A Plan of Adjustment for the proposed debt restructuring for Commonwealth general obligation (GO), Public Building Authority (PBA) and Employee Retirement Securities (ERS) was announced. Thus far, only a small fraction of bondholders have signed on to the plan. The terms of the underlying Restructuring Support Agreement remain relatively fluid.

- The Puerto Rico Aqueduct and Sewer Authority successfully renegotiated USD 380mn of debt held by federal agencies.
- The Puerto Rico Electric Power Authority (PREPA) announced that the remaining bond insurers with exposure to the utility have joined the Restructuring Support Agreement, increasing bondholder support for the plan to 89%.
- On 24 July 2019 Judge Swain ordered a stay on a significant portion of Commonwealth General Obligation, Employee Retirement Securities, Puerto Rico Electric Power Authority and Highway & Transportation Authority’s ongoing litigation and ordered all parties to attend mediation sessions. The stay will remain in effect until 30 November.
- Governor Rosselló resigned on 28 July after the release of incriminating text messages. He nominated Pedro Perluisi as his successor but the appointment was invalidated by the Puerto Rico Supreme Court. Wanda Vazquez, the Secretary of Justice, was subsequently sworn in as the Commonwealth’s 13th governor on 7 August 2019.

New Plan of Adjustment announced

The Puerto Rico Financial Oversight and Management Board (the "FOMB") filed a revised Plan of Adjustment (the "POA") on 27 September. In the FOMB’s formal announcement, they disclosed that only 22% of bondholders had joined the POA. We expect significant opposition from creditors to the revised POA, which may lengthen the time until a final resolution is achieved. Municipal market participants have long viewed parity debtors as one class of creditors. The FOMB treats parity debtors as different classes under the plan. We anticipate creditors will litigate this issue, among others and that rulings by the District Court will be appealed to the US Court of Appeals for the First Circuit.
The POA would restructure USD 35 billion of bonded debt and other claims against the Commonwealth of Puerto Rico (GO), the Public Building Authority (PBA), and the Employee Retirement System (ERS) and more than USD 50 billion of unsecured pension liabilities.

The most significant change in the newly revised POA is the inclusion of ERS creditors; secured bondholders, and unsecured pensioners.

- The POA proposes a 12.7% recovery for ERS bondholders.
- Unsecured pensioners could see their pensions reduced by a maximum of 8.5% of total monthly benefits. The reductions only apply to pensioners whose monthly pension exceeds USD 1,200. The cuts would not apply to 74% of current or future retirees.

For GO and PBA bondholders, the Plan of Adjustment appears similar to the original Restructuring Support Agreement promulgated in June with some adjustments to recoveries.

The proposed recoveries range from approximately 64.1% (down from 72.6%) for some PBA bonds to a low of 23.1% for holders of Series 2012 PBA bonds that choose to continue to litigate. Under the POA, vintage GO and PBA bondholders (i.e. those issued prior to 2012) would recover 64.1% of par. The holders of Series 2012 and 2014 bonds would receive 45% and 35%, respectively, provided they agree to join the POA and cease further litigation. If they choose to continue to litigate and prevail, they could receive a maximum recovery of 89.4% of par. However, under the terms of the POA, bondholders run the risk of forfeiting any recovery if they choose to continue to litigate and lose.

The POA includes a provision for a "Litigation Trust." GO and PBA bondholders who are subject to the Recovery Litigation (see sidebar) and who choose to litigate, and lose, may be subject to a demand that they return prior payments of principal and interest to their respective bond issuers. Holders of PBA and GO bonds who opt to settle their claims would be immune to any collateral effects of the Recovery Litigation on their claims and distributions. ERS bondholders remain subject to the outcome of the Recovery Litigation.

The proposed settlement covers a large majority of the Commonwealth’s liabilities at what market participants, appear to deem, low recovery rates. The GO, PBA and ERS bonds are currently trading well above the recoveries offered in the POA (see Fig. 2, 3 & 4).

**Puerto Rico Aqueduct and Sewer Authority**

The Puerto Rico Aqueduct and Sewer Authority (PRASA) announced it had reached agreements with the federal agencies holding its debt. Under the terms of the agreements, almost USD 1bn of federal debt was restructured to (1) provide debt service relief of USD 380mn over ten years (2) eliminate approximately USD 1bn of Commonwealth guarantees on the federal debt and (3) improve the lien status on the debt from Junior to Senior.

The agreement appears to be a mixed bag for municipal bondholders depending on the particular obligor to whom they are exposed. For PRASA bondholders, the agreement is a marginally negative development. While PRASA once again may be eligible for federal pro-

**Litigation Trust:** applies to GO and PBA Late Vintage bondholders. Late Vintage refers to series of bonds which were issued after 2011. The Litigation Trust will be established for the purpose of litigating or settling the Late Vintage Litigation and distributing its assets in accordance with US Treasury regulations.

The Late Vintage Litigation, if continued, will ultimately determine the validity of the Late Vintage bonds. If the creditors prevail, they will receive 64.1% of par and a pro rata share of Bondholder Settlement Savings and pro rate share of Residual Distributions. If the FOMB and the Authority (as defendants) prevail in the Late Vintage Litigation, but not the priority litigation, the creditors are projected to recover only 1.8% of par under the plan. Priority litigation refers to priority of claims. If GO holders are on parity with and not senior to general unsecured creditors their recovery will be significantly reduced (64.1% vs 1.8%). If the creditors do not prevail in both the Late Vintage Litigation and the priority litigation, they will receive no recovery (0%) under the plan.

A disputed claims reserve will be established in the Litigation Trust, to hold in escrow the New Bonds and cash equal to 64.1% of the aggregate amount of the non-settling 2012 & 2014 Commonwealth Bond Claims and the 2012 Commonwealth Guarantee Bond Claims.

The Recovery Litigation, if successful, would allow the Commonwealth to recover payments (principal and interest) made during the lookback period. The Commonwealth has stated that it would seek recovery from beneficial holders of GO, PBA and ERS Bonds, holding more than USD 2.5mn, issued after March 2011, and who received payments during the lookback period (3 May 2013 – 21 May 2017).
grams for infrastructure projects (a positive), it places the federal debt on parity with bondholder projects (a negative). The resolution of the status of the federal loans provides the Commonwealth with more flexibility in its negotiations with GO and PBA guaranteed debt holders. PRASA thus far has refrained from filing for protection from creditors under Title III and remains current on principal and interest payments. However, continued vigilance is warranted.

PREPA restructuring takes a step forward
The Puerto Rico Electric Power Authority (PREPA) announced on 9 September 2019 that National Public Finance Guarantee Corporation (National) and Syncora Guarantee Inc. (Syncora) agreed to join the previously disclosed (3 May 2019) Definitive Restructuring Support Agreement (RSA). The salient terms of the agreement remain unchanged (for greater detail click here). U.S. Bank, as trustee for PREPA announced on 7 October 2019 that it had obtained approval from owners of 89% of the bonds currently outstanding. The announcement includes updates on various adversary proceedings and on the court approval process (click here for greater detail). With this level of investor support, we expect the court to confirm the plan and order the bond exchange envisioned by the RSA.

Insured bond holders may elect one of three possible discrete options from which to make an election under a bond-exchange. The amended RSA outlines what the election options may look like. CIO recommends reviewing your options carefully; all terms remain subject to revision.

Judge Swain orders litigation stay and mediation
On 24 July 2019 Judge Swain issued an order staying about 20 motions and around 30 adversary proceedings. The parties were ordered to attend mediation sessions in order to reach a consensus as to prioritization of matters for litigation or further mediation. The stay is in effect until 30 November 2019. The Mediation Team Leader (Chief Judge Barbara J. Houser, US Bankruptcy Court; Northern District of Texas) must recommend by 28 October 2019 whether the stay should be continued past 30 November. The court order stays further proceeding directly or indirectly and affects, most, if not all, of the current Title III court cases.

The US Supreme Court hears appeal
The US Supreme Court on 15 October heard an appeal challenging a decision by the US Court of Appeals for the First Circuit. The First Circuit upheld the FOMB’s prior actions, despite finding that members of the FOMB were appointed absent a valid confirmation, in contravention of the constitutional requirement that principal officers of the US Government be subjected to US Senate confirmation. Creditors, as plaintiffs, are seeking to have the Board’s actions declared null and void and for the court to order the dismissal of the Commonwealth Title III cases. A ruling in the plaintiff’s favor would delay the resolution of the remaining Title III debt. The high court is expected to rule on the case before it adjourns in June 2020.
One week, three governors
Governor Rosselló resigned on 28 July after weeks of protesters demanding he step down following the release of incendiary and derogatory text messages. Rosselló named Pedro Perluisi Puerto Rico’s Secretary of State before he stepped down, thus placing Perluisi next in line to become governor. Perluisi was sworn in and became Governor without confirmation from the island’s Senate. The Supreme Court of Puerto Rico ruled Perluisi could not serve as governor since the Senate did not act on his confirmation. Justice Secretary Wanda Vazquez, next in line of succession, was confirmed and became the island’s new governor. Governor Vazquez will remain in office until January 2021.

Changes proposed to Puerto Rico Oversight Management and Economic Stability Act (PROMESA)
The Chairman of the House Natural Resource Committee, Raul Grijalva, announced that he will propose changes to the federal law (PROMESA) implemented to guide Puerto Rico’s debt restructuring process. He mentioned adding federal funding for the FOMB which currently is funded by the Commonwealth, creating a reconstruction coordinator to oversee the island’s recovery from Hurricane Maria and a public audit of the territory’s debt.

Puerto Rico’s economy continues to contract
The Economic Development Bank for Puerto Rico (EDB) published its Economic Activity Index (EAI) in August. 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 August data reveals a decrease of 0.6% on a year over year basis. Two of the four indicators that make up the EAI were higher on a year over year basis while two were lower. Both Non-farm payroll employment and electricity sales were up but remain below their pre-hurricane Irma and Maria levels. Gasoline consumption and cement sales were both down on a year over year basis by amounts which exceeded the growth in non-farm payroll and electricity sales. Only cement sales are higher than the pre-hurricane level and this can be attributed to the ongoing rebuilding efforts on the island. The index peaked in June 2015 at 158.4 and today stands at 121.1, a 23.5% decline (see Fig. 9 Appendix).

According to US Census Bureau data, Puerto Rico’s population decline has accelerated. Puerto Rico’s population declined by 129,848, from July of 2017 to July 2018, a 4% reduction. This is the single largest year-over-year decrease since 2010. The rate of population loss has increased every year since 2013. In total, the island population has decreased by 14.1% since 2010. West Virginia (-2.6%) is the only state to suffer a population loss greater than 0.8% over the same time period. The population decline poses a substantial challenge to economic growth.
Conclusions

• The Plan of Adjustment is unusual for two reasons. First, different creditor classes (GO vs. ERS) usually have their own POA. Second, the revised POA includes a Litigation Trust to allow non-consenting creditors to pursue litigation rather than join the POA. Market participants are uncertain as to what the joint filing of the POA signifies. It is unclear if all three creditors must have an agreement in place for the POA to be certified by the courts or if they can be certified individually.

• We are obliged to remind readers that the litigation now underway in federal courtrooms remains fluid. Creditors have coalesced into warring factions that seek a relative advantage in court. On more than one occasion, we have opined that traditional financial analysis has diminished in importance. Bondholder recoveries will depend upon the strength of arguments made in federal court – some of them quite novel – and are subject to judicial discretion. The terms on offer in the POA, in fact, reflect some of the arguments made in court and how the litigating parties view the possible outcomes.

• The POA presents asymmetric risk ERS bondholders. The downside of continuing litigation is the total loss of par where the upside associated with a win in litigation could mean multiples of the 12.7% recovery currently on offer. While ERS bondholder security is being challenged on several different fronts by the FOMB, we are inclined to believe that ERS bondholders will demand a higher recovery and pursue appeals to gain negotiating leverage.

• Under the terms of the POA, the FOMB is bifurcating GO and PBA parity creditors into multiple creditor classes for recovery purposes. The proposed treatment of parity creditors is unparalleled in the municipal market. The FOMB has argued that Late Vintage bonds were issued ultra vires (illegally) and thus are null and void. If GO bondholders litigate this point and lose they will recover 0% par; if they win they may recover 64.1% of par. As an incentive to cease litigation, the FOMB has offered a settlement to the Series 2012 GO and Series 2012 PBA bondholders of 45% of par and 35% of par for Series 2014 GO bondholders. If bondholders accept the offer, they will no longer be subject to Recovery Litigation. If bondholders choose to continue litigation they will remain subject to the outcome of the Recovery Litigation.

• If all of the POA’s, which have been put forth to date, are certified and implemented and combined with the already restructured and non-defaulting debt then 90% of Puerto Rico’s liabilities will be resolved. A conclusion to this historic municipal bankruptcy could theoretically happen next year but we are inclined to believe that the revised POA has engendered enough opposition from institutional creditors to delay a final resolution beyond 2020.
End notes


[3] Case Nos. 18-1671, 18-746, 18-1787, filed 15 February 2019

[4] The National Resources Committee has jurisdiction over "insular areas of the US." In effect, insular areas are areas that are neither states nor federal districts but are territories such as Puerto Rico.
Appendix

**Fig. 9: Economic Activity Index historical graph: January 1980 - August 2019**

![Economic Activity Index historical graph](image)

Source: Economic Development Bank for Puerto Rico, UBS as of 25 September 2019

**Fig.10: Select credits and price trends of Puerto Rico municipal bonds**

![Select credits and price trends of Puerto Rico municipal bonds](image)

Source: MSRB trade data, Bloomberg, UBS, as of 23 October 2019
Appendix

Analyst certification
Each research analyst primarily responsible for the content of this research report, in whole or in part, certifies that with respect to each security or issuer that the analyst covered in this report: (1) all of the views expressed accurately reflect his or her personal views about those securities or issuers; and (2) no part of his or her compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed by that research analyst in the research report.

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Municipal bonds - 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.

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Terms and Abbreviations

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<td>TEY</td>
<td>Taxable Equivalent Yield (tax free yield divided by 100 minus the marginal tax rate)</td>
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Rating Agencies

Credit Ratings

I n v e s t m e n t G r a d e

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