Puerto Rico Credit & Market Update

- Puerto Rico’s political climate has become more chaotic. On 29 April, the Commonwealth’s House of Representatives rejected Governor Alejandro García Padilla’s proposal to replace the island’s current sales and use tax with a value added tax.
- The Commonwealth’s financial condition continues to deteriorate. The release of audited financial statements for fiscal year 2014 has been delayed until July and Puerto Rico expects to report an operating deficit for the current fiscal year ending 30 June.
- Bond prices have weakened as the scope of the island’s financial distress becomes more apparent. We expect the appetite for Puerto Rico bonds among crossover investors to wane until such time as the Commonwealth communicates its strategy for a broader debt restructuring.
- The government of Puerto Rico has warned investors that it may lack sufficient financial resources with which to meet all of its debt service obligations during the next fiscal year beginning 1 July. While Governor García has reasserted the intent of the Commonwealth to honor its debt obligations, we believe a moratorium on debt service payments is increasingly likely.
- Neither the Commonwealth Treasury nor the Government Development Bank has provided firm guidance as to the process by which it will seek to restructure its debt obligations.
- We are inclined to believe that timely payment of debt service on all Commonwealth debt, including general obligation bonds and the bonds from the Puerto Rico Sales Tax Financing Corporation (COFINA), is susceptible to interruption.

Puerto Rico pricing update

The Commonwealth’s benchmark general obligation bonds, the 8s of 2035, hit a new low of USD 77.50 (10.75% yield) on 4 May 2015, before drifting higher to USD 79.00 (10.53% yield) by the end of last week. These bonds were originally issued in March 2014 at a price of USD 93.00 (8.727% yield) (see Fig. 1).

Bond prices on various securities issued by government agencies have converged in recent weeks. For example, prices on subordinate lien COFINA bonds and PREPA bonds with comparable coupon and

Fig. 1: Price trends, Puerto Rico GO 8.00% due 1 July 2035

Note: Puerto Rico GO 8.00% 2035 were issued at USD 93.00 on 11 March 2014. Source: MSRB trade data, Bloomberg, UBS CIO WMR, as of 8 May 2015.
Audited financial statements for FY2014 delayed

The Commonwealth of Puerto Rico filed a notice with the Municipal Securities Rulemaking Board (MSRB) on 21 April stating that it would not file its audited financial statements for fiscal year 2014 by 1 May as it had promised in connection with the sale of previous bond issues. In its official notice on behalf of the Commonwealth, the Government Development Bank (GDB) cited various obstacles that prevented the timely release of financial statements. These included the failure of component units of government to deliver audited financial statements in a timely manner and a delay in the completion of audits for the island’s three public employee retirement systems.

The GDB also cited the need for additional analysis related to “liquidity risk and uncertainties of the Commonwealth and certain discretely presented component units” of government.1 The reference to liquidity risk as a rationale for failing to deliver an audit within twelve months of the close of a fiscal year is disconcerting. The Commonwealth plans to file the audited statements by 31 July but warned that further delays are possible.2

Based upon subsequent disclosures, the preliminary General Fund budget deficit for fiscal year 2014 is expected to be roughly USD 869 million.3 This number differs from the estimated deficit of USD 300 million reported by GDB officials in the past. We attribute the discrepancy to the fact that the USD 869 million includes approximately USD 575 million in debt service that was refinanced and not paid during the fiscal year.

Another operating deficit expected in FY2015

According to its quarterly report dated 7 May 2014, General Fund revenue for the fiscal year through April was approximately USD 7.335 billion. While operating revenue over the first ten months of the fiscal year exceeded the amount collected last year over a comparable period, the amount was still USD 250.6 million short of budgeted estimates. The single biggest contributor to the shortfall in revenue was the repeal of the gross receipts tax (the patente nacional) in December 2014. The repeal of the tax was supposed to be accompanied by the passage of tax reform legislation, which subsequently failed to garner enough political support for enactment.

Motor vehicle excise taxes and individual income taxes are expected to fall short of expectations by USD 90 million and USD 60 million, respectively, by fiscal year end. Economic recession was identified as the leading cause for both revenue shortfalls. Other sources of revenue, most nonrecurring, have been used to offset the tax revenue underperformance. The failure of the Commonwealth to accurately
forecast its revenue has been a challenge for many years. While the reason for this year’s underperformance is explicable, it does little to inspire investor confidence.

Puerto Rico now projects that it will close the current fiscal year ending on 30 June with an operating deficit of USD 191 million. The current projection is based on an assumption that the estimated shortfall of USD 651 million will be partially offset by new revenue measures and expenditure reductions. We are compelled to note that there is little time left in the current fiscal year in which to achieve those expenditure reductions. The estimated deficit also does not account for the USD 344 million of capitalized interest on general obligation bonds sold to investors in March 2014. The Commonwealth is scheduled to begin paying interest on those bonds (the 8s of ‘35) in fiscal year 2016 at an initial rate of USD 205 million per annum.

Rising operating costs in FY2016

The Commonwealth’s Office of Management and Budget estimates that Puerto Rico’s fixed costs will increase by more than USD 1 billion in fiscal year 2016, complicating efforts to balance the budget. According to the recent quarterly report, the mandatory cost escalators include an additional USD 553 million in aggregate debt service requirements, USD 130 million in higher operating subsidies to the island’s health insurance plan, and an increase of USD 257 million in employer contributions to public pension plans. The public pension plans are rapidly approaching the point where they will be obliged to operate on a “pay-as-you-go” model. Based on the most recent actuarial valuation (2014), the Employees Retirement System (ERS) had a funded ratio of 0.7%, with USD 210 million of assets supporting USD 30.2 billion of liabilities. ERS net assets may well be exhausted by the end of the current fiscal year.

The Garcia Administration had believed that the new value added tax (VAT) would generate enough incremental revenue to meet the higher expenditure requirements. While the revenue estimates may have been optimistic, the point is now moot. In the wake of the failure to receive legislative support for tax reform, more drastic expenditure reductions are necessary. The governor has reaffirmed his administration’s commitment to pay debt service in a timely manner; however, his public comments are becoming more nuanced.

This is unsurprising, in our view, given that current revenues are insufficient to support the current debt load and the island’s fixed costs are rising quickly. In his budgetary address to the legislature, the Governor made reference to the “fine balance between fulfilling our responsibilities to the people … and to the market.” That sense of balance may be difficult to achieve, as private investors in Puerto Rico hold many of the bonds susceptible to default. Garcia conceded as much when he said that the Commonwealth has “not only contracted debt with wealthy and foreign investors. Our debt is also with Puerto Ricans who have put their savings in our bonds.”

Political risk is on the rise

We believe Puerto Rico’s dysfunctional political environment has been a contributing factor to the island’s enduring financial distress. Even in those circumstances when one might expect proposed legislation
to garner bipartisan support based on past rhetoric, the two principal political parties appear incapable of reaching agreement. Of course, a cursory review of events in Washington and in various state capitals will attest to the fact that highly partisan politics is not unique to Puerto Rico. However, the island no longer has any room to maneuver, it now being difficult to mask any inability to balance its budget by borrowing in the capital markets.

In the absence of any meaningful bipartisanship, legislative leaders must rely upon their own caucuses to pass legislation. Otherwise, it can undermine investor confidence. The House of Representatives’ failure to pass the Commonwealth of Puerto Rico Tax System Transformation Act is a case in point. The House rejected the proposed bill by a vote of 28-22 on 29 April when a handful of members of Governor Garcia’s own majority party broke ranks with their political brethren and registered their opposition to tax reform.

The proposed law, which would have replaced the existing sales and use tax (SUT) with a value added tax, was controversial from the start. Critics argued that the enactment of another major tax overhaul – the third in six years – was ill timed in light of the island’s ongoing fiscal crisis. Puerto Rico has long exhibited a proclivity for optimistic forecasts of future revenue. Many observers, and we include ourselves among them, doubted whether a new value added tax would generate as much new revenue as anticipated. Regardless, the majority’s failure to pass the legislation after almost six months of discussion is a sign that the governor’s political influence may be waning in the run-up to the next election.

**Liquidity position weakens**

The liquidity position of both the Government Development Bank and the Commonwealth has weakened materially in the past six months as legislators debated the merits of the tax reform program. The GDB is obliged to repay USD 900 million in short-term notes by the end of the current fiscal year. The GDB had sold the notes to fund the purchase of Puerto Rico tax and revenue anticipation notes. The bank also must pay debt service on its outstanding bonds, USD 876 million of which come due in FY2016.

The Government Development Bank is legally required to hold reserves equal to 20% of its demand deposits. Barring the successful completion of the long awaited USD 2.95 billion bond issue through the Puerto Rico Infrastructure Financing Authority (PRIFA), which appears less likely with each passing week, the bank now estimates that it will be unable to comply with this requirement by September 2015. The liquidity forecast also is predicated on the repayment of lines of credit extended to the Commonwealth government.

The General Fund’s liquidity position also appears to have deteriorated significantly. The GDB commissioned an independent assessment of the Commonwealth’s financial position in the absence of any cash flow borrowing this spring. The analysis indicated that the Treasury’s Concentration Account would be depleted of all cash by September 2015. At that point, the Commonwealth would be faced with the stark choice of suspending the delivery of various public services or postponing the payment of debt service.
PREPA forbearance agreements extended

Puerto Rico Electric Power Authority (“PREPA”) creditors, which include a group of bank lenders, bond insurers, and institutional investors, have extended their forbearance agreement with the utility for a third time. The current agreement, which now expires on 4 June, requires PREPA’s rate consultant to provide certain information to the creditors’ own advisors by 11 May and to deliver a recovery plan proposal by 1 June 2015. Meantime, in the midst of disagreements among creditors as to who holds the senior lien position, Citibank has reportedly sold its own USD 146 million loan to the utility to a third party specializing in distressed investments. Puerto Rico’s electric utility has failed to meet prior deadlines for the release of utility restructuring proposals and has rejected a restructuring proposal by creditors.

Economy remains mired in recession

The Puerto Rico Planning Board estimates that the real gross national product decreased by 0.2% and 0.9% in Fiscal Year 2013 and Fiscal Year 2014, respectively. The estimates were released in April and the Board warned that the likelihood of another reduction in GNP for FY2015 was high.

Outlook and conclusion

We retain a negative outlook on the full array of Puerto Rico’s bonded debt obligations and believe that a moratorium or temporary suspension of debt service payments is all but inevitable. We also recognize that bond prices across the board have declined to the point where the market is expecting a worst-case outcome. On that basis, we can foresee a scenario where prices for some securities, such as the GO bonds and senior COFINA obligations may rebound to a higher price level once the Commonwealth begins to communicate its intentions.

That scenario, one in which prices increase modestly, may explain why some high profile fixed income investors have taken a small position in Puerto Rico securities. For our part, we are reluctant to suggest that private clients count on such an improvement in price. The expenditures associated with burdensome pension liabilities and escalating health care costs are liable to make Puerto Rico a speculative credit play for the indefinite future.

End Notes

2 Ibid.
4 Ibid.
5 Ibid. The Teachers Retirement System is better funded, at least on a relative basis, with a preliminary funding ratio of 11.5%. The Judiciary Retirement System’s preliminary finding ratio at 30 June 2014 was 12.3%.
Robert Slavin, “Puerto Rico Governor Rebukes Default Talk”, Bond Buyer, 1 May 2015

Ibid.


Ibid. The GDB hired Conway to perform the independent assessment. The firm’s results are discussed on page 49 of the most recent quarterly report.

BusinessWire, PREPA Bondholder Group Agrees to Extend Forbearance Agreement with PREPA for 35 Additional Days, 30 April 2015.

Nick Brown and Edward Krudy, “Citi sells $146 million loan in Puerto Rico’s power authority, Reuters, 8 May 2015

Ibid.
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

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<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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Issuers have exceptionally strong credit quality. AAA is the best credit quality.
Issuers have very strong credit quality.
Issuers have high credit quality.
Issuers have adequate credit quality. This is the lowest Investment Grade category.
Issuers have weak credit quality. This is the highest Speculative Grade category.
Issuers have very weak credit quality.
Issuers have extremely weak credit quality.
Issuers have very high risk of default.
Obligor failed to make payment on one or more of its financial commitments. This is the lowest quality of the Speculative Grade category.
Municipal Brief

Appendix

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