MOODY'S
INVESTORS SERVICE

Rating Update: Moody's affirms Puerto Rico general obligation bonds at Baa3; affirms notched and related debt as well

Global Credit Research - 03 Oct 2013

Approximately $39 billion of debt affected; outlook is negative

PUERTO RICO (COMMONWEALTH OF)
State Governments (including Puerto Rico and US Territories)
PR

Opinion

NEW YORK, October 03, 2013 --Moody's Investors Service has affirmed the general obligation rating of the Commonwealth of Puerto Rico at Baa3. Ratings that are based on or capped at the G.O. rating of the commonwealth (see list later in the report) were also affirmed. The outlook is negative. Moody's also downgraded to A2 the Puerto Rico Sales Tax Financing Corporation's (COFINA) outstanding senior sales tax revenue bonds and affirmed the A3 on COFINA's outstanding subordinate sales tax revenue bonds. The outlook for both COFINA liens has changed to negative from stable.

SUMMARY RATING RATIONALE

While Puerto Rico's economy remains weak, the commonwealth's recent fiscal measures have been significant. The affirmation of Baa3/negative reflects the following primary rating drivers:

-The administration passed a projected $2.5 billion in new revenue initiatives, or 25% of budget, in the past 6 months, including rate increases and new revenues for two of its struggling authorities aimed at stabilizing the commonwealth's fiscal situation.

- The legislature passed major pension reform for the Employees Retirement System (ERS) targeting cash-flow sufficiency, but has not yet passed reform for the Teachers Retirement System (TRS).

- The economy is weak and continues to struggle. Economic growth prospects are nascent after seven years of recession and could be further dampened by large revenue increases which were needed to address the commonwealth's fiscal crisis. Declining population also creates headwinds for economic recovery, though some negative indicators have been amplified by artificially elevated results in 2012, an election year.

-Reduced liquidity and increased refinancing risk, as the commonwealth substitutes short-term financings for planned long-term financings as it waits out volatile market conditions.

-Debt levels are very high and continue to grow.

-Financial performance has been weak, including large structural budget gaps that have led to a persistent reliance on deficit financings and serial debt restructurings to support operations in recent years.

CREDIT STRENGTHS

- Politically and economically linked to the US, with benefit of the nation's strong financial, legal, and regulatory systems

- Large economy, with gross product exceeding that of 15 states and population exceeding that of 22 states

- Broad legal powers to raise revenues, adjust spending programs, and employ borrowing in order to maintain fiscal solvency

- Constitutional first priority lien on revenues of the commonwealth for general obligation and commonwealth-guaranteed debt

CREDIT CHALLENGES

- Very large unfunded pension liability relative to revenues; major reforms to one of two main plans helped restructure cash flow pressure, but outstanding liability remains and reforms to second plan have not yet been announced

- Very high and growing government debt relative to the size of the economy, due in part to financing budget deficits

- High unemployment, low workforce participation, and high poverty levels compared to the US; average income levels remain well below 50% relative to the US mainland median

- Declining population

- Large size of commonwealth government relative to the economy

- Multi-year trend of large General Fund operating deficits, financed by deficit borrowing

- Local economy that has been in recession since 2006

- High dependence on capital markets financing during period of increased risk of reduced market access

DETAILED CREDIT DISCUSSION

SEVERAL NEW REVENUE INITIATIVES PASSED FOR FISCAL 2014

The new administration passed several revenue initiatives aimed at stabilizing the commonwealth's finances, including an increase and extension to the temporary corporate excise tax under Act 154. Other revenue initiatives include adjustments to the alternative minimum tax calculation, a new tax on gross sales of businesses and higher corporate income tax rates. The commonwealth passed almost a dozen other measures in the adopted budget, expected to generate $300 million in revenue, including a reduction in tax credits, a 1% tax on insurance underwriting premiums and an increase in excise taxes on cigarettes.

The commonwealth also raised water rates at the Puerto Rico Aqueduct and Sewer Authority (PRASA) for the first time since 2006. This rate increase is projected to result in $340 million annually, relieving pressure on the general fund to support this struggling authority. The commonwealth also passed laws to increase revenue to the Puerto Rico Highway and Transportation Authority with $270 million annually projected from licensing fees, gas taxes (including automatic inflation adjustments) and cigarette taxes. Again, these revenues will help relieve pressure on the commonwealth and the GDB to support PRHTA.

The additional recurring revenue will help address the commonwealth's ongoing structural imbalance and improve both the sustainability and stability of the commonwealth's finances. The implementation of the new taxes, however, carries significant risks, particularly when the amount to be raised is large as a percentage of the total budget. Altogether, the new revenue initiatives represent over $2.5 billion of new revenues. Though not all will flow to the general fund, the amount represents over 25% of the general fund budget, a very large number.

The package of new taxes and revenue initiatives could further dampen the already weak economy. Actual collections could also fail to meet projections. Moreover, an economic forecast of 0.2% growth underpins these revenue projections and we expect this number to be revised downward. Since the commonwealth has little room for cost cutting and the current administration has indicated no interest in reducing government employment through forced firings (although it has expressed willingness to reduce employment through attrition and incentivized retirement measures), if the new revenues do not meet forecasts, a mid-year budgetary shortfall could emerge in fiscal 2014.

MAJOR PENSION REFORMS ENACTED FOR EMPLOYEES RETIREMENT SYSTEM (ERS)

On April 4, the commonwealth enacted Act 3, which has several components designed to reduce pressure on ERS cash flows and allow the commonwealth to meet reduced ERS obligations in the near term. The new law includes multiple components which act together to stabilize the system.

The Act freezes ERS's current defined benefit plans and moves all participants to a new hybrid plan where future benefits depend solely on employees' contributions plus a return on investment. Current employees retain benefits accumulated prior to the reform. The act also increases the retirement age for all employees (except certain high risk employees) and increases required employee contributions from 8.275% to a minimum of 10%.

The new law no longer permits participants in ERS's existing hybrid plan, known as System 2000, to take lump-sum payments upon retirement. Accrued balances will be annuitized, decreasing the cash demands from lump-sum payments that otherwise would likely have occurred during the same period as significant debt service requirements from previously issued pension obligation bonds. The new law further reduces a number of special benefits, such as seasonal bonuses for current retirees, and eliminates these bonuses for future retirees. Disability benefits from the system will be replaced with mandatory disability insurance, and certain survivor and death benefits will be modified or eliminated.

The ERS reform plan also assumes an estimated $140 million annual incremental contribution from the general fund for the next 20 years (1.4% of general fund expenses for fiscal year 2014), enacted by Act 32 of 2013, in addition to previously scheduled increases. The commonwealth projects that the combined impact of these measures will allow the retirement system to maintain total assets above the $1 billion level in all years and meet the revised future obligations.

The actuarial unfunded ratio will remain low for a long time as assets are not expected to begin to accumulate for another 25 years. The reported UAAL was $23.7 billion in fiscal 2011 for the ERS and $9.1 billion for the TRS. Based on our calculations, the combined adjusted net pension liability was $36.6 billion, or 234% of the commonwealth's fiscal 2012 all governmental fund revenues. Together with net tax-supported debt of $53 billion, the Commonwealth's combined debt and adjusted pension liabilities are roughly $90 billion, or more than 10 times general fund revenues in fiscal year 2012.

Additional reforms to the Teachers Retirement System are expected this year.

ECONOMY STILL WEAK WITH ONLY NASCENT GROWTH DRIVERS

Until the mid-2000s, Puerto Rico's economic growth direction tended to mirror that of the US. In 2006, however, Puerto Rico entered recession when the rest of the US was still in full expansion mode. Since then, the commonwealth has remained in recession. Some economic indicators, such as retail, auto and cement sales and the Government Development Bank for Puerto Rico's Economic Activity Index (GDB-EAI), were positive for part of 2012 due to elevated election-related spending and hiring, but not sustained. Since then, the GDB-EAI has trended negative, pointing to a likely revision downward of original estimates of 0.2% economic growth for fiscal 2014.

Moreover, the commonwealth's economy is looking to nascent growth drivers as its manufacturing sector, and private sector employment overall, continue to see employment reductions. New emphases on medical devices - a natural offshoot from strengths in pharmaceutical production - and "under the flag" operations in aerospace and military apparel will see growth in the near term. Population, however, declined by 3% from 2005 to 2011 and slight declines are expected to continue. At the end of fiscal 2013, unemployment remained stubbornly high at 13.4% versus a US average of 7.6%. Tourism has been a relatively good performer, but it remains relatively small and is susceptible to weakness in the larger US economy. Puerto Rico has also suffered in particular due to weakness in its key pharmaceutical sector. From 2005 to 2010, this sector lost over 29% of its jobs.

WEAK REVENUE PERFORMANCE IN FISCAL 2013 LED TO WIDE BUDGET GAPS AND MORE DEFICIT FINANCING

The commonwealth's general fund revenues materially underperformed in fiscal 2013. Weak general fund revenues, in conjunction with higher than estimated expenses, opened a large mid-year budgetary gap and increased the estimated fiscal 2013 structural imbalance from $1.1 billion to almost $2.2 billion, or 22% of the revised budget. The adopted budget had already incorporated using $333 million from proceeds of the issuance of Puerto Rico Sales Tax Financing Corporation (COFINA) bonds backed by the commonwealth's sales taxes, and assumed $775 million of debt service restructuring. The commonwealth filled the remaining gap in part with a variety of one-time measures, including release of certain excess swap collateral reserves, certain accelerated corporate royalty payment revenue, a tax amnesty program, the aggressive pursuit of delinquent tax payers and reining in spending.

Despite these measures, year-end general fund revenues of $7.8 billion were 11% below estimates and were also down 11% from fiscal 2012 revenues of $8.7 billion. The shortfall was a result of sluggish economic growth and overly aggressive revenue projections coupled with a statutory rate decline in the Act 154 excise tax.

VOLATILE MARKET CONDITIONS HAVE REDUCED FINANCIAL FLEXIBILITY

Sharply higher credit spreads have caused the commonwealth to scale back on planned long-term financings in

fiscal 2014 and instead rely on short-term financings for liquidity as it waits for more favorable market conditions. This has reduced their financial flexibility, though lending from private sector banks continues. In the past 2 months, the commonwealth has issued $1.125 billion in TRANs and expects to issue another $75 million in TRANs by the end of October.

The commonwealth reported that general fund revenues are currently slightly ahead of initial projections for July and August, the first two months of the fiscal year, though down slightly from fiscal 2013 collections reflecting the transition period for some new revenue sources to take effect. However, the commonwealth had planned $820 million of deficit financing and debt service restructuring for fiscal 2014, and that amount could increase if projections fall short. While net liquidity at the GDB was over $3 billion at the end of fiscal 2012, that amount has narrowed significantly due to continuing loans to the Commonwealth and other authorities and the inability to refinance certain lines in the long-term market. If the Commonwealth faces extended difficulties accessing the long-term market, its overall liquidity position could become severely strained. The GDB reports that the commonwealth's agencies, public corporations and municipalities maintain approximately $2.8 billion at private banking institutions, a portion of which could be moved to the GDB on short notice.

The commonwealth has, however, been able to take advantage of the low interest rate environment the past several years and proactively refinanced its debt lowering overall interest costs. The commonwealth currently has over $70 billion of public debt outstanding and over $53 billion in net tax-supported debt outstanding. While rising rates will increase the commonwealth's overall cost of funds, it is unlikely to represent a significant increase over the current cost of funds.

DEBT LEVELS ARE HIGH AND CONTINUE TO RISE

As reported in our 2013 State Debt Medians Report (published in May 2013), debt ratios for the commonwealth are very high, with net tax-supported debt at over $14,000 per capita and approximately 89% of personal income, significantly higher than any US state, and also reflective of the relatively low per capita incomes in the commonwealth. Net tax-supported debt as of December 31, 2012 was $53 billion. While residents of Puerto Rico do not pay most federal taxes and therefore do not carry the burden of US federal debt, debt measures are also relatively high for similarly rated sovereigns and regional governments outside the US.

ACTION AFFECTS MULTIPLE CREDITS

The affirmation and negative outlook affects general obligation bonds of the commonwealth, and also affects bonds whose ratings are determined by or linked to that of the commonwealth. Affected credits are listed below.

AFFIRMED AT Baa3

--General obligation bonds

--Pension funding bonds

--Puerto Rico Infrastructure Finance Authority (PRIFA) Special Tax Revenue Bonds

--Convention Center District Authority Hotel Occupancy Tax Revenue Bonds

--Government Development Bank (GDB) Senior Notes

--Municipal Finance Authority (MFA) Bonds

--Puerto Rico Highway and Transportation Authority (PRHTA) Transportation Revenue Bonds

--Puerto Rico Aqueduct and Sewer Authority (PRASA) Commonwealth Guaranteed Bonds

AFFIRMED AT Baa2

--Puerto Rico Highway and Transportation Authority (PRHTA) Highway Revenue Bonds

AFFIRMED AT Ba1

--Puerto Rico Public Finance Corporation (PRPFC) Commonwealth Appropriation Bonds

--Puerto Rico Aqueduct and Sewer Authority (PRASA) Revenue Bonds

--Puerto Rico Highway and Transportation Authority (PRHTA) Subordinate Transportation Revenue Bonds

Outlook

The rating outlook is negative, reflecting the stress the commonwealth will face in the near term as new revenue and economic development initiatives ramp up and US growth remains low. The outlook also incorporates continuing demands on liquidity, increased refinancing risk and continued reliance on deficit financing to fund budget.

WHAT COULD MAKE THE RATING GO UP

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

--Spending controls and/or revenue increases that lead to long-term improved budgetary results and outlook.

--Reversal of General Fund's deficit position.

WHAT COULD MAKE THE RATING GO DOWN

--Lack of liquidity

--Lack of market access

--Indication that total fixed costs, including pension contributions and debt service on bonded debt, have become unsustainable or unaffordable.

--Steep growth in structural budget gap and an increase in GAAP deficits, solved with non-recurring solutions.

--Further recession, resulting in declining revenues, deficit financing and continued out-migration

--Inability to curtail increase in debt experienced in recent years.

The principal methodology used in rating the bonds discussed in this report was the US States Rating Methodology published in April 2013. The additional methodology used in rating the Government Development Bank for Puerto Rico was Rating Transactions Based on the Credit Substitution Approach: Letter of Credit backed, Insured and Guaranteed Debts published in March 2013. The additional methodology used in rating the Puerto Rico Public Finance Corporation appropriation debt was the Fundamentals of Credit Analysis for Lease-Backed Municipal Obligations published in December 2011. The additional methodology used in rating the Puerto Rico Highway and Transportation Authority bonds, the Puerto Rico Convention Center Authority Hotel Occupancy Tax Revenue bonds and the Puerto Rico Infrastructure Finance Authority Special Tax Revenue bonds was the US Public Finance Special Tax Methodology published in March 2012. The additional methodology used in rating the Puerto Rico Aqueduct and Sewer Authority was the Analytical Framework for Water and Sewer System Ratings published in August 1999.

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