Municipal Brief
Puerto Rico credit and market update
24 April 2018
Wealth Management Research
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• The dramatic rebound in Puerto Rico bond prices owes much to the optimism expressed by Governor Rosselló regarding future operating surpluses. We see it as another opportunity for private clients to rebalance their portfolios and reduce exposure.

• The fiscal plans submitted by Governor Ricardo Rosselló and another certified by the Financial Oversight and Management Board are too optimistic, in our view. Assumptions regarding economic growth rely upon prompt implementation of structural reforms, legislative action, and the prompt confirmation of a plan of adjustment, all of which are likely to take longer than anticipated.

• The crucial issue of whether COFINA bondholders have an exclusive right to sales tax revenues remains unresolved. General obligation bondholders argue that the Sales Tax Financing Corporation (COFINA, by its Spanish acronym) issued bonds in violation of the Puerto Rico constitution and the lien on the resulting revenue is invalid. COFINA bondholders disagree and argue that they have an exclusive right to the pledged revenue. Judge Laura Taylor Swain has taken the issue under advisement.

Puerto Rico has faced numerous challenges in recent years. A prolonged economic recession prompted many residents to seek employment on the US mainland. Weak financial performance, characterized by structural operating deficits, undermined the territory’s ability to support its substantial debt burden. A catastrophic hurricane wreaked havoc across the island, forcing the government to redirect scarce financial resources to the preservation of public health and safety. Persistent disagreements between Puerto Rico’s two leading political parties have made the search for bipartisan compromises exceedingly difficult, while the absence of audited financial reports has undermined market confidence.

Puerto Rico’s physical infrastructure also remains exceptionally fragile, leading to periodic blackouts and water shortages. After Hurricane Maria smashed the island’s transmission grid, the Puerto Rico Electric Power Authority scrambled to restore electricity service. Seven months later, the blackouts continue to discourage residents. An explosion and fire at a generating station in early February plunged San Juan into darkness. Less than two months later, a severed transmission line cut power to 900,000 customers. Another transmission line failure last week triggered an island-wide blackout last week.
Water quality poses another challenge for the island’s residents. When ranked by the number of customers it serves, Puerto Rico suffers the highest rate of Clean Water Act violations of any state or territory in the country.¹ Bacterial contamination in the wake of Hurricane Maria posed a serious safety hard for island residents. More than 40% of the water produced by the Puerto Rico Aqueduct and Sewer Authority (PRASA) is lost through leaks and physical breaks in the system.² PRASA estimates that a capital investment of more USD 1bn will be necessary to replace aging infrastructure and reduce water losses to a level closer to national standards.

As Puerto Rico approaches the fifth anniversary of its financial crisis, the territory and its creditors are mired in litigation. And yet, despite the looming prospect of prolonged legal proceedings, general obligation bond prices have rebounded strongly. From a low of USD 21.18 in early December 2017, the benchmark 8s of ’35 traded as high as 43.00 last week (see Fig. 1). Sales tax revenue bonds have exhibited similar strength, with prices on senior lien obligations reaching USD 63.375 on 23 April 2018.

We believe the abrupt increase in market valuations is attributable to a variety of factors. First and foremost, the Roselló Administration announced in December that the Commonwealth’s liquidity position was better than expected after it discovered additional cash in various bank accounts. Second, a USD 18bn supplemental appropriation by Congress in February was greeted with enthusiasm by creditors. While well short of the USD 94bn requested by Governor Rosselló, it was enough to convince investors that the influx of federal aid will stimulate economic growth and allow the Commonwealth to offer a better recovery for bondholders. And third, the governor responded to the federal appropriation by forecasting an operating surplus, before the payment of debt service, through 2023.

While Puerto Rico bond prices may have been beaten down to unsustainably low levels in the final quarter of 2017, the speed with which the bonds have rebounded is surprising given myriad challenges faced by the government. Persistent population loss and a declining labor force participation rate pose an obstacle to economic redevelopment (see Fig. 2). Health care expenditures will increase abruptly in 2019, while pension fund balances have been depleted, forcing the Commonwealth to pay retirement benefits on a pay-as-you-go basis.

For the better part of five years, we have advised private clients to take advantage of periodic increases in bond prices to diversify their portfolios and reduce exposure. We see the current rebound in bond prices as another opportunity to do so (see Fig. 3 on page 6). The sustainability of current prices will depend, first and foremost, upon the willingness of Puerto Rico to negotiate constructively with capital market creditors and, second, on the accuracy of forecasts set forth in the government’s most recent fiscal plan. Puerto Rico’s track record in either endeavor does not inspire confidence.
Political skirmishes and policy disputes
The US Congress enacted the Puerto Rico Oversight, Management & Economic Stability Act (PROMESA) in 2016. The Act provided for the creation of an independent authority (the Financial Oversight and Management Board or "Oversight Board") to enforce fiscal discipline in a territory unaccustomed to the enactment of balanced budgets. Among other tasks, the Oversight Board was given responsibility for the development and implementation of a fiscal recovery plan. Board members were entrusted with the responsibility of certifying budgets, developing independent revenue forecasts, and supervising creditor negotiations.

Both political parties in Puerto Rico expressed profound misgivings over the federal legislation. Former governor Alejandro Garcia Padilla criticized PROMESA for placing limitations on the authority of elected officials to enact budgets and for constraining their ability to unilaterally restructure debt service obligations. More recently, Governor Ricardo Rosselló has clashed with the Oversight Board over the scope of his authority.

Meanwhile, Rep. Rob Bishop (R-UT) has accused the Oversight Board of intentionally misinterpreting legislative intent and has encouraged it to show greater "transparency, accountability, good will, and cooperation with creditors." As chairman of the House Natural Resources Committee, he has the discretion to convene another Congressional hearing and may choose to do so later this year. The net result is an Oversight Board caught in the middle, often condemned on the island as an unelected junta and simultaneously criticized by some members of Congress as insufficiently attuned to the rights of creditors.

In the wake of last year’s hurricanes, the Oversight Board directed the Rosselló Administration to revise last year’s fiscal plan for the Commonwealth. The governor’s revision was presented to the Board on 24 January but subsequently rejected as insufficiently austere. The Board mandated revisions, including an average 10% reduction in government pensions, the elimination of holiday bonuses, and constraints on salary increases. Governor Rosselló rejected the Board’s instructions as counterproductive to the economic recovery of the island. He asserted his belief that the Board’s authority is limited to making recommendations and that it is not authorized to impose changes to his administration’s fiscal plans.

Despite opposition from Governor Rosselló, the Federal Oversight and Management Board convened on 19-20 April to vote on fiscal plans for the Commonwealth and some of its agencies. As expected, the Board certified its own version of a fiscal plan for the Commonwealth over the objections of the governor. In addition to the provisions described in the preceding paragraphs, the Oversight Board has instructed the Rosselló Administration to consolidate government agencies and reduce financial support for municipal governments. Some provisions of the fiscal plan will necessitate legislation. The governor has already said he will withhold support for the necessary bills. The Oversight Board is expected to ask a federal court to resolve the escalating dispute and to clarify its authority to direct the government to take certain actions.

No one should believe that these reforms are being implemented without clear and direct benefit to the people of Puerto Rico. This will require tough choices and disciplined execution.

Natalie Jaresko,
Executive Director
Fiscal Oversight and Management Board quoted by Associated Press 19 April 2018

Our position has always been clear. Issues that are not in line with my government’s public policy will not be carried out. Period.

Ricardo Rosselló
Governor
Commonwealth of Puerto Rico quoted in The New York Times 19 April 2018

Both plans appear to disregard potential pitfalls by optimistically assuming the prompt adoption of structural reforms, additional supplemental appropriations by Congress, and the incorporation of pension reforms in a comprehensive Plan of Adjustment.
Many observers have been preoccupied, understandably, with the quarrel between a Congressionally-chartered Oversight Board and a popularly elected governor. It is easy to overlook the degree to which both parties exhibit unbridled optimism regarding future economic growth. Both Governor Rosselló and the Oversight Board have asserted in their respective fiscal plans that economic growth will accelerate based upon an influx of federal disaster aid.

For example, the Oversight Board concedes that the island’s economy will contract by 13.2% in the current fiscal year. However, the Board also believes that the dramatic reduction in GNP is a temporary phenomenon. An infusion of USD 62 billion of public and private financial assistance over the course of the next decade is expected to prompt a sharp rebound, offsetting the recessionary impact of structural reforms and expenditure reductions. The net result is a certified fiscal plan that optimistically concludes that Puerto Rico will generate a USD 6.7 billion surplus before the payment of any debt service.

The estimated surplus is higher than Governor Rosselló’s rosy forecast by approximately USD 400 million, which may help to explain the recent run-up in bond prices. And yet, upon closer inspection, both plans appear to disregard potential pitfalls by optimistically assuming the prompt adoption of structural reforms, additional supplemental appropriations by Congress, and the incorporation of pension reforms in a comprehensive Plan of Adjustment. Moreover, the Oversight Board’s certified fiscal plan does not address the need to reduce reliance on Act 154 revenues, nor does it address the probability that Puerto Rico may be less attractive as a business location for US corporations following enactment of The Tax Cuts and Jobs Act.

Litigation continues
Judge Laura Taylor Swain convened a hearing on 10 April to resolve the ongoing dispute between COFINA and general obligation (GO) bondholders. Attorneys for COFINA creditors asserted that they retain an exclusive lien on revenue derived from the pledged sales tax. Opposing lawyers for general obligation creditors argued that the COFINA bonds were issued invalidly more than a decade ago as an “end-run” around the Commonwealth constitutional debt limit.

The arguments were made in conjunction with a request for summary judgment. Judge Swain concluded the hearing without ruling and by taking the issue under advisement. She conceded that the question was “very serious, very difficult, and quite consequential to Puerto Rico.” Absent a summary judgment or referral by Judge Swain to the Puerto Rico Supreme Court for adjudication, we are inclined to believe that both GO bondholders and sales tax revenue bondholders will be obliged to accept a substantial haircut on their principal investment. The alternative is a ‘winner-take-all’ result that will trigger an abrupt and severe revaluation of bond prices for one of the two credits.

GDB Settlement
The Government Development Bank (GDB) and the Puerto Rico Fiscal Agency and Financial Advisory Authority (AAFAF) announced that they had reached a new settlement with enough holders of outstanding GDB debt to amend the existing Restructuring Support Agreement (RSA). The original RSA was executed in 2017 but never
received a formal vote by bondholders. It provided for an exchange of outstanding debt for one of three tranches of amortizing bonds collateralized by GDB assets.

The newly amended RSA is designed to provide some relief to Puerto Rico’s municipal governments, which are still recovering from the damage wrought by last year’s hurricanes. Among other provisions, the amended RSA now allows the municipalities to apply their deposits held at the GDB to any loans they may owe and to receive up to 55% of the undisbursed tax levies held on deposit at GDB. In return, creditors will be able to exchange their outstanding claims against the bank for a single tranche of new securities at an exchange ratio of 55%. AFFAF reports that creditors will receive additional assets in the restructuring. The amended RSA still needs to be approved by the requisite number of bondholders and by the Oversight Board. The GDB Restructuring Act also will need to be amended.

Conclusion
The rebound in Puerto Rico bond prices is attributable to optimistic assumptions embodied in the fiscal plans regarding future operating surpluses prior to the payment of debt service. We agree that the infusion of federal aid will have a positive impact on the island’s economy. However, we believe the fiscal plan proposed by the governor and the separate fiscal plan certified by the Oversight Board both underestimate the implementation challenges. Bondholder recoveries will be predicated on the outcome of litigation, which has few precedents. Private clients are encouraged to take advantage of another opportunity to rebalance their portfolios.

End notes
5 The Oversight Board had initiated legal actions against the governor in 2017 to compel compliance with certain directives. The Board withdrew its complaint in the wake of Hurricane Maria as the Commonwealth grappled with urgent public safety concerns.
6 Puerto Rico Financial Oversight and Management Board, Certified Fiscal Plan, Chapter 15, 19 April 2018. Please also refer to Puerto Rico Credit and Market Update, UBS Financial Services, 8 February 2018.
7 Robert Slavin, Puerto Rico Bankruptcy Judge Hears Arguments on COFINA’s Legality, The Bond Buyer, 11 April 2018.
8 Dawn Giel, “Puerto Rico bond investors argue over first dibs on a key source of cash”, CNBC, 10 April 2018.
Fig. 3: Select credits and price trends of Puerto Rico municipal bonds

Last price, in USD

Source: MSRB trade data, Bloomberg, UBS, as of 23 April 2018 2:30 PM ET
Appendix

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<td>GO</td>
<td>General Obligation Bond</td>
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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

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- Issuers have very strong credit quality.
- Issuers have high credit quality.
- 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.
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Appendix

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