MOODY'S INVESTORS SERVICE

New Issue: Moody's assigns provisional (P) Ba2 to Puerto Rico's planned $3.5B GO Ser 2014 A; outlook negative

Global Credit Research - 28 Feb 2014

Commonwealth has $55B of outstanding net tax-supported debt

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

Moody's Rating

ISSUE		RATING
2014 A General Obligation Bonds		(P)Ba2
Sale Amount	$3,500,000,000	
Expected Sale Date	03/11/14	
Rating Description	General Obligation	

Moody's Outlook NEG

Opinion

NEW YORK, February 28, 2014 --Moody's Investors Service has assigned a rating of (P) Ba2, with a negative outlook, to the Commonwealth of Puerto Rico's planned issuance of up to $3.5 billion 2014 A General Obligation Bonds. The bonds, which are scheduled to price in the next few weeks, would provide liquidity to repay internal loans from the Government Development Bank for Puerto Rico (GDB), the commonwealth's fiscal agent, as well as to refund the commonwealth's general obligation variable rate bonds and terminate related swaps.

SUMMARY RATING RATIONALE

The Ba2 rating is provisional because documents are not finalized, and the authorizing legislation for the current issue allows these bonds to include atypical terms and conditions. We expect the transaction's conditions to provide for New York legal jurisdiction in the event of litigation related to the bonds, as discussed further below, but the full extent of any investor-requested terms remains unknown. We will finalize the rating following an evaluation of actual bond terms, conditions and amount of proceeds. A material change in terms or amounts could also result in a change in ratings on the commonwealth's outstanding debt.

Supporting the Ba2 rating is the fact that the current administration has taken notable steps to rein in debt and spending, to reform the retirement systems, and to promote economic growth. The Ba2 rating also reflects our belief that the commonwealth will raise enough cash in the upcoming financing to enable it to maintain an adequate liquidity profile through the end of 2015. Failure to raise sufficient funds in this transaction for Puerto Rico's pressing liquidity needs would have severe implications for the commonwealth's credit profile, and could result in a multi-notch downgrade.

The Ba2 rating negative outlook is also based on chronic deficit financing, pension underfunding, and budgetary imbalance, along with seven years of economic recession and uncertain prospects for future economic growth. These factors, over a long period, have driven up Puerto Rico's debt and fixed costs, narrowed its liquidity, and hampered its bond-market access. Puerto Rico faces years of difficult decisions, as its debt and pension costs climb.

CREDIT STRENGTHS

-- Political and economic links 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 solvency

-- Major actions 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, high energy costs, declining population and high unemployment

-- Weak internal liquidity with reliance on external financing

-- 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

DETAILED CREDIT DISCUSSION

PROVISIONAL RATING REFLECTS POTENTIAL INCLUSION OF INVESTOR-REQUESTED TERMS

Puerto Rico anticipates that non-traditional municipal investors may demand legal terms or conditions that have not applied to its other outstanding $10.2 billion of general obligation bonds. Such provisions may include consent by the commonwealth to subject the 2014 A bonds to New York laws and to jurisdiction by New York state or US courts rather than to those in Puerto Rico. The potential inclusion of conditions to satisfy prospective investors underscores how the commonwealth's market access has become increasingly constrained in recent months. These investors may also seek other special terms as a pre-condition for participating in the current offering, although we have no specific information about such provisions . If and when any special terms are finalized, they may affect our rating on the current issue or on already issued debt. The provisional rating we are assigning assumes that terms subjecting this offering to New York laws and to court jurisdiction will ultimately be included in essentially the form that has been proposed. These terms also clearly express a waiver of sovereign immunity on a limited basis for purposes of payment on these bonds only.

LESS-THAN-EXPECTED PROCEEDS WOULD EXACERBATE CURRENT LIQUIDITY PRESSURES

Our liquidity analysis of Puerto Rico focuses on GDB, the central repository and manager for most of the commonwealth's unrestricted, public-sector funds (including those of agencies, public corporations, and local governments). Net liquid assets at the GDB have narrowed significantly after loans to the commonwealth and authorities and failure to refinance certain lines of credit in the long-term market. We believe that GDB's liquidity is sufficient to make debt service payments through the current fiscal year's June 30 end. Assuming net proceeds of $2.8-$3 billion from the current offering, we estimate GDB's fiscal year-end 2014 liquidity would total over $3 billion. If the current sale falls substantially short, we believe liquidity would remain weak and not be consistent with the current rating category. The implications of this would likely be a multi-notch downgrade. If the current sale fails altogether, the commonwealth would face exhaustion of GDB net liquid assets as soon as July and a mounting liquidity crisis. In that scenario, we would anticipate even steeper downgrades for the GO and related debt, consistent with escalating expected loss.

Lack of bond market access would leave the commonwealth and GDB with few options to meet immediate liquidity needs, such as potential support of the government's variable rate demand obligation bonds (VRDOs), mandatory tender bonds, and swap obligations. A portion of the current issue's proceeds (estimated at $540 million) would refund commonwealth general obligation VRDOs and floating rate debt and cover associated swap termination costs. GDB is currently negotiating with bank liquidity facility providers and private lenders to avoid acceleration provisions that could be triggered by downgrades to the commonwealth earlier this month. In general, GDB's liquid assets are also used to meet other needs including debt service on GDB's own notes and expected support for the commonwealth's budget.

FIXED COSTS ARE HIGH AND RISING

Debt ratios for the commonwealth are very high. Debt is approximately 87% of personal income, significantly higher than any US state. As of September 30, 2013, net tax-supported debt was $54.6 billion, essentially unchanged since December 2012 but up approximately 20% as a percent of gross product since the commonwealth's recession began in 2006. The growth in debt in relation to the increasing financial liabilities and the weak economy has significantly eroded the island's credit profile.

Fixed costs for Puerto Rico are high and growing. Debt service plus pension contributions are expected to rise from 17% to approximately 20% of revenues (using an approximation of fiscal year 2014 revenues available for paying all debt and pension payments) in the next 10 years, a high portion compared with US states. To keep debt and pension costs from crowding out funding for general governmental operations, difficult decisions about revenues, spending or funding deficits will have to be made. In the past, deficits were funded with long-term debt, but as the credit profile of the commonwealth has deteriorated, that has become more challenging.

ECONOMY REMAINS WEAK

The commonwealth has been in recession since 2006, suffering from a steep decline in manufacturing, mainly in its key pharmaceutical sector. Recent economic indicators, such as the Economic Activity Index (EAI) have shown potential signs of stabilizing. The EAI, which is derived from figures on total payroll employment, cement sales, gasoline consumption and electricity generation, posted slight gains on a month-over-month basis in September through November, but it fell in December and remained negative on a year-over-year basis for all of 2013. The real GDP growth estimate for fiscal 2014 is -0.8%. The estimate for growth in nominal GDP is 4.3%. Population, which declined by 4.4% from 2005 to 2012, is expected to continue to decline. Unemployment was 15.4% in December, and the labor force participation rate was just over 40%.

The commonwealth's economic plan targets job creation in its agricultural and small business sectors and stabilization in the dominant pharmaceutical sector through a combination of tax incentives, wage subsidies, outreach and infrastructure improvements. New emphases on medical devices - an offshoot from strengths in pharmaceutical production - and "under the flag" operations in aerospace and military apparel may spur job creation over the next five years, but the scale of this growth is uncertain. Tourism has been a good performer, but it remains a relatively small part of the economy.

The federal government supports Puerto Rico through many regular programs, including transportation aid and Medicaid, and it is working with the island to help maximize federal dollars received through these programs. Nevertheless, we do not expect extraordinary support from the US federal government in the case of heightened credit stress.

INITIAL FISCAL 2014 BUDGETARY PERFORMANCE ON TARGET

Fiscal 2014 general fund revenue growth (July through January) has been on target, with collections 0.89% (or $39 million) over estimates and 13.2% ($539 million) over the same period of fiscal 2013. Sales tax and personal income tax revenues were down compared to initial forecasts, but corporate taxes were up. The commonwealth has revised its forecasts for the fiscal year downward to adjust for lower-than-expected sales tax in the first half of the year. Despite the weaker sales tax revenues, the government has announced that it plans to reduce the fiscal 2014 budgetary gap by about 21% from original forecasts (to $650 million), through decreased spending.

Revenues from the excise tax on multinational corporations (known as the Act 154 taxes) have improved: these taxes represent indirect support of the US federal government, as the IRS has not challenged the opinion that those taxes paid by multinational companies (largely US pharmaceutical companies) can be claimed as credits against US taxes.

STRONG ACTIONS TAKEN RECENTLY TO SUPPORT FINANCES

The new administration last year 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. These measures are expected to generate $1.9 billion of General Fund revenues.

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 generate $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 (PRHTA), with $270 million annually projected from licensing fees, gas taxes (including automatic inflation adjustments) and cigarette taxes. These revenues will help relieve pressure on the commonwealth and the GDB to support PRHTA. The additional recurring revenue will help reduce the commonwealth's budget imbalance going forward. The governor recently announced that the budget he will propose in coming weeks for fiscal year 2015 will be structurally balanced.

The legislature has passed significant reforms of its two main retirement systems, the Employees Retirement System (ERS) and Teachers Retirement System (TRS). The reforms have several components designed to reduce pressure on cash flows and allow the commonwealth to meet reduced obligations in the near term. The new law includes multiple components that act together to reduce benefit accruals, increase employer and employee contributions, and stabilize the systems on a cash-flow basis, although the unfunded liabilities of both will remain very large.

The actuarial funded ratio will remain low for a long time, given that assets are not expected to begin to accumulate for another 25 years. The reported unfunded actuarial accrued liability was $23.2 billion in fiscal 2012 for the ERS and $10.3 billion for the TRS. Based on our calculations, the combined adjusted net pension liability was $46.4 billion. Together with net tax-supported debt of $53 billion as of 2012, the commonwealth's combined debt and adjusted pension liabilities were roughly $100 billion.

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

--We do not expect the rating to go up in the near term

WHAT COULD MAKE THE RATING GO DOWN

-- Failure to raise sufficient funds in the current offering to provide adequate liquidity through 2015

--Inclusion of burdensome terms in the current transaction

--Indication that the commonwealth is actively considering debt restructuring or other strategies adverse to bondholders

--Evidence of significant further weakening of GDB liquidity

--Continued economic weakness resulting in declining revenues and accelerated out-migration of residents

The principal methodology used in this rating was US States Rating Methodology published in April 2013. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

REGULATORY DISCLOSURES

For ratings issued on a program, series or category/class of debt, this announcement provides certain regulatory disclosures in relation to each rating of a subsequently issued bond or note of the same series or category/class of debt or pursuant to a program for which the ratings are derived exclusively from existing ratings in accordance with Moody's rating practices. For ratings issued on a support provider, this announcement provides certain regulatory disclosures in relation to the rating action on the support provider and in relation to each particular rating action for securities that derive their credit ratings from the support provider's credit rating. For provisional ratings, this announcement provides certain regulatory disclosures in relation to the provisional rating assigned, and in relation to a definitive rating that may be assigned subsequent to the final issuance of the debt, in each case where the transaction structure and terms have not changed prior to the assignment of the definitive rating in a manner that would have affected the rating. For further information please see the ratings tab on the issuer/entity page for the respective issuer on www.moodys.com.

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