

COFINA

PUERTO RICO SALES TAX FINANCING CORP

JANNEY FIXED INCOME STRATEGY

JUNE 29, 2010



Secured by an island wide sales tax, COFINA senior and subordinated bonds represent the strongest credits among Puerto Rico issuers.

SENIOR SALES TAX REVENUE BONDS

\$5.2 billion outstanding

Aa3/AA-/A+

FIRST SUBORDINATED SALES TAX REVENUE BONDS

\$8.3 billion outstanding

A1/A+/A+

VARIOUS STRUCTURES

Taxable and tax free zeros

Taxable and tax free current interest bonds

Mandatory tender bonds

Some issues are insured by Assured Guaranty Municipal Corp. (Aa3/AAA/NR)

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SUMMARY

- COFINA's dedicated income stream, based on a broad based consumption tax, offers strong revenue support and debt service coverage
- Current collections are estimated to equal only 50-60% of potential collections
- Non-impairment provisions of enacting legislation protect this revenue source

INTRODUCTION

COFINA was created in 2006 to refinance appropriation debt of the Commonwealth of Puerto Rico (\$6.8 billion 6-30-06). Legislation in 2009 expanded the corporate purpose to include funding of the Commonwealth's deficit through 2012

as well as certain other needs. Since 2007, COFINA (the Spanish acronym for Puerto Rico Sales Tax Financing Corporation) has issued more than \$14 billion in senior and subordinated debt.

The bonds are secured by sales tax revenues based on the Commonwealth's 5.5% sales tax (another 1.5% can be levied by local municipal governments). The tax is applied to most products and services but excludes automobiles and energy. The Secretary of the Treasury has authority to establish further exemptions and limitations. Certain goods and services may be exempted if the governor declares a state of emergency. In 2008,

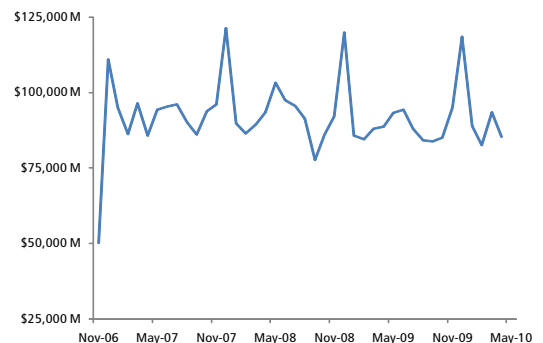
the legislature created a three day back-to-school holiday when tax on some items was exempt. The annual peaks observed in the graph represent spending spikes during holiday seasons. Collections in FY 2007-08 averaged \$95.3 million a month, \$91.5 million per month FY 2008-09 and \$90.8 million per month in the eleven months through May 2010.

The enabling legislation (Law 91 of 2006) requires that a Pledged Sales Tax Amount (PSTA) be deposited into a dedicated sales tax fund (segregated in a government account at Banco Popular). The PSTA is the greater of:

- \$550,264,000 beginning in fiscal 2009-2010, increasing 4% each subsequent fiscal year up to \$1,850,000,000 in 2041 through 2057) or
- Half of the 5.5% tax collected (2.75%)

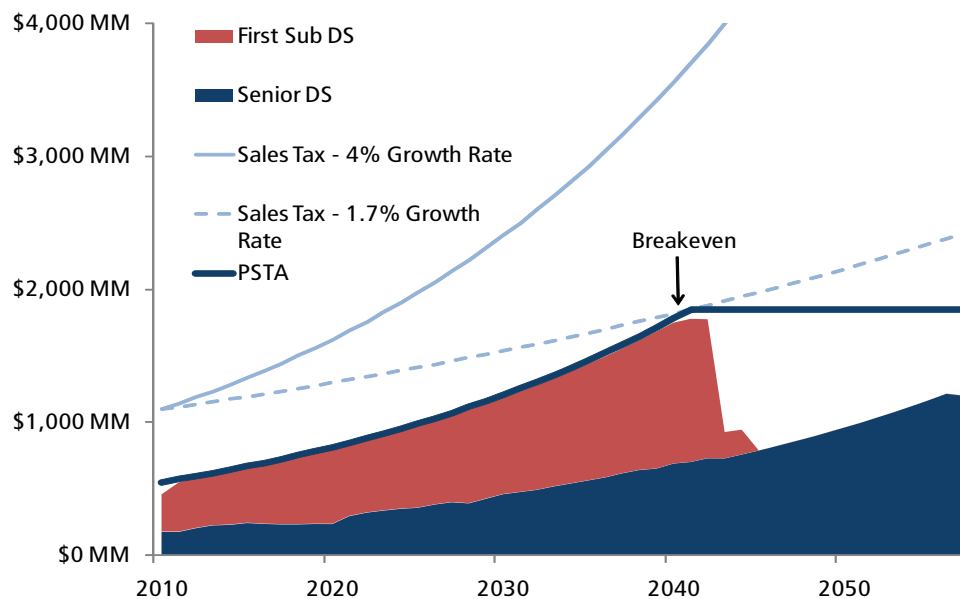
Each fiscal year, sales tax revenues must be deposited into the COFINA account until the pledged amount (\$550 million in FY2009-2010) is reached. Thereafter collected taxes are transferred to the Commonwealth's general fund until the Commonwealth has received the same amount (\$550 million FY2009-2010). Once the COFINA account and the Commonwealth have each received the pledged amount, subsequent revenues are split equally between COFINA and the Commonwealth.

Monthly Tax Collections



Source: GDB Puerto Rico

Estimated Sales Tax Receipts and Debt Service



Source: PRSTFC Official Statements and Janney Fixed Income

Security of the Bonds

Key security points include a strong additional bonds test, comfortable projected debt service coverage and non-impairment covenants from the Commonwealth. The ability to issue additional sales tax revenue bonds is restricted by an additional bonds test, which requires the pledged sales tax amount to equal at least 102% of total annual debt service (principal and interest on outstanding bonds plus any additional bonds). In other words COFINA can issue no more bonds if annual debt service would exceed the Pledged Sales Tax Amount (PSTA). The most recent issue refinanced certain outstanding debt. The PSTA is shown by the dark blue line on the graph. Except for refunding bonds, no significant amount of additional bonds can be issued unless debt service begins beyond 2040 (the empty area below the blue line), which pretty much limits additional bonds to zero coupon issues maturing in twenty years or more.

Pro forma debt service coverage, which assumes sales tax revenues grow at a 4% annual rate, is at least 2 times throughout the life of outstanding subordinate bonds, and 5 times for the senior debt. Pledged revenues cover debt service of subordinate and senior bonds 1 times and 2 times respectively. The solid areas of the graph show debt service requirements for the senior and first subordinated bonds. The top two lines show projected sales tax revenue – one assuming a 4% growth rate and the other a breakeven, 1.7% growth rate. At 1.7% sales tax growth, taxes collected would approximately equal annual debt service in 2041. A growth rate of 4% is an underlying assumption used by COFINA in offering statements and as well as a component of the additional bonds test. We believe that longer term, a 4% growth rate is realistic based on combined impacts of inflation, future economic growth and more aggressive collection and enforcement processes.

Another important security feature is found in the legal structure underlying the bonds. In 2009, modifications were made to the bond resolution. Under these strengthened provisions, the sales tax may only be lowered or abolished if it is replaced by a "like or comparable security" and if the ratings agencies have provided the bond trustee with written confirmation that bond ratings would not be reduced with the substitute revenue stream. According to legal opinions issued by Puerto Rico's Secretary of Justice as well as outside bond counsel, sales tax revenues are not subject to the Commonwealth's "clawback" provisions, keeping this revenue stream insulated from Puerto Rico's fiscal problems.

Estimated debt service coverage for all bonds is above 2 times based on projected 4% sales tax growth rate.

THE SALES TAX AND ISLAND ECONOMY

The sales tax is broad based and dependent on a diversified range of products and services, save for the more volatile auto and energy sectors. Despite Puerto Rico's long running economic recession, experienced over the past three years, sales tax collections are relatively stable. Recent estimates for the amount of uncollected tax range from 40% to 48%. The Commonwealth's Treasury Department is in the process of implementing systems and programs designed to improve enforcement and increase collections of the tax. This includes a point of sale system and other technology solutions to enable the Treasury to better track and collect the tax.

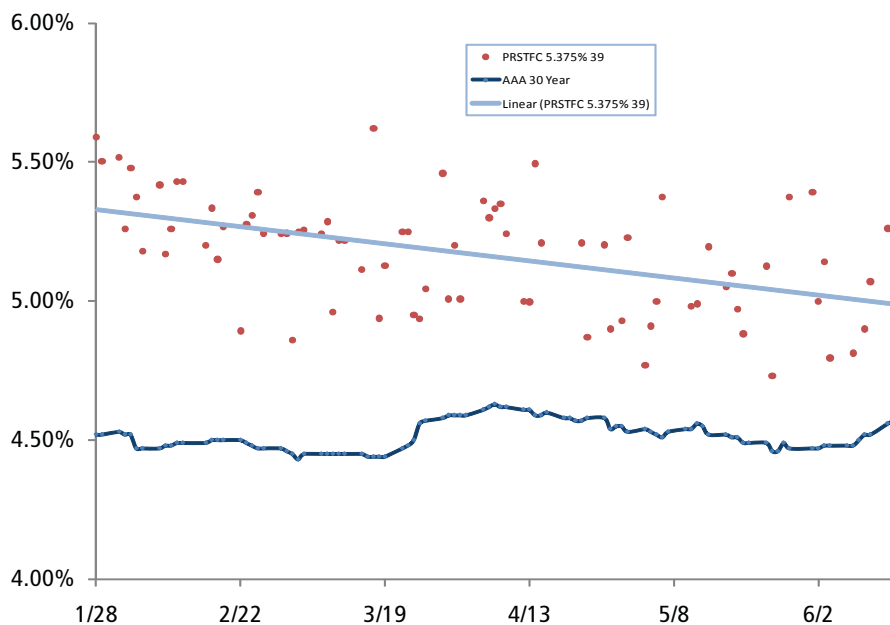
Although COFINA's revenue stream is not subject to a clawback from the Commonwealth, the generation of sales tax is inextricably linked to the island economy. The ratings for the senior and subordinated bonds are strong, reflecting the security features mentioned, but the credit quality is impacted by the Commonwealth's credit, reflected by the A3/BBB- rating of Puerto Rico's general obligation debt. The island's GNP declined an average 2.6% in fiscal years 2007, 2008 and 2009. In March, the Puerto Rico Planning Board revised its projection for GNP from growth of 0.7% in FY 2010 to a 3.6% decline. GNP growth, including the negative numbers of the past three years, has averaged 1.6% since 1990.

TRADING AND YIELDS

COFINA bonds have been issued in a variety of structures including zero coupons and convertible zero coupons, as well as senior and subordinate bonds. Interest on most of the senior lien bonds is subject to federal income tax while most of the first subordinate bonds are tax exempt. The 2007 and 2008 series, which primarily refinanced appropriation backed debt, were issued as taxable bonds, since there are restrictions on using tax free bonds for refunding purposes. The proceeds of the tax free bonds, issued in 2009 and 2010, were used to fund the Commonwealth's budget deficit.

The graph below looks at yields based on trades of the January new issue of 5.375% first subordinate bonds (A1/A+/A+) maturing in 2039, as reported by the Municipal Securities Rulemaking Board (MSRB), compared to Municipal Market Advisors' (MMA) thirty year AAA consensus yields. The trend-line shows that trading yields fell slightly while benchmark yields finished modestly higher.

Trading Yields vs AAA MMA Benchmark



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COFINA is the strongest Puerto Rico issuer from a credit standpoint

Yield information from MSRB is volatile and includes some significant outliers as is evident from the graphs. Given the unique triple tax free nature of Puerto Rico debt (interest exempt from state and local income taxation) and the strong credit quality of these issues, we believe recent spreads reflect fair value.

CONCLUSION

COFINA is the strongest Puerto Rico issuer from a credit standpoint. The sales tax revenue bonds have a secure foundation, based on a broad based sales tax and a strong legal framework, including an additional bonds test, which limits the potential of additional bonds being issued to share in the sales tax revenue stream. The rating agencies see this credit as stronger than Puerto Rico's GO debt, although ultimately, like GO debt, the credit strength of COFINA is dependent on the island's economic prosperity and related consumption expenditures. The senior issues, primarily taxable, have extremely strong debt service coverage, 2 times by pledged revenues and 5 times by projected sales tax revenues. The first subordinate debt is also well secured with projected sales tax revenues covering debt service 2 times and pledged revenues, by design, covering maximum annual debt service 1.02 times.

Investors seeking state tax exemption using mid investment grade taxable or tax free municipal bonds should consider investment in COFINA bonds based on recent trading levels.

INFORMATION FOR THIS REPORT WAS OBTAINED FROM A VARIETY OF SOURCES INCLUDING MOODY'S, STANDARD AND POOR'S, OFFICIAL STATEMENTS, COMMONWEALTH PROVIDED FINANCIAL REPORTS AND OTHER SOURCES.

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