Municipal Brief

Puerto Rico Credit & Market Update

- The Puerto Rico Electric Power Authority announced that it would not deliver a restructuring plan by early March as originally envisioned by a forbearance agreement with creditors.
- PRASA reached agreement with a local commercial banking syndicate to extend an existing credit facility for two more months and repaid the banks USD 40 million.
- The University of Puerto Rico’s system revenue bonds were downgraded to Caa2 on 12 March by Moody’s. The rating agency also downgraded the University’s subordinate educational facilities revenue bonds to Caa3. The rating outlook is negative.
- PRIFA sold bond anticipation notes. The notes mature in 2017 but are expected to be repaid with proceeds from the public corporation’s next bond issue.
- The US House of Representatives’ Subcommittee on Regulatory Reform, Commercial and Antitrust Law held a hearing on the merits of HR870. We believe the prospects of enactment of the Puerto Rico Chapter 9 Uniformity Act of 2015 are slim.

Market update
Puerto Rico credit spreads have oscillated since our last Credit and Market Update report was published on 17 February 2015. Credit spreads on the Commonwealth’s general obligation bonds widened substantially at the 10-year spot but exhibited less volatility at the long end. According to MMD, spreads widened by 50 bps at the 10-year spot but narrowed by 10 bps at the 30-year maturity. (See Fig 1.)

The price on Puerto Rico’s new benchmark GO bond, the 8s of ‘35, strengthened from a low of USD 81.00 on 9 February 2015 (10.235% yield) to a high of USD 85.25 in 12 March 2015 (9.67% yield) before reversing course. It now stands at USD 84.50 on 16 March (9.767% yield) according to MSRB trade data.

In our last Market and Credit Update, we noted that prices on debt issued by the Puerto Rico Electric Power Authority (PREPA) had improved in the wake of a decision rendered in federal court on 6 February to permanently enjoin the Commonwealth from enforcing the provisions of the Puerto Rico Public Corporation Debt Enforcement and Recovery Act.
The Act would allow certain public corporations to restructure their outstanding debt without obtaining the unanimous consent of creditors. The Commonwealth has appealed the decision to the United States Court of Appeals for the First Circuit.

The initial enthusiasm among investors for a higher recovery rate on PREPA bonds in the wake of the Recovery Act’s invalidation has been tempered to some degree. Prices on the utility’s 5s of ’42 increased markedly from below 50 at the end of January to a high of USD 58.13 on 17 February 2015. A few weeks later, on 12 March, prices slipped back to USD 52.70, before reversing course (again) and drifting up to USD 58.00 on 18 March, according to MSRB trade data.

PREPA misses a milestone
The Puerto Rico Electric Power Authority announced on 27 February that it would not deliver a restructuring plan by 2 March as originally envisioned by the forbearance agreement with creditors. The forbearance agreement was executed on 14 August 2014. Chief Restructuring Officer Lisa Donahue characterized the ongoing discussions with creditors as "productive" and indicated that the utility would seek an extension of the existing forbearance agreement beyond the 31 March expiration date.

Moody’s released a report on 16 March that forecasted a default by PREPA “within a few months.” We are inclined to believe that a default has already occurred in light of the depletion of debt service reserve funds, the use of other construction funds to pay principal and interest, and the execution of a forbearance agreement with creditors. Moody’s reference to a ‘default’ is more likely focused on the utility’s inability to draw upon any other funds with which to meet ongoing debt service obligations. The next debt service payment of approximately USD 400 million, covering both principal and interest, is due on 1 July 2015. Moody’s did note that its Caa3 rating incorporates an estimated recovery rate of between 65% and 80% on outstanding revenue bonds. Moody’s analysis is based on a variety of scenarios, each of which involves the deferral of principal repayments for five to ten years.

Puerto Rico seeks Chapter 9 amendments
On 11 February, Resident Commissioner Pedro Pierluisi introduced a bill in Congress entitled the Puerto Rico Chapter 9 Uniformity Act of 2015 (HR 870). The bill would amend the US Bankruptcy Code to treat Puerto Rico as a state government and allow the Commonwealth to pass enabling legislation to restructure the debt of its municipalities and public corporations. Two weeks later, the House Judiciary Committee’s Subcommittee on Regulatory Reform, Commercial and Antitrust Law convened a hearing to assess the merits of the legislation. The speed with which the subcommittee convened a hearing was remarkable but attests to the level of concern over Puerto Rico’s deteriorating financial position.

Three witnesses, including GDB President Melba Acosta, testified in favor of the legislation. Arguments in favor of amending the US Bankruptcy Code included the absence of an established legal framework for the adjustment of debt and the necessity to reduce the financial burden on certain public corporations to ensure their self-sufficiency. One witness, Thomas Mayer, testified in opposition to the legislation. Mr. Mayer argued that the law was unnecessary because
the public corporations have not exercised other available options to reduce expenses and to raise revenue.

There have been few concrete developments in the wake of the sub-committee hearing. While discussions regarding the merits of the legislation are underway among members of the House with an interest in the issue, further action has not been scheduled. Currently, there is also no corresponding legislation in the Senate. We have consulted our colleagues in the UBS US Office of Public Policy and believe that enactment of the proposed legislation is unlikely in the near term.

**Tax reform still on the agenda**
The Garcia Administration appears undeterred in its attempt to introduce a value added tax in lieu of the existing 7% sales and use tax (IVU by its Spanish acronym). The governor filed legislation to replace the existing IVU with a broader value added tax, or VAT, at a higher rate of 16%. Opposition to the tax reform proposal appears to be on the rise, which may explain why both GDB President Acosta and Treasury Secretary Zaragoza have penned editorials in various business publications in favor of the legislation. As we have noted in prior reports, the introduction of the VAT would represent the third attempt in six years to introduce a new tax structure on the island that would raise revenue, promote economic activity, and capture more of the underground economic activity.

While the principles associated with such an effort are laudable, we are skeptical that the anticipated revenue will meet expectations given the Commonwealth’s track record of optimistically forecasting receipts. Recent press reports have suggested that a coalition of unions representing government workers has expressed its opposition to the proposed value added tax, a development that makes legislative enactment still uncertain. On a more ominous note for investors, public employee unions have objected to the introduction of the VAT on the basis that it favors bondholders over island residents.

**Revenue update**
Treasury Secretary Zaragoza announced on 13 March 2015 that General Fund net revenues for the first eight months of the fiscal year were USD 121.7 million below estimates. While tax receipts from individuals were higher than anticipated, the sales and use tax and revenue derived from Act 154 were both lower than expected on a fiscal year-to-date basis. To address the shortfall, Secretary Zaragoza announced that a bill had been introduced in the legislature to allow for the pre-payment of certain tax liabilities at a discounted rate. Zaragoza estimated that projected revenue from the program would equal USD 160 million prior to the enactment of a new system of taxation centered on a VAT.

**UPR downgrade**
Moody’s downgraded the University of Puerto Rico’s credit ratings on 12 March 2015. The rating on its university-system revenue bonds declined to Caa2 from Caa1 while the rating on the less well-secured educational facilities revenue bonds fell to Caa3 from Caa2. The rating outlook remains negative. The University relies upon the Commonwealth of Puerto Rico for approximately 75% of operating revenue and on the Government Development Bank for liquidity support.
Population declines and smaller high school graduating classes present an operating challenge in an environment where fixed costs are high.

Student enrollment was down nearly 8% from fall 2013 to fall 2014 and popular opposition to tuition increases has limited the university’s ability to raise revenue. Healthcare exposure through its academic medical center was also identified as a concern. In the wake of a CDC report highlighting bacterial infections of hospital patients, the university’s medical center reported a nearly 20% revenue decline and operating loss on a preliminary basis for FY14. On a related note, Resident Commissioner Pierluisi has introduced legislation in Congress that would reimburse hospitals in Puerto Rico for inpatient services at the same rate under Medicare Part A as US mainland hospitals.

PRASA update
The Puerto Rico Aqueduct and Sewer Authority (PRASA) captured the attention of investors when it filed an event notice on 3 March 2015 indicating that it reached an agreement with a local commercial banking syndicate to extend the maturity date on a USD 200 million line of credit by two months to 29 May 2015. Upon execution of the extension, PRASA paid the lenders USD 40 million, which will be applied towards a reduction of the outstanding principal balance. The Authority also agreed to make two additional principal payments of USD 5 million on 1 April and 1 May.

Independent research firm Municipal Market Analytics (MMA) classified the extension as a default but conceded that the transaction might be better characterized as a facility roll. The Authority has announced plans to sell approximately USD 500 million of revenue bonds in 2015; the proceeds would be used to restructure various credit lines into longer-term debt. The average price on a senior lien obligation of the Authority with a 5.25% coupon due in 2042 fell from USD 70.362 on 12 February 2015 to USD 67.00 as of 17 March, according to MSRB trade data.

Unemployment rate improves
The US Department of Labor reported a substantial drop in Puerto Rico’s unemployment rate on 17 March. According to new data posted by the Bureau of Labor Statistics, the island’s unemployment rate declined to 12.4% from 13.7% a month earlier. Puerto Rico’s Secretary of Labor and Human Resources, Vance Thomas, attributed the drop in the jobless number in part to increased activity in the tourism sector.

GDB liquidity update
The Government Development Bank has published a monthly statement regarding its own liquidity position for some time now. The GDB released its monthly report for February right on schedule on 13 March. The bank’s net liquidity position stood at USD1.227 billion as of 28 February 2015, a decline of USD247 million from the USD1.474 billion reported by the GDB as of 31 January 2015. On the February reporting date, cash and bank deposits stood at USD 302.6 million, federal funds sold and money market instruments represented USD 276.4 million and investments in Treasuries and agency paper (net of amounts pledged elsewhere) was USD 648.2 million. By contrast, these amounts were equal to USD 442.6 million, USD 530.6 million...
and USD 500.9 million in January, respectively. A note payment of approximately USD 279.7 million was also due in that month.

**PRIFA bonds and notes**

After an extended debate, the Puerto Rico legislature has amended Act Number 1 of 2015, which allows the Puerto Rico Infrastructure Financing Authority to sell up to USD 2.95 billion of bonds secured by petroleum taxes. The amendments authorize an annual adjustment to the tax rate to satisfy prospective investors who worried that a static rate might not generate enough revenue to repay the obligations. The enactment of these amendments clears the way for the sale of PRIFA’s bond issue, one that has been under discussion for more than five months and is essential to the replenishment of the GDB’s liquidity position. The timing of the sale remains unclear, and according to at least one news report, the bond issue may be delayed for another six weeks due to ongoing negotiations and further due diligence by potential buyers. A successful sale also may depend upon the ability of Puerto Rico to obtain credit enhancement on some part of the transaction.

In the meantime, PRIFA has sold USD 246 million of bond anticipation notes to RBC Capital Markets. The BANs bear an interest rate of 8.25% and mature in May 2017. Proceeds were used to refinance outstanding Highways and Transportation Authority BANs that were scheduled to mature in September. Sinking fund payments reportedly commence in July but the new PRIFA notes are expected to be repaid with proceeds from the larger bond sale on tap for May.

**Outlook**

As the preceding discussion suggests, Puerto Rico’s reliance on the capital markets for liquidity has not diminished. Bond prices have fluctuated abruptly based on judicial decisions and the enactment of new legislation. The Commonwealth has placed itself in a position where it must sell another massive bond issue to restore the GDB’s liquidity position even as political risk on the island has increased. We expect the dynamic tension between many of the island’s residents and its creditors to rise over time.

In that context, we are obliged to reiterate our concerns that credit risk on the island is still increasing across all borrowers and all bond types. A fundamental change in the island’s tax structure increases the degree of uncertainty over revenue collections even as the prospect of higher health care expenditures looms on the horizon.

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2 Municipal Market Analytics, Default trends, 12 March 2015.
Fig. 3: Select credits and price trends of Puerto Rico municipal bonds

Last price, in USD

Source: MSRB Trade Data, Bloomberg, UBS CIO WMR, as of 18 March 2015
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>
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<td>Taxable Equivalent Yield (tax free yield divided by 100 minus the marginal tax rate)</td>
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MMD

### Rating Agencies

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### Credit Ratings

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