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Fitch Rates Puerto Rico's $7.5B Subordinate Lien Sales Tax Revs 'A'

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NEW YORK--(BUSINESS WIRE)--Fitch Ratings has assigned a program rating of 'A' to approximately $7.5 billion of Puerto Rico Sales Tax Financing Corporation (COFINA) sales tax revenue bonds, first subordinate series 2009A and 2009B. The 2009A and 2009B bonds are expected to sell the week of June 8, 2009 through negotiation. This is the first offering of subordinate lien sales tax revenue bonds by the corporation, an independent governmental instrumentality of the commonwealth and affiliate of the Government Development Bank of Puerto Rico (GDB). Fitch also affirms at 'A+' and removes from Rating Watch Negative COFINA's $5.2 billion of outstanding senior lien bonds. The Rating Outlook for both the senior and subordinate lien bonds is Stable.

The ratings on the senior and subordinate lien bonds reflect a structure and revenue pledge that result in a much stronger credit than the Commonwealth of Puerto Rico's (the commonwealth) strained general obligation (GO) credit. Bonds have a first claim on all commonwealth sales tax revenues, providing strong current coverage. The legal opinions are strong, finding that neither the commonwealth general fund nor commonwealth GO bondholders have a claim on pledged sales tax revenues. Recent enhancements to the bond resolution, in particular a strengthening of non-impairment language, provide some additional protection to bondholders. The sales tax base is broad and the retail environment in Puerto Rico has shown strength even in challenging economic times. Offsetting these credit strengths is the very long final maturity of both the senior and subordinate lien bonds and the program's rising debt service profile, which requires some growth in revenues to achieve coverage of later maturities. Additional risks include the commonwealth's strained fiscal and economic environment.

The bonds are secured by a portion of the commonwealth's island-wide sales and use tax, which became effective on Nov. 15, 2006. This broad-based tax was instituted as part of Puerto Rico's 2006 tax and fiscal reform and its use is being restructured as part of a comprehensive fiscal and economic package designed to stimulate Puerto Rico's economy and address recurring budget deficits. The tax is currently levied at the rate of 5.5%, with a 1.5% additional municipal option. As originally structured, the commonwealth's general fund received 4.5% of the 5.5% sales tax with the remaining 1% dedicated to debt service on the senior lien bonds, which were used to retire extraconstitutional (i.e., appropriation) debt of the commonwealth. As noted in the original analysis of the structure, a key credit feature supporting the 'A+' rating on the senior lien bonds is that the pledge for the senior lien sales tax revenue bonds is the greater of collections from the 1% or a base (minimum) amount payable from all commonwealth sales tax revenues each year. Since debt service in any year is capped at the applicable base amount, debt service on senior lien bonds will be covered by pledged revenues as long as collections from the entire commonwealth sales tax, rather than just the 1%, are sufficient to fund the base amount.

Legislation was passed in early 2009 amending the governing resolution and authorizing COFINA to issue subordinate lien bonds secured by an additional 1.75% of the 5.5% sales tax. The base amount, which was originally $185 million in fiscal 2008, rising 4% per year thereafter, has been increased to $550 million, also rising 4% per year thereafter up to a maximum of $1.85 billion. The 'A' rating on the subordinate lien bonds incorporates coverage by the full 5.5% due to the strong flow of funds. At the start of each fiscal year, revenues from the entire commonwealth sales tax flow directly from Banco Popular de Puerto Rico to the trustee until revenues deposited with the trustee in that year equal the base amount. Only thereafter does the general fund receive its share of collections.

Coverage of annual debt service from current revenues is ample; however, debt service escalates fairly rapidly. Sales tax revenues would have to grow just 0.38% annually to assure 1.0 times (x) coverage of senior lien debt service throughout the life of the bonds and approximately 1.6% annually to assure 1.0x coverage of senior and subordinate lien debt service throughout the life of the bonds by the entire 5.5% tax. Even with escalating debt service and the long final maturity of the bonds, achieving this relatively low level of growth in tax revenues appears reasonable.

The 2009 legislation also strengthened non-impairment language, making it more difficult for the commonwealth to eliminate or divert the sales tax in the future. This is positive for bondholders given that the former Governor of Puerto Rico proposed suspending collection of 4.5% of the 5.5% sales tax in February 2008, shortly after the senior lien bonds were issued. Fitch placed the rating on the senior lien bonds on Negative Watch at that time. The former Governor's proposal was not implemented. The revised resolution includes language specifying that only the non-pledged portion of the sales tax may be lowered or abolished and only if it is replaced with a 'like or comparable security'. To do so, the trustee must be provided written ratings confirmation and written opinions from the Secretary of Justice, bond counsel, and other experts concluding that the Puerto Rico Supreme Court would conclude that the substituted assets/revenues have been validly imposed by law, validly transferred to COFINA, and do not constitute available resources of the commonwealth subject to the clawback provisions for GO debt in the constitution.

Bond proceeds provide deficit financing for fiscal years 2009 and 2010 until the commonwealth's fiscal restructuring plan is fully implemented and new revenues and expenditure reductions bring the budget into balance. Bond proceeds will also be used to repay outstanding extra-constitutional debt of the commonwealth, lessening the burden going forward on the general fund, and will support the commonwealth's efforts to stimulate the local economy.

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