

**Rating Action: Moody's downgrades Puerto Rico GO and related bonds to Ba2, notched bonds to Ba3 and COFINA bonds to Baa1, Baa2; outlook negative**

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**Approximately \$55B of rated debt affected**

New York, February 07, 2014 -- Moody's Investors Service has downgraded the general obligation (GO) rating of the Commonwealth of Puerto Rico to Ba2 from Baa3. Ratings that are capped by or linked to the commonwealth's GO rating were also downgraded two notches, with the exception of the Puerto Rico Aqueduct and Sewer Authority (PRASA) Revenue Bonds, which were downgraded to Ba2 from Ba1. At the same time, Moody's downgraded the Puerto Rico Sales Tax Financing Corporation's (COFINA's) senior-lien bonds to Baa1 from A2 and its junior-lien bonds to Baa2 from A3. The outlooks for ratings on the GO and the related bonds, as well as the COFINA bonds, are negative. For the ratings affected by this action, all of which were placed on review on December 11, 2013, see the list at the end of this report.

**SUMMARY RATING RATIONALE**

The problems that confront the commonwealth are many years in the making, and include years of deficit financing, pension underfunding, and budgetary imbalance, along with seven years of economic recession. These factors have now put the commonwealth in a position where its debt load and fixed costs are high, its liquidity is narrow, and its market access has become constrained. In the face of these problems, the administration has taken strong and aggressive actions to control spending, reform the retirement systems, reduce debt issuance, and promote economic development. Despite these accomplishments, however, in our view the commonwealth's credit profile is no longer consistent with investment grade characteristics.

While some economic indicators point to a preliminary stabilization, we do not see evidence of economic growth sufficient to reverse the commonwealth's negative financial trends. Without an economic revival, the commonwealth will face difficult decisions in coming years, as its debt and pension costs rise. The negative outlook signals the remaining challenges facing the commonwealth.

The commonwealth's general obligation bonds and all the notched and related ratings were downgraded by two notches, with the exception of the Puerto Rico Aqueduct and Sewer Authority (PRASA) Revenue Bonds, which were downgraded one notch, to Ba2. This brings them to the same rating as the commonwealth general obligation rating, which reflects recent rate increases enacted by the legislature that will improve net revenues and are expected to reduce the authority's reliance on commonwealth support.

**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 US states and population exceeding that of 22 US states
- Broad legal powers to raise revenues, adjust spending programs, and borrow to maintain fiscal solvency
- Major actions taken to stabilize commonwealth finances, including significant reform to main pension system, and tax increases to reduce budget deficit

**CREDIT CHALLENGES**

- Ongoing economic weakness due to long-term decline in dominant manufacturing sector, decreased competitiveness as a result of expired federal tax benefits, and high energy costs
- Dependence on capital markets financing to fund operating expenses and debt service during period of increased risk of reduced market access

- Very large unfunded pension liabilities relative to revenues, even after major reforms to two main plans that helped reduce cash-flow pressure
- Very high government debt, equal to more than 50% of gross domestic product
- Multi-year trend of large general fund operating deficits relative to revenues, financed by deficit borrowing

#### ACTION AFFECTS MULTIPLE CREDITS

The downgrade and negative outlook affect general obligation bonds of the commonwealth and of related entities listed below.

#### DOWNGRADED TO Ba2 FROM Baa3

- General obligation bonds
- Public Building Authority 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

#### DOWNGRADED TO Ba2 from Ba1

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

#### DOWNGRADED TO Baa1 from A2

- Commonwealth of Puerto Rico Sales Tax Financing Corporation Senior Lien Bonds

#### DOWNGRADED TO Baa2 from A3

- Commonwealth of Puerto Rico Sales Tax Financing Corporation Junior Lien Bonds

#### DOWNGRADED TO Ba1 FROM Baa2

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

#### DOWNGRADED TO Ba3 FROM Ba1

- Puerto Rico Public Finance Corporation (PRPFC) Commonwealth Appropriation Bonds
- Puerto Rico Highway and Transportation Authority (PRHTA) Subordinate Transportation Revenue Bonds

#### OUTLOOK

The rating outlook is negative, based on our expectation of continued economic stagnation or decline. The outlook also incorporates continuing demands on liquidity, increased refinancing risk and constrained market access.

#### WHAT COULD MAKE THE RATING GO UP

- Strong rebound in economic growth leading to improved and sustained financial performance
- A trend of declining debt

#### WHAT COULD MAKE THE RATING GO DOWN

- Evidence of further constraints on market access or significant further weakening of GDB liquidity
- Indication that total fixed costs, including pension contributions and debt service on bonded debt, have become unaffordable
- Steep growth in structural budget gap and an increase in GAAP deficits, solved with non-recurring solutions
- Economic weakness resulting in declining revenues and continued out-migration
- Reacceleration of growth in government debt

The principal methodology used in rating the Puerto Rico Sales Tax Financing Corporation bonds was the US Public Finance Special Tax Methodology published in March 2012. The principal methodology used in rating the other Puerto Rico (Commonwealth of) bonds 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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