Municipal bonds

Puerto Rico Credit and Market Update | 2 February 2016

CIO WM Research
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- The Working Group for the Fiscal and Economic Recovery of Puerto Rico released a summary of its voluntary debt exchange proposal (the "restructuring proposal") on 1 February. The proposal incorporates a 46% reduction in the mandatory payment of tax-supported debt.

- The proposal would create a new special purpose entity to issue two types of securities to bondholders who accept the exchange offer and tender their existing securities. A "base bond" would have a fixed rate of interest and a defined maturity schedule. A "growth bond" would be payable only if Commonwealth revenues exceed certain thresholds, subject to a cap.

- As proposed, approximately USD 49.2bn of outstanding debt would be traded for USD 26.5bn of "base bonds" with a secured statutory lien on certain tax revenue, and for another USD 22.7bn of "growth bonds." The proposal relies on numerous optimistic assumptions, including the willingness of most GO and COFINA creditors to refrain from litigation and accept a substantial reduction in probable principal repayment.

- We assign a very low probability of success to this restructuring proposal. Creditors do not have enough of an incentive to accept the embedded losses given the absence of any convincing plan for renewed economic growth and operational reforms. Instead, we believe the Commonwealth is positioning itself for protracted negotiations with creditors.

- Puerto Rico's demand that creditor groups respond promptly and constructively to its proposal was accompanied by an announcement that a failure to do so may result in a debt service payment moratorium by 1 May 2016.

The Commonwealth of Puerto Rico unveiled a plan to restructure USD 49.2 billion of outstanding tax-supported debt. The restructuring proposal calls upon creditors to voluntarily exchange their existing bonds for new securities. Existing creditors would receive a par amount of base bonds and a notional amount of...
growth bonds in return for surrendering the bonds they currently hold.

The base bonds would carry a fixed rate of interest and a mandatory amortization schedule. The par value of the base bonds granted to each existing creditor would depend on the type of credit they currently hold. General obligation bondholders would receive a higher ratio of new base bonds than would subordinate COFINA bondholders, for example, but losses would be sustained across the capital structure.

Interest payments on the base bonds would commence in fiscal year (FY) 2018 at a rate of 3%. The interest rate would subsequently increase incrementally to 4% in FY2020 and to 5% in FY2021 and remain stable thereafter. Needless to say, the yields on offer are far below current market rates for the island’s distressed securities. The Commonwealth would guarantee payment of debt service on these base bonds and would grant bondholders a secured statutory lien on two discrete sources of revenue.

The revenue derived from a 4.5% sales and use tax (SUT) and up to USD 325 million per annum of petroleum products tax revenue would be pledged towards repayment. The identification of the SUT as pledged security for the base bonds is interesting for a number of reasons, not the least of which is the absence of any mention of a value added tax (VAT). After almost two years of planning to replace the SUT with a VAT, it appears the Commonwealth has reconsidered.

The payment of debt service on the notional growth bonds entails substantially greater risk. Debt service in this instance would not commence until FY2026 and is contingent on the Commonwealth’s ability to exceed certain revenue targets. The formula is reasonably complicated and inadequately explained in the public release, but it appears that revenue growth would have to exceed the rate of inflation before any payment on the growth bonds would be made. The proposal is silent on the issue of operational reforms and the means by which the Commonwealth will increase its revenue in the face of almost ten years of economic recession.

**Outlook for the proposal**

Puerto Rico’s restructuring proposal appears to be an opening gambit in what is likely to be protracted negotiations with the island’s capital market creditors. We believe the document’s abrupt release before a House of Representative hearing on 2 February was a calculated attempt to convince wavering members of Congress that its negotiations with creditors were likely to be unsuccessful.

We are obliged to remind investors that the ability of Puerto Rico to negotiate effectively with its myriad creditors has been undermined by persistent delays in the release of audited financial statements and by the release of revised estimates of revenue and expenditures for the current fiscal year. While the inherent shortcomings of the proposal, including an inability to discharge outstanding debt, might well be used as an argument in favor of federal bankruptcy court jurisdiction, we believe that the Commonwealth has failed to convince many
creditors that it is serious about reaching a consensual resolution to the challenges it faces.

The García Padilla administration now warns investors that it may be forced to institute a debt service payment moratorium if creditors do not respond promptly and constructively to its current restructuring proposal, which suggests that future negotiations are likely to be increasingly acrimonious.

Puerto Rico’s proposal was roundly criticized by market participants upon its public release. Assured Guaranty, for example, issued a statement yesterday bemoaning the fact that Puerto Rico failed to seek any substantive input from creditors. National Public Finance Guarantee, another bond insurer and major creditor, reminded the Commonwealth that its proposal lacked any specificity with regard to the implementation of economic reforms and the elimination of fiscal mismanagement.

**Market update**
The restructuring proposal did not have a significant impact on market prices for Puerto Rico bonds on Monday. Trading remained lackluster, with almost two thirds of the activity involving the Commonwealth’s general obligation bonds. Trading in the benchmark 8s of 2035 opened at a price of USD 71.125. In the late afternoon, a single USD 5mn block traded at a price of USD 70.625, followed by another USD 3mn trade at USD 70.25 at the close of the trading session. Other trades involved blocks of bonds that were too small to reflect an abrupt change in market sentiment. Among more seasoned GOs, the 5 ¾% of 2041 last traded at USD 62.75, closely aligned with the average price posted one month earlier.

Prices on subordinate lien COFINA bonds improved modestly on the day. The 5 ¼s of 2043 last traded at a price of USD 38.401, up from USD 35.00 at year-end. The 5s of 2043 last traded at a price of USD 37.90, up from USD 34.25 on 31 December 2015. Again, these were smaller trades so their utility value as a sign of market sentiment is limited.

At the same time, Puerto Rico Public Building Authority (PBA) bonds appeared to show some price improvement. For example, an institutional sized trade of PRPBA, 5 5/8s of 2039, changed hands at a price of USD 56.00, up from an average price of USD 54.54 on 13 January 2015. This uptick may reflect some investors’ expectations that recovery values on bonds from this issuer may now more closely align with that on the island’s general obligation debt. Payment of the obligation is guaranteed by the Commonwealth.

Meanwhile, Puerto Rico Highways and Transportation Authority (HTA) revenue bonds exhibited strong price improvement, albeit from a very low starting point and based only on odd lot trading. The HTA 5s of 2042 changed hands at a price of USD 22.00, up from only USD 11.74 on 31 December 2015.
Conclusions

The restructuring proposal is unlikely to represent a positive step towards a resolution of the island’s financial distress for a variety of reasons. First and foremost, the Commonwealth has no unilateral ability to discharge outstanding debt held by creditors who fail to exchange their bonds. As a result, nonconforming investors will retain a legal right to the revenue that is otherwise being redirected to support the base bonds. The resulting confusion undermines the security of both the outstanding debt and the base bonds contemplated in the agreement.

Second, the Puerto Rico Supreme Court will need to validate the proposal prior to implementation. The court has to date not adjudicated the question of whether the revenue pledged to the repayment of COFINA bonds can be "clawed back" to support general obligation indebtedness. To the extent the matter is presented to the court, its decision on the matter could well undermine the restructuring proposal.

Third, Puerto Rico reserves the right to adjust the pertinent terms of the restructuring proposal if there is insufficient investor interest or if the federal government reduces its financial assistance for the island’s various programmatic expenditures.

Finally, the plan does not address escalating health care expenditures and pension liabilities. We have reminded investors on many occasions that these two line items are likely to trigger further operating deficits in the absence of substantive reforms. The restructuring proposal fails to adequately address either topic.

While the release of the new proposal captured the market’s attention yesterday, it comes in the context of other developments crucial to creditors:

- The Puerto Rico legislature thus far has failed to pass enabling legislation in support of the Puerto Rico Electric Power Authority’s amended and restated restructuring agreement with utility creditors. While the agreement has been reinstated to allow the legislature more time to enact the necessary statutes, the failure to comply with the requirements of the agreement undermines market confidence.

- The House of Representatives’ Subcommittee on Indian, Insular, and Alaska Native Affairs will convene a hearing today titled "The Need for the Establishment of a Puerto Rico Financial Stability and Economic Growth Authority." As previously noted, we believe that the restructuring proposal’s abrupt release ahead of the hearing may be a calculated attempt to convince wavering members of Congress that the Commonwealth’s negotiations with creditors are likely to be unsuccessful. The Commonwealth is actively seeking Congressional enactment of an amendment to...
the US bankruptcy code that would enable it to file for protection from creditors, potentially allowing it to enforce more punitive losses on bondholders.

- In addition to the lobbying effort now underway in Washington, the Commonwealth presumably is anxious to hear the oral arguments in its plea for a reversal of the US District Court decision that invalidated the Debt Enforcement and Recovery Act. The US Supreme Court has scheduled those arguments for 22 March.

**Fig. 4: Select credits and price trends of Puerto Rico municipal bonds**

Last price, in USD

Source: MSRB trade data, Bloomberg, UBS, as of 1 February 2016
Appendix

Statement of Risk

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.

Terms and Abbreviations

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<th>Term / Abbreviation</th>
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<td>GO</td>
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Appendix

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