Illinois eyes USD 550m bond sale with no budget in sight

By Gunjan Banerji
16 June, 2016

Illinois's competitive bond sale today will feature a tug-of-war between the state's credit quality and favorable municipal market dynamics that could benefit primary market pricing, said market participants.

The Prairie State comes to market today for the second time this year with a USD 550m competitively-priced bond deal for its USD 31bn capital program, just weeks after state Democrats and Republicans failed to agree on a fiscal pact before the formal legislative session ended. The state is still without a budget for FY16, just weeks before it ends, while FY17 looms.

Current Illinois GO secondary trading levels—around 165bps-170bps above the AAA MMD—could be a good indicator for final pricing tomorrow, said a municipal bond trader. However, price talk has reached 200bps above the AAA MMD, said a second trader. The bonds will have a final maturity of 2041. The state is accepting bids on the deal until 10:00 AM Central Standard Time, according to the state's notice of bond sale.

Goldman Sachs released a pricing scale seen by *Debtwire Municipals* indicating that spreads on the debt would come in 180bps above the AAA MMD for fifteen-year maturities. **Morgan Stanley**'s scale, also seen by *Debtwire*, indicates similar spreads hovering at 173bps above the AAA MMD for bonds maturing in 2031. A preliminary pricing scale from **Barclays** indicates that 2031 maturities could print 183bps above the AAA MMD, while 10-year maturities come in 179bps above the AAA MMD.

Goldman Sachs declined to comment. Morgan Stanley and Barclays did not return requests for comment.

A seller's market

Municipal market dynamics could make yields on this bond issuance come in tighter than what has so far been indicated, said market participants. Cook County's negotiated deal came in 15bps tighter than price talk indicated for 2030 maturities, according to *Electronic Municipal Market Access*. Additionally, some underwriters may decide to hold the bonds in their books and print the deal on the lower end of the scale for the sake of doing business with Illinois, said two traders.

Demand for tax-exempt bonds has been high, as investors flee toward anything with an attractive yield, noted the first trader. Municipal bond fund flows to long-term mutual funds hit USD 1.4bn as of 8 June, up 43% from the prior week, according to ICI.

Year-to-date inflows for calendar year 2016 are USD 29.8bn. This is more than three times the USD 8.8bn that had entered the market by this time in calendar year 2015, according to *Debtwire Municipals*' analysis.

Warning Signs

An investor roadshow presentation highlights the general obligation debt's strong security features. The state sets aside portions of principal and interest payments every month in the General Obligation Bond Retirement and Interest (GOBRI) Fund, said Kelly Hutchinson, the state's director of capital markets, in the presentation, noting that the state's GO bond program has a perfect payment history. But the state's 2016 offering documents take a different tone, bewildering some investors.

The offering documents state that Illinois is not authorized to file for bankruptcy protection under current federal bankruptcy law, and that "the rights and remedies of the bondholders may be limited by and are subject to equitable principles that may affect the enforcement of creditors' rights and liens securing such rights, the police powers of the state and its political subdivisions, the exercise of judicial discretion in appropriate cases and limitations on legal remedies against the state."

"It's definitely strong disclaimer language, hedging against the remote possibility that the State would, for the first time, not be able to make its bond payment," said John Schomberg of Clark Hill. Schomberg previously served as general counsel to Illinois Governor Pat Quinn (D).

The state has borrowed from its GOBRI fund in the past, as reported. The offering documents also warn investors of the fact that it has operated without a budget since 1 July 2015, that it lost up to USD 5bn in revenues from an income tax sunset, and that there are risks associated with its variable-rate debt.

Swap, and price, risk

Despite the heightened disclosure, actual default risk for the state of Illinois does not seem to be at the forefront of investors' minds currently, said market participants. Spreads on Illinois debt have been relatively stagnant this calendar year, despite the deepening political gridlock in Springfield, noted the second trader. However, future price risk might play into the investor calculus regarding this primary market deal, buysiders noted.

Moody's recently downgraded the state to Baa2 from Baa1, while S&P knocked the credit to BBB+ from A-. Fitch placed its BBB+ rating on the state to "negative watch," indicating that it would resolve the designation based on how the FY17 budget progresses. Moody's and S&P have negative outlooks on Illinois.

The state has USD 600m in Series 2003B variable rate general obligation bonds, which are supported by six letters of credit with a 260bps fee, expiring on 26 November 2016, according to an Illinois RFP.

The letters of credit are tied to five outstanding interest rate swaps, one of which it was able to negotiate the terms of. The ratings thresholds for AIG Financial Products Corp., Bank of America, Merrill Lynch Capital Markets, and JPMorgan Chase, is Baa2 by Moody's and BBB by S&P, according to the offering documents. This means that the banks can terminate the swap agreements if the rating falls below these grades, requiring the state to pay negative present values on the agreements.

The five agreements have negative present values of USD 155m as of 30 April, according to the offering documents.

Deutsche Bank agreed to amend terms with the state, and could terminate swaps if the state's GO bond rating is withdrawn, suspended, or rated below BB+ by S&P or Ba1 by Moody's, according to a supplement to Illinois's offering documents.

Deutsche Bank did not charge the state a fee for re-negotiating the threshold, said a person close to Illinois state government. But the renegotiation could foreshadow a refinancing to shed the swap risk associated with the USD 600m in variable rate debt, said a public finance attorney and buyside analyst.

Deutsche Bank declined to comment. An Illinois spokesperson did not respond to a request for comment regarding preliminary price talk or a possible refinancing.

Organized anarchy

The General Assembly needs to grant appropriation authority to fully expend the proceeds from the bond sale, although existing FY16 appropriations could be used to expend a portion of them, said the person close.

It seems irresponsible for a state without a budget to borrow money, said Don Fullerton of the University of Illinois. For some investors, lending money to a state that can't pay its bills is not prudent, said Tom Schuette of Gurtin Fixed Income.

Illinois has made good on debt service payments, pension payments, consent decrees, and other expenses as its backlog of bills has climbed to USD 7.5bn and vendors continue to wait in line to get paid by the state. That's up from prior estimates of USD 5.9bn for the end of the 2015 calendar year.

The ongoing impasse hurts the state's economic outlook as higher education and human services entities grow increasingly strapped for cash, leaving Illinois citizens hanging, Fullerton noted. Higher education institutions that have had to lay off employees have a "multiplier" effect on the state economy, Fullerton said. That's one more person in a town without a job, who is not spending at the local stores—this potentially puts other people out of work.

Roughly 70% of the state's general fund revenues come from income taxes, said Illinois budget director Tim Nuding during the roadshow presentation. Income tax revenue fell by up to USD 5bn as an increased income tax expired. The director expects a FY16 deficit of USD 4.3bn as the state spends approximately USD 36bn, outweighing its USD 31.7bn in revenues.

Over the past decade, the state has increased its contributions to its retirement systems, which have a USD 119bn net pension liability. The state increased its contributions by 600%, to USD 7bn in FY15 from USD 1bn in FY06, according to offering documents. It contributed 88.9% of the actuarially required contribution in FY15, as opposed to just 33% in FY06.

The state's projected required annual statutory contributions to its pensions increase by 28% over the next decade to USD 9.6bn in FY25 from USD 7.5bn in FY16, according to offering documents.

The state will need a sustainable roadmap in order to address these rising actuarially-based costs, based on the percentage of Illinois budgets that retirement payments constitute, Schuette said, referring to Illinois's finances as existing in a state of "organized anarchy."

Currently, there is no plan to fund school, human services, and a litany other government services for FY17.