Municipal Brief

Puerto Rico Credit & Market Update

- The Commonwealth successfully sold USD 3.5bn of general obligation bonds last week. Proceeds will be used to repay variable rate debt and allow the Government Development Bank to replenish its own liquidity position. The new debt has an 8% coupon and was priced to yield 8.727% (USD 93.00). The bonds mature in 2035 and feature a six year call option at par which will permit refinancing in 2020, without premium, as market conditions allow.
- The true interest cost was lower than many anticipated, which we attribute to the market’s technical strength and an expectation among crossover investors that they can find a secondary market for the bonds reasonably soon.
- While the bond issue provides the Commonwealth with some much needed near-term breathing room, it is not a longer-term solution to the island’s longstanding fiscal and economic challenges, in our view. Investment in the Commonwealth’s bonds continues to pose speculative grade investment risks.
- We believe the recent improvement in Puerto Rico bond valuations presents an attractive opportunity for risk-averse individual investors still holding Puerto Rico bonds to rebalance and diversify their portfolios.
- For investors who are intent on seeking exposure to the Commonwealth despite the pronounced credit risk, we prefer the general obligation (GO) bonds and the debt issued by the Puerto Rico Sales Tax Financing Corporation (COFINA, by its Spanish acronym). We believe the bonded debt of public corporations and agencies of the Commonwealth present a higher degree of risk and should be monitored closely.

Significant appetite for new issue

The size of Puerto Rico's most recent general obligation bond offering was increased to USD 3.5bn at the time of pricing from a planned USD 3bn due to very strong demand. The Government Development Bank (GDB) reports that the transaction was oversubscribed by a factor of 4.5x, with 270 different accounts placing orders. GDB Chairman David Chafey confirmed in an interview with Bloomberg News that the majority of buyers were hedge funds.¹
The Commonwealth will receive USD 3.2bn from the offering, approximately USD 900mn of which will be used to refinance short-term obligations and swap termination payments. Approximately USD 400mn will be used to fund a capitalized interest account for the bonds. Puerto Rico plans to use the remaining proceeds to refinance certain obligations owed by the Commonwealth and its instrumentalities to the GDB, which will provide the bank with a liquidity infusion of USD 1.9bn. We agree with the Bank’s assertion that repayment of all outstanding variable rate debt, excluding a small amount of index-linked bonds, simplifies the Commonwealth’s capital structure and reduces market risk. According to the GDB, the Commonwealth retains USD 900mn in additional GO bond capacity following the sale under its constitutional debt limit.

Puerto Rico’s timing proved to be fortuitous. Investor anxiety over whether the Commonwealth would find enough buyers dissipated in the week prior to sale. The absence of much competition, combined with the sheer size of the deal and a willingness by the Commonwealth to concede venue in case of litigation, captured the market’s attention. Credit spreads on 10y Commonwealth GOs narrowed to 625bps as of 14 March 2014 from a peak of 775bps as recently as 18 February, according to MMD (see Fig. 1). At the 30-year spot, credit spreads narrowed to 375bps from 420bps over the same time frame.

In a speech following the bond sale, Governor Alejandro Garcia Padilla stated that the bond offering would allow the Commonwealth to meet its obligations for the next eighteen months and that detailed cost cutting measures would be announced in the weeks ahead. Although lower government spending runs the risk of prolonging the economic recession that remains underway on the island, Governor Garcia is focused on private sector job creation as a means of offsetting the recessionary impact of austerity at the government level.

Robust trading following the sale

After an exceptionally active trading session on 12 March, the total daily trade volume for the new bonds declined steadily in the next two trading sessions. Volume dropped from USD 585mn on 12 March to USD 257mn a day later. After a dramatic rally on Wednesday, bond prices also declined a bit as the week wore on. In the most recent trading session, we observed that dealers were net buyers of this Puerto Rico bond versus being net sellers for the previous trading days, according to Bloomberg data.

By Friday (14 March), the average price on the Commonwealth of Puerto Rico’s new 8.00% coupon bond maturing in 2035 had declined by roughly ¾ point to USD 94.817 (8.53% yield) from USD 95.588 (8.45% yield) one day earlier. This data is based on 138 trades and volume of USD 160.9mn. Roughly 40% of the total number of trades were in amounts of USD 1mn and greater.

The frenetic trading in the new bond issue stood in contrast to the subdued activity elsewhere in Puerto Rico debt. We observed significantly lower trade volume in the Commonwealth’s more seasoned GO’s. For example, just USD 2mn in par amount of Puerto Rico GO 5 ¼% due 2017 traded on 14 March based on 16 trades. We attribute the difference to the unique circumstances and size of the new bond

Fig. 1: Credit spreads for Puerto Rico GO bonds

Source: MMD, UBS CIO WMR, as of 14 March 2014

In bps
transaction, in which hedge funds dominated the early trade activity and apparently flipped bonds quickly after the sale.

**New disclosure addresses outstanding questions**

In a nod to the demands of traditional investors for more information regarding the Commonwealth's financial condition, the GDB released a quarterly operating supplement and a comprehensive liquidity analysis in quick succession before the sale. The Preliminary Official Statement was comprehensive and carefully delineated the credit risks associated with an investment in the general obligation bonds. Together, in our view, they represented a substantial improvement in the quality of information provided to investors and may have played a supporting role in the strong market reception. We believe investors will remain highly attuned to whether the recent disclosure was an aberration or a welcome sign of things to come.

**Rating agency feedback**

Fitch recognized the offering as evidence of Commonwealth's ability to access the market. The rating agency expressed its belief that the transaction's successful execution provides the Commonwealth with breathing room as it continues to address its ongoing fiscal and economic challenges. Fitch also noted that the sale will improve liquidity at the GDB and remove potential near-term liquidity constraints.

S&P affirmed its BB+ rating on the Commonwealth's GO debt on 14 March 2014, and also affirmed the ratings on various general fund-supported and highways and transportation authority debt. The rating agency also removed the ratings from CreditWatch with negative implications. S&P described last week's bond sale as a success and, like Fitch, noted that it will relieve near-term liquidity pressure. With the removal of the CreditWatch designation, the rating agency assigned a negative rating outlook to the Commonwealth’s debt.

While Moody's had not addressed the bond sale at the time we went to press, we expect their reaction to be similarly positive.

**Public corporations under scrutiny**

In the wake of the GO bond sale, investors will be closely following the Commonwealth's progress against the Administration’s stated fiscal and economic reform measures. Chief amongst these is Governor Garcia's commitment to a balanced budget in FY15. The Governor has promised investors that he would achieve this without further reliance on the capital markets for operating funds.

In the absence of any evidence that the economy is expanding, we expect that the FY15 budget must rely upon expenditure reductions in order to be balanced. In addition, we believe it will be essential for the Commonwealth to cease its longstanding practice of providing support for public corporations and agencies across the island. The governor has made it clear that he expects these corporations, such as the Puerto Electric Power Authority (PREPA), to operate without further public subsidy going forward. The legislature, for its part, appears eager to support more comprehensive reforms to wean the
various agencies off of a reliance on loans from the GDB. Indeed, Governor García and other key members of the legislature have expressed a desire to reform PREPA in order to lower energy costs for some time.

Senators Ángel Rosa and José Nadal Power recently introduced legislation (Senate Bill 993) to provide the legal structure by which insolvent public corporations may restructure their debts. In response to market speculation in the wake of the bill’s introduction, the GDB and the Treasury Department issued a statement saying that neither the GDB, nor the executive branch, was involved in the drafting or formulation of this legislation.⁵

According to the GDB and the Treasury Department, the Administration remains focused on creating jobs, balancing the budget, and making public corporations self-sufficient. While the Garcia Administration was not consulted prior to the introduction of the bill, the proposal is another reminder that some legislators may be increasingly reluctant to adopt austerity measures indefinitely. To the extent the public corporations are unable to demonstrate their self-sufficiency absent support from the GDB, a restructuring of outstanding debt remains a distinct possibility, in our opinion.

Conclusions

The expenditure reductions contemplated by the governor are absolutely essential to ensure a balanced budget in the next fiscal year. Given the market’s skepticism as recently as four weeks ago, the bond sale can reasonably be termed a success at a true interest cost below 9%. The Puerto Rico Supreme Court is expected to rule in the next week or two on the constitutionality of legislative reforms to the Teachers Retirement System.

The market anticipates that the court will uphold the validity of the law. Absent a surprise decision, we anticipate a brief period of relative tranquility for Puerto Rico. While there will be some media attention devoted to the planned reform of the Puerto Rico Electric Power Authority, the liquidity injection from the bond sale should temper the volatility before investors refocus their attention on the degree to which the borrowing raised the Commonwealth’s fixed costs.

That said, while the bond issue provides the Commonwealth with some much needed near-term breathing room, it is not a solution to the island’s longstanding fiscal and economic challenges, in our view. Investment in the Commonwealth’s bonds continues to pose speculative grade investment risks.

The liquidity infusion provided by the bond sale gives us greater comfort with Commonwealth GO and guaranteed debt maturities through the end of calendar year 2015. For maturities beyond this date, we believe that the recent improvement in Puerto Rico bond valuations continues to present an attractive opportunity for risk-averse individual investors still holding Puerto Rico bonds to rebalance and diversify their portfolios. For investors intent on investing in Puerto Rico, we continue to favor the debt issued by the Puerto Rico Sales Tax Financing Corporation (COFINA, by its Spanish acronym) and Commonwealth GOs over the debt issued by the public corporations and agencies of the Commonwealth. In our view, it may be more difficult for the latter group to achieve balanced operations in the years ahead.
Endnotes

1 Bloomberg News, "Puerto Rico Lures Hedge Funds for Record Junk Deal: Muni Credit", 12 March 2014
3 Fitch, "Puerto Rico’s $3.5B GO Sale Provides Breathing Room", 12 March 2013
5 As reported by Caribbean Business and Noticel on 15 March 2014. We had not obtained a copy of the statement as we went to press.
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>
<td>TEY</td>
<td>Taxable Equivalent Yield (tax free yield divided by 100 minus the marginal tax rate)</td>
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MMD = Municipal Market Data

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