New Issue: Puerto Rico (Commonwealth of)

MOODY'S ASSIGNS Baa3 RATING TO APPROXIMATELY $350 MILLION PUERTO RICO PUBLIC BUILDING AUTHORITY GOVERNMENT FACILITIES REVENUE REFUNDING BONDS, IN CONJUNCTION WITH REFUNDING AND CONVERSION FROM VARIABLE RATE TO FIXED RATE

OUTLOOK IS STABLE

Puerto Rico (Commonwealth of)
State
PR

Moody's Rating

ISSUE		RATING
Government Facilities Revenue Refunding Bonds, Series K		Baa3
Sale Amount	$347,065,000	
Expected Sale Date	05/11/04	
Rating Description	General Obligation	
Government Facilities Revenue Refunding Bonds, Series P		Baa3
Sale Amount	$350,000,000	
Expected Sale Date	07/01/09	
Rating Description	General Obligation	

Opinion

NEW YORK, Jun 24, 2009 -- Moody's Investors Service has assigned a long-term rating of Baa3 to approximately $326.25 million Puerto Rico Public Building Authority (PBA) Government Facilities Revenue Refunding Bonds, Series P. In addition, Moody's affirms the Baa3 rating on the Government Facilities Revenue Refunding Bonds, Series K Term Bonds due July 1, 2027, which are being converted from variable to fixed rate. The Series P and converting Series K bonds are scheduled to sell and to be remarketed, respectively, on June 25 and to close on July 1. The full faith and credit of the commonwealth, like with general obligation bonds, are pledged for such payments. As a result, the bonds are rated the same as the commonwealth's general obligation bonds.

Puerto Rico's Baa3 debt rating and stable outlook reflect the commonwealth's recessionary environment, challenging budgetary and financial situation, and the plans put in place by the administration to deal with the budgetary gaps and economic challenges.

Strengths:

* Politically and economically linked to the U.S., with benefit of the nation's strong financial, legal, and regulatory systems.

* Large economy, with gross product exceeding those of 10 states and population exceeding those of 24 states.

* Wide legal powers to raise revenues, adjust spending programs, and employ borrowing in order to maintain fiscal solvency.

* Strong management dedication to tax and fiscal reform, including strengthening the commonwealth's general obligation and other credits.

Challenges:

* High unemployment, low workforce participation, and high poverty levels compared to the U.S. Average income levels remain below 50% relative to the U.S. mainland median.

* Large size of commonwealth government relative to the economy reduces practical flexibility on fiscal issues.

* Multi-year trend of large General Fund operating deficits, primarily due to overspending, and financed by deficit borrowing.

* Very high government debt level relative to the economy, due in part to financing budget deficits.

* Low pension funding ratios relative to U.S. states.

* Local economy that has been in recession since 2006.

FLOATING RATE AND SWAP EXPOSURE REDUCED

In May, 2004, the PBA issued Government Facilities Revenue Refunding Bonds, Series K, in the original aggregate principal amount of almost $350 million as mandatory tender bonds, with a tender date of July 1, 2007. These bonds were remarketed as mandatory tender bonds in 2007 with a tender date of July 1, 2009; interest was in a variable rate mode. At this time, the PBA has decided to refund two portions of the Series K bonds, one of which was uninsured and one of which was insured by MBIA. The refunding bonds (the Series P bonds) will be fixed rate. A third portion, in the amount of $50 million and insured by FSA, is being converted to fixed rate mode. The two swaps outstanding on the bonds will be terminated and the termination fee of approximately $21 million will be paid with proceeds of the refunding.

SECURITY FOR THE BONDS

The security for the bonds is the rentals of government facilities financed or refinanced by parity bonds and leased by the authority to departments, agencies, and municipalities of the commonwealth. The bonds are further secured by the guarantee of the commonwealth, under which the commonwealth pledges to draw from any funds available in the Treasury such sums as may be necessary to cover any deficiency in the amount required for principal and interest payments on the bonds. The full faith and credit of the commonwealth, like with general obligation bonds, are pledged for such payments. As a result, the bonds are rated the same as the commonwealth's general obligation bonds.

NEW LAWS AIMED AT ACHIEVING FISCAL BALANCE

Governor Luis Fortuno, who ran on a platform of expenditure reduction, won the election in 2008 with 52.8% of the popular vote. This support translated into the passage of seven pieces of legislation in the first three months of the newly elected governor's term, evidencing a change in Puerto Rico's willingness to make structural changes in its operations meant to lead to an improvement in financial position. The newly adopted laws establish a state of fiscal emergency in Puerto Rico due, in large part, to the decline in revenues, projected rise in expenditures, and expected gap of $3.2 billion in fiscal 2009 and each subsequent year during the forecast period. The plan being implemented is designed to eliminate gaps and to attain structural balance by fiscal year 2013.

Most significantly, one of the new laws permits the reduction of workforce to save the island a total of $2 billion annually. The new laws also provide for some permanent and other temporary revenue enhancements estimated to be worth approximately $1.2 billion per year to the commonwealth as soon as they are fully implemented. Through two different measures, the government has dedicated an additional 1 3/4 cents of the existing sales and use tax to support sales tax revenue bond issues (called COFINA bonds due to the Spanish acronym for the Puerto Rico Sales Tax Financing Corporation) that will repay some debt, help to ease the deficit, and fund local fiscal stimulus (one cent of the existing sales and use tax was already leveraged in this manner).

EMPLOYMENT REDUCTIONS PLANNED

Expenditure reductions were initiated by the governor in his first executive order whereby he ordered a 10% reduction in government expenses, a hiring freeze and the reduction of 30% of trust (non civil service) personnel. The government then offered voluntary retirement to government workers. The administration asserts that these measures plus further workforce reductions will result in $2 billion in annual savings. The administration has announced it is committed to completing the implementation of most of this headcount reduction plan by January 1, 2010.

NEW TAXES TO RAISE REVENUES

The bills contain a multitude of revenue raising measures, some permanent and some temporary. Tax revenue collections are down, and these measures attempt to increase revenues to the commonwealth. The permanent revenue increases include an alternate base tax to be imposed on certain items of exempt income, repeal of the credit against sales and use tax for purchases of products manufactured in Puerto Rico for export, an increase of the cigarette tax by $1.00 per pack, addition of motorcycles to that class of vehicles on which an excise tax is charged, replacement of the exemption certificate for resellers with a credit for taxes paid, and an increase in excise taxes on alcoholic beverages.

The temporary measures include a modification to the alternative minimum tax on corporations to limit deductions for expenses incurred outside Puerto Rico for taxable years beginning after December 31, 2008 and before January 1, 2012; also for tax years beginning after December 31, 2008 and before January 1, 2012, a 5% surcharge on corporations and individuals whose adjusted gross income exceeds $100,000 or $150,000 for married persons filing joint returns, a special income tax of 5% on Insurance Credit Unions whose net income exceeds $250,000, a special income tax of 5% on Savings and Loan Credit Unions whose net income exceeds $250,000, a special income tax of 5% on every international banking entity on its net income for the taxable year (but only to the extent such income has not been subject to income tax as "excess income" under the International Banking Center Regulatory Act); for fiscal years 2009-10, 2010-11, 2011-12 and 2012-13, a special tax on all residential real estate in an amount equal to the property tax; and a three-year (2009, 2010 and 2011) moratorium on certain tax credits related to all but those under the Tourism, Film Industry and Economic Incentives Acts.

ADDITIONAL DEFICIT FINANCING

Puerto Rico is already highly leveraged and has begun to issue considerably more debt to strengthen the Government Development Bank's balance sheet, fund a local stimulus package, and pay for operations. The commonwealth intends to use these funds to bridge operations while it restructures the size and cost of its government and increases its recurring revenues. We will monitor the implementation of corrective actions to ensure that our rating appropriately reflects improvement in the commonwealth's financial position over the next few years. The commonwealth has issued bonds backed by a dedicated portion of the existing sales and use tax. A portion of the proceeds will be used to fund operational deficits.

FEDERAL AND LOCAL STIMULUS BILLS WILL PROVIDE SOME RELIEF

Puerto Rico estimates it will receive approximately $5 billion in federal stimulus aid. Of this, approximately $187 million in additional Medicaid funding is available to be used to close the budget deficit, and a small portion (approximately $100 million) of education aid may also be used for gap-closing purposes. In addition, the commonwealth created the Puerto Rico Economic Stimulus Plan Act in an attempt to promote economic growth on the island. The local stimulus program is worth approximately $500 million, as estimated by the commonwealth, and is expected to be funded with proceeds from sales tax revenue bonds. It contains mortgage relief, a stimulus for home purchases, loans for small and medium businesses, and workforce retraining.

GAAP DEFICITS HIGH; FISCAL 2008 CAFR NOT YET RELEASED

The consolidated annual financial report for fiscal year 2007 reports a GAAP-basis General Fund balance of negative $511 million, compared to negative $384 million for fiscal 2006. The General Fund showed an operating deficit (revenues minus expenditures) of $872 million, compared to an operating deficit of $740 million in the previous year.

FISCAL 2008 REVENUES AND EXPENDITURES BOTH BELOW BUDGET

Fiscal 2008 expenditures for the commonwealth were slightly below budgeted amounts, at $9.05 billion (preliminary estimates) compared to a budgeted $9.23 billion. Revenues were well below budgeted amounts; collections were reported at $8.2 billion, almost $800 million below budgeted revenues of $9 billion. The gap was closed with one-time measures including: Federal funds recovery ($287 million); debt service reduction through refinancings ($100 million); cash management measures including holding back payments to vendors ($300 million); and the sale of government properties ($150 million). Revenues were approximately $600 million, or 7%, below 2007 levels.

ECONOMY REMAINS A WEAKNESS

The commonwealth is currently in a recession, and has been since March 2006. The risks associated with the economy are heightened by the national slowdown. The housing market has been sluggish in the commonwealth for the past three years, with housing permits, number of new dwelling units, and the value of new dwelling units all showing declines in recent years. It appears, however, that the poor performance of the housing market in the commonwealth is a result of the general economic weakness of the commonwealth, and is not connected to the housing downturn caused by the sub-prime mortgage crisis in the U.S. Downside risks to the economy exist once the commonwealth reduces government employment. The commonwealth is attempting to mitigate this risk by funding a local stimulus program (funded with sales tax revenue bond proceeds).

DEBT CONTINUES TO BE HIGH

Debt ratios for the commonwealth are very high, with net tax-supported debt at over $8,000 per capita and more than 63% of personal income. Debt measures are expected to increase as the commonwealth has begun to issue debt backed by sales tax revenues to fund operating deficits.

Pension funding ratios are low relative to U.S. states, even considering the commonwealth's issuance of pension funding bonds in 2008.

MOST RECENT RATING ACTION AND PRINCIPAL METHODOLOGY

The last rating action with respect to the Commonwealth of Puerto Rico was on September 3, 2008, when the rating of Baa3 with a stable outlook was assigned to the Commonwealth of Puerto Rico Public Improvement Bonds of 2008, Series A (General Obligation Bonds).

The principal methodology used for this rating action was "State Rating Methodology", which can be found at www.moodys.com in the Credit Policy & Methodologies directory, in the Ratings Methodologies subdirectory. Other methodologies and factors that may have been considered in the process of rating this issue can also be found in the Credit Policy & Methodologies directory.

Outlook

The rating outlook for the commonwealth is stable at this time, reflecting the enactment of numerous measures to steadily bring the commonwealth to fiscal stability.

What could move the rating--UP

--Strong rebound in economic growth leading to improved revenue results.

--Spending controls that lead to long-term improved budgetary results and outlook

--Significant improvement in the condition of the commonwealth's pension system, including greater recurring budgetary contributions.

--Reversal of General Fund's deficit position.

What could move the rating--DOWN

--Growth in structural budget gap and an increase in GAAP deficits.

--Prolonged recession, resulting in declining revenues and deficit financing in excess of currently projected amounts.

--Increase in structural imbalance.

--Lack of market access.

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