PUERTO RICO
Investment Category: Aggressive Income | Sector: Various

Municipality Overview
This opinion does not apply to these bonds:
- Puerto Rico Housing Finance Authority
- Prerefunded or escrowed-to-maturity bonds

Underlying Credit Ratings
Moody’s............................................. Ca/Negative
Fitch............................................. D/No Outlook
Standard & Poor’s Rating Was Discontinued
Moody’s ......................................... Ca/Negative

Financial Data
Debt Per Capita.................................. $14,480.0
Unemployment Rate.......................... 12.4%
Median U.S. State Debt Per Capita is $1,074.

U.S. Recommended Municipal Bond Sector Weightings

<table>
<thead>
<tr>
<th>Category</th>
<th>Weight (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>General Obligation</td>
<td>30% - 80%</td>
</tr>
<tr>
<td>Revenue Bond - Tax-Backed</td>
<td>5% - 20%</td>
</tr>
<tr>
<td>Revenue Bond - Utilities</td>
<td>10% - 20%</td>
</tr>
<tr>
<td>Revenue Bond - Transportation and Other</td>
<td>5% - 20%</td>
</tr>
<tr>
<td>Revenue Bond - Education</td>
<td>0% - 10%</td>
</tr>
<tr>
<td>Revenue Bond - Health Care</td>
<td>0% - 5%</td>
</tr>
<tr>
<td>Revenue Bond - Housing</td>
<td>0% - 10%</td>
</tr>
</tbody>
</table>

U.S. Recommended Bond Ladder

<table>
<thead>
<tr>
<th>Maturity</th>
<th>Weight (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Short-term (up to 5 years)</td>
<td>30% - 40%</td>
</tr>
<tr>
<td>Intermediate-term (6-15 years)</td>
<td>40% - 50%</td>
</tr>
<tr>
<td>Long-term (16+ years)</td>
<td>15% - 25%</td>
</tr>
</tbody>
</table>

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 lower and delayed payments, extended maturities, 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), ongoing negotiations, and/or court rulings. 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

10/23/2018: Puerto Rico's oversight board approved an updated fiscal plan, which outlines a $17 billion surplus before debt service through 2023, which is up from a $6.7 billion surplus reported in the fiscal plan approved in June. The fiscal plan also discloses that the surpluses do not represent anticipated future payments on restructured debt. The higher surpluses are driven by improved economic growth assumptions caused by the expectation of larger disaster-relief spending from public and private sources, including federal assistance. In our view, much of the improvement is short-term in nature. We also believe Puerto Rico's new fiscal plan is subject to a high level of uncertainty, and may vary significantly over time, as it has over the past year. The fiscal plan relies on uncertain levels of financial aid, full and successful implementation of certain fiscal and economic reforms, and demographic change assumptions, among other assumptions. According to the plan, even with the implementation of reform measures, the Puerto Rico economy is expected to begin contracting again by 2023, and deficits are expected to return by 2034. We expect the volatility of prices on Puerto Rico bonds to continue to be elevated, and we recommend clients sell Puerto Rico bonds.

8/10/2018: Puerto Rico’s oversight board released a notice that a potential agreement has been reached with the Puerto Rico government and COFINA bondholders to reduce COFINA debt by 32%. Reportedly, the proposal would allocate only a portion of total Puerto Rico sales taxes to newly structured COFINA bonds that would replace currently outstanding COFINA bonds, among many other aspects of the agreement. Although the information released provides additional transparency into ongoing negotiations, and certain bond prices reacted positively, we continue to believe the outcome could vary widely from this proposal. Negotiations are continuing on various details of the agreement, other stakeholders (including general obligation bondholders) could challenge the proposal, and the agreement is subject to court approval. We expect the volatility of prices on Puerto Rico bonds to continue to be elevated, and we recommend clients sell Puerto Rico bonds.

7/31/2018: A partial settlement with a portion of Puerto Rico Electric Authority (PREPA) bondholders was announced that outlined a possible restructuring of PREPA debt. The proposed restructuring would replace certain outstanding PREPA bonds with two new classes of bonds. One class would represent recovery of about 68 cents on the dollar, and the other would represent recovery of 10 cents on the dollar. The bonds would be backed by a "transition charge," which would be a demand-based revenue stream. While the proposal provides some transparency into Puerto Rico's debt-restructuring negotiations, the ultimate outcome could vary widely from this proposal. The settlement still requires court approval, and negotiations are continuing with some other creditors, including bond insurers. We expect the volatility of prices on Puerto Rico bonds to continue to be elevated, and we recommend clients sell Puerto Rico bonds.

4/20/2018: This week, the federal oversight board is certifying multiple updated restructuring plans for Puerto Rico. While the projected amount of money leftover before debt service has risen in some plans, ultimate recovery for the various types of Puerto Rico bonds remains highly uncertain. We believe the outcome is likely to vary widely from current projections as negotiations and court processes continue and the plans are implemented over time. We expected the volatility of prices on Puerto Rico bonds to continue to be elevated.

1/25/2018: Puerto Rico released an updated fiscal plan, which incorporates the impact of the hurricanes. New projections in the five-year fiscal plan show no money is expected to be available for debt payments. The Puerto Rico Electric Authority released a separate fiscal plan, but did not outline possibilities for outstanding debt. The Aqueduct and Sewer Authority's separate fiscal plan outlined potential 17%-47% recovery possibilities over the next five years. We expect the plans to change materially as negotiations and court challenges continue.

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., we believe Puerto Rico's economic prospects have grown increasingly uncertain following the major hurricanes of 2017. According to the island's fiscal plan, its economy has shrunk by 20% and labor participation has fallen to a record low of 38%. Furthermore, the plan assumes the economy contracted by another 8% in 2018, though growth is expected from 2019-2022. 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. We're concerned that the economic stimulus is short-term in nature, and a significant number of additional economic and fiscal reforms will be needed to ensure long-term economic growth is sufficient to support debt payments.

The size and impact of a potential demographic shift following the hurricanes also remain uncertain. According to the fiscal plan, Puerto Rico's population has been declining by 1%-2% every year but could have dropped by over 5% following the hurricanes to around 3.1 million people. An annual 1% decline is estimated for the coming years. With the challenges of a decade-long recession and increasingly uncertain job growth, Puerto Rico's out-migration trends are likely to remain weak. 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 Projected, Even After Changes

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. Using debt and other one-time revenue sources to fund operating deficits eventually becomes unmanageable, especially in a weak economy. 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. Even if all the fiscal and economic reforms are implemented as outlined in the island’s fiscal plan, deficits are expected to return by 2034, given the short-term nature of some funding sources. 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 2016 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’s governor, Ricardo Rosselló Nevares, 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, negotiations, and court rulings 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.

Before the hurricanes of 2017, 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, the fiscal plans have been revised multiple times since the original version was released, which we believe demonstrates the extreme uncertainty that remains for bondholders. The outcome could vary widely from current projections as negotiations and court processes continue and the plans are implemented over time. Furthermore, we expect different types of debt to be treated differently, and the differences could be significant.

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.

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.

Puerto Rico Bond Issues

The commonwealth has various vehicles through which it issues debt. Bonds issued by these vehicles are rated differently regardless of their security features. We believe the island’s very weak credit profile affects all of the following bonds.
Rico’s restructuring process is determining how each of these different types of debt are treated relative to one another, and the outcome of these debates is likely to drive bondholder recovery. 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 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 weak 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.

Valuation is based on our analysis of potential recovery in bankruptcy or restructuring.
Required Research Disclosures

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<tbody>
<tr>
<td>Appropriate for Income</td>
</tr>
<tr>
<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>
</tr>
</tbody>
</table>

Initiated Coverage (SELL) 7/25/12

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