Chicago water bond deal prices next week amid credit concerns, but a broad market rally
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The **Chicago Water System** will pay a premium on its upcoming debt issuance because of its connection with the city, despite a broad market rally. The secondary market should provide a valuable guide, said two analysts.

The deal will price the week of 9 May, said a spokesperson for Chicago's budget office. The agency is authorized to issue up to USD 200m to buy back swaps, however it expects less.

"What we've seen with a lot of rates is that as we've gotten rid of the variable rate debt and gotten rid of the associated swaps, there's been upgrades," the spokesperson said.

Secondary market trading activity could be a good indicator of primary market pricing, said Thomas Tzitzouris, fixed income strategist at Strategas Research Partners, depending on the final structure of the deal.

The spread is higher for **Chicago** than other large water agencies, which shows traders have likely already priced in at least some of the risk associated with the city and the bonds, said an analyst.

A USD 11.6m tranche of Series 2014 Chicago second lien water revenue bonds which mature in 2030 last traded in odd lots on 19 April between 110.2 and 111.0 yielding 3.5% to 3.6%, according to *Electronic Municipal Market Access (EMMA)*. The bonds were last rated AA/negative by Fitch Ratings on 26 April, Baa2 with no outlook by Moody's Investors Service on 16 March, and A/stable by Standard and Poor's on 26 April.

To compare that to another large water agency, a USD 10.4m tranche of Series 2012A subordinate water revenue bonds which mature in 2030 and were issued by the **Public Facilities Financing Authority of the city of San Diego** last traded in odd lots on 3 May at 122.8 yielding 1.2%, according to *EMMA*. The bonds were last rated AA-/stable by Fitch on 18 April and Aa3 with no outlook by Moody's in August 2015.

Despite the higher yield for Chicago water paper, it still manages to benefit from a municipal market rally in 2016. Yield traced by the S&P Dow Jones Municipal Bond Index, a broad market value-weighted basket of municipal debt, rose from 1.99% to 2.00%recently, but yields have generally tightened this year, kicking it off at 2.25%.

Spreads on 10-year Chicago water bonds have tightened around 20-25bps while liquidity has ticked up, despite little change in Chicago GO and **Chicago Board of Education** trading activity, said Stephen Stowe, head of credit research at Chilton Trust Company.

A USD 11.5m tranche of Series 2012 second lien water revenue bonds which matures in 2025 last traded in round lots on 29 April at 112.0 yielding 3.0%, according *EMMA*. A few weeks prior, on 15 April, the bonds had traded in round lots at between 111.1 and 111.2 yielding 3.1%, according to *EMMA*.

The roughly USD 200m Chicago water issuance is the first chunk of over USD 2bn in debt the city and its agencies will come to market with this year, as reported. **PNC** is underwriting the deal next week. PNC did not respond to requests for comment.

Portfolio managers look to issuers associated with credits like Chicago, which tend to have a bit more hair on them, and seek value, said one trader. The market may punish related credits such as **O'Hare International Airport** or the water revenue bonds for the City of Chicago's financial troubles, the trader said.

One concern over the water deal is whether the city will co-mingle funds, as reported. However, the fact that the city has not done that so far has stayed some investors concerns.

“If the city wanted to take money from the water fund it could, legally they could not take it out before debt service was paid,” said the first analyst. “That risk is widely understood by the market.”

There are risks associated with how the city could behave as its distress increases, said Stowe.

“That is the central concern right now in Chicago – that the gridlock at every level of government could intensify, especially if service quality slips, thereby raising the odds of bondholder unfriendly outcomes,” said Stowe.

Chicago’s FY16 proposed budget was the first time that it billed its water and sewer systems for money management services, USD 395,000 and USD 270,000 respectively, as reported.

The question of how much commingling matters depends on if you think the city will file for Chapter 9, currently a political impossibility, said the analyst and Stowe.

In Chapter 9, the water enterprise system may be considered a department of the city and could be included in the bankruptcy, said Stowe. The solution reached in Detroit does not set a legal precedent one way or the other, said the analyst.