

Municipal Brief

Puerto Rico Credit and Market Update

2 May 2019

Chief Investment Office GWM

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- The Puerto Rico Electric Power Authority (PREPA) and the territory's Fiscal Agency and Financial Advisory Authority filed an urgent motion with the US District Court announcing that they had reached an agreement in principle to execute a Definitive Restructuring Support Agreement with a large group of creditors.
- Two bond insurers, AMBAC and FGIC, joined a group of institutional investors in support of a motion by the Financial Oversight and Management Board (the "Oversight Board") to invalidate *two series* of Commonwealth general obligation (GO) bonds.
- Puerto Rico filed a motion to invalidate the Employee Retirement System's pension obligation bonds. The Unsecured Creditor Committee (UCC), in conjunction with the Commonwealth and the Employee Retirement System (ERS), filed an omnibus objection on 12 March asserting that the ERS bonds were "illegally made" and were issued ultra vires (i.e. beyond ERS' powers).
- The Oversight Board, acting through the Special Claims Committee, filed a motion on 8 April 2019 with the US District Court. The motion asked the court to compel trustees and broker-dealers to produce the names of bondholders that received principal and interest payments associated with certain GO and pension bonds issued by ERS, the Public Building Authority and the Commonwealth of Puerto Rico. The Oversight Board seeks to clawback principal and interest payments made to certain bondholders.

Puerto Rico's economy has been undermined by persistent outmigration and a deteriorating physical infrastructure. An onerous debt burden and poor financial management have compounded the territory's challenges, while a natural disaster, in the form of a devastating hurricane, has only made matters worse. We have monitored the decline of Puerto Rico for many years and have published more than fifty reports on the subject.

We have now arrived at a point in time where the ability to perform fundamental credit analysis arguably is less relevant than demonstrable expertise in bankruptcy restructurings. Bondholders who retain an ownership stake in Commonwealth securities are obligated to monitor numerous lawsuits now underway in a variety

Fig. 1: Puerto Rico debt outstanding by issuer, prior to restructurings

Issuer	Total bonds & private loans (USD)	% of total
COFINA	17,880	24.10%
GO	13,267	17.90%
PREPA	8,956	12.10%
Other Central Gov't Entities ⁸	5,670	7.60%
PRASA ⁶	4,568	6.20%
HTA ¹	4,247	5.70%
PBA	4,129	5.60%
GDB ^{2,3}	4,126	5.60%
ERS	3,156	4.20%
PRIFA ⁴	2,207	3.00%
Municipality Related Debt ⁷	1,696	2.30%
Children's Trust	1,460	2.00%
PFC	1,197	1.60%
HFA	542	0.70%
UPR ⁵	496	0.70%
PRCCDA	386	0.50%
PRIDCO	156	0.20%
PRICO	98	0.10%
AMA	28	0.04%
Total	74,265	100.00%

Source: Government of Puerto Rico: 2017 Fiscal Plan For Puerto Rico; filed 13 March 2017

¹ HTA includes Teodoro Moscoso bonds

² GDB private loans includes Tourism Development Fund ("TDF") guarantees

³ Includes GDB Senior Guaranteed Notes Series 2013-B1 ("CSFE")

⁴ PRIFA includes PRIFA Rum bonds, PRIFA Petroleum Products Excise Tax BANs, PRIFA Port Authority bonds and USD 34.9m of PRIFA ASSMCA bonds

⁵ UPR includes USD 64.2m of AFICA Desarrollos Universitarios University Plaza Project bonds

⁶ PRASA bonds includes Revenue Bonds, Rural Development Bonds, Guaranteed 2008 Ref Bonds

⁷ Municipality Related Debt includes AFICA Guaynabo Municipal Government Center and Guaynabo Warehouse for Emergencies bonds

⁸ Additional USD 5,031m bonds from other related entities

of Federal courts. For the private investor, an investment in Puerto Rico bonds poses an inherent risk of substantial loss due to arcane interpretations of law as adjudicated by federal judges. Individual investors that choose to remain invested in the territory's securities must possess a willingness and ability to interpret and closely monitor legal developments.

PREPA makes another run at a settlement

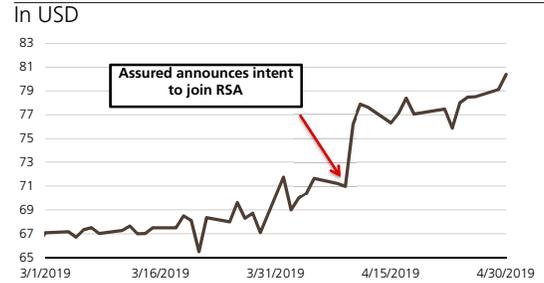
The Puerto Rico Electric Power Authority (PREPA) and the island's Fiscal Agency and Financial Advisory Authority (AAFAF) filed an urgent motion with the US District Court on 9 April. PREPA asked the court to extend the hearing date for its motion for relief on the appointment of a Receiver by two weeks. Assured Guaranty joined the motion and stated in the filing that "together with an ad hoc group of uninsured PREPA bondholders holding over USD 3 billion..., we have reached an agreement in principle for a Definitive RSA (Restructuring Support Agreement or RSA) and are in the final stages of documenting and executing the agreement.[1]"

According to the court filing, the creditors represent holders of approximately one-half of the outstanding PREPA Bonds. On the following day, National Public Finance Guarantee (National) filed a motion in opposition to the extension of a deadline. According to its own filing, National initially was excluded from negotiations and was only consulted after key parameters were already determined. National contends that the RSA as negotiated "does not work for National." [2] On 11 April, the US District Court approved the motion for the two week extension, over National's objection. Assured subsequently requested an additional one week extension of the Receiver motion stating "Settling Parties have made substantial progress toward finalizing the Definitive RSA and related documents (including complex and technical securitization, legislative, and demand protection term sheets), but this process is not yet complete." [3] The US District Court approved the motion granting the extension two days later.[4]

The terms of the Definitive RSA have not been released but it would appear that the terms of any debt exchange have improved in favor of creditors. PREPA Bonds have recently traded at levels that suggest the market agrees with that assessment (See Fig. 2). If Assured and PREPA do execute a Definitive RSA, Assured will be required to withdraw from the receivership proceedings. The court will then have to determine if the two remaining movants (National and Syncora) maintain enough requisite holdings to sustain their motion or opt to dismiss the motion in its entirety.

Discord among bond insurers in credit workouts is not unprecedented but rarely documented in court filings. Longer term, the fracturing of interests may diminish the bond insurance industry's relative strength in future negotiations and may allow crossover investors to exercise more influence over any settlement.

Fig. 2: Price trend, PREPA 6.125% due 1 July 2040



Source: Bloomberg, UBS, as of 30 April 2019 4:07 PM ET

Fig. 3: 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, as of 1 May 2019 4:31 PM ET

Two series of general obligation bonds targeted for invalidation

The Oversight Board, acting through the Special Claims Committee and the Official Committee of Unsecured Creditors, filed a motion on 14 January 2019 with the US District Court to invalidate *two series* of Commonwealth general obligation bonds. The GO bonds in question were sold to investors in 2012 and 2014, respectively. The Oversight Board argues that the two bond issues are null and void because the sale of these securities violated the Commonwealth's constitutional debt limitations and its balanced budget requirements.[5]

In another instance where the fracturing of the bond insurance industry has become readily apparent, AMBAC and FGIC joined a group of institutional investors in support of a motion to support the Oversight Board's argument that the Series 2012 and 2014 general obligation bonds are *invalid* securities. The ad hoc group calls itself the Lawful Constitutional Debt Coalition.

The decision by AMBAC and FGIC to break publicly with other guarantors surprised market participants who are accustomed to seeing bond insurers follow similar – if not identical – scripts. The two companies do not guaranty the payment of principal and interest on the Series 2012 or 2014 bonds but do wrap other GO bonds. Presumably, they have concluded that their own recoveries will improve if the Oversight Board is successful in nullifying the '12s and '14s. Both companies are operating in "runoff mode."

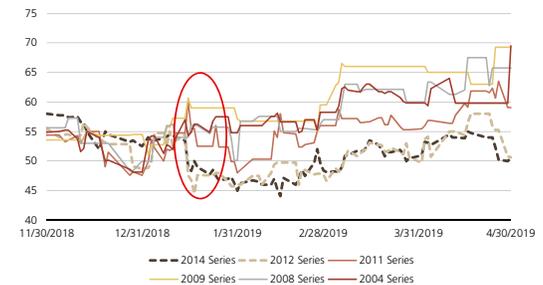
Employee Retirement System bonds also targeted

Puerto Rico has also targeted pension obligation bonds for invalidation. The Unsecured Creditor Committee (UCC), in conjunction with the Commonwealth and the Employee Retirement System (ERS), filed an omnibus objection on 12 March.[6] The filing asserts that the ERS bonds were "illegally made" and were issued ultra vires (i.e. beyond its powers). The claimants want the US District Court to nullify the bonds in their entirety, thereby eliminating the ability of bondholders to exert any remedy upon default.

The attempted invalidation comes hard on the heels of a decision by the US Court of Appeals for the First Circuit that affirmed the secured interest of ERS bondholders. The appellate court ruled ERS creditors satisfied Uniform Commercial Code filing requirements and thereby retained a perfected security interest that cannot be avoided under the Puerto Rico Oversight Management and Economic Stability Act ("PROMESA"). Having failed to impair the creditors' secured interest in pledged revenues, the Commonwealth has raised the stakes by attacking the validity of the pension obligation bonds directly. We expect more litigation to ensue.

The FOMB disclosed that 66 municipalities and 24 public corporations have failed to remit their required monthly employer pension contributions on a pay-as-you-go basis. The entities have failed to remit USD 340mn to the ERS over the course of the last two fiscal years.

Fig. 4: GO pricing by vintage



Source: Bloomberg, UBS as of 30 April .2019 2:04 PM

Fig. 5: ERS price trend, 6.15% due 1 July 2038



Source: Bloomberg, UBS as of 30 April 2019 4:09 PM ET

Clawbacks sought

The Oversight Board, acting through the Special Claims Committee, filed a motion on 8 April 2019 with the US District Court that has few precedents.[7] The motion, which has rocked the US municipal market, asked the court to require trustees and broker-dealers to produce the names of bondholders that received principal and interest payments in association with certain debt issued by the Employee Retirement System, the Public Building Authority and the Commonwealth of Puerto Rico. Should the specific series of bonds cited in the motion be ruled invalid, the Commonwealth is expected to pursue avoidance and recovery of payments that were made in the four-year lookback period prior to the commencement of the Commonwealth Title III case. The Oversight Board subsequently disclosed that it aimed to pursue clawback litigation against bondholders with aggregate holdings (of the challenged bonds) which exceed about USD 2.5mn[8].

On 12 April 2019, both US Bank and Bank of New York Mellon (BNYM) filed objections to the expedited discovery request for the production of a list of securities holders. BNYM also attached a letter from JPMorgan in their filing indicating the bank's objection to the motion. The bank cited potential legal liabilities associated with the disclosure of confidential information, and objected to the unreasonable deadline of 19 April. The court overruled their objection but agreed to allow rolling disclosure over an extended time period.

We view the attempt to claw back prior interest and principal as a tactical move to increase the Oversight Board's negotiating leverage. We are obliged to remind readers that few developments in these insolvency proceedings have corresponded with market expectations.

The Puerto Rico economy continues to contract

The Economic Development Bank for Puerto Rico (EDB) published its Economic Activity Index (EAI) in February. The EAI is a coincident index for economic activity in Puerto Rico and, in the past, has been reasonably well correlated to Puerto Rico's real GNP. The EAI is made up of four indicators: payroll employment, electric power generation, cement sales and gas consumption.

The January-February data reveals an increase of 3% when compared to the same time period last year. However, the comparison is skewed since the island was still suffering from wide spread power outages due to the hurricanes which hit the island in the fall of 2017. If we compare the February 2019 EAI 121.0 to August 2017, the last month prior to the hurricanes, the EAI was 123.5. When adjusted, EAI has declined about 2%. The index peaked in June 2015 at 158.4 and has been in a fairly continues decline since then (Fig. 8 Appendix) The index has dropped 23.6% since 2005.

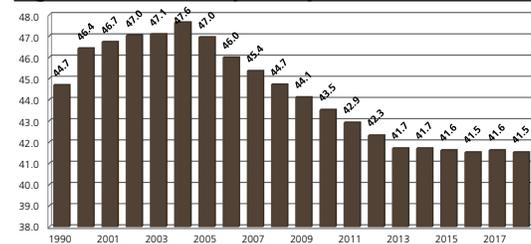
The labor force participation rate (Fig. 7) in Puerto Rico increased from the early 1990's until 2004, when it peaked. It declined rapidly from 2004-2013 and has remained fairly consistent since. Puerto Rico's labor force participation rate compares unfavorably with the US mainland and remains an ongoing challenge.

Fig. 6: Bonds identified by the Oversight Board as subject to clawback

General Obligation	PBA Bonds
2007 A-4	Series K
2009 A	Series P
2009 B	Series Q
2009 C	Series R
2011 A	Series S
2011 C	Series T
2011 PIRB	Series U
2011 D	
2011 E	
2012 A	
2012 B	
2014	
	ERS Bonds
	Series A
	Series B
	Series C

Source: Case:17-03283-LTS Doc#6143 filed in 8/4/19 United State District Court for the District of Puerto Rico

Fig. 7: Labor force participation rate



Source: The World Bank, UBS as of 21 March 2019

The struggle for transparency continues

Puerto Rico's retains the ignominious distinction of being among the least punctual borrowers in the US municipal bond market. The Oversight Board delivered a formal request for information related to the date upon which it could expect to receive the audited financial statements for fiscal year 2016 (which ended in June 2016). While the Commonwealth's CFO, Raul Maldonado Gautier, had previously indicated that the audit would be finalized and issued in August 2018. More recently he told the Oversight Board the audit would be produced on 31 March 2019. A copy of that document has not yet been posted on the Municipal Securities Board web site.

Conclusion

- PREPA appears to be moving closer to a consensual restructuring support agreement, although significant obstacles remain. Assured and PREPA need to complete the documentation of their agreement, additional creditors need to join the RSA, and Judge Swain must validate the Agreement. The uninsured bonds of 2040 are trading around USD .80 up marketable since the Assured announcement. The FOMB rejected an RSA that would have seen uninsured bondholders recover USD .85 and the bond insurers a full recovery in June of 2017.
- The Oversight Board's attempt to invalidate certain bonds issued by the Employee Retirement System, Public Building Authority and the Commonwealth of Puerto Rico General Obligation bonds reaffirms our view that insolvent borrowers in the muni market are more likely than ever to adopt an adversarial and contentious stance with creditors during bankruptcy proceedings.
- The economy of Puerto Rico continues to contract, a trend exacerbated by the bankruptcy proceedings now underway in San Juan and New York. We expect the economy to remain stagnant for the foreseeable future, hampering any long-term recovery in credit quality regardless of the reductions in debt service achieved through the Title III proceedings.
- Demand for new Puerto Rico bonds will be constrained by skepticism over the willingness or ability of the territory to provide reliable operating statements.

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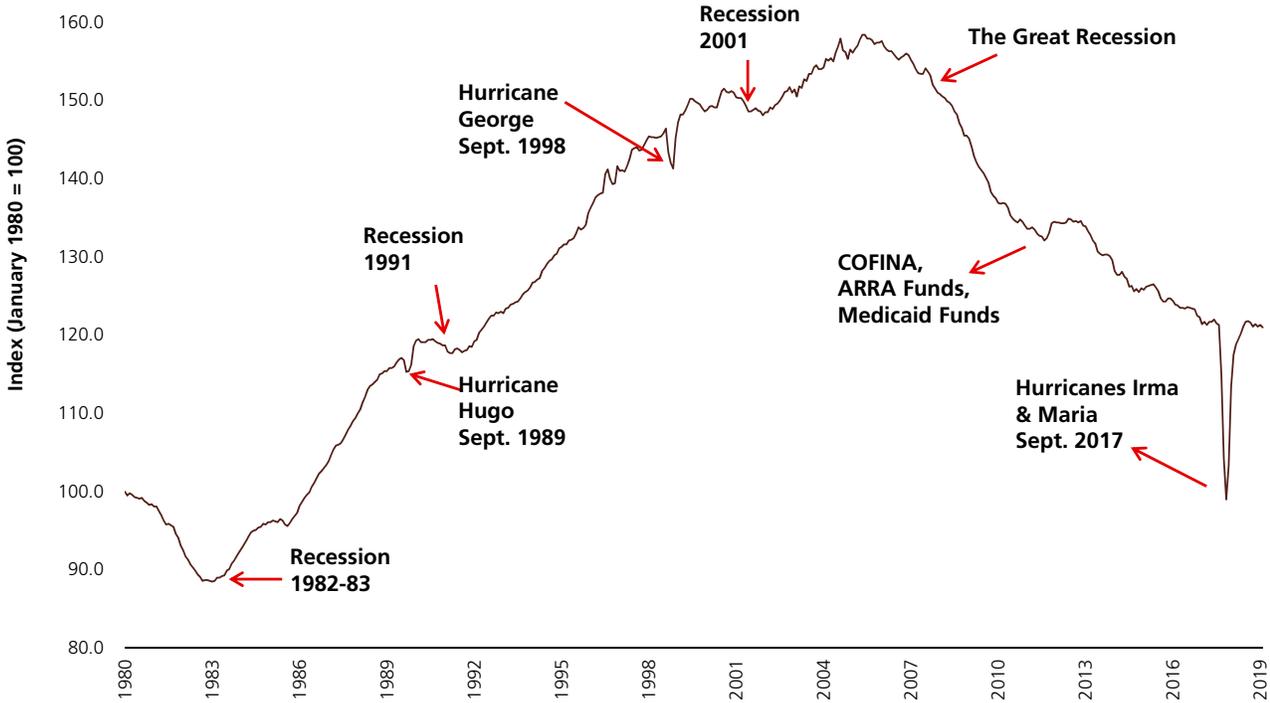
- [1] Case:17-04780-LTS Doc#1176 filed on 09/04/19 United State District Court for the District of Puerto Rico
- [2] Case:17-04780-LTS Doc#1181 filed on 10/04/19 United State District Court for the District of Puerto Rico
- [3] Case:17-04780-LTS Doc#1203 filed on 23/04/19 United State District Court for the District of Puerto Rico
- [4] Case:17-04780-LTS Doc#1204 filed on 25/04/19 United State District Court for the District of Puerto Rico
- [5] UBS, Puerto Rico Credit and Market Update 11 February 2019
- [6] Case:17-03566-LTS Doc# 381 filed on 12/3/19 United State District Court for the District of Puerto Rico
- [7] Case:17-03283-LTS Doc#6143 filed on 8/4/19 United State District Court for the District of Puerto Rico

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[8] Case:17-03283-LTS Doc#6540 filed in 29/4/19 United State District Court for the District of Puerto Rico

Appendix

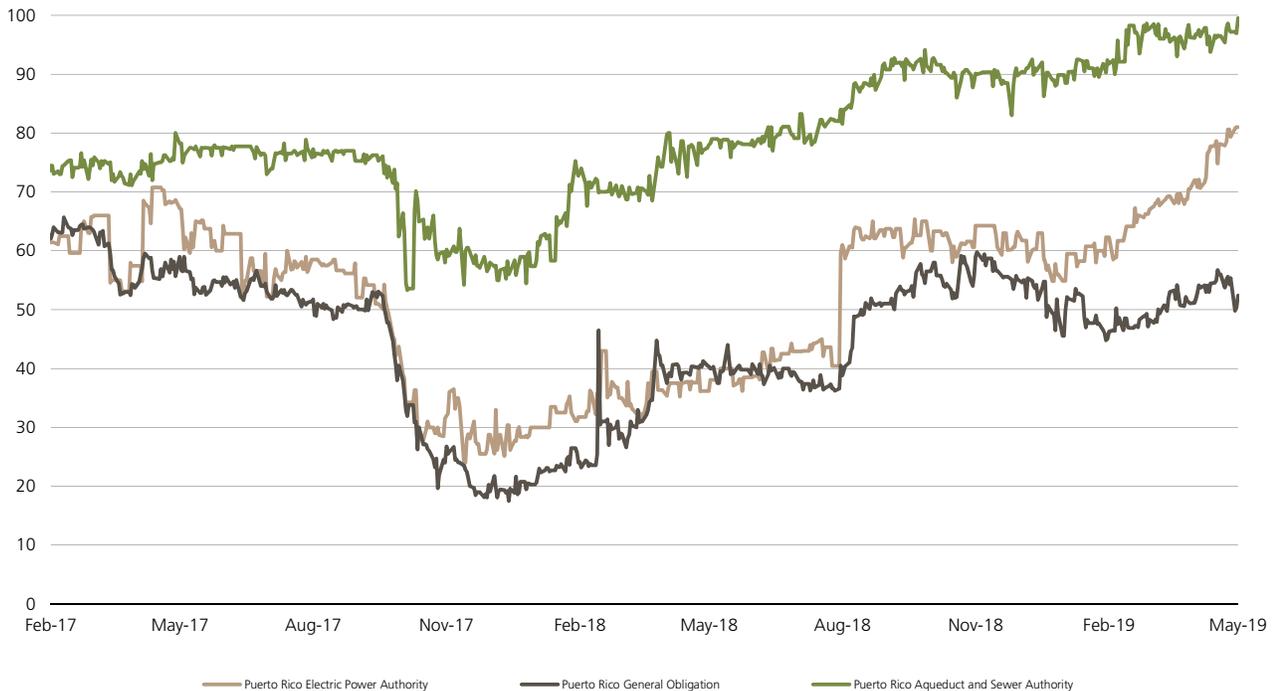
Fig. 8: EDB EAI Historical graph: Jan 1980 - Feb 2019



Source: Economic Development Bank of Puerto Rico

Fig. 9: Select credits and price trends of Puerto Rico municipal bonds

In USD



Source: MSRB trade data, Bloomberg, UBS, as of 1 May 2019 4:41 PM ET

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Appendix

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Term / Abbreviation	Description / Definition	Term / Abbreviation	Description / Definition
GO	General Obligation Bond	TEY	Taxable Equivalent Yield (tax free yield divided by 100 minus the marginal tax rate)

MMD Municipal Market Data

	Rating Agencies			Credit Ratings
	S&P	Moody's	Fitch/BCA Definition	
Investment Grade	AAA	Aaa	AAA	Issuers have exceptionally strong credit quality. AAA is the best credit quality.
	AA+	Aa1	AA+	Issuers have very strong credit quality.
	AA	Aa2	AA	
	AA-	Aa3	AA-	
	A+	A1	A+	Issuers have high credit quality.
	A	A2	A	
	A-	A3	A-	
	BBB+	Baa1	BBB+	Issuers have adequate credit quality. This is the lowest Investment Grade category.
	BBB	Baa2	BBB	
BBB-	Baa3	BBB-		
Non-Investment Grade	BB+	Ba1	BB+	Issuers have weak credit quality. This is the highest Speculative Grade category.
	BB	Ba2	BB	
	BB-	Ba3	BB-	
	B+	B1	B+	Issuers have very weak credit quality.
	B	B2	B	
	B-	B3	B-	
	CCC+	Caa1	CCC+	Issuers have extremely weak credit quality.
	CCC	Caa2	CCC	
	CCC-	Caa3	CCC-	
CC	Ca	CC+	Issuers have very high risk of default.	
C		CC		
		CC-		
D	C	DDD	Obligor failed to make payment on one or more of its financial commitments. this is the lowest quality of the Speculative Grade category.	

Appendix

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