Municipal Brief

Puerto Rico Credit & Market Update

- In a webcast investor presentation hosted by the Government Development Bank (GDB) on 18 February, Puerto Rico announced plans to sell approximately USD 2.8bn of general obligation bonds next month. The Commonwealth indicated a larger sale, of up to USD 3.5bn, is possible. Bond proceeds will be used to refinance outstanding debt and repay lines of credit with the GDB.

- The decision to refinance some of the outstanding debt was given impetus by recent rating downgrades to the non-investment grade category which triggered acceleration provisions on approximately USD 1.1bn of short-term liabilities. Commonwealth officials reported on the webcast that no counterparty had exercised acceleration or termination rights on these obligations to date.

- The Commonwealth has no further plans to return to the bond market in the current fiscal year aside from this borrowing, but noted that additional debt is possible in FY15 depending on the success of the upcoming transaction.

- Recent price action on Puerto Rico credits suggests a high degree of confidence that the bond deal will be executed, thus providing short-term relief from the liquidity crunch. It should not, however, be construed as a reflection of fundamental and lasting improvement in the credit profile of Puerto Rico, in our view. With this in mind, the improvement in valuations may present an attractive opportunity for risk averse individual investors still holding Puerto Rico bonds to rebalance and diversify their portfolios.

Market update

The Government Development Bank’s investor webcast captured most of the attention directed towards Puerto Rico this past week. The webcast provided Governor Garcia and senior members of his administration with an opportunity to review recent financial developments and offer some details regarding the Commonwealth’s next bond sale. The governor reiterated his commitment to a balanced budget by FY15 and highlighted his administration’s demonstrable willingness to address recurring fiscal and economic challenges.
While the webcast included some information already disseminated to the investment community in one form or another, the presentation did clarify some of the details pertinent to the bond sale. First and foremost, GDB Chairman Chafey confirmed the expected par amount of the transaction. At approximately USD 2.8bn, the transaction is significant for its size and for its reliance on "crossover" (non-traditional) investors to support the bond sale. Commonwealth officials have requested legislative authorization to issue up to USD 3.5bn.

We suspect that traditional municipal bond investors no longer have the capacity to absorb a bond issue of this magnitude for Puerto Rico. The recent downgrades will constrain the ability of most tax exempt investment grade mutual funds from participating in the offering to any meaningful degree. High yield bond funds are already heavily invested in the Commonwealth and, while we would expect them to participate in the upcoming transaction, their ability to anchor a very large deal alone is uncertain. The recent reversal in mutual fund flows should provide these high yield funds with some flexibility to participate in the GO bond sale but Puerto Rico must still rely on crossover investors to ensure success. Fortunately, these investors appear to be actively engaged in discussions with the Government Development Bank regarding the new GO bond transaction. Thus far, there appears to be sufficient appetite among hedge fund managers to absorb the new issue. The high coupon offers these investors an income opportunity that has become increasingly rare in the fixed income markets.

A key consideration for these new investors is whether the traditional municipal bond buyer will return to market and reinvest in Puerto Rico bonds once the Commonwealth achieves a balanced and sustainable operating budget. It appears that many crossovers have concluded that the security behind GO bonds is sufficiently robust to protect their investment until traditional retail demand returns. While we suspect that they may be underestimating the amount of time necessary to restore broader market confidence in the Commonwealth’s finances, the institutional interest in purchasing the deficit funding issue is a positive development for Puerto Rico. We expect the Commonwealth to successfully conclude the sale and relieve the short-term liquidity challenges. The longer-term outlook is less certain, however, and will depend upon Puerto Rico’s ability to break out of the economic recession that has gripped the island for the past seven years.

Following the investor webcast, prices on Commonwealth bonds have strengthened. Prices of actively-traded Puerto Rico Sales Tax Financing Corporation (COFINA) bonds secured by a subordinate lien that carry a 5 ¼% coupon maturing in 2040 jumped by almost 2 points to USD 80.787 versus USD 78.848 last Friday (based on institutional size trades). At about the same time, prices on COFINA senior lien bonds 5 ¾% due 2057 increased by over 2 points to trade at an average price of USD 83.441 versus USD 81.298 on 13 February.

We observed similar price gains on Puerto Rico’s general obligation bonds. For example, Puerto Rico GO 5.0% coupon bonds with a maturity term of 2041 traded at an average price of USD 70.227 versus USD 68.720 one day earlier. In other actively traded Puerto Rico credits, even larger gains occurred. We note Puerto Rico Aqueduct and Sewer Authority’s (PRASA) 5 ¼% coupon bonds with a maturity of 2042 exhibited price gains of over 3 points (USD 68.125 versus USD 64.226 on 18 February). In the meantime, although prices on
bonds issued from Puerto Rico Electric Power Authority (PREPA) with a similar coupon and maturity (5 ¼%, 2040) were basically unchanged over the past two days, they now stand about 2 ½ points higher than the price levels posted earlier this week.

Shifting to the taxable Puerto Rico bond market, prices on GDB bonds with a 3.448% coupon, maturing in 2015, rose to USD 92.70 on 19 February versus USD 90.30 on 11 February. On a spread basis, improvements have also occurred. At the 10-year spot, the yield differential between PR GOs and MMD’s AAA benchmark narrowed by 75bps to now stand at 700bps on 20 February from 775bps, as recently as 18 February. At the long end of the curve, spreads decreased by 25bps to 395bps from 420bps over the same time frame. (See Fig. 1). We note that yield levels on the Commonwealth’s longer dated debt (7.79%) are now at their lowest levels seen since the beginning of December 2013. The price action suggests a high degree of confidence that the bond deal will be executed, thus providing short-term relief from the liquidity crunch. It should not be misinterpreted as a reflection of fundamental and lasting improvement in the credit profile of Puerto Rico, in our view.

While credit default swap (CDS) insurance costs remain near their six month highs (per MMD commentary), the cost of insuring against a Commonwealth default did drop in the past week in the wake of the rating agency downgrades. The CDS move may similarly be attributable to increasing confidence that Puerto Rico will be able to restore its liquidity in the near term through the deficit funding bond issue.

Credit update

The Commonwealth Treasury and the GDB affirmed their intention to provide more information regarding their respective liquidity requirements as part of the forthcoming bond offering. Investors were told to expect GDB financial statements for FY13 in the coming weeks and were promised an English translation of the recommended FY15 budget for the Commonwealth (after the budget is presented in Spanish) in either March or April. Puerto Rico also is expected to file its comprehensive annual financial report for FY13 on-time by 1 May 2014, with no material restatement of the estimated budget deficit for the period.

During the webcast, GDB Chairman Chafey discussed the amount of public sector deposits transferred to the GDB since September (USD 522mn as of 31 December 2013), in an effort to bolster the bank’s liquidity. The amount had not previously been disclosed, nor had the expectation of transferring an additional USD 450mn through the balance of FY14 been discussed publicly. We note one discrepancy between the initial estimates of the amount available for transfer and the total now expected to be made. While the GDB earlier suggested that approximately USD 2.8bn of such deposits were available, the amount presented in the webcast was USD 2.2bn.

The Commonwealth has pursued a number of legislative measures to bolster market access and liquidity in recent months. These include a new pledge of 0.5% of sales and use tax revenue to reinforce existing debt service coverage on outstanding COFINA bonds and allow for potential future issuance under a third lien. The Com-
monwealth estimates that this effort will provide over USD 1bn of new borrowing capacity for COFINA. Meanwhile, Governor García’s Tax Reform Advisory Group has retained consultants to determine whether a comprehensive reform of the island’s tax structure is necessary to promote economic development. To the extent COFINA is targeted for a radical restructuring, we believe the outstanding bonds will be protected through the substitution of an equivalent pledged security.

Other highlighted legislative achievements include the creation of the Municipal Finance Corporation (COFIM), which is authorized to issue debt secured by the portion of the sales and use tax dedicated to Commonwealth municipalities. Commonwealth officials estimate that this provides COFIM with approximately USD 500mn of borrowing capacity and would allow the municipalities to refinance an equivalent amount of loans currently held on the books of the GDB.

Finally, legislation that transfers certain underperforming mass transit assets from the Puerto Rico Highways and Transportation Authority (HTA) to a newly created entity is expected to relieve some of the pressure off of the HTA and allow it to regain access to the capital markets. In this case, the Commonwealth suggests that an additional USD 1bn of debt capacity would be available. This similarly would relieve pressure on the GDB which reported to have USD 1.7bn in outstanding loans to the HTA as of September 2013.

The Commonwealth filed a quarterly report on the same date as the webcast. The disclosure document is intended to update certain information contained in the Commonwealth’s most recent Financial Information and Operating Data Report (18 October 2013). The quarterly report reviews recent events, such as rating downgrades, and apprises investors of pertinent economic and fiscal conditions. As is customary in a document of this nature, the quarterly report offers a lengthy list of principal fiscal and economic challenges that could affect the credit quality of Commonwealth securities. These challenges include: (i) significant short-term liabilities; (ii) a constrained liquidity position at the GDB, (iii) a high debt burden; (iv) recurring budget deficits; and (v) economic recession. The document also cites the Commonwealth’s heightened reliance on Act 154 excise tax revenues as a component of the general fund budget and the historic challenges associated with accurately projecting tax revenues. Adverse demographic trends exacerbate the difficulties associated with accurately estimating future tax revenues, as more individuals of working age migrate to the mainland US.

Puerto Rico’s reliance on federal grants as a source of fiscal stability is evident in the report’s discussion of the Mi Salud health insurance program. The Puerto Rico Health Insurance Administration provides health care coverage for 1.63 million people, or more than 40% of the island’s population. The cost associated with this program is significant and growing. As the report readily concedes, Mi Salud represents one of the largest budgetary challenges for Puerto Rico and one that is disproportionately dependent on federal assistance.

The risks associated with federal transfer payments are underscored by the Commonwealth’s recent agreement to reimburse the US Treasury for unspent proceeds and overpayments associated with the American Recovery and Reinvestment Act. The USD 349mn will be
repaid over the course of the next year from GDB assets that comprise a portion of the bank’s current funding sources. Thus far, the federal government appears empathetic to Puerto Rico’s strained financial position but unwilling to provide direct financial assistance that might create a costly precedent.

We have received numerous inquiries regarding the Commonwealth’s efforts to reform the public pension system. Puerto Rico enacted comprehensive reforms of its three retirement systems into law in 2013. Modifications include reducing benefits, increasing employee contributions and replacing most of the defined benefit elements of the systems with a defined contribution plan. The Puerto Rico Supreme Court upheld the constitutionality of the reform program directed at the Employees Retirement System in 2013 but amendments to the Teachers Retirement System (TRS) and the Judiciary Retirement System (JRS) are currently being challenged. The Court suspended the application of reforms to the Teachers Retirement System pending the completion of an evidentiary hearing and granted both parties until 3 March 2014 to file briefs on the constitutionality of the amendments. A decision is expected to be reached soon thereafter.

Regardless of the outcome of the litigation, higher employer contributions to each plan will be required in the years ahead. The increases, however, are well below the amount that would have been necessary had the Commonwealth foregone the reform programs and funded the obligations on a pay-as-you-go basis. For example, for the Teachers Retirement System alone, the Commonwealth estimates that the annual cost of the annual cash flow deficit prior to reform would have approximated USD 562mn per year from the general fund over FYs 2020-2050. Post reform, it estimates that the required additional annual employer contribution payable from the general fund associated with this plan will be USD 30mn in FYs 2017-18 and USD 60mn thereafter until FY 2042. Clearly, there is a lot riding on the outcome of the Supreme Court decision. Commonwealth officials have reiterated their belief that the reforms will be upheld based on the precedent of the ERS.

Another rating action

On 18 February, Fitch announced that it had downgraded its rating of PREPA to BB+ from BBB- and revised the rating outlook to negative from stable. The rating agency also downgraded its rating of the PRASA revenue bonds to BB+ from BBB- and maintained its negative rating outlook at the same time. Both PREPA and PRASA are affected by many of the Commonwealth’s own credit challenges, including a weak economy, strained liquidity, and uncertain market access. Fitch’s decision to downgrade PREPA and PRASA come as little surprise in the wake of its decision to downgrade the Commonwealth’s GO bond rating to the non-investment grade category earlier this month.

PREPA is the sole provider of electric power to the Commonwealth. Growing receivables, declining energy sales, and narrow debt service coverage have been cited as credit concerns in recent years. According to Fitch, government and municipal receivables increased by 44% in FY13 and total receivables were equal to nearly 30% of PREPA’s FY13 revenues. Coverage declined to less than 1x in the last fiscal year and
operating cost reductions achieved through the first six months of FY14 were largely offset by a 2% decline in energy sales.

While PREPA’s capital needs are anticipated to be fully funded through FY15, Fitch noted that the Authority will still need to access the capital markets in FY16 to refinance maturing debt and adjust its fuel mix. PREPA has approximately USD 765mn in working capital lines due between May and December of 2014 but is reportedly renegotiating these maturity dates and related acceleration provisions. The Garcia Administration is eager to reduce energy costs and the governor has been outspoken in his desire to reform the Authority. Legislative proposals now under consideration contemplate opening Puerto Rico’s energy market to competition and creating a regulatory agency empowered to approve or reject energy rates. The impact of such legislation on PREPA’s creditworthiness is unclear but does introduce uncertainty, in our view.

PRASA, by contrast, has exhibited an improving standalone credit profile since a 67% average rate increase was enacted, enabling it to become self-sufficient in FY14 after years of reliance on the Commonwealth and the GDB for financial support to address growing operating deficits. The rate adjustment is expected to provide for balanced operations through FY18. PRASA provides water service to most of the island and sewer service to about 60%. Unfortunately, the recent rating downgrade is apt to result in higher borrowing costs and increased market access risk for the foreseeable future.

For a comprehensive review of recent rating actions affecting the Commonwealth and its related agencies and authorities, please refer to Figure 2.

Conclusions

The webcast and quarterly report reinforced two of our long-held perspectives regarding the Commonwealth. First, the Garcia Administration remains committed to the full and timely payment of its bonded debt obligations. Second, the massive debt burden incurred over the past decade represents the single biggest obstacle to meeting those obligations.

The Commonwealth is still reliant on refinancing its debt until such time as the economy rebounds enough to allow the government to operate on a self-sustaining basis. The island faces numerous material fiscal and economic challenges that could adversely affect the credit quality of Commonwealth securities and the risk of further deterioration in its financial condition is a real one. There appears to be diminishing political will to support further austerity - a trend that we believe is worth monitoring.

That said, institutional interest in purchasing the proposed deficit funding bond issue is a positive development for Puerto Rico. Following the investor webcast, prices on Commonwealth bonds strengthened. Investors may be encouraged by this trend. We expect the Commonwealth to successfully conclude the next bond sale and relieve its short-term liquidity challenges. The recent improvement in valuations may present an attractive opportunity for risk averse individual investors still holding Puerto Rico bonds to rebalance and diversify their portfolios.
### Municipal Brief

#### Fig. 2: Puerto Rico credit rating update

<table>
<thead>
<tr>
<th>Category</th>
<th>S&amp;P</th>
<th>Moody's</th>
<th>Fitch</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Commonwealth GO bonds</strong></td>
<td>BB+ / credit watch negative</td>
<td>Ba2 / negative outlook</td>
<td>BB / negative outlook</td>
</tr>
<tr>
<td><strong>Appropriation debt</strong></td>
<td>BB / credit watch negative</td>
<td>Ba3 / negative outlook</td>
<td>not rated</td>
</tr>
<tr>
<td><strong>Commonwealth employee retirement system pension obligation bonds</strong></td>
<td>BB / credit watch negative</td>
<td>Ba3 / ratings on review for downgrade</td>
<td>not rated</td>
</tr>
<tr>
<td><strong>Government Development Bank Senior Notes</strong></td>
<td>BB / credit watch negative</td>
<td>Ba3 / ratings on review for downgrade</td>
<td>not rated</td>
</tr>
<tr>
<td><strong>Puerto Rico Highways &amp; Transportation Authority</strong></td>
<td>BB+ / credit watch negative</td>
<td>Ba3 (highway revenue; Ba3 senior liens) / ratings on review for downgrade</td>
<td>not rated</td>
</tr>
<tr>
<td><strong>Puerto Rico Sales Tax Financing Corporation (COPRAN)</strong></td>
<td>AA- (senior liens); A+ (subordinate liens)</td>
<td>A2 (senior liens); A3 (subordinate liens)</td>
<td>not rated</td>
</tr>
<tr>
<td><strong>University of Puerto Rico University system revenue bonds</strong></td>
<td>BB+ / credit watch negative</td>
<td>Ba2 / negative outlook</td>
<td>not rated</td>
</tr>
<tr>
<td><strong>PRASA (Commonwealth guaranteed)</strong></td>
<td>BB+ / credit watch negative</td>
<td>Ba3 / ratings on review for downgrade</td>
<td>not rated</td>
</tr>
<tr>
<td><strong>PRASA revenue bonds</strong></td>
<td>BB+ / credit watch negative</td>
<td>Ba3 / ratings on review for downgrade</td>
<td>not rated</td>
</tr>
<tr>
<td><strong>PRFA special revenue bonds</strong></td>
<td>BB+ / credit watch negative</td>
<td>Ba3 / ratings on review for downgrade</td>
<td>not rated</td>
</tr>
</tbody>
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Source: S&P, Moody’s, Fitch, UBS CIO WMK, as of 20 February 2014
Appendix

Statement of Risk

Although historical default rates are very low, all municipal bonds carry credit risk, with the degree of risk largely following the particular bond’s sector. Additionally, all municipal bonds feature valuation, return, and liquidity risk. Valuation tends to follow internal and external factors, including the level of interest rates, bond ratings, supply factors, and media reporting. These can be difficult or impossible to project accurately. Also, most municipal bonds are callable and/or subject to earlier than expected redemption, which can reduce an investor’s total return. Because of the large number of municipal issuers and credit structures, not all bonds can be easily or quickly sold on the open market.

Terms and Abbreviations

<table>
<thead>
<tr>
<th>Term / Abbreviation</th>
<th>Description / Definition</th>
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<th>Description / Definition</th>
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<tbody>
<tr>
<td>GO</td>
<td>General Obligation Bond</td>
<td>TEY</td>
<td>Taxable Equivalent Yield (tax free yield divided by 100 minus the marginal tax rate)</td>
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<thead>
<tr>
<th>Rating Agencies</th>
<th>Credit Ratings</th>
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<tr>
<td>S&amp;P</td>
<td>Moody's</td>
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<table>
<thead>
<tr>
<th>Rating</th>
<th>Definition</th>
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<tbody>
<tr>
<td>AAA</td>
<td>Issuers have exceptionally strong credit quality. AAA is the best credit quality.</td>
</tr>
<tr>
<td>AA+</td>
<td>Issuers have very strong credit quality.</td>
</tr>
<tr>
<td>AA-</td>
<td></td>
</tr>
<tr>
<td>A</td>
<td>Issuers have high credit quality.</td>
</tr>
<tr>
<td>A-</td>
<td></td>
</tr>
<tr>
<td>BBB+</td>
<td>Issuers have adequate credit quality. This is the lowest Investment Grade category.</td>
</tr>
<tr>
<td>BBB</td>
<td></td>
</tr>
<tr>
<td>BB+</td>
<td>Issuers have weak credit quality. This is the highest Speculative Grade category.</td>
</tr>
<tr>
<td>BB</td>
<td></td>
</tr>
<tr>
<td>B+</td>
<td>Issuers have very weak credit quality.</td>
</tr>
<tr>
<td>B</td>
<td></td>
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<tr>
<td>CCC+</td>
<td>Issuers have extremely weak credit quality.</td>
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<tr>
<td>CCC</td>
<td></td>
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<tr>
<td>CC</td>
<td>Issuers have very high risk of default.</td>
</tr>
<tr>
<td>C</td>
<td></td>
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<tr>
<td>D</td>
<td>Obligor failed to make payment on one or more of its financial commitments. This is the lowest quality of the Speculative Grade category.</td>
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MMD: Municipal Market Data
Appendix

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