Municipal Brief

Puerto Rico Credit & Market Update

- General obligation bond prices plunged following Governor Alejandro García Padilla’s discouraging comments regarding the Commonwealth’s inability to support its debt burden, a sentiment he reiterated last night in a televised address. The governor described an ultimate goal whereby the Commonwealth would enter into a negotiated agreement with bondholders to defer debt repayment for a number of years as part of a larger effort to improve the island’s finances and revive its economy.

- The Government Development Bank released a report entitled Puerto Rico: A Way Forward. The report, which was prepared by independent economists, concludes that a more comprehensive debt restructuring can no longer be avoided.

- Fitch downgraded Puerto Rico’s GO rating to CC from B. The rating remains on Credit Watch with negative implications. Fitch believes that the probability of a GO bond default has increased. S&P revised its rating on all Puerto Rico debt to CCC- from CCC+. It now views a default or distressed exchange inevitable within six months absent any unanticipated improvement in the island’s circumstances.

- The proposed debt restructuring is only a first step in what are certain to be adversarial negotiations between the Commonwealth and a disparate group of creditors. In that context, we expect more price volatility across Puerto Rico credits.

- While bond prices may look appealing in the months ahead, private investors are advised to diversify exposure as we remain skeptical that the Commonwealth will resolve its financial challenges quickly. We expect a long and litigious road ahead.

In our last report dated 25 June, we reaffirmed our existing opinion that Puerto Rico’s ability and willingness to support its massive debt burden was waning in the context of a protracted economic recession. A diminishing investor base, ever more reliant on crossover investors (e.g. hedge funds), no longer appeared interested in providing the fresh capital necessary to postpone a restructuring of outstanding debt. Governor García’s subsequent admission that the Commonwealth’s debt was “not payable” triggered an abrupt reaction by the market. Many market participants had accorded substantial deference to the governor’s prior assurances that Puerto Rico had no intention of defaulting on its obligations.

The sacrifice must be shared with the bondholders who share part in the responsibility of our debt. The creditors who wish to cooperate in good faith are welcome to do so. That said, those who attempt to exploit this situation to gain a financial or political advantage on the backs of our people, I say to them, Puerto Rico will be united against you.

Governor Alejandro García Padilla
29 June 2015

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GO bonds, so the reaction was all the more severe when the governor acknowledged the island’s intractable fiscal challenges. While the Commonwealth’s financial constraints are self-evident, the credibility of the current administration has been damaged by its policy reversal regarding the payment of its bonded indebtedness.

Televised address

In a televised speech yesterday evening, Governor García reiterated his opinion that the island’s debt burden could no longer be supported by an economy mired in recession. He indicated that the problems facing the island were no longer about politics but "about math." He also provided more detail on the process by which Puerto Rico would negotiate with creditors. According to the governor, the Commonwealth would seek a negotiated moratorium on debt service payments. The postponement would be part of a larger effort to improve the island’s finances and revive its economy.

Garcia also announced the appointment of a "Working Group for the Economic Recovery of Puerto Rico" (the Working Group) through an executive order. The Working Group, which includes senior members of his administration and legislative leaders, are asked to devise fiscal reforms sufficient to promote economic development. The working group is also required to develop a debt restructuring and fiscal reform plan in consultation with the affected parties that could be approved in a legislative session beginning in mid-August. A guarantee of essential services to citizens and a just income to pensioners are among the agenda items set forth by the governor.

The Commonwealth is also reported to have retained the services of Judge Steven A. Rhodes as an adviser. Judge Rhodes gained notoriety when he presided over the bankruptcy proceedings for the City of Detroit. While Puerto Rico cannot seek protection from its creditors in federal bankruptcy court, the Commonwealth is actively engaged in a lobbying effort before Congress for authority to do just that.

Budget update

In other developments, Bloomberg News reported that the Puerto Rico legislature agreed upon a FY16 budget proposal yesterday evening as well. The plan, which now heads to the Governor for signature, includes provision for the repayment of the central government’s debt obligations despite the restructuring dialogue that has captured focus this week.

Market update

The Commonwealth’s general obligation bonds were very actively traded on Monday as investors reassessed the likelihood of a more comprehensive restructuring of Puerto Rico’s bonded debt obligations. More than 70% of trade volume in Puerto Rico credits was associated with the island’s general obligation bonds, which plummeted in price. By comparison, approximately 5% of yesterday’s trades were associated with the debt issued by the Puerto Rico Sales Tax Financing Corporation (COFINA) and less than 3% with obligations of the troubled Puerto Rico Electric Power Authority.

We cannot allow the heavy weight of the debt to bring us to our knees. We cannot allow the situation to force us to choose between paying our creditor, and paying our policemen, teachers and nurses. Another way is possible. We must act now, together. We must all share the responsibility, and the sacrifice, so that we can share in the benefits of a growing Puerto Rican economy.

Governor Alejandro García Padilla
29 June 2015
The price of the Commonwealth’s benchmark GO bonds, the 8s of ’35, declined by almost 9 points to rest at USD 68.75 (12.20% yield) at yesterday’s close. Those bonds, which are widely held by institutions, reached an intraday low of USD 64.50 before recovering some of the losses at the end of the day. The same bonds traded at an average price of USD 77.34 on Friday and USD 84.26 on the 1st of June. As we go to press, the price on these securities fell again to USD 65.75.

Trading was relatively light in COFINA bonds, as noted, where the senior lien zeroes of 2054 last changed hands at 7.15% yield versus 7.00% on 22 June 2015. However, with that said, the price loss was greater in odd lot trading. For example, senior lien COFINA bonds, 5 ¼% of 2040, traded at an average price of USD 59.347 (9.54% yield) versus USD 71.750 (7.84% yield) on 25 June 2015.

Please refer to the accompanying charts for an illustration of the recent price activity (see Figs. 1 and 2).

At the same time, despite the price declines on Puerto Rico bonds, conditions elsewhere in the municipal market were improving. The flight to quality bid in the Treasury market had a spillover effect among municipals, with yields on high grade tax-exempt bonds declining by 2bps to 6bps across the curve.

The outlook

While Governor García’s comments to The New York Times may have sparked the sell-off in GO debt, the release of an independent report by noted economist Anne Krueger was a contributing factor in its severity. Dr. Krueger’s report entitled “Puerto Rico – A Way Forward” includes a recitation of economic and fiscal challenges, most of which were already widely acknowledged.

However, the release of the report by the Government Development Bank, and the degree of importance accorded to it by the Commonwealth government, suggests a larger purpose. The report’s frank discussion of the necessity for more comprehensive debt restructuring has opened Pandora’s box and will likely to lead to a wider debate regarding the concessions demanded from creditors.

As we have described in many previous reports, the Commonwealth’s financial challenges in FY 2016 are only likely to increase as the calendar year progresses. The Obama Administration has rejected the idea of a financial bailout for Puerto Rico, which leaves the island with few alternatives. In comments yesterday, Press Secretary Josh Earnest reiterated Washington’s willingness to provide technical assistance but stopped short of offering direct financial aid.7 The Commonwealth’s efforts to be treated as a state under the auspices of Chapter 9 of US Bankruptcy Code are apt to continue. As Congress debates the merits of affording such treatment, time is running out in terms of the US territory’s ability to make its upcoming debt service payments.

Puerto Rico faces an increase of more than 30% in general obligation debt service for the upcoming fiscal year.8 Meanwhile, the ability of the Commonwealth to access the capital markets to issue tax and revenue anticipation notes remains uncertain. In order to manage its cash position in the absence of a short-term borrowing solution, the...
legislature has authorized the government to stop setting aside cash each month to pay the sizable GO debt service bill.

Moody's described that action as credit negative for bondholders because it suggests that "a growing liquidity crisis is threatening Puerto Rico's ability to repay bonds with the strongest legal protections." And, in response to the more recent expression by the government to pursue a broader debt restructuring, the rating agency remarked that such an effort "is likely to be protracted and legally contentious" in light of the unique security pledges assigned to the various Commonwealth obligations and uncertain outlook for economic growth. We couldn’t agree more.

Conclusion

The proposed debt restructuring is only a first step in what are certain to be adversarial negotiations between the Commonwealth and a disparate group of creditors with diverging interests. In that context, we expect more price volatility across the breadth of Puerto Rico’s portfolio of outstanding bonds. We also take this opportunity to reiterate a view we have offered many times in the past. While bond prices are likely to look appealing in the months ahead, private investors are well advised to diversify their exposure as we remain skeptical that the Commonwealth will resolve its financial challenges quickly. We expect a long and litigious road ahead.

End notes

2 Members of the Working Group include the governor’s Chief of Staff, the GDB President, the Secretary of Justice, the Senate Majority Leader, and the House Speaker.
3 Press release, Governor Garcia addresses the public on the Commonwealth’s Fiscal Condition, 29 June 2015.
5 ibid
8 Moody’s, "Puerto Rico’s General Obligation Bonds Face Threat from Bill Allowing Suspension of Monthly Debt Service Deposits," 29 June 2015. Note: GO debt service will require USD 1.16bn in FY16 in comparison to USD 881mn in FY15. Overall debt service for the central government and its public corporations excluding PREPA is USD 4.7bn for the period.
9 ibid
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>
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<td>TEY</td>
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Issuers have exceptionally strong credit quality. AAA is the best credit quality.

Issuers have very strong credit quality.

Issuers have high credit quality.

Issuers have adequate credit quality. This is the lowest Investment Grade category.

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.

Oblior failed to make payment on one or more of its financial commitments. This is the lowest quality of the Speculative Grade category.
Appendix

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