manufacturing companies to avoid corporate income taxes made in US territories, including Puerto Rico. Some of the largest manufacturing companies that flocked to the island were by the pharmaceutical industry. The provision faced opposition in the 1990s for being too costly and by 1996 President Bill Clinton signed into law a phase out of Section 936 over 10 years after which the financial crisis hit.

16Rock published on May 4, 2023 ‘The Great Reset’ where we commented, “While we’re bullish on the post-bankruptcy world for Puerto Rico, Detroit is an everyday reminder to never bet against a state or local government that provide essential services, has nothing but time, resources, the backing of taxpayers and pension beneficiaries, and an ability to change law on their side.” Betting against a state or local government that is distressed or in default brings with it many legal risks that might not be apparent initially. We have said in the past that we as a firm are not comfortable or experts in evaluating the ‘legal’ risk inherent in this municipal restructuring. When you introduce to the value determination of a bond, the variability of decision making by a judge or a court, that may be political, that is a risk you cannot quantify.

The municipal bond industry, like recent bank failures, at times falls victim to ‘yield-seeking’ behavior. This creates as much relative value trading opportunity as it does systemic concerns

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regarding fund flows from holders of the debt at the various industry fund providers. The municipal industry has a lot of very smart credit research professionals who work hard evaluating fundamentals. This was a big miss, however. These bonds have been trading with zero accrual for years and at prices that in no way anticipated news like this. This week’s event stresses the value of having experienced portfolio managers that employ both a relative value approach incorporated with a strong fundamental credit framework.

16Rock does not own any Puerto Rico debt. For our clients that mandate high yield bonds, we’ve started to re-evaluate whether bond prices are adequately assessing the inherent risks now. As we approach quarter-end, with more legal challenges expected, we see more pain to come regarding Puerto Rico debt trading.

[1] PR ELEC PWR AUTH 5.25% 07/2040 c23 - 74526QVX7



Source: Bloomberg as of June 29, 2023

16ROCK ASSET MANAGEMENT

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