PUERTO RICO
Investment Category: Aggressive Income  |  Sector: Various

Municipal Bond Research  Tom Larm, CFA  October 19, 2017

Sell

Recommendation
We recommend investors sell these bonds. We believe bonds backed by the commonwealth of Puerto Rico are not an appropriate fixed-income holding for Income-seeking clients because, in our opinion, they offer an unattractive risk/reward scenario at current prices.

Edward Jones Credit Strength Assessment

Investment Summary
Puerto Rico faces a weak economy, a high debt load, an unfunded pension liability, and chronic budget deficits. Puerto Rico’s weakening credit profile has been reflected in several rating-agency downgrades and recurring bond defaults.

Puerto Rico leaders have been evaluating various options to restructure the government, which could negatively impact bondholders in various ways including principal and interest payments being lowered, payments being delayed, maturities being extended, or bonds being exchanged with new bonds, among many other possibilities. We expect negotiations to take place over many years and face legal challenges. While it's too early to know how bondholders will ultimately be impacted, the outcome will be driven by the federal oversight board put into place by the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA). Although we believe PROMESA will make the restructuring more orderly, we do not expect it to prevent additional defaults and an ultimate restructuring of Puerto Rico’s debt.

Puerto Rico bondholders face extreme uncertainty. The risks to our opinion include a surprise federal bailout or some other type of unexpected government support that ultimately leads to higher recovery for bondholders.

Bond Strengths
- Puerto Rico benefits from its relation with the U.S.
- Interest from Puerto Rico bonds is exempt from federal, state and local taxes

Bond Challenges
- Puerto Rico has already defaulted on certain types of debt.
- High debt load and unfunded pension liabilities
- Socioeconomic indicators are weak.

This opinion applies to all insured bonds issued by Puerto Rico.
Recent News and Analysis

10/4/2017: Our thoughts and prayers go out to all those impacted by the devastation brought on by Hurricane Irma and Hurricane Maria. After sustaining significant damage to the island's transportation, utility and health care infrastructure, the government's first priority is to focus on the safety and well-being of its population. Given the unique challenges Puerto Rico faces as an island territory and the severity of these weather events, we expect the recovery process to take years.

Referring to Puerto Rico's debt, President Trump was quoted yesterday saying "We're going to have to wipe that out." In reaction to the comment, bond prices on Puerto Rico bonds have declined significantly overnight. Since Hurricane Maria, some bonds have dropped by more than 20 points, losing about a third of their value.

We believe President Trump's comments demonstrate the significant challenges faced by Puerto Rico. However, he cannot act unilaterally in regards to restructuring Puerto Rico's debt. Although court proceedings have been delayed, we expect negotiations and the restructuring process to continue over time.

Although bond prices have dropped significantly, we continue to believe clients should sell these bonds. We expect an eventual revision to the federal oversight board's 10-year fiscal plan, and the revision is likely to include delayed and/or lower debt payments than had been previously projected over that same time frame. Puerto Rico's complex financial problems have been magnified following the storms, and recovery values have grown more uncertain. Bondholders face significant risks in regards to recovery and redevelopment efforts, population shifts, economic prospects, and political issues, among many others.

6/30/2017: The federal oversight board has approved the Puerto Rico Electric Power Authority to file for court protection under Title III. The court filing follows the board's action earlier this week to reject a restructuring agreement.

6/1/2017: Puerto Rico is not expected to pay the debt service due on COFINA bonds today. Earlier this week, the judge overseeing the Title III court case ruled to suspend the payments as she evaluates how these bonds should be treated relative to other bonds issued by Puerto Rico.

5/3/2017: The federal oversight board announced it approved for Puerto Rico to file for bankruptcy-like court protection. The move was largely expected. In recent months, proposals and priorities from competing parties remained far apart. Additionally, protection against lawsuits expired May 1. While the federal oversight board is still advocating for consensual restructuring agreements, the courts could help the island force through certain cuts to creditors.

4/5/2017: Moody's downgraded certain Puerto Rico bonds from Ca to C. The lowest Moody's rating, C, indicates the rating agency's expectation of recoveries ranging from 0%-35% for those bonds. The outlook was revised to negative, which demonstrates the possibility of lower recoveries on other bonds.

3/14/2017: The federal oversight board revised the 10-year fiscal plan by outlining average payments of less than 25% of the debt service due every year through 2026, down from 35% in the previous plan due mainly to more conservative economic growth assumptions.

3/3/2017: As required by the federal oversight board, the governor has submitted a 10-year fiscal plan for Puerto Rico. The governor expects to pay about 35% of debt service every year, on average, through 2026. We believe the outcome of the negotiations are likely to vary widely from this plan. The federal oversight board is currently reviewing the plan and will decide where to go from here.

7/1/2016: Puerto Rico announced that payment obligations due today on its general obligation and guaranteed debt are suspended, which constitutes the first payment default on general obligation bonds issued by Puerto Rico.

In other events yesterday, the federal government passed the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA). We expect PROMESA to help Puerto Rico's restructuring process be more orderly. However, we do not expect PROMESA to prevent additional defaults or an eventual restructuring of Puerto Rico's debt.

1/5/2016: Puerto Rico defaults have become more widespread, and now include the Highways and Transportation Authority, the Puerto Rico Infrastructure Financing Authority, and the Convention Center District Authority. Some bondholders still received payment in full and on time since funds were available from debt-service reserve funds or bond insurers.

8/3/2015: Debt service due today on Puerto Rico Public Finance Corporation debt was not made in full. This default is the first debt payment default from a Puerto Rico bond-issuing entity.

Municipality Outlook

The commonwealth of Puerto Rico is an island territory linked politically and economically to the U.S. and had been one of the largest issuers of municipal debt. Puerto Rico is able to benefit from the U.S.'s strong financial system and can issue debt that is exempt from federal, state and local taxes. This feature made Puerto Rico municipal bonds attractive to investors and had historically helped the commonwealth raise cash. However, the commonwealth's debt load grew sizably as the island's government faced a long recession leading to overspending, lower tax revenue and large budget shortfalls. We believe Puerto Rico has a long road to recovery.

Economic Challenges Continue

Puerto Rico, an unincorporated territory of the United States, benefits from its political and economic linkage to the United States. Although it has no vote, Puerto Rico is represented in Congress through a resident commissioner in the House of Representatives. Puerto Rico has used this representation to advocate for federal resources and a process to restructure debt.
Although linked to the U.S., Puerto Rico’s economy continues to show weakness even as the U.S. economy improves. The island has an economy where almost half of the gross domestic product (GDP) is generated from manufacturing. The service sector makes up 35% of total jobs and the government makes up 28%. However, the drastic decline in the public-sector payroll, as the government has tried to cut expenses, could constrain the economy. Economic indicators have continued to show signs of further economic weakness. According to the Puerto Rico Government Development Bank, real gross national product declined by 1% in 2016. Other data from the Puerto Rico government, such as the island’s economic activity index, continue to show similar trends.

We believe economic prospects have grown increasingly uncertain following the major hurricanes of 2017. As resources shift to prioritize critical needs such as utilities, health care, and transportation infrastructure, economic development has taken a back seat, which we expect to negatively impact long-term growth.

The size and impact of a potential demographic shift following the hurricanes also remain uncertain. The population of Puerto Rico has declined from a peak of 3.73 million in 2010 to 3.4 million estimated for 2016. With the challenges of a decade-long recession and increasingly uncertain job growth, Puerto Rico’s out-migration trends are likely to worsen. Unemployment remains more than double the rate of the U.S. Median household income in Puerto Rico is $19,624, or 37% of the U.S. average. Also, 45% of the population is below poverty, according to the U.S. Census Bureau. Weak demographics are likely to make it tougher for Puerto Rico to make the changes needed to repay its higher debt levels.

Large Deficits Led to Above-Average Debt

Puerto Rico’s budget deficits have been as high as a third of recurring revenues of the commonwealth. Deficits of this magnitude in a weak economic environment make it hard for a government to find enough expenditure cuts and new revenue sources to close the deficit on a sustainable basis. With a focus on tax increases and keeping expenditures low, the commonwealth has found it difficult to stimulate the sluggish economy, which led to years of recurring budget deficits.

Historically, Puerto Rico decided to use some one-time funding sources, including additional debt issuance, to obtain the cash needed to pay its expenses. Many of these options are no longer available, and Puerto Rico continues to explore options that are not likely to provide a long-term solution. Using debt and other one-time revenue sources to fund operating deficits eventually becomes unmanageable, especially in a weak economy.

Puerto Rico’s net tax-supported debt totals roughly $52 billion, or $14,480 per capita. The median net tax-supported debt per capita for the 50 states is just over $1,000, according to Moody’s. If all debt issued by Puerto Rican public agencies is included, the total grows to roughly $70 billion, or over $19,000 per capita. With the budget challenges faced by Puerto Rico, especially following the hurricanes of 2017, the island’s debt load is unsustainable, in our view, and is likely to face significant cuts.

Audited financial statements for the 2015 fiscal year have yet to be released. The lack of transparency makes it hard to fully understand the extent of Puerto Rico’s financial distress.

Even With Drastic Changes, Uncertainty Remains High

Puerto Rico voters elected Ricardo Rosselló Nevaレス as their new governor, who took office in January 2017. Rosselló is a member of the New Progressive Party, which is the party that favors statehood and is the opposing party of the previous governor. The new governor has made comments and taken some actions that are more favorable to bondholders; however, the federal oversight board will ultimately drive where Puerto Rico’s restructuring goes from here.

The federal government passed the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA) in 2016. We expect PROMESA to help Puerto Rico’s restructuring process be more orderly by, for example, preventing multiple lawsuits from being filed against Puerto Rico following bond payment defaults. However, we do not expect PROMESA to prevent additional defaults or an eventual restructuring of Puerto Rico’s debt. Furthermore, we believe it’s too early to know what the ultimate outcome of negotiations and the restructuring process will be. Some possibilities include principal and interest payments being lowered, payments being delayed, maturities being extended, or bonds being exchanged with newly structured bonds, among many other possibilities. We expect negotiations to take place over many months, to include many creditors and stakeholders, and to face legal challenges.

The federal oversight board approved a 10-year fiscal plan that outlined average payments of less than 25% of the debt service due every year through 2026. However, we expect the fiscal plan to be revised following the devastation of the hurricanes, and the
revised plan is likely to include worse bondholder losses than had previously been projected.

We will continue to monitor discussions in Washington, D.C., regarding any support the federal government may offer to Puerto Rico. Some of the assumptions being made in restructuring negotiations highly depend on certain actions being taken at the federal level and could drastically change the outcome.

**Market Access and External Cash Sources Needed**

After many years of financial results showing the island’s increased dependence on issuing debt and drawing on reserves to pay for annual expenses, and with significant redevelopment needs following the devastation caused by the 2017 hurricanes, we believe it’s important for Puerto Rico to have the ability to access the bond market and other sources of cash to maintain and improve its credit profile. However, after multiple credit-rating agency downgrades, recurring defaults and other unfavorable market conditions, Puerto Rico has very limited access to the bond market, which limits financial flexibility. Puerto Rico reserves are also critically weak.

With insufficient reserves, an inability to issue debt, and very limited budget flexibility, access to external resources, such as federal government support, has become increasingly important. However, it remains highly uncertain how many additional resources Puerto Rico will receive, what those resources will be, and if those resources will be used in a way that sufficiently repairs essential services and restores Puerto Rico’s economic prospects. We expect recovery to take years.

**Puerto Rico Bond Issues**

The commonwealth has various vehicles through which it issues debt. Bonds issued by these vehicles are rated differently based on their security and legal structure. We believe the island’s deteriorating credit profile affects all of the following bonds regardless of their security features. A brief discussion on some of the various issuers follows:

**Puerto Rico General Obligation (GO) Bonds.** The commonwealth of Puerto Rico’s GO bonds are backed by the good faith, credit and taxing power of the commonwealth. GOs are further secured by a “clawback provision” which gives these bonds a first claim on all available commonwealth revenues. The clawback provision allows the commonwealth to pay its GO debt before any expense, including most other bonds. This feature makes the GO bonds attractive to many investors, relative to other debt of the commonwealth. However, the strength of GO bond security relative to other types of debt (mainly COFINA bonds) will be a key debate in the island’s restructuring negotiations.

**Puerto Rico Highways and Transportation Authority (HTA) Bonds.** The Puerto Rico HTA is responsible for building, operating and maintaining the commonwealth’s toll-road system, highways and transportation facilities. The pledged security for different types of debt issued by HTA is different depending on the use of proceeds but generally include motor vehicle license fees, gasoline and diesel taxes, and toll revenues. The clawback provision of the general obligation bonds has negatively impacted HTA bonds, and will likely continue to do so going forward.

**Puerto Rico Electric Power Authority (PREPA) Bonds.** PREPA is the sole power provider to the commonwealth of Puerto Rico. Bonds issued by PREPA are secured by the net revenues of the system. The system’s revenues are not subject to the clawback provision. However, we believe PREPA is tied to and can be materially impacted by the weakening credit profile of the commonwealth. Puerto Rico has actively been working on restructuring PREPA’s debt, which we expect to negatively impact bondholders.

**Puerto Rico Convention Center District Authority (CCDA) Bonds.** The Convention Center District Authority was created to develop and operate the convention center located in San Juan. CCDA bonds are secured by a gross pledge of hotel occupancy taxes levied on all hotels on the island. The pledge is subject to the general obligation clawback provision, which we expect to negatively impact bondholders.

**Puerto Rico Infrastructure Financing Authority (PRIFA) Bonds.** The Infrastructure Financing Authority was created to provide financial assistance to municipalities and governmental agencies in need of repairing, maintaining or constructing an infrastructure project. PRIFA bonds are secured by a pledge of federal excise taxes on rum and goods produced in Puerto Rico and sold in the U.S. PRIFA bonds are often referred to as “rum bonds.” The federal excise taxes are subject to the clawback provision, which we expect to negatively impact bondholders.

**Puerto Rico Sales Tax Financing Corporation (COFINA).** The Puerto Rico Sales Tax Financing Corporation, also known as its Spanish acronym COFINA, was created in 2006. The bonds issued by COFINA are secured by a pledge of a portion of the island’s sales tax. One of the strengths of COFINA bonds is that the revenue pledge is not subject to the commonwealth’s clawback for GO bonds, though the strength of the pledge has become a key debate in the island’s restructuring process.

**Edward Jones Credit Strength Assessment**

We believe Puerto Rico’s credit strength assessment is low. Although the territory benefits from its relation to the U.S., Puerto Rico faces the challenges of very high debt and unfunded pension obligations, a weak economy, chronic budget deficits, and poor financial reporting. Furthermore, Puerto Rico has already defaulted on many types of bonds and is highly likely to restructure its debt obligations, which we expect to negatively impact bondholders.
**Required Research Disclosures**

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<td>Appropriate for Income – We consider bonds to be an appropriate holding for investors seeking income within a well-diversified portfolio. Our time horizon is 3-5 years.</td>
<td>Appropriate for Aggressive Income – We consider bonds appropriate only as a small Aggressive Income portion within a well-diversified portfolio. Bonds within this category are riskier, with a higher possibility of loss due to default, than bonds classified as Income. Our time horizon is 3-5 years.</td>
<td>Sell – We recommend investors sell these bonds. We believe these bonds are no longer an appropriate fixed-income holding because, in our opinion, they offer an unattractive risk/reward scenario at current prices. Our time horizon is 3-5 years.</td>
<td>FYI: For informational purposes only; factual, no opinion.</td>
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Initiated Coverage (SELL) 7/25/12

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