Despite substantive fiscal progress in the past two years, Puerto Rico’s financial stability continues to erode. In coming years, we believe restructuring/default of most or all PR debt is likely.

**DETERIORATING ECONOMY AND FINANCES ELEVATE DEFAULT RISK**

- Puerto Rico’s anemic economy is both a cause and effect of declining population as residents, particularly younger college graduates, migrate to the mainland.
- The island’s debt load continues to grow, with as much as $4 billion in new borrowing planned in the near future.
- Most of recent and proposed bond issuance is to repay short term loans, which in turn were often issued to finance operating deficits. Debt service is growing, but capital investment is declining.
- Although Puerto Rico’s budget for the current fiscal year is closer to balance than it has been in many years, structural balance is elusive with pension and medical expenses as well as debt service costs likely to increase dramatically in coming years.
- The administration’s plan to reform the tax system by replacing the sales tax and some income taxes with a new value added tax faces stiff local resistance and adds significant uncertainty to the future revenue picture.
- Currently, Puerto Rico’s public corporations are not eligible to seek protection under the federal bankruptcy code. A restructuring law was declared unconstitutional and future status under federal bankruptcy code is uncertain.
- Elevated yields have made Puerto Rico a mainstay of the municipal high yield (junk) bond market, with bond ownership transitioning from an individual investor dominated base to nontraditional investors such as hedge funds.
- PREPA, in the midst of restructuring discussions, is likely to default on its $400 million July 1, 2015 debt service payment. We believe other PR issues will probably default/restructure in coming years, potentially including general obligation bonds and COFINAs.

**Excepting a Pause in 2012, PR Economy Has Been Contracting Since 2006**

Source: Janney Fixed Income Strategy and Research, PR Government Development Bank
The current administration and legislature, which took office in January 2013, has significant fiscal accomplishments under their collective belt, both positive and questionable, but the big picture continues to be one of fiscal deterioration, as the economy contracts further and debt continues to grow.

Few societies can thrive or even tread water if the youngest and brightest move to greener pastures.

An underlying rhythm to the contracting economy is population decline, as many of the younger residents, including recent college graduates, seek opportunities on the mainland. For example, Census Bureau data for the 12 months from July 1, 2013 to July 1, 2014 show some organic growth (7,650 more births than deaths), but negative net migration is illustrated by the loss of 55,092 residents (about 1.5% of population). Looking back over the past 9 years, the graph shows that as the population over 44 years old grows, the younger population segments are in decline. Few societies can thrive or even tread water if the youngest and brightest move to greener pastures.

Much of the recent information flowing from the PR government is about further debt issuance. Most prominent is the proposed borrowing of $2.9 billion, using the PR Infrastructure Financing Authority as a conduit. Recent amendments to the law authorizing this debt give potential buyers additional security, including an automatic increase in the tax rate of the island’s petroleum tax (currently $15.50 per barrel) should oil consumption fall below certain levels. Proceeds of this loan will be used primarily to refinance short term loans from the PR Government Development Bank (GDB) to the PR Highway and Transportation Authority (PRHTA). In recent years, PRHTA borrowed from GDB to finance annual operating deficits, with the accumulated total growing to exceed $2 billion.

GDB has historically been the liquidity cushion for Commonwealth entities including the Treasury, public corporations and municipalities, but being the lender of last resort depleted GDB’s resources. As of February 28, 2015, net GDB liquidity was $1.2 billion. Successful sale of petroleum tax backed bonds would add more than $2 billion to the liquidity pool, but of course long term debt would increase and various challenges, including Treasury revenue shortfalls in the first eight months of the current fiscal year, will put further strains on liquidity. Recall that proceeds of the $3.5 billion general obligation issue of March 2014 were used primarily to pay off various short term loans, including $1.9 billion of GDB credit lines.
Other near term issuance may come from the Puerto Rico Aqueduct and Sewer Authority (PRASA), which is reportedly considering a $750 million deal. According to reports in local media, about $160 million will be used to pay off loans from local banks; $72 million will pay off GDB lines; and the balance would finance operations and capital improvements. Last month the Puerto Rico House of Representatives passed legislation authorizing issuance of $225 million of general obligation bonds to finance capital expenditures, a more appropriate use of long term bond proceeds than the repayment of short term debt.

Unfortunately, most of the new debt is funding repayment of short term debt, which is effectively using long term debt to finance operating deficits. The Center for a New Economy, a San Juan based independent research and policy think tank, follows Puerto Rico’s fiscal situation closely, producing annual budget updates among other reports. Their graphic of annual debt service and public improvement expenditures as a percent of the consolidated budget (general fund plus other government entities including public corporations) illustrates that, beginning in 2008, debt service grew while capital investment in public improvement declined, an unsustainable trend if it continues. Looking at the above mentioned PRASA issue, for example, much of the proceeds will repay short term debt, and it is unclear how much will ultimately go towards actual capex.
BUDGETS, DEFICITS AND EXPENSE GROWTH

When it was finalized in June 2014, the budget for the current fiscal year (ending June 30, 2015) was proclaimed as the first balanced budget in 22 years. The $9.6 billion package certainly represented progress, compared to past years. Annual deficits averaged $2.2 billion from 2009 to 2013; they were financed primarily with long term debt (Sales Tax Financing Corp. – COFINA). But actual budget balance remains elusive, which will further strain liquidity. In the first eight months of FY15, revenues are 2.4% or $122 million behind budget. It’s noteworthy that the first one and a half years of interest payments ($423 million) on last year’s $3.5 billion new issue (8% coupon) were paid from issue proceeds, so the $280 million annual interest nut was not included in the FY 2015 budget, but will be an additional expense in future budgets.

POTENTIAL BUDGET BUSTERS

It seems that, as with the arcade game Whack-A-Mole, no sooner is one problem addressed, than others pop-up. Significant progress has been made to balance fiscal operations, but serious challenges lurk on the horizon.

Health Insurance Expense - Puerto Rico provides health insurance to 1.6 million residents (generally low income). Much of the funding for this program come from federal sources, including non-recurring payments provided through the Affordable Care Act (ACA). ACA funds are expected to be depleted in May 2018 if US Congressional action to extend payments is not forthcoming. Barring federal help, medical related expenses could require as much as $2 billion of additional annual general fund expenditures in future years, a lot of money in the context of the $9.6 billion 2015 budget.

Pensions – Puerto Rico enacted significant reforms to the primary Employee Retirement System (ERS), although similar legislation enacted to reform the teacher and judicial plans was struck down by the Puerto Rico Supreme Court. The changes to the ERS may relieve funding pressures on a long term basis, but large near term liabilities remain. As of June 30, 2013, the three systems had $2.7 billion in assets and $36.4 billion of liabilities, for a 7.4% funding ratio. With no change, assets of the Teachers Retirement System will be depleted in 2020 and Judicial Retirement System assets will be depleted in 2019. Reforms to the ERS were supposed to stabilize assets at a minimum of $1 billion, but a recent Moody’s report noted that “ERS is also at risk of fully depleting assets around the same time [as the Teachers – 2020], particularly if the plan experiences one to two years of adverse investment performance and the commonwealth continues to neglect its additional contribution requirements. Shifting to covering the cost of benefits from operating revenue will pose a new and significant fiscal burden on the commonwealth; combined benefits and expenses of the two major plans (TRS and ERS) would amount to $2.3 billion
Resistance to the VAT is evident from many quarters of the Puerto Rico economy, and it is uncertain if it can pass in the legislature.

Perhaps the largest risk of tax reform is the inherent uncertainty surrounding such a major change.

Debt Service – Puerto Rico has a long habit of deferring debt service. The $3.5 billion general obligation issue of March 2014 was issued with an 8% coupon, creating additional annual interest expense of $280 million; however, since $423 million was scraped from the top of the proceeds to fund one and a half years of interest, this expense was not included in the FY2015 budget but beginning in FY 2016 will need to be paid in future years. Also, the days of borrowing at 5% are distant. In March 2012, the interest rate of a new issue of general obligation 5% due in 2041 was 5.32%. Last year’s new issue 8% bonds due in 2035, which were sold at a discount, carried a yield to maturity of 8.73% and are now trading at 9.75% yield to maturity. Interest rates and associated debt service of future loans will be almost double the levels of just three years ago, adding further strain to future budgets.

TAX REFORM TENSION

The administration has proposed reform of Puerto Rico’s tax system, centered on a new value added tax (VAT). Unlike a sales tax, typically charged to end users, VAT is collected at each stage of the products and services cycle, based on the “value added” at each stage. An October 2014 report from KPMG estimates that a 16% VAT, with 75% compliance, would generate $6.7 billion of annual revenue. The current sales and use tax (SUT) brings in about $1.3 billion annually (about half of which is used for debt service on outstanding COFINA bonds). Based on the KPMG study, the existing SUT and the Patente Nacional (corporate gross receipts tax) would be eliminated and individual income taxes would be simplified and reduced. Recent reports suggest that the administration believes it will receive about $1.2 billion in additional annual income after the change. The study also notes the administrative benefits of a VAT compared to the SUT. “The existing consumption tax [SUT] exempts numerous goods and services, the consequences of which are reduced revenue, complexity, increased administrative cost and tax avoidance opportunities. Indeed the current compliance rate is estimated to be 56 percent…. The adoption of a broad based goods and services tax (VAT) could mitigate these deficiencies.”

Resistance to the VAT is evident from many quarters of the Puerto Rico economy, and it is uncertain if it can pass in the legislature or what modifications might be made to make it palatable to enough legislators. Governor Garcia Padilla argues that reform is a financial and economic imperative. Another stumbling block to eliminating the SUT is the $15 billion of outstanding senior and subordinate PR Sales Tax Financing Corp (COFINA) bonds which are secured by revenue from the sales tax. The bond resolution underlying COFINA bonds includes provisions that allow the Commonwealth to “substitute like or comparable security in the form of taxes, fees, charges, or other receipts” if the PR Secretary of Treasury certifies that projected revenues will meet or exceed future debt service requirements and coverage requirements, further requiring that the trustee receive “written confirmation of all outstanding ratings of the Bonds in 2021.”

PR Yields Have Moved Persistently Higher, and are Now Well Into High Yield Territory

Source: Janney Fixed Income Strategy and Research, Bloomberg
Within a few weeks of the August 2013 issuance, new issue PREPA bond prices had dropped by more than 10 points, and by the end of 2013, PREPA price declines exceeded 20 points.

Uninsured Puerto Rico bonds are generally not appropriate investments for individual investors.

The stance of Puerto Rico’s leaders has evolved from one of willingness to stand behind all PR debt, to enacting legislation allowing restructuring (and bondholder impairment) of public corporations.

from the applicable rating agencies, taking substitution into account.” Perhaps the largest risk of reform is the inherent uncertainty surrounding such a major change. Will revenues come in as forecast? How will the economy respond to the changes?

RISING YIELDS AND CHANGING INVESTORS

After remaining steady following publication of several negative reports in summer 2012, including Puerto Rico’s Debt Overload, yields on Puerto Rico paper began to rise, and were particularly propelled higher by an August 2013 Barron’s cover story titled “Puerto Rico in Trouble.” As bond markets grew stronger in summer 2013, Puerto Rico yields continued to rise, with GO and public corporation bond yields moving in proximity. COFINA yields also rose, but stayed below those of other PR issues. PREPA was able to come to market in August 2013, borrowing $675 million at yields in the 7% range, and receiving enough demand to upsise the issue from $600 million. Within a few weeks of issuance, in the days following publication of the Barron’s article, new issue PREPA bond prices had dropped by more than 10 points, and by the end of 2013, PREPA price declines exceeded 20 points.

As prices fell and perceived (and real) risk grew, individual PR bond investors were increasingly sellers, with nontraditional municipal investors such as hedge funds, attracted by higher yields, taking up the slack. The March 2014 new issue of $3.5 billion general obligation bonds (which had minimum $100,000 holding requirements) received strong hedge fund support. These new investors often have different timeframes and objectives than traditional retail bondholders. As liquidity becomes strained, they may require stronger security features on new debt which could be detrimental to holders of existing debt. Whereas a retail investor may be willing to “clip the coupon” while waiting (and hoping) for the bond to be redeemed at par upon maturity, a hedge fund may be very satisfied with a sale (or recovery after restructuring) at 65 cents if the purchase price was 53. We believe this creates the potential for extreme price volatility as events play out. Uninsured Puerto Rico bonds are generally not appropriate investments for individual investors.

BOND RESTRUCTURING

In June 2014, Puerto Rico enacted a law which established a framework for restructuring of public corporations including PREPA, PRASA, and PRHTA. Prior to the law’s passage, PREPA yields had uncoupled from other PR bonds, moving higher on liquidity concerns. Passage of the restructuring law, and PREPA’s tapping of debt service reserve funds to make the July 1, 2014 debt service payment, accelerated the electric utility’s bond price deterioration. In August 2014, PREPA hired a restructuring officer and under the umbrella of a nondisclosure agreement embarked on negotiations with stakeholders, including the GDB, mutual funds, hedge fund investors, and bond insurers. Although a restructuring plan was due earlier this month, the deadline was missed. We believe it is very likely that PREPA will not make its full $400 million debt service payment on July 1, 2015.

Last month, the restructuring law was ruled unconstitutional by a federal court in San Juan. A bill was introduced in the US House of Representatives that, if passed, would put Puerto Rico on equal footing to states under the bankruptcy code, allowing Puerto Rico to determine if and how its public corporations and political subdivisions could file for bankruptcy. Although a subcommittee of the House Judiciary Committee held a hearing on the bill in late February, the likelihood of further action is uncertain. Recently, three members of the Puerto Rico House of Representatives proposed legislation that would allow a referendum on a constitutional amendment to allow Puerto Rico and its public corporations, including COFINA, to restructure.

The stance of Puerto Rico’s leaders has evolved from one of willingness to stand behind all PR debt, to enacting legislation allowing restructuring (and bondholder impairment) of public corporations such as PREPA, PRASA and PRHTA so that their financial challenges will not further weaken Treasury finances or the GDB balance sheet. The emphasis is on assuring delivery of public services (electricity for example). A recent Moody’s FAQ on PREPA weighed the utility’s capital requirements of $300 million annually against estimated cash of about $678 million (after January 1, 2015 interest payment) and $1.2 billion of scheduled maturities over the next five years. By deferring principal payments in coming years, PREPA would retain much of the money needed to fund its capex plan, which is focused on conversion of oil fired electric generating assets to dual use generation, reducing the island’s dependence on oil.
When forced to decide between paying bondholders or significantly reducing government services and pension payments, the government may opt for restructuring liabilities, which would likely include general obligation issues and perhaps COFINA debt.

Moody’s, which believes PREPA will default within a few months, suggests a 65% to 80% recovery range for PREPA bondholders.

**A Cloudy Future For Bondholders**

Assuming economic stagnation continues and given the likelihood of sharp expenditure growth in coming years (pensions, medical, debt service), structural budget imbalance will grow, since it will be increasingly difficult to raise new revenue to pay for increasing expenditures. When forced to decide between paying bondholders or significantly reducing government services and pension payments, the government may opt for restructuring liabilities, which would likely include general obligation issues and perhaps COFINA debt. The questions become how long before such a restructuring and what would a restructuring look like.

We believe Puerto Rico has one to three more years before the burden of increasing expenses makes balancing the budget impossible. At that point, debt restructuring may be a compelling path for political leadership, if the alternatives are reduced public services and reductions in promised pension payments. In 2016, government and related debt service obligations will be about $3.6 billion, with the major public corporations adding another $1.3 billion. This $5 billion annual debt service obligation will be an increasingly important consideration for island leadership when deciding which bills to pay.

### Temptation to Cut Debt Payments?

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<tr>
<th>Estimated Debt Service Payments in 2016</th>
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<tr>
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Source: Janney Fixed Income Strategy, PR Financials

**Analyst Certification**

I, Alan Schankel, the Primarily Responsible Analyst for this report, hereby certify that all of the views expressed in this report accurately reflect my personal views about any and all of the subject sectors, industries, securities, and issuers. No part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in this research report.

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