Municipal Market Analytics, Inc. (**MMA**)

Written Testimony for the House Judiciary Subcommittee on Regulatory Reform, Commercial and Antitrust Law

Presented by Robert Donahue, Managing Director

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Good morning Chairman Marino, Ranking Member Johnson and members of the Committee. My name is Robert Donahue and I am a Managing Director at Municipal Market Analytics, Inc. (**MMA**). **MMA** is the leading independent research and data-provider for the municipal bond industry whose clients include a broad group of investors, banks, securities dealers, issuers and federal and state regulators. To be clear – **MMA** does not buy, sell or trade municipal bonds – the industry values us for our independent perspective.

Thank you for inviting me to testify before you today to share **MMA**'s opinions on HR 870.

The notion of bankruptcy is a last resort to any government or individual. No government official should consider it lightly—nor does **MMA.** While we do not advocate bankruptcy for any state, locality or municipal agency, **MMA** believes this is the best available option for Puerto Rico and the municipal market at this time.

In my experience of nearly 20 years covering Puerto Rico's credit for three of the largest US institutional investment management firms, there have been few times when I have observed the same level of consensus that exists towards giving the territory this option. Governor Garcia Padilla of the Popular Democratic Party has expressed his support for the bill as firmly as New Progressive Party (NPP) Resident Commissioner and At-Large Representative Pedro Pierluisi. This rare bipartisan moment demonstrates the importance of providing this financially troubled jurisdiction with an orderly framework for debt adjustment that is consistent with the restructuring framework to which all states currently have access.

To summarize we believe that HR 870:

1) Provides a technical fix of the Bankruptcy Code, simply extending the Chapter 9 framework available to the 50 states to Puerto Rico's government instrumentalities;
2) Reduces the near-term likelihood that Puerto Rico will request assistance in order to secure essential services to its citizens;
3) Sets no adverse precedent for the broadening of municipal bankruptcy provisions that may destabilize issuers' access to capital via the municipal bond market, the nation's source of efficient low cost infrastructure funding;

4) Will not, in and of itself, pose any incremental systemic risk to the current lenders or the broader capital markets; and,
5) Establishes a basis by which the island may focus on efforts to foster economic growth for enduring fiscal stability.

Approval of this bill is a technical fix to an oversight that has remained un-remediated since 1984 when the Bankruptcy Amendments and Federal Judgeship Act, a law to correct technical errors in the 1978 Bankruptcy Code, defined "State" to include Puerto Rico (and the District of Columbia), **except for purposes of who may be a debtor under Chapter 9**, a definition that has lasted to this day.

The purpose of this exemption, and original Congressional intent, is vexing to legal scholars. Initially, the Act actually defined a "governmental unit" to include a Territory. Subsequent versions **expressly included** Puerto Rico in the definition of a "State". The record indicates that an amendment introduced by Senator Robert Dole states that Puerto Rico had been "inadvertently left out of the definition of "state' during the passage of the [1978] Reform Act." Inexplicably, the definition of "State" was changed to its current form during the amendment process and remains so to this day.

Chapter 9 provides a standardized, orderly legal framework guided by an existing body of case law in an appropriate arms-length venue. **MMA** believes this is far preferable to a receiver-driven restructuring. A court supervised process would put all vested parties together on a far more even playing field than currently exists. All creditor classes would fully participate, with limited political interference if negotiations break down. Chapter 9 still provides a high degree of stakeholder influence on creditor recoveries and a plan that a US federal court judge will ultimately determine.

A perfect storm has gathered over a long period of time, resulting from years of policies of both political parties. The island's economic deterioration, the accelerating depopulation of Puerto Rico, and persistent budget deficits threaten the provision of basic services, and the ability to meet obligations to bondholders and other financial participants.

Puerto Rico's leadership recognized the immediacy of its crisis and attempted its own fix by passing the Puerto Rico Debt Enforcement and Recovery Act on June 28, 2014. The Act was patterned on Chapter 9, allowing Puerto Rico's public corporations to restructure their debts. This Act was intended to allow the continuation of essential public services while at the same time protecting the interests of creditors. The Act also provided leverage for the commonwealth in negotiations with various creditors who consequently entered into forbearance agreements, which are in place today but expire imminently.

The Act was declared unconstitutional on February 6 by the U.S. District Court. In its motion to appeal to the First Circuit Court of Appeals in Boston, Massachusetts, the commonwealth acknowledged that "the acute fiscal crisis that gave rise to the Recovery Act is still very much a reality, and is just as pressing now as ever." Indeed, as we sit here today, several of the forbearing creditors could potentially trigger actions that could begin a disorderly debt crisis. Puerto Rican officials acknowledged in court papers that Puerto Rico Electric Power Authority (PREPA) bondholders, as soon as March 31, could take unilateral actions against the utility that could "disrupt the provision of essential public services." These include attempts to accelerate PREPA debt payments, suits to increase already high electricity rates, or an appointment of a receiver to take over PREPA's management, all within their rights as stipulated in loan and bond documents. Any of these actions could place an undue burden on Puerto Rican citizens, many of whom are unaware of the complexities of the island's tenuous fiscal conditions.

In the three weeks since, two rating agencies further downgraded the island deeply into junk bond status. S&P dropped the island's bond rating to 'B' on February 12 and Moody's cuts its rating to 'Caa1' one week later, reflecting "very high credit risk." The agencies state that Puerto Rico's current economic and financial trajectory could ultimately impair its ability to fund basic services and its debt commitments. Subsequently, yields on Puerto Rico bonds have ascended above 10%, to levels comparable to deeply distressed sovereigns of Greece and Ukraine, as investors again have sold bonds.

Absent the Chapter 9 framework, the current rules under which public corporations may restructure debts present grave uncertainty. For example, bondholders of PREPA, the most

likely initial candidate for debt restructuring, are dependent on the utility's 1974 Trust Agreement, which **MMA** believes provides a wholly inadequate legal framework within which to address PREPA's highly complex financial restructuring needs among a diverse group of stakeholders.

We believe that the superficial process for debt reorganization contained in PREPA's Trust Agreement falls far short of the Chapter 9 process. Section 208 of PREPA's charter provides for the appointment of a receiver vested with vague powers other than to carry on the purposes that are of public good ("utilidad pública") and prohibited from encumbering or dispose of property. Creditor rights are limited, primarily to bringing suit to compel compliance with the Rate Covenant. However, a weak receiver with vaguely defined powers will be hard-pressed to enforce rate increases with PREPA's per kilowatt hour rates over twice the US average costs. Accordingly, PREPA's Trust Agreement states: "Remedies are subject to discretion and delay and may not be readily available or may be limited. Equitable principles may also delay or otherwise adversely affect the enforcement of bondholders' rights." We note that any judicial action regarding the appointment of a receiver must be filed in Puerto Rico court applying Puerto Rico law.

The argument has been made that the extension of Chapter 9 to Puerto Rico at this time is an impairment of existing protections available in the Trust Indenture under which bondholders purchased bonds. **MMA** disagrees. Any investor holding PREPA bonds in August 2013, or thereafter, was forewarned that risks existed. Specifically, the Risk Section of the official statement (OS) dated August 15, 2013 states that;

- For each of the last four fiscal years, the Authority incurred losses, deterioration of its liquidity, pension funding shortfalls, and a decrease in electric energy sales…if (these) trends were to continue, the Authority's ability to fund its operations and finance its capital program could be negatively impacted.

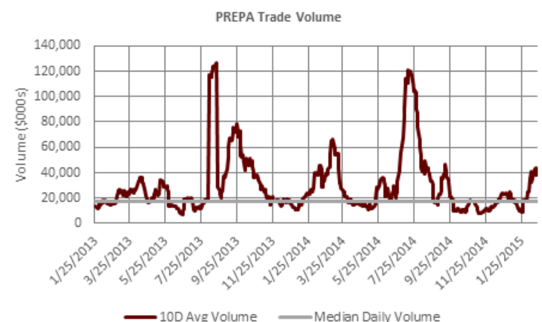
In the March 2014 OS for the Commonwealth's $3.5B GO offering, dated March 11, 2014, PR officials incorporated a candid 14-page risk section warned that Puerto Rico:

- "may be unable to meet its debt obligations" if market access is lost; that emergency actions, restructuring, moratorium, and alternative courses of action are being evaluated;
- "remedies available to bondholders are potentially subject to substantial discretion and delay."

As the territory's situation has worsened, Puerto Rico's investor base has changed. Municipal bond investors such as mutual funds or retired individuals, the island's traditional lenders, have significantly reduced their ownership of Puerto Rico debt. Fitch Ratings estimates starting in 2Q and 3Q 2013, U.S. mutual funds reduced their Puerto Rico exposure by approximately 65%, on average.[1] Municipal bond funds, once the primary owners of Puerto Rico debt, now own less than one third of the island's debt with holdings concentrated in largely insured, general government issuers.[2]

The result is that the island's current debt, as well as its future access to capital is now held by, and dependent on, alternative investors who demand high costs in return for their investment. Fitch estimated that there are now over 60 alternative fund managers holding more than $16 billion, or 25% of the island's debt.

The rotation away from risk-averse municipal investors to opportunistic buyers is indication that the debt markets are functioning efficiently. Trading in Puerto Rico debt has remain active through downgrades and other negative events, allowing for efficient reallocation of risk, significant price discovery and trading opportunities as risk-averse owners have sold to willing hedge funds and qualified buyers. Bond prices have risen and fallen with evolving investor opinions as occurs in healthy capital markets. The chart, to the **right**, illustrates that PREPA trading volume actually spiked six times the median daily volume during the periods of stress over the past two years.



[1] Big Changes for Puerto Rico Bond Market, Fitch Ratings Fund and Asset Manager Rating Group, August 18, 2014
[2] Ibid

MMA believes that the extension of Chapter 9 to Puerto Rico is not a bailout or panacea, but is a last resort to avert a broader crisis and brings an orderly process to any restructuring of the commonwealth's agencies, while keeping such important decisions within the hands judges and out of the hands of politicians. We believe that this action is not likely to encourage other municipalities to borrow irresponsibly, knowing that they could later restructure their debt in bankruptcy. As witnessed in Detroit, Michigan and Stockton, California, Chapter 9 has a tendency to negatively affect all stakeholders: municipal services are often reduced, employees have faced benefit reductions, and investors experienced deep losses. Bankruptcy judges in both Detroit and Stockton have stated on record that public pensions can be reduced in Chapter 9, even when strong state legal protections exist.

In the absence of a Chapter 9 framework for restructuring and the Recovery Act determined to be unconstitutional, Puerto Rico lacks a powerful, motivating tool to bring all parties into an organized restructuring at the two functionally insolvent public corporations, PREPA and the Highway and Transportation Authority (HTA). Both entities have large outstanding loans due to the Government Development Bank (GDB), which itself faces insolvency if these debts are written down. In turn, the GDB's diminished liquidity and potential loss of funding will preclude its ability to extend emergency short-term credit to the central government as it has in the past. The GDB announced months ago that it would issue a $3 billion bond, backed by a recently increased petroleum products tax, to enhance liquidity and shift large HTA loans off its balance sheet issue. To date, GDB has been unable to execute its plan because certain legislators have blocked key elements of the GDB's plan, concerned about long-term fiscal sustainability and the costs layering more debt.

Chapter 9 is an effective way for Congress to assist Puerto Rico, with no expenditure of taxpayer dollars, and the extension of such to the commonwealth amends an existing flaw in the bankruptcy law. Residents and businesses in Puerto Rico today can access all protections offered through other chapters of the US Bankruptcy Code (i.e., Chapter 13, 12, 11 and 7). Chapter 9 will likely remain a rarely used mechanism that allows a municipality to adjust its debts while continuing to provide public services. This action is neither a bailout nor a precedent for further Chapter 9 actions, merely a fix to clarify Puerto Rico's right to develop a

plan of adjustment in an orderly way and begin its path toward recovery. We fully expect that the island's leaders will take great care in crafting enabling statute in fair and equitable manner, assuring that proceeding in good faith will preserve the island's long-term need for affordable capital.

Thank you for asking me to testify today, and I welcome your questions during this session.

Appendix

Puerto Rico Research as Published in the **MMA** Weekly *Municipal Outlook*

www.mma-research.com

Dated January 27, 2014
Through February 9, 2015

February 9, 2015

PUERTO RICO UPDATE: Late Friday, the PR District Court struck down the Recovery Act as unconstitutional, citing PREPA's extant non-impairment, acceleration and receivership provisions. The decision upheld claims of three plaintiffs that the Act violated legal remedies and liens. With the Commonwealth's home-cooked 'Creole bankruptcy' framework now struck down, **MMA** believes a broad, disorderly restructuring is increasingly likely unless Congress moves forward with a chapter 9 extension. **The decision squarely undermines the "ring-fence" strategy of investors who assumed restructuring would be contained within the public corporations. We now believe all PR debt, including GO's, are on the table for potential restructuring and/or claw back.** Hypothetically, PR could begin claim emergency powers (cf. Home Building & Loan Ass'n v. Blaisdell) to protect key assets like the Government Development Bank (GDB), recognizing:

1) *Increasing Lack of Ability*: PR's finances were approaching crisis before this decision. While low oil prices have lessened pressure on PREPA somewhat, the economy and budget stresses have intensified. GDB's funding is at risk and liquidity likely exhausted, facing sizeable outflows by June and beyond (including $437M Note payments, largely to critical local institutions). The $2B+ petroleum tax-backed PRIFA bond deal, a futile, ill-advised attempt that compounds PR's unsustainable debt load, is likely doomed. Without GDB's ability to subsidize deficits, PR's faces threats to public safety and essential services. The Governor's platform for recovery, a sweeping PR tax reform via a Value Added Tax (VAT), is unlikely to take hold for years, the next chapter in which bondholders may be unwilling spectators.

2) *Demonstrated Lack of Willingness*: The Recovery Act, a pivot away from bondholder obligations, cost the island its ratings and market access. The Act, hastily enacted ahead of expiration of PREPA's fuel

financing lines to 1) shield the utility from immediate acceleration; 2) establish a debt restructuring framework for PR public corporations in the absence of chapter 9 recourse; and 3) ensure these public corporations have the ability to continue to provide vital public services. There is little reason to believe this stance has softened. The PDP-AGP friendly daily, El Nueva Dia, wrote last week, "Puerto Rico is Bankrupt" bringing increasing calls for broad debt restructuring and shared pain.

3) *Clock is Ticking*: Weeks before PREPA's March 2nd debt restructuring plan date and the March 31st Forbearance Agreement termination date, the decision deprives PR leverage in negotiations to extend creditor agreements. PR's investor pool—short-play, low-cost-basis hedge funds, ad hoc ring-fencers, long bondholders, bond insurers, fuel financing banks, and fuel suppliers (e.g. troubled Petrobas)—is a tenuous mix of interests and sophistication. The CRO's clout in preventing internecine feuds between creditors groups is now effectively neutered. The trump card is held by GDB, also a forbearance agreement signatory and creditor which can use claw back provisions.

Chapter 9 Prospects Are Likely Improved: While the Recovery Act provided bondholders and the island framework, the specter of a disorderly restructuring may be too be the catalyst to push Congressional action on potential extend of chapter 9 to PR. In fact, Resident Commissioner Pierluisi is refiling last year's bill (H.R. 5305) to amend chapter 9 this Thursday. Reportedly, government officials, Congressional leaders, and key stakeholders (hedge funds and other investors) believe this amendment may get traction as a result of the judge's decision.

January 12, 2015

PUERTO RICO'S 2015 BEGINS THIS WEEK:

· In 2015, PR's credit downside risk is elevated and rising given: 1) execution risk in substantial restructuring/reform efforts and; 2) the possibility of a budget shortfall in the neighborhood of $500 million.

· With media requiems for 2014 written—a year with some successes, but far more failures—2015 now begins in earnest. The island and its lenders are weary after six of years of austerity, no employment growth, and persistent outmigration of jobs, people and investment assets (down 5.5% with UBS losing 19% of its client assets).

· The list of PR issues to monitor this year includes: the gas tax hike and PRIFA bond deal, tax reform, GDB liquidity and solvency, a PREPA restructuring by March, a prospective PRASA bond issue, the economy (and now, Cuba), and ever-fluid political tides. Over the weekend, the resignation of HTA's executive director, Javier Ramos was announced, among several others (generally routine midterm replacements). Ramos' departure is untimely but was not unexpected.

· PR's Legislative session opens today. Central on the agenda is the "crudita", the Petroleum Products Tax bill. After receiving an unacceptable version in late 2014, passed under severe controversy, the Governor has three options: 1) a pocket veto, 2) sign the bill then amend, and 3) request the Legislature to amend the bill itself and then send it back. **MMA** expects the bill will be passed with necessary changes to move forward with the PRIFA bond, given the importance of enhancing GDB liquidity entering a challenging period in 1Q15. Chief of Staff Suarez was actively lobbying Legislators

over the break of the stakes. If not amended, GDB would be forced to write off over $2B of PRHTA loans, risking the possibility GDB's auditors could determine the bank insolvent. More importantly, GDB would be unable to cover potential central government and corporations deficits, triggering a potential cash flow crisis.

· **MMA** remains concerned about "surprise" late year budget shortfalls. Through November, the Commonwealth general government has only collected $2.7B of its expected $9.5B annual revenues. When compared to initial projections this is below the $2.9B expected YTD with the "Other" category lagging significantly along with the Corporation and Motor Vehicle taxes. The current shortfall is reported at $32M and $217M (or 2.4%) below last year's levels. Some favorable tailwinds: strong holiday tourism, and the drop in oil prices, both which will benefit Sales and Use Tax collections. The COFINA bucket fills up sometime this month and begin flowing to the general fund, ultimately totaling 8% of revenues.

· PR's most recent disclosure (1/5/15) indicates a slim $23M projected Treasury cash balance at for end of Fiscal Year 2015. The report however sheds little light on spending patterns, and budgeted savings in education and health care (specifically the government health insurance plan) are significant risks to balance. Tax refunds also remain opaque.

· Disclosure also indicates Section 4.15, a "Budgeted Revenues Covenant" of the TRANs agreement apparently sets certain (3% and 5%) thresholds, likely required by lenders. What triggers and how stringent (acceleration, automatic spending cuts, for example) are not specified.

· The wildcard: PR's comprehensive, controversial tax reform will be revealed February 15 to be approved on or before March 31. The transition to a Value Added Tax—the only such tax in the US—is challenging in the best of times, requiring payment throughout the distribution chain. Count us as skeptics given PR's secretiveness to date in disclosing the conceptual basis of the reform, its spotty track record implementing tax changes, the traditional corporate gamesmanship, and a culture of rampant evasion on the island. The island's tenuous liquidity could be devastated by hasty adoption and botched implementation.

December 1, 2014

PUERTO RICO'S NEW DEAL PLACEMENT PROSPECTS ARE GOOD: Puerto Rico is contemplating a multi-billion dollar issuance late this year. Whether or not this actually happens, **MMA** compares market issuance conditions today versus the broadly successful $3.5B GO deal issued in March 2014. Important to note is that PR buyers are no longer typical municipal funds, rather a potential investor base would be composed of cross-overs, corporate high yield funds, and hedge funds. This investor base is dependent not only on municipal market conditions, but also on broader corporate and sovereign bond trends.

Supply: Positive: Corporate supply numbers have dropped significantly since September in response to Treasury and equity volatility, and has not regained its footing despite a resurgent Treasury market.

Demand: Negative: In contrast to the municipal market, corporate fund flows were drastically negative in recent months. The divergence between taxable and tax-exempt markets may cause dysfunctional absorption patterns for a PR issuance. Positive municipal dynamics could be misinterpreted as good for

PR when in fact, the cross-over, taxable investor base has seen massive redemptions and may not have the excess capital to allocate to the municipal market.

Performance in Alternatives: Modest Positive: Corporate high yield spreads have widened considerably since the summer but are still far below long-term averages. In sovereigns, Greece specifically has under-performed the broader market as European deflationary concerns have driven high grade Eurozone yields to extreme lows. Seen in this context, Puerto Rico offers value at tax equivalent yields of +16%.

Performance in Puerto Rico: Negative: Perhaps the most important factor surrounding a potential PR issuance is the performance of the major island credits. As can be seen, the island has seen significant price underperformance this year, specifically PREPA. Additional debt on an overly burdened economy may push prices of alternate credits down even further as cash flows are diverted into an expanding pie.

Overall, the environment is worse for a new PR issuance than it was in March, noting questionable corporate absorption and better value in alternative (competing) investments. However, current PR holders may well see the new issue as a tool for building total return in their investments, and, in general, credit spreads are still tight, yield scarce by historical standards. Our conclusion is that the new loan will be successfully placed, although yields may need to be higher than those for the March issue, all else being equal.

PUERTO RICO TAX HIKE UPDATE: Puerto Rico's governor appears to have persuaded several same-party (PDP) dissidents to support an unpopular 68% gas tax hike and avert a risky transit shutdown. The governor announced Sunday night that he has gained the required 26 votes for approval of the house bill. Last week, the house and senate suspended a controversial special session until today, because they did not have the votes needed to pass the tax hike, known in Spanish as the "crudità". Reportedly, opponents of the bill have not yet declared their support to confirm the governor's assertion. Today's session (beginning shortly) will indicate whether the Governor is bluffing or has necessary votes to move forward with the $2B+ PRIFA bond issue. While **MMA** believes the outcome will likely be approval of the crudità, the Governor has lost considerable political capital and authority. Amidst the above controversy, the GDB announced on Friday that year-over-year gasoline consumption dropped 12%, cement sales down 10%, energy sales down 1.6% and employment down 0.3%. The total EAI decline was 2.2%, the largest decline in the last eight months

November 17, 2014

PUERTO RICO BORROWING PLANS, TAX PLANS: Governor García Padilla was forced to convene a special session when Legislators failed to approve a tax-increase intended to back a $2.9 billion GO-backed deal Puerto Rico Infrastructure Financing Authority (PRIFA) bond deal possibly before the end of the year. This is a blow to the Governor whose approval rating has sunk to 19% according to an El Nuevo Día poll last week.

The Governor met with Legislative leaders over the weekend and again today, and will hold a broader Legislative session on Tuesday. Despite the intense lobbying effort, the bill currently is short by one vote in the House. Resistance to the bill comes from various corners: some lawmakers fear the economic impact of a large hike (some advocate a toll increase instead), others prefer to implement the tax

increase in conjunction with the coming tax reform, other insist on a HTA reorganization to cut expenses, and powerful companies (e.g. Puma) are lobbying hard against the oil tax hike. **MMA** believes a heavily amended bill, that includes pre-conditions that HTA will be reorganized to cut costs, will be signed into law by Thanksgiving, if not this week. The Governor simply has no alternative and will reasonably make what concessions are needed.

Enhancing GDB's Liquidity: The bill would enact a petroleum excise tax hike to $15.50 per barrel, of which $8.25 (nearly $180M annually) would cover debt service adequate to service a $2.9B PRIFA bond. The Governor has heavily lobbied lawmakers in his own majority party to approve the tax as an economic stimulus and infrastructure improvement, but the primary purpose is to bolster GDB's liquidity position and allow the bank to refinance outstanding short term obligations maturing in FY2015. The GDB disclosed that its liquidity, and likely solvency, depends on spinning off about $2.2B in HTA credit lines.

The financing scheme is intended to garner investment grade ratings based on: (a) a highly structured, COFINA-like security package, (b) provisions demanded by the market like acceleration, sovereign immunity waiver, choice of venue, guarantees and legal protections similar to the recent GO deal; and (c) assurances PRIFA is permanently barred from restructuring its debts under the Recovery so as to firewall investors from PR-related risk.

The Deal Must Get Done: Commonwealth officials are highly motivated to place this deal by year-end in order to ensure sufficient GDB liquidity prior to a PREPA restructuring that could occur early in 2015 (and push the GDB liquidity problem out beyond reelection in November 8, 2016). Below are demand challenges:

· Accurately forecasting tax revenues and coverage. Reportedly, projected revenue growth after last year's increase have been well below projections.

· Overcoming rating agency reluctance. In the aftermath of the ill-timed Recovery Act, rating agencies cast a broad brush questioning the willingness to pay. We doubt this structure will be so tightly structured as to eliminate concerns that PR's future (and current) leaders could undo the protections.

· Securing credit enhancement **MMA** is skeptical that adequate and material insurance capacity exists.

Attracting alternative investors. PR buyers are no longer typical municipal funds. Investors in the March 2014$3.5B GO deal issued in corporate high yield funds, and hedge funds. Since March, corporate supply numbers have dropped significantly (esp. in September) in response to Treasury and equity volatility.

Despite challenges, **MMA** believes that the PR will place the PRIFA bond deal, albeit at high rates. Alternative PR investors have assessed PR's myriad challenges and asymmetric risks closely in the last six months in contrast to other sovereign and distressed investments. Some have determined to limit exposure. However, the generally favorable conditions for issuance, global demand for yield, and PR's incentive to complete the transaction are overriding factors

November 3, 2014

PUERTO RICO ADVANCES PLANS TO BOLSTER CONFIDENCE: PR GDB's investor call on Thursday was an effort to bolster investor confidence ahead of a return to the capital markets. The commonwealth laid out ambitious plans for both the HTA and sweeping tax reform while intensifying its efforts to inform investors and establish practices consistent with other municipal borrowers. However, municipal bond investors remain unlikely to direct unfettered capital toward the island, being well acquainted with PR's chronic fiscal and economic woes, wary of optimistic fiscal and economic "recovery" plans, and increasingly concerned about willingness to honor obligations after the botched Recovery Act rollout. For its various deficit financing needs, PR remains almost wholly reliant on hedge funds, an investor class easily distracted by other investing opportunities and reasonably worried over a lack of quick profits in PR so far.

In general, **MMA** remains skeptical: 1) that the tax plan will be fully enacted as presented, especially as the island's political cycle ramps up; 2) that various tax adjustments "intended to simplify" will be efficiently imposed and ultimately yield the expected revenue upside; 3) that the substantial new taxes will not damage the weak economy and demographic (i.e. outmigration) situation; and 4) that the island will achieve a cost of borrowing with a rate and structure that is both palatable to local stakeholders and doesn't expose the island to longer term risk.

PR bondholders are exposed to several other principal risks at present, the largest being knock-on trauma from any (hypothetical) triggering of the Recovery Act for PREPA. The investor call featured only two brief slides on PREPA, which is not suggestive of a detailed plan being developed to protect capital market creditors. PREPA's five-year business plan will "serve as baseline for discussions of the Recovery Plan…and require contribution from all stakeholders." Other looming risks include burgeoning FY15 budget shortfalls for the central government (our specific concerns are Mi Salud and education); GDB's liquidity and its impending audit; and various bond rollovers.

HTA: Leaders filed HB 2212 on Thursday which, if approved, will raise fuel taxes (68% from $9.25 to $15.50 per barrel) "at a time when oil prices have decreased significantly." The GDB expects the tax will yield an additional $178 million per year to: 1) finance HTA budget gaps (39%); 2) back up to $2.5B of debt, proceeds of which will liquefy the GDB by refinancing $1.9B HTA loan and take out the August 2013 $400M bond anticipation notes with RBC (53%); and 3) finance a new Mass Transit Authority (8%). This tax will be effective March 2015.

Tax Reform: The government presented a complex project to remove the Sales and Use Tax (IVU) and replace it with a Value Added Tax (VAT) and, among other things, eliminate the payment of taxes for hundreds of thousands of taxpayers who earn less than $50,000. The proposed 15% VAT will be felt broadly as will a likely property tax increase and increase in tax rates to top earners. PR officials state that the tax would be implemented retroactively to January, and must be approved by March.

October 20, 2014

PUERTO RICO LIQUIDITY IS CONCERNING: PR's Government Development Bank (GDB) released a Special Liquidity Update on Friday night, just days after announcement of management changes and a week after placement of $900M of TRANs at 7.75% interest cost. The main takeaway is that GDB's current Ending Liquidity Balance is even more precarious than previously thought, roughly $1.8B*, which

is 28% below the $2.3B projected in March, as well as the $3.5B actual liquidity in March and $3.1B in June.

Although GDB's liquidity position "improved significantly in March 2014 as a result of the issuance of the Series 2014 Bonds," the GDB has experienced greater balance sheet deterioration than anticipated, seven months later. The report raises serious concerns regarding further liquidity risks, the GDB's solvency (audit will be released in coming months), its ability to raise additional capital this year, and capacity to provide credible projections.

The decrease in GDB liquidity came from a variety of factors, including the following:

- Deterioration in the bank's funding base. GDB cites "seasonal and cyclical factors" which have inhibited the bank's ability to access fresh capital bringing liquidity to perilously low levels. Cash and deposits totaled $883M in March; by September the amount had dropped to $232M.
- Lower than expected deposit recapture and higher deposit attrition.
- Unanticipated draws. For example there was a $247M lines of credit "reprogramming" to close the fiscal year 2014 budgetary gap totaling. In May 2014, GDB repurchased $200M in HTA VRDNs.
- Various other unplanned obligations including payout of vacation and sick leave at the Department of Education, a loan to the Puerto Rico Industrial Development Company and the PRPA to finance capital expenditures related to Lufthansa Technik's relocation to Puerto Rico.

Risky Outlook. Looking forward, various potential short-term liquidity needs could reduce liquidity further:

- Central government deficits are again likely. The report states that General Fund revenues are approximately $36M below budgeted revenues and "the Commonwealth may have a deficit for fiscal year 2015." How large is the question, and **MMA** projects it will perhaps again be in the $700M range (last year's deficit was $783M). This is a wide estimate which factors: 1) projected $309M of unrealized budget savings with "high implementation risk"; 2) a 2% shortfall revenues would cost about $193M; 3) health insurance and education overspending of about $200M; and 4) unanticipated interest on the TRAN.
- Both GDB and the public corporations have significant short-term funding needs related to obligations that mature, may be accelerated or terminated. GDB faces a $397M note maturity FY 2015 of its medium-term while PREPA, HTA and PRASA short-term obligations at $696M, $ 292M and $ 200M, respectively. Making these payments is critical and the report states that "in the event that the public corporations cannot obtain third party financing, public corporations could take advantage of all legal alternatives available under Puerto Rico law, including seeking relief under the Recovery Act."
- Finally, letters of credit and financial guarantees, termination payment guarantees, and municipal loans pose further risk.

Taken in full perspective, the GDB report highlights the risk the dependencies between the GDB and other entities have broadly across the island. The report states that $1B of loans made to PRHTA by GDB must be refinanced during 2Q2015 from a portion of the proceeds of a long-term bond issued through the Puerto Rico Infrastructure Financing Authority ("PRIFA"). This number contrasts with the publicly reported anticipated $2.5B issuance.

The report highlights the market access risk stating "there is no assurance that the Commonwealth or its instrumentalities will be able to access other sources of financing or funding sufficient at any one time to meet their obligations." Although GDB has assumed that it will not provide financing in excess of that projected, the reader is cautioned that GDB may be forced for public policy reasons to provide such financing in an emergency situation or on a temporary basis and the liquidity position of the GDB could be adversely affected." In short, PR situation is far from resolved with great risk looming in the next several months.

*This number includes the recent $400M reimbursement of GDB's higher than projected TRAN line caused by underperforming revenues.

October 14, 2014

PUERTO RICO TRANs/DORAL: Last Thursday, PR's GDB announced it had successfully placed $900M of TRANs with a syndicate of banks in furtherance of raising $1.2B in near-term liquidity for the commonwealth. EMMA now shows five CUSIPs, four with maturity dates of 6/30/2015 and one on 6/15/2014. Two CUSIPs are variable rate, all are 144A (meaning private placements that ostensibly may be resold to qualified institutional buyers) and two had specific language stating they are "guaranteed by the commonwealth of Puerto Rico." This guaranty—which reportedly had been authorized under Act 24 of December 2013—appears to be another attempt by PR to navigate a short-term predicament by exposing itself to long-term ambiguity. The guaranteed TRANs may well have a better security pledge than the other notes, but how this guaranty stacks up against a full GO pledge may ultimately require judicial interpretation. If the commonwealth's fiscal affairs to continue to deteriorate through the spring, GO bondholders may well need to understand the extent of "claw back-able" resources available. Unfortunately, municipal bondholders are now painfully aware that the commonwealth's own perspective on relative security can vary with situational politics and immediate funding needs.

Doral: For example, the Doral case. In recent financial disclosures, Doral Bank's balance sheet had counted $229M of assets related to an agreement with PR's treasury (under Fortuño) to reduce Doral's tax liability in respect of past tax overpayments. FDIC regulators subsequently questioned the validity of those assets, and in May, treasury secretary Melba Acosta declared the commonwealth's obligation "null and void," arguing that Doral had committed "fraud and irregularities" in restating inflated earnings from 1998 to 2004. Last week, a San Juan superior court judge ruled the Doral agreement with PR's treasury was "valid and effective." In a 48-page ruling, the court ordered the commonwealth to pay out a sum that places further liquidity pressure. The governor has since called this tax deal "immoral".

If the court ruling stands, the Doral payment will be amortized over five years of ~$50M payments: an incremental liquidity burden on the commonwealth and its emerging budget deficit (currently estimated at $500-850M for FY15). However, this ruling also draws more negative attention to PR's management practices and its inconsistent willingness to honor obligations. And the subsequent vitriol between parties further deflects PR's efforts to reverse negative perceptions, particularly among prospective investors. **MMA** also notes the lawsuits filed by several large municipal bond funds and a hedge fund over the Recovery Act that allege, in many ways, similar charges raised in the Doral case.

October 6, 2014

PUERTO RICO TRANS: Puerto Rico Senate President Eduardo Bhatia is expected to bring forward a version of the TRAN bill for a full Senate vote. The House passed its version of the TRAN bill 27-17, along party lines over a week ago. According to President Bhatia, the Senate bill will be materially identical to the bill that passed the House. If the Senate passes it, the bill will move to the Governor's desk. The approval and placement of the TRAN will bring much needed liquidity and relief for the Commonwealth.

The Senate bill provides strong TRAN bondholder protections via a segregated, trustee-held Special Fund, in which "all moneys deposited are hereby irrevocably pledged for the benefit of the holders…and will be dedicated to the payment of principal and redemption premium, if any, and interest until all obligations on the notes have been satisfied. The irrevocable pledge created is automatically perfected without the need for a public document filed or notarized or any other act intended that still is and will be a statutory lien." Rumored buyers are all banks, some on-island banks, along with several traditional bank lenders that have provided GDB capital. It is believed that few, if any, alternative investors will participate.

According to the MSRB EMMA filing on Puerto Rico's upcoming TRANs, it will have four separate CUSIPS as shown in the table below. Noteworthy aspects of the EMMA filing are:

· All notes will mature prior to the June 30 Fiscal Year end. However, the Variable Rate Series B–2B will mature 15 days prior to the three other securities, effectively time-subordinating the three other CUSIP holders;

· Two securities have 9/30/2014 dated and closing dates, prior to the TRAN Bill being enacted into law;

· The principal amount of notes being issued is blank. It has been reported that the size of the note is $900 million with another $300 million purchased by the GDB, but the size could be considerably larger; and,

· There is no Official Statement filed, nor is it expected that such a document will be filed given the nature of the private placement

· The stated issuer for the notes is Puerto Rico Commonwealth Government Development Bank Senior Notes rather than the Commonwealth of Puerto Rico. The security structure has been evolving and MMA understands that the GO guarantee is being applied via the GDB Notes that will wrap the TRANs. This is a unique structure but provides the strong priority that the banks were seeking.

It had been reported that note would not only provide general government liquidity but also provide capital to the GDB, which will require capital to retire maturing senior notes (e.g. a $250M maturity coming due on 2/1/2015) as well as supplement internal liquidity. However, the current issue reportedly does not include additional liquidity for GDB. Future issues are in the works to monetize assets in GDB's balance sheet, specifically with regard to the Highway and Transportation. The legislation transferring the loans and revenues to PRIFA apparently is being debated (specifically regarding the controversial increase in both the petroleum tax and the crude oil tax) and is expected to be refiled for approval soon.

September 29, 2014

PUERTO RICO UPDATES: TRANs: Last week, the commonwealth's house of representatives passed a bill that: 1) creates a more structured and insulated fund segregation for the upcoming tax revenue anticipation notes (TRANs); 2) established NY court jurisdiction for disputes with creditors; and 3) waives the commonwealth's right to sovereign immunity with respect to the 2014-15 notes. There is also word that the ostensible lending group for the transaction has demanded: 4) additional security, including a potential GO pledge (unlikely, in our view) or some form of guaranty. **Even without a GO, this is a different and stronger security than used for past TRANs (which had little protection versus the commonwealth's general obligation claw back) and thus subtly erodes the base of resources available to secure PR general obligation bonds.** While the legislation does protect several other bondholder securities (exempting COFINA revenues, special act 22-2000 deposits on behalf of HTA, crude oil and cigarette excise taxes directed to HTA, and sales and use taxes to be used by the convention center district) from capture by the special TRANs fund, PR is once again drawing resources away from outstanding (GO) bondholders to secure new borrowing access: a trade that is unsustainable in the long term.

Economics: PR's August EAI was disappointing, decreasing 1.11% versus 2013: the biggest drop in four months. A lack of economic growth on the island poses considerable risk to economic forecasts and will reasonably worsen the commonwealth's cash position. Of the four EAI components, only non-agricultural wage employment increased (by 0.4%), the GDB citing construction employment as a particular bright spot (up 6.6%). The other components were all negative: cement sales fell 22.4%; gasoline consumption was 0.3% lower, and electricity generation decreased 4.1%. Continually negative readings underscore the uncertainty of PR's business climate amidst the government's fiscal crisis, the ongoing inability of the public sector to stimulate growth, and the ostensible tightening of bank credit.

Management: It is widely expected that significant changes in Garcia Padilla administration will come this week, following the recent resignation of the chief of staff Ingrid Vila and several others. To an extent, changes like these are consistent with an administration at its midpoint between elections, but turnover of key positions can make already complex financial and stakeholder discussions more difficult. For example, PR management is now working to ensure adequate operating liquidity through a challenging FY2015 budget year, execute future borrowing with the island's alternative lenders, to interface with variously-politicized legislators, implement complex tax reforms and system reforms, and manage public corporation restructurings with hired experts.

September 8, 2014

PREPA RESTRUCTURING ADVANCES: Ahead of today's deadline to appoint a chief restructuring officer, PREPA's governing board on Friday announced the appointment of Lisa Donahue, a turnaround and restructuring expert. Her experience as a consultant in the energy field are impressive, especially her role as chief financial officer at Calpine through its bankruptcy and as a restructuring officer in the oil and gas field. Her appointment appears to have been well received, and she will most likely be "reasonably acceptable" to the bondholders, as required in the forbearance agreements.

As with other distressed municipal situations, however, the honeymoon will be short. Most concerning is the capacity of PREPA's entrenched, labor-influenced board and legislative overseers to swallow the same bitter pill they have long resisted. Count us as skeptics. The governor will be required to show leadership in intervening in disputes between the CRO's nebulous authority and other stakeholders, including impatient investors. Thus far, Garcia Padilla's record of statesmanship has been unconvincing.

Ultimately, the CRO brings much needed credibility and buys time (again) before what we believe is going to be a rocky operational and debt restructuring, despite the ambitious, scripted reform timeframe outlined in the creditor forbearance agreements. PREPA's path to self-sufficiency and lower power costs will require: 1) overhauling its indefensible labor structure; 2) transitioning from the currently unsustainable crude oil power generation to something else; and 3) rationalizing its unwieldy cost structure, which will include a debt restructuring.

August 18, 2014

PREPA, BACK TO THE WALL, FORBEARING AGAIN: Late Thursday, Puerto Rico's GDB reached forbearance agreements with three separate groups: long-term bondholders, fuel-purchase creditors (Citibank/Scotiabank group) and the GDB, all which will last through March 31, 2015.

Given PREPA's precariously low gross liquidity position, now about $382M unrestricted, and creditor's questionable security position, both parties had strong incentives to settle. The agreements allow the supermajority of PREPA insurers (primarily National with $1.3B and Assured with $655M of its $9.3B debt) and bondholders to avoid painful write-downs and live another day. PREPA can preserve cash for critical operations and fuel purchases by delaying payment on credit lines, suspending required Revenue and Sinking Fund transfers, delaying all payments on GDB loans, and using construction funds to pay current expenses and capital improvements (budgeted at $300M this year). PREPA also averts legal actions over technical default, noting the acknowledgement that PREPA "did not make the required monthly Bond Service Account and Redemption Account deposits on July 25, 2014."

Although post-forbearance trading is reflecting price rebounds, we expect to see continued PREPA volatility. The temporary agreements only delay deep bondholder haircuts. The agreement on page 3 cites likelihood for new financing, loan, or "debtor in possession" facility in any proposed recovery program or debt enforcement plan restructuring plan. And the processes by which PREPA will ultimately submit itself, or be forced to, privatize its heavily unionized and politically entrenched operation will be rocky.

What's Next? The conditions included in this agreement are severe. For example, PREPA must use "pursue overdue accounts" (e.g. PREPA's $640M receivable from the PR government), and also record revenue from municipalities and associated receivables as well as Contributions in Lieu of Taxes beginning September 1, 2014. Although PREPA has stipulated to pay all P&I, in advance of the next bond payment on January 1, 2015, creditors demand the transfer of five payment installments ($170M aggregate) to a special Trustee-held defeasance fund "if Reserve Account funds are required." Further anticipating the possibility of disruption, the counterparties have a January 15, 2015 termination option. Creditors also extracted numerous early termination provisions and withdrawal rights (specified for the "Ad Hoc Group") if PREPA fails to deliver throughout the term. For example, the

agreement contains an automatic suspension provision if the Recovery Act (or any other action seeking to adjust or challenge the claims of PREPA's creditors) is instituted by or on behalf of PREPA.

The creditors insist on detailed disclosure, including monthly cash reports, weekly updates to the Initial 13-Week Cash Flow Statement and Construction Fund disbursement, and various notices, to "Forbearing Bondholders and/or their advisors who have executed non-disclosure agreements." It is unclear from the document whether non-signatories will be provided access to this information and if these "Forbearing Bondholders" will be restricted from trading on privileged information.

PREPA must also appoint a chief restructuring officer (CRO) by Sept. 8 and a debt restructuring plan by March 2nd, both. It remains unclear how the CRO is appointed, what powers the position holds, and whether PREPA will even cooperate. The agreement also appears to obligate PREPA to hire FTI Consulting to develop a report on "best practices" to be delivered to PREPA no later than November 15, 2014.

The restructuring plan will also require negotiations with PREPA's largest union, UTIER, now the focus of reform efforts. The union, which reportedly barricaded doors outside PREPA headquarters as this agreement was being negotiated, will resist payroll reductions and layoffs.

PREPA's leaders have long resisted reform and this agreement is no panacea. Reducing the cost of energy by diversifying fuel sources will require patient, fresh capital and receptivity toward innovative technologies and approaches. The task at hand and strict conditions detailed above may be more than the utility alternative can reasonably handle. Despite ceding considerable authority via the agreement, PREPA's Board and management team remains intact and, we believe, an obstacle to successful execution of this plan as long as they remain in place.

July 28, 2014

PUERTO RICO TO ROLL OR FILE: PREPA's forbearance agreements with its credit line providers—Citibank ($146 million) and the Scotiabank consortium with Banco Popular and Oriental Bank ($525 million)—expire on Thursday. Reportedly, negotiations were ongoing over the weekend. **MMA** sees another extension as likely via extension of the lines themselves via a DIP structure as provided by PR's Recovery Act. The bank negotiations coincide with PR talks a group of hedge funds currently targeting an entry point for deeper financial involvement in PR's restructuring efforts. In theory, this implies an acceleration of proceedings and lenders considering the lower rungs of PR's capital structure should choose new positions with caution. Also, immediate assistance from traditional municipal managers remains unlikely: there are now two lawsuits against the Recovery Act (the second of which being led by Ted Olson, a high-profile plaintiff's attorney). The Commonwealth has fired back against these suits with its own motion to dismiss stating that the, "US Supreme Court has long rejected the argument that Congress's authority to enact uniform bankruptcy legislation automatically precludes states or territories from passing their own restructuring laws where, as here, there is no conflict between the Act and federal bankruptcy law."

Note the backdrop of Argentina's unfolding default brinksmanship between two sets of investors, both clinging to specific terms (the "Rights Upon Future Offers" or RUFO) that were hammered out in the depths of that crisis years earlier. As with PR, jurisdictional issues over court rulings and populist

dynamics are key ingredients. Millstein and Clearly Gottleib certainly will have an eye on Argentina and its implications as they work toward their own client's best outcome.

PREPA INSURED BOND TRADING IS REASONABLE: While uninsured PREPA Cusips have traded down into the low $40s, insured bonds have retained a range of values, indicating market perceptions of the individual insurers' ability to cover their policies. In general, we find these company-by-company opinions to be quite realistic, if not a bit cheap regarding Syncora. We also note differential treatment of these insurers' anticipated recovery values across the curve: virtually all insured, short-maturity bonds trade at or close to par. However, as maturity increases, bonds begin to trade at increasing discounts, reflecting both the uncertainty in long-term PREPA proceedings plus an increasing risk of insurance payment haircuts (**Figure 6**).

The Model: Uninsured PREPAs are now trading in a 43-46 range. Using the worst-case experience of FGIC's rehabilitation (which will pay an estimated future value of 25% of policy claims to FGIC-insured bondholders), the market-implied insured PREPA payout should thus, at a minimum, be 45+25 or 70 cents. We say "at a minimum" because FGIC's experience and losses are very likely to be worse than those of any still existing bond insurer, FGIC being brought down by outsize portfolio risks to damaged structured finance transactions (with no help from JeffCo, Detroit, and some PR). All of the remaining insurers have, by definition, already survived their structured portfolios, meaning their individual worst-case scenarios, if modelled, would reasonably bring bondholders a better total payout.

PREPA's insurers: Insurers wrap approximately $2.9B in PREPA bonds with main insurers including Assured Guaranty ($1.1B), National Public Guaranty ($1.4B), and XLCA ($248M). However, there are four PREPA Cusips secondarily-wrapped by BHAC, which, since its very limited entrance into the municipal market, has been the monoline insurance gold-standard. BHAC-wrapped PREPAs accordingly trade at a premium or at par, depending on their coupon. BHAC thus continues to represent what AAA bond insurance once did—pure credit replacement of the underlying issuer, with little investor thought needed for what is happening below the Berkshire level.

Investors give Assured Guaranty (AGC and AGM) and National policies more modern treatment as credit enhancement, where expected recovery = underlying credit performance + that of the insurer. Among these, short maturity PREPA bonds also continue to trade at par, intermediates at a 5-cent discount (95 cents), and long maturity bonds at a 10-cent discount (90 cents). Thus, bondholders are assuming Assured and National would provide almost twice the bondholder recovery were they to undergo a FGIC-style rehabilitation. This is not an unreasonable assumption. We agree that the risk of either of these companies needing rehabilitation is low (but not zero), and that, even if this were to happen, bondholder payouts should be substantially greater than with FGIC.

By contrast, bonds insured by Syncora (XLCA)—which has the largest proportional exposure to PREPA with $248M out of $348M total—are trading at more significant discounts: short maturity bonds at a 10-cent discount (90 cents) and long maturity bonds at a 25-cent discount (75 cents). Again, this implies that Syncora, were it to undergo rehabilitation, would wind up within 5 points of FGIC. We find this scenario highly unlikely. While Syncora, being in runoff, is a more obvious candidate for rehabilitation than the other two, its portfolio has already survived the collapse in structured finance. It thus should, today, represent an incrementally better risk than did FGIC, meaning Syncora-insured PREPA should be trading at slightly better levels.

PREPA Insured Market Recovery Analysis			
PREPA Assumptions	**Short**	**Intermediate**	**Long**
Par Value	100.00	100.00	100.00
Uninsured Recovery	46.20	43.18	43.12
Market Prices	**Short**	**Intermediate**	**Long**
BHAC	N/A	103.79	108.36
Assured	99.37	94.66	90.67
National	99.34	95.50	88.84
XLCA	90.49	N/A	75.26
Implied Minimum Payout	**Short**	**Intermediate**	**Long**
BHAC Payout	N/A	56.82	56.88
Assured Payout	53.16	51.48	47.55
National Payout	53.14	52.31	45.72
XLCA Payout	44.29	N/A	32.14

July 21, 2014

PUERTO RICO CREDIT UPDATE: Last week, the commonwealth's financing team presented a scripted investor call highlighting “meaningful and decisive actions to protect its fiscal health and establish a foundation for economic growth,” followed by the far gloomier Quarterly Report of the GDB. The carefully worded filing generally mirrors much of the previous February 18th Quarterly Report and March 11th POS’s 15-page risk section, primarily restating the key point that the Commonwealth “may not be able to honor all of its obligations as they come due if it does not have sufficient access to the capital markets.” A statement was released over the weekend seeking to "contextualize" the report stating, "any claim that the government admits in the document that the crisis has worsened in wrong." The report makes a few notable modifications from the prior reports, specifically:

1. *The impact of recent downgrades*. With PR's GO ratings now at B2, BB- and BB, “there may not be sufficient demand... to issue any future bonds or notes.” An added sentence in the new report states that, “In addition, changes in the Commonwealth’s credit ratings are likely to affect its relationships with creditors and other business counterparties.”

2. *A more negative economic outlook*. According to the PR Planning Board, for fiscal years 2014 and 2015, real GNP is projected to increase by only 0.1% and 0.2%, and "more recent data from the GDB suggest even slower growth or possibly a decline." This will have dividends in a commonwealth budget shortfall as revenue models assume positive growth.

3. *A snapshot of GDB's liquidity, improved but not a panacea*. While it is favorable that GDB has increased liquidity by $1.7 billion after the GO bond deal, it is unclear how long its capital will remain adequate. As of June 30, 2014, GDB’s cash, bank deposits and investment portfolio at fair market value was $3.2 billion. The Report specifically warns the "delays in the repayment of outstanding GDB lines of credit limit GDB's ability to continue providing liquidity to the Commonwealth."

4. *FY2015 budget execution risk looms*. The report highlights concerns that the Commonwealth will not meet projected FY2015 revenue levels or achieve the required spending cuts for to achieve a balanced General Fund budget. This may require emergency measures "that may include a restructuring, moratorium or other actions affecting creditors' rights." Which creditors' rights are not specified? **MMA** sees this stated contagion risk quite consistent with the rationale cited by all three rating agencies in their recent downgrades.

5. *Spotlight is now on government liquidity*. PR is seeking to access external borrowing to cover critical intra-year cash flow imbalances with TRANs (Tax And Revenue Anticipation Note). Lending under a TRAN line requires considerable faith in budget execution given the need for full TRAN "bullet" payment at maturity. As **MMA** noted in our May ***OUTLOOK***, the various banks that participated are unlikely to renew their commitment for obvious reasons. Given the precarious nature of the FY2015 budget, the appetite for new borrowing is likely limited, heightening the risk of a midyear liquidity event.

Other Developments. The report also adds that:

· FY 2014's $208M budget deficit was covered by a $93M loan from GDB, and $115M in cash management measures. After considering the $575M refunding, the total amount of the fiscal year 2014 budget deficit was $783M. It appears that a good portion of this was closed via one-time transfers of costs and/or revenues between the General Fund and the agencies.

· The $344M of annual interest costs for the last GO deal will require "significant" resources beginning in FY2016.

· Should Doral prevail on its claim against the Commonwealth, the Commonwealth would be required to pay $230 million over a five-year period.

· On May 5, 2014, the Commonwealth was formally notified that the United States Army Corps of Engineers had agreed to waive all cumulative Cerrillos Dam-related penalty interest and fees.

The report acknowledges that PREPA is headed for restructuring. Although "no public corporation has sought relief under the Recovery Act…PREPA may need to seek relief under the Recovery Act." PREPA's two fuel financing lines (totaling $146 million and $550 million as of July 6, 2014) are currently subject to acceleration and the July 31 forbearance deadline approaches. The report states that "over the next few weeks, PREPA expects to continue discussions with the lenders concerning its vision for the future as it evaluates various alternatives to improve its financial situation and operations." The report takes note of a lawsuit filed against PREPA and PR's intent to defend itself vigorously, noting that it "will take time to be ultimately resolved."

Beyond PREPA: We continue to have concerns about all levels of the island's capital structure if a liquidity crisis arises in coming months. We do however believe that PR will be most diligent in attempting to protect its GO securities first and foremost, given the Constitutional protections.

We generally believe that believe COFINA will remain protected as well, but with less conviction. In addition to our ongoing concerns over lack of clear judicial backing of COFINA's claw back-proofed legal framework (among other political considerations), we note last month's passage of Act 72-2014. Act 72 postpones the October 2013 direction of a 0.75% sales tax increment to COFINA until the "fiscal year

following the year in which the COFINA bond issue is consummated." The dedication of this increment had been viewed as a credit positive for COFINA's existing bondholders. Thus even this ostensibly lock-solid credit is not entirely safe from a government in need of cash flow.

We also increasingly of the opinion that the Commonwealth will protect the GDB. We see House Bill 2039, recently introduced into the Puerto Rico Legislature, as an attempt to carve out GDB's exposure to Highway and Transportation Authority (HTA). If approved, the bill will transfer HTA's debt, together with the revenues that were enacted last year (Act 30 and 31), to PR Infrastructure Financing Authority (PRIFA). The bill does not explicitly state the HTA will need to be restructured, it does appear that a possible to isolate the GDB from the impact of HTA debt write down if the agency files for protection under the restructuring act.

HB 2039 has received a positive report from the Treasury Commission of the House and a positive recommendation from the GDB. The bill is scheduled to be put to a vote when the Legislature reconvenes in August. It then goes to the Senate and on to the Governor for his signature. As with the Recovery Act, it is unclear whether this legally is possible without violating bondholder covenants, and/or could be voided as an unlawful preferential transfer.

July 7, 2014

SYSTEMIC RISK FROM PUERTO RICO: With the flow of negative news heading into the holiday weekend—particularly concerns that PREPA drew from reserves to make its payment last week—investors continue to re-price the risk in PR securities. This creates concerns that: 1) certain fund complexes heavily concentrated in PR holdings will see large NAV declines, causing outflows and selling pressure, and pushing broad market yields, spreads, and cross-market yield ratios all higher; 2) other issuers will be similarly "disciplined" by the market; and/or 3) there will be negative implications for Congressional support of the tax-exemption. Noting caveats below for affected market sub-sectors.

Broad Market Impacts Should be Manageable but with Caveats: If near-term mutual fund outflows are larger than anticipated AND the taxable bond market begins a bigger struggle against inflation and growth fears, PR could be a contributor or accelerant to market weakness. However, even in a worst case, this is more likely to be a matter of weeks not months, and dozens not scores of basis points. In our view, PR's downgrades and likely restructurings more likely represent an incremental threat to near-term performance, noting mitigants in:

1. The current market context—extreme supply scarcity and persistent rally in yields and spreads. Funds thus should also have access to unspent cash, temporary lines of credit, and reasonably liquid securities (i.e., tobaccos) to afford emergency funding needs. This may weaken somewhat if the prices in USTs continue to reverse, but that does not appear likely.
2. The fact that many portfolio adjustments have already been made—and many headlines already have already been filed—since PR's crisis accelerated last summer. We assume a number of retail clients and their brokers were not up to speed ahead of last week's downgrades, but most institutional investors surely were.

3. The ready capitulation on price by initial sellers of PR securities (via sub-70 cent GO and sub-50 cent utility trades and even the large 2014 GOs lodged only one (1) trade at or above 85 cents on Thursday, having never fallen below 85 cents prior to last week) is likely easing the secondary order flow, although it will magnify the impact on mutual fund NAVs. To the extent PR-heavy funds liquidate non-PR bonds to afford outflows, their internal PR concentration (and thus exposure to falling price evaluations) rises, making continued investors outflows more likely.

Caveat One, Puerto Rico Goes Tribal: We do expect that market sub-sectors related to PR could and likely will be negatively affected in the near term, including generic high yield and, in particular, other US Territory bonds. Should PR's Restructuring Act be validated by the courts, all US Territories—and not just PR—will have effectively been awarded the right to unilaterally adjust their contracts with bondholders in a manner unconnected to Federal legal precedents. In effect, **Territory bonds may need to be treated and priced like Tribal financings** and perhaps ultimately moved away from a traditional, municipal market borrowing context (into emerging markets?). Current holders of Guam and VI paper should strongly consider taking gains (selling their bonds) immediately before there is a greater appreciation of the related risks to their credit profiles.

June 30, 2014

PUERTO RICO PREPARES TO RESTRUCTURE PUBLIC CORPORATIONS: PR's Governor Alejandro Garcia Padilla signed the Public Corporations Debt Enforcement and Recovery Act (Recovery Act) into law over the weekend, with limited debate, just days after it was filed. The law is the island's attempt to rectify a long-standing problem: a gap between federal bankruptcy code and the PR law for the island's troubled public corporations. Specifically three entities, the electricity, water, and highway authorities—which collectively have over $20B in debt outstanding—had nowhere to go to in case of financial distress and insolvency. This law advances a framework for relief specifically for public corporations, while explicitly protecting GO COFINA and GDB bondholders, as well as municipalities' debt, among others, in the meantime. In a larger sense, this bill may represent PR's pivot with respect to bondholders: meaning, a transition from describing debt obligations as inviolable to describing the risk if debt payments and bondholder remedies interfere with the corporations' other stakeholders and their critical public missions. That pivot is a critical feature: if this law is ultimately upheld by the courts, bondholders in PR will be uniquely exposed to considerations of willingness to pay.

What it Does: The bill itself allows the public corporations to be restructured on declaration of a financial emergency and with approval of the GDB and/or Commonwealth government. Restructuring can follow two tracks named for their section number. Chapter 2 entails a negotiated restructuring with bondholders, requiring 3/4ths of impaired holders to agree to reduce or extend repayments. Chapter 3 is a court-ordered process built to mimic Chapter 9; however, the bill sets a minimum recovery for each creditor at the sum of: 1) the minimum recovery each creditor would receive were all creditors to exercise their remedies simultaneously, and 2) a pro-rata share of a hope note, secured by 50% of excess cash flow generated by the corporation for ten years following the restructuring.

Prices Affected: We emphasize that NO corporation has filed under this new law yet. But there is widespread speculation that a PREPA filing is close at hand, possibly imminent, accelerating related bond trading at distressed prices. Last week, PREPA-issued securities traded into the mid-40s, as did some PRHTA bonds. Commonwealth GOs traded up—apparently in expectation of the island's improving

economic prospects should electric and water rates be lowered through bondholder cramdowns—while COFINAs were off slightly.

Legal Pushback: Investors are challenging the Constitutionality of the Recovery Act. Two large fund groups, Oppenheimer and Franklin, filed suits saying that only Congress can approve bankruptcy laws and that the law violates constitutional protections in that it would allow PREPA to use existing debt as collateral for future loans. Reportedly 23 other fund managers are also filing a lawsuit which states that activation of the restructuring process represents an unconstitutional seizure of the assets of the bondholders, impairment of contracts, and illegal delegation of power to the courts of PR as the law intended to stop and prevent lawsuits against corporations public in federal court. Finally, it is unclear what strategy the Commonwealth would pursue were these plaintiffs to succeed in invalidating the new law. A reasonable scenario in that instance would be disorderly defaults by PREPA and perhaps other public corporations, to the direct detriment of the GDB and thus indirectly impacting the other Commonwealth credits.

PREPA: The power utility is indeed a logical and convenient scapegoat for the island's economic woes. Its high rates combined with other factors are driving businesses away, consuming family budgets, and depressing economic activity. PREPA's entrenched management has been remarkably unresponsive to reform attempts despite repeated assurances that it will diversify power and lower costs. Most immediately, large debt obligations loom as lines of credit expire in the very near term, threatening liquidity. PREPA's director has said publicly that its large fuel financing lines are being called in by two large banks. Lacking sufficient internal resources, PREPA would face an event of default. Using the Recovery Law would allow the entity to continue providing power across the island while it contends with scores of legal challenges.

More broadly, PR's central government simply is out of options to balance its own budget and can no longer afford to support public corporations. The June 30 fiscal year end arrives today, with a large current year gap, and next fiscal year's (2015) balance at best precarious leaving the Governor little option other than to finally choke off the public corporations. This effectively makes bondholders unwitting austerity participants, shouldering the burdens previously borne by central government subsidies. A PREPA debt restructuring provides an expedient way to achieve the budgetary "balance" Governor Garcia Padilla pledged when he presented his FY2015 spending plan. Painful cuts and fiscal emergency laws have failed to ameliorate the downward slide. Facing labor strikes and rapidly declining popularity, the Governor is pivoting to the populist inclinations, forcing to make bondholders share the pain.

The Credibility Gap: Recently, more aggressive PR investors have allocated shareholder dollars to PR issuers based on several key premises. Specifically: 1) the indentures and legal framework protects them. PREPA's 1974 indenture explicitly states that bondholders can name a trustee to run the corporation, under certain conditions; 2) these public corporations are essential service monopolies which will raise rates to manage costs and protect market access; and 3) if all else fails, they can always rely on the longstanding protection of the GDB, the government's fiscal agent. The GDB is now backing away from that implied support and advancing a view of the individual loans as separately supported by their own various sources of revenues and income. It is noteworthy that GDB has considerable loans to these same corporations that it purports to be protecting and expect to hear much more about these potential conflicts of interest. For instance, 15% ($2.1B) of the GDB's loan portfolio is to the PRHTA.

Which is not to say GO and COFINA holders should breathe easily. The potential financial relief and economic benefit restructuring public corporation debt represents is not a panacea, but a step to enable potential relief from one set of shareholders. PR's finances remain in critical condition and it is possible this step may eventually prove to have caused more harm than good. Specifically, the Recovery Act is an attempt to establish a precedent that contemplates bondholder impairment: a door that previously was considered closed. In direct response, S&P has put the GO and COFINA ratings on CreditWatch, speaking to the pivot in willingness mentioned above. Further today's *Caribbean Business* headline "PR Government Eyes $60M Bond Issue," highlights the island's need for continued market access and for capital markets support and trust. It's hard to see the Recovery Act increasing either. And finally, remember that the introduction of this bill and its messaging is occurring during a period of heightened scrutiny of municipal issuers by the SEC. There are also disclosure-related issues—as of this morning, **MMA** found no notice of the new law filed in EMMA and only partial disclosure of the recent rating changes. GDB's own website was carrying incorrect ratings this morning. There are also potential issues for broker dealers recommending PR bonds to retail investors; the evolution in risk has been rapid and sales and marketing material may not be up to date, arousing further regulator concerns.

June 2, 2014

PUERTO RICO'S MARKET RISK IS SMALLER, NOT FORGOTTEN: In **MMA's** view, PR's systemic impact on the rest of the municipal market has waned, in particular as most large holders have, by now, likely come to grips with the risks in their exposure. But diminished is not eliminated, and there is still latent risk of market disruption, in particular if the Commonwealth's financial and solvency issues become more pressing so soon after completion of their $3.5B in deficit financing bonds. It may simply be that PR leadership has done a poor job managing investor expectations, raising the potential for a larger, unexpected downside. We highlight some of these risks below.

ECONOMIC MALAISE CONTINUES -- The GDB's latest Economic Activity Index (EAI), released Friday, shows that the island's battered economy has registered its 17th consecutive YoY decline with the recession now nearing eight years in duration. The April EAI showed a 1.3% YoY reduction, on the heels of a 1.0% decrease in March 2014. Components of the EAI include non-farm employment, which dropped 1.5% YTD FY2014, electricity generation which was down 3.1%, gasoline consumption which declined 2.1%, and cement sales, which were 14.6% below last year.

While these numbers are concerning, investors may find that the reality is actually worse. Puerto Rico's Planning Board recently acknowledged that "certain significant deficiencies" and unreliable economic statistics have existed for several years. The GDB states that it will be releasing a new seasonal adjustment procedure next month to "allow more reasonable month-over-month comparisons…and further reduce the volatility of the Index."

Regardless of the outcome, PR's worsening economic backdrop and $442M revenue shortfall in April ($380M because of corporate tax underpayments) have heightened focus on the island's near-term liquidity, the FY2015 budget, and further borrowing plans. Key PR financial officials traveled to NYC last week to assuage rating agency concerns as the island enters the last month of the fiscal year. Reportedly PR officials stated that large manufacturing firms were being asked to make advance tax payments to contain the budget gaps and that GDB "is willing to step in with financing to shore up the public coffers."

The Commonwealth's OMB Director stated that emergency cuts would leave the island close to budget for this year, but recent analysis by Sergio Marxuach, director of Public Policy at the Center for New Economy, shows that PR may carry a structural budget gap forward into FY2015 as large as $1B. While the Governor has declared the budget "balanced", **MMA's** view is that this balance is illusory given the island's aggressive revenue estimates (up over $650M resulting from new revenue measures), continued reliance on a handful of corporations, over $500M of non-recurring revenues, speculative proposed budget cuts, questionable savings, and lastly, the effect of the budget on the general economy.

LIQUIDITY REMAINS THE FOCUS -- **MMA's** primary concern remains the island's ability to repay its TRANs on June 30 (see table below) and find willing

participants in next year's TRAN borrowing, where lenders (some of whom face their own fiscal challenges) will be asked to put considerable capital at risk based on a budget that, in the PR OMB Director's own words, "entails complex implementation processes and a high degree of estimation risk."

Issuance	TRAN Series	Amount	Lender	Due Date	Rate
1-Jul-13	Series A	$300,000,000	GDB	30-Jul-14	Greater of (i) prime rate plus 150 basis points or (ii) 6.0%,
16-Jul-13	Series B	$100,000,000	Oriental Bank	30-Jun-14	Base LIBOR plus the applicable margin
23-Jul-13	Series C	$100,000,000	Banco Popular de Puerto Rico	30-Jun-14	Base LIBOR plus the applicable margin
13-Aug-13	Series D	$200,000,000	Banco Santander	30-Jun-14	Base LIBOR plus the applicable margin
22-Aug-13	Series E	$200,000,000	JP Morgan Chase	30-Jun-14	3.25% multiplied by a margin rate factor,
12-Sep-13	Series F	$100,000,000	Scotiabank	30-Jun-14	3% per annum, up to 6% upon a downgrade
Sept/Oct	Series G	$200,000,000	Bank of America	N/A	N/A

the

transfer, but according to PREPA's Treasurer, the agency has considerable latitude to pay for capital projects from internally generated funds and replenish these with highly fungible borrowed moneys. According to PREPA's most recent financial report (3/31/14), the agency's (restricted) Construction Fund balance was $433M, assumedly from last year's bond proceeds. Of greater concern is the utility's liquidity, which is operating now with ten days cash. Financial disclosures also show PREPA's widening $1.6B accounts receivable balance, of which $672M is due from government clients and $1.3B accounts payable ($762M for fuel oil). Considering the above, a negative $1B net deficit position (+23% versus last year), and inevitably rising capital costs, PREPA's BBB rating is sorely lacking credibility.

PR's political leaders (particularly Senate President Bhatia) clearly recognize the risks that PREPA poses to the island's economy and bondholder confidence (how a PREPA restructuring would affect other bondholders is a major question). While recent PREPA reform law signed by the Governor is a good first step toward imposing some discipline on PREPA's operations, it may be too late. PREPA's entrenched management team continues to desperately maintain its position stating that its FY2014 recommended budget, to be released today, will reflect "today's realities." PREPA's reality is that it is operating deep in the red, with antiquated technology, high costs and declining sales. All-in debt service costs are $702M for next year, not factoring Scotiabank's $550M Fuel Financing line of credit, expiring on 8/14/14, and a $250M Citi line, expiring 1/9/15, create major liquidity challenges for an entity that already spends much of its $5B on fuels and salaries. And: it was reported last week that 30 agents from the PR Special Investigations Bureau seized documents from the agency's Fuels Purchasing Office. Many on the island have speculated about the possibility of selective power blackouts to manage cash, but this will cause considerable economic and civil disruption, that may entail debt restructuring as well.

May 27, 2014

PR HIGHWAYS DRAWING ON BANK SUPPORT: Last week, Puerto Rico's Highways and Transportation Authority (HTA) filed a notice that: 1) a series of its VRDOs (745190Y77; $200M Series A of 1998) have recently become bank bonds under their LOC; 2) the GDB appears to have stepped in to replace the LOC provider; and 3) HTA and GDB intend to amend the bonds' repayment provisions and the security pledged for repayment. In our view, the first development has been common enough in the last few years not to warrant special consideration. But the second and third—which may imply an extension of maturity or a recast interest rate—is another negative data point for the credit and the related messaging for Puerto Rico in general. In the worst case, developments could warrant HTA's inclusion in our database of defaulted and impaired bonds, reasonably under the "Support" or "Other" categories.

HTA may be headed for our database in any event. There are rising operating subsidy requirements to the Tren Urbano light rail, an underperforming and underutilized asset, which has long been a burden on the overall system. Recent reports also indicate that the system has stopped paying third-party vendors amid mounting cash flow pressures. Finally, HTA will need to access the market in the coming months to repay RBC's $400M loan or face increasingly punitive interest rates. And remember that a quarter of the GDB's own loans are to the HTA: a material weakening in the latter's credit raises the issue of GDB write downs and related knock-on risks across the island. The ongoing $230M Doral Bank dispute has also raised criticisms regarding Puerto Rico's ability and willingness to honor existing bank obligations

May 12, 2014

PUERTO RICO, APRIL SURPRISE: Puerto Rico missed its estimated revenue target April by 26%, or $442M. In dollar terms, PR expected $1.67B this April but only received $1.22B. Year-to-date (July-April) revenues are now below budget estimates by $356M with two months left. The primary cause of the monthly shortfall was the corporate income tax, which was $380M, or 50%, below the $776M estimate. Reportedly, thousands of corporations filed tax returns with applications for extensions, many of which (53%) included no payments. The time extension for corporations is 3 months, ending July 15, 2014. There is much speculation about the causes for the extensions, including that many business owners are deferring payments for purely fiscal reasons. Apparently many companies have opted to ask for the extension without sending an estimated payment, hoping they would be able to negotiate lower payments with Treasury in exchange of not firing people or having to simply shut down or downsize.

The shortfall also underscores a point that **MMA** has focused on for some time—Puerto Rico's skewed reliance on a highly volatile corporate tax. Act 154 excise tax makes up more than 20% of Puerto Rico's General Fund revenue and other business taxes push the total reliance above 40%. The US state average is about 6%.

Implications are broad. A cash flow shortfall would require immediate spending cuts or external borrowing measures to bridge the gap. It is unclear whether the Treasury has requested a line from GDB (yet). The Commonwealth also has roughly $1B of TRANs (intra-year cash flow borrowing, originated before the downgrade) with a variety of banks as well as the GDB. The ability to repay these

notes with internal liquidity is a concern, but perhaps as importantly will be the ability to find TRAN lenders next year.

More broadly, the credibility of the Commonwealth's estimates and forecasts are wearing increasingly thin. Recall that FY2014's gross receipts tax proposal was quickly cobbled together after the Center for New Economy stated that the Commonwealth's initial proposals were, "logically incoherent in the best case, and as bordering on economic illiteracy in the worst….we fear that that the end product may be an incoherent jumble of new taxes and exemptions that will significantly increase the complexity of the system, complicate both compliance and enforcement efforts, and fail to generate the expected revenues….in which case a further GO downgrade would be inevitable."

Note that PR's Treasury is again predicting an increase of between $615M and $700M in revenues next year from various other revenue measures as well as rosy economic projections. Last week, a respected PR-based economist estimated that the economy, at best, will shrink by 0.8%, rather than grow by 0.1%, the PR Planning Board estimate upon which the new budget is being based. In a press release entitled, "April Revenues Increase 20%

Year-Over-Year; Year-To-Date Revenues Exceed Last Year Period By $465 Million", the Secretary of the Treasury, Melba Acosta, stated "Certainly, these are not exactly the results we expected." We expect better and again urge the Commonwealth to adopt legislation introduced by Senator Bhatia to create a professional nonpartisan, oversight and analysis body as soon as possible.

April 14, 2014

PUERTO RICO PENSION REFORM AND ECONOMIC DATA ARE INCONCLUSIVE: Late Friday, the Supreme Court of Puerto Rico, declared in a 5-3 decision (Justice Feliberti recused himself) declaring key provisions of Law 160 teacher's pension reform unconstitutional. Specifically, the Court reasoned that aspects of the pension law did not comply with the strict standard of being "reasonable and necessary in furtherance of an important government interest." Several justices stated that the Legislature did not adequately study the legislation's probable effects and that it did not adequately prove that Law 160's solved the problem. According to Politank, a PR-based Government Affairs law firm that has been closely tracking the issue, the Justices factored into their ruling the potentially "disastrous effects" of Law 160 were it to triggering a massive retirement of teachers to avoid the law's cuts. Such premature retirements would potentially consume all retirement system assets in short order. Note that several key components of Law 160 were upheld (eliminating collateral benefits and medicine bonuses, and post-reform reductions) and we believe the island leadership will take action to remedy many of the Court's concerns.

Still, this court ruling appears to undercut assertions that Puerto Rico's judiciary will always defer to "legislative determinations." This claim was cited as an island credit strength on a GDB's October 31 conference call, in response to investors' legal concerns about COFINA and related claw back issues vis-à-vis the GO security's first claim on revenues. **MMA** has long urged the Commonwealth to settle this dispute via a mandamus validation process (common in many US states) where the Supreme Court can rule (or not) whether sales tax revenues constitute "available resources" which, under Puerto Rico's constitution, are dedicated on a first priority basis to the payment of Puerto Rico's "public debt."

Additionally, as the island continues to engage more “restructuring” experts, Justices may also be forced to weigh contractual commitments to bondholders versus Puerto Rico’s other stakeholders and economic growth prospects. In our view, the majority’s opinion ruling that the ban of impairment/violation of contracts is not absolute keeps a door open in this area, although clearly the standards for such a reversal would need to be high.

The decision is also a blow to Gov. Alejandro García-Padilla (a pro-Commonwealth, strict constructionist attorney) who showcased the teacher pension reform as evidence of his administration’s fiscal successes in marketing the large bond deal. The ruling relies on data that conflicts with, and undermines, some of the administration's arguments regarding the system’s solvency. Reportedly, the Governor is now hammering the Justices’ perceived “free-lancing,” saying their court decision could sidetrack his efforts toward fiscal balance and revive the economy.

Economic data remain inconclusive, which is better than clearly negative: On this note, Puerto Rico’s economic recovery statistics remain inconclusive and conflicting. Official BLS data show Puerto Rico’s payroll employment plunging by more than 25,000 jobs since January 2013, while the Governor continues to cite 45,000 new jobs created by his administration over the same period. Note that the GDB reported that its February 2014 Economic Activity Index dropped another 2.4% YOY as public employment decreased by 3.7% (9,300 jobs) and gasoline consumption dropped 6.4%. It does appear that there has been some recent Puerto Rico private sector job growth (up 1.5% YOY, or 10,300 jobs), specifically in the Professional & Business Services sector as well as in Leisure & Hospitality. It is not clear at this time whether the biotechnology and pharmaceutical companies are driving this growth, or other more diverse job-intensive sectors. These data are important in tracking PR’s success in reversing the recent malaise and negative perceptions among residents that beget continued outmigration and brain drain. PR needs an optimistic “buzz.”

To this end, Puerto Rico is ramping up efforts to bring in outside companies and investors and will host many in events this week and next. The island’s unique territorial ability to make special tax arrangements is a powerful tool that is now being leveraged effectively. Specifically, Act 20 is very appealing for American business owners who can incorporate and operate their business from Puerto Rico at significantly lower effective tax rates that on the mainland. And under Act 22, an American citizen, living and earning Puerto Rican-sourced capital gains and certain interest and dividends income in Puerto Rico pays a zero tax rate. Large multinational corporations continue to benefit from Puerto Rico’s Law 154 manufacturing excise levy as a creditable tax against federal income tax. Favorably, the IRS recently confirmed it will not challenge this credit. Additionally, the island will have to manage these incentives carefully so as not to appear to be another Cayman Island-like tax haven that pushes the rising tax burden on other states and municipalities.

The island is also taking decisive action to stimulate sustainable, indigenous economic activity. Going back to Operation Bootstrap (the 1950s industrial transformation) to Section 936 (enacted in 1976) to the triple-tax exemption to Act 154, the island has relied on external measures that have not created adequate job growth and in some cases, exacerbated the island’s economic challenges (e.g. increased reliance on debt and a handful of corporations to keep the government going). Puerto Rico has a long history of writing up exciting and detailed economic development plans but these seem to change with through each political transition. Some of the most experienced and respected economists,

conservative and liberal, have studied the problem ad nauseam. Yet the political leaders have not been had the decisiveness, wherewithal or luck to convert these plans into results. The GDB must return to its role as long-range, non-political facilitator of long-range economic development. After years of half-measures and quick-fixes, Puerto Rico stands at an economic and financial precipice. Now, as never before, the pressure on the island is intense and it will probably need to cut significant government spending and raise more taxes to balance a large structural deficit in the anticipated FY2015 budget and bring down its debt levels at the same time.

March 17, 2014

PUERTO RICO FOLLOW UP AND RESTRUCTURING BILL: Last week's successful execution of an up-sized PR bond (to $3.5B with $16B in reported subscriptions) is a testament to continuing market demand for exposure to PR debt. In the near-term, this is comforting: the commonwealth's principal credit strength, after all, is its ability to access new capital if needed. But of course the new bond will add some financial pressure to the commonwealth's annual budget (once capitalized interest runs out next year) and could make any future restructuring, if needed, incrementally more difficult to effect. Importantly, we also expect that, with the successful sale that depended largely on hedge funds, Puerto Rico as an investment is continuing to its transition away from the traditional municipal bond market (even if some traditional players have decided to re-engage and speculate on near-term performance of the island's new GOs). This is an important perspective, as it implies a thicker cushion between what happens in PR and the market as a whole. This is not to say that renewed problems would not lead to mutual fund outflows again; they likely would. But this is also increasingly a temporary risk. We find it hard to expect that investors in any mutual fund with material PR exposure now have not effectively re-underwritten their purchases in these funds with that information in mind, meaning preparing themselves for PR-related problems that might occur.

MMA is also following last week's filing of PR Senate Bill 993, the "Public Corporation Restructuring Act", which lays out a process for the restructuring of an insolvent public corporation. The bill is sponsored by Senators Ángel Rosa and José Nadal Power, two committee chairs of the same party as the Governor, both described as "mavericks" who opposed the $3.5B bond deal. This bill portrays a process substantively different from chapter 9. Specifically it allows for: 1) bankruptcy of a Puerto Rican public corporation to be initiated by a creditor not just the issuer, and 2) the standard for eligibility to be as little as liabilities exceeding assets. Also, 3) a plan of adjustment seems to be able to come from creditors, not just the corporation; 4) liquidation of the corporation is possible, under control of the respective judge; 5) there are few carve outs or protections for contracts, pensions, etc.; and it seems that 6) there is no special revenue provision that would protect revenue bonds as in chapter 9. Finally, 7) the Commonwealth Court is in charge, not a federal court.

MMA notes that this is just a draft bill which appears to have been hastily drafted in both English and Spanish without consultation with the GDB, lacking proper governance, legal and financial advice, implying that parts may or may not be consistent with commonwealth and Federal law. The PR Legislature, like the US Congress, files many bills which never find a vote (and Senate President Bhatia has yet to state his position). Also, the GDB has stated that neither it, nor the Governor's Office, participated in the drafting of SB993 and that they have no specific plans in case one or more public corporations were not self-sufficient. "The GDB, as the government's and its instrumentalities' fiscal

agent, is evaluating the financial condition of public corporations to assist them in drafting plans to assure their self-sufficiency. No contingency plan, including debt restructuring, has been adopted in case their financial condition doesn't improve." Of course, GDB could also provide much needed guidance to the bill's drafters and flesh out many of its skeletal positions.

But despite its many flaws, there appears to us some compelling logic behind this bill. Specifically, the lack of a clear path for a restructuring is a negative for all stakeholders, with taxpayers, employees, and bondholders forced to operate with some suspension of disbelief that defaults can and might occur. Further, the lack of a restructuring provision has in the past been a major inhibitor to deeper hedge fund involvement in PR agency debt. This bill, were it to provide some clarity on how a restructuring might actually occur, could allow investors to better price speculative positions in agency debt, opening up substantially better liquidity in related blocks of bonds. And finally, this type of bill could be a tool to induce parties to a private restructuring negotiation to reach an agreement or submit themselves to a potentially less "professional" court procedure.

MMA notes several larger block PREPA trades below $70 on Friday (CUSIP 74526QA7), likely related to the bill's filing. Although PREPA is the most obvious target within the bill's rhetoric (which would, incidentally, allow for even COFINA to be drawn in to this process, although we strongly expect that this is an issue with drafting and not intent), no senior level PREPA executive has yet reacted to the bill. A PREPA public interest director did say that PREPA is current in all bond payments and that debt issuance plans are limited. PRASA's Executive Director stated the agency would study the bill carefully, but that the agency will end this fiscal year with no deficit and that PRASA no longer expects to receive General Fund subsidies due to the agency's recent rate hikes. This bill incidentally came on the same day that a measure to create a Public Utilities Regulatory Commission with oversight over PREPA was filed in the House (the Senate filed a similar bill recently). Hindrances to fully monopolistic rate setting by either agency likely increase their medium-term.

March 10, 2014

PUERTO RICO THIS WEEK: PR's issue this week may well be the most scrutinized and eagerly anticipated deal in municipal bond history. Accordingly, the POS provides a candid 14-page depiction of the Commonwealth's myriad risks and contemplates the potential for adverse out-comes. It is of significance that the issuer has now established a new baseline for transparency and disclosure for prospective investors, current bondholders, and regulators—a constructive sign from this issuer. **MMA** finds it particularly noteworthy that:

· PR concedes it has not complied with disclosure requirements in three of the last five years;

· The Commonwealth (finally) acknowledges it has a "very high level of debt" that approaches debt limit capacity;

· Leverage is exacerbated by a complex web of private bank lending arrangements and inter-agency dependencies;

· The Commonwealth explicitly states it "may be unable to meet its debt obligations" if market access is lost;

· Operating requirements and political opposition "from affected constituents" present further risk to bondholders;

· GDB liquidity has dropped by $1.033B this year and, even in the most optimistic scenarios, the bank may end the fiscal year with just $679M in net cash available and probably have to seek loans from private banks or in the public market by the end of FY2015;

· "Claw back protection" is less solid than thought; it is unclear what steps a GO bondholder has to "compel the diversion...to the payment of public debt or how the necessary available Commonwealth resources would be allocated";

· FY2015 budget risk is ~$1.5B (due to cost escalators and revenue assumptions) and further gaps may widen as outmigration, economic deterioration, education and health spending trends are revealed;

· Emergency actions, restructuring, moratorium, and alternative courses of action are being evaluated;

· The GDB has hired a "financial advisory" firm (Millco Advisors) specializing in debt restructurings. GDB states that Millco is NOT advising on restructuring but assisting with "cash flow and projected liquidity." As a result, PR's restructuring risk should temporarily abate with this bond sale; and

· There is no collateral, acceleration, or mortgage lien, and remedies available to bondholders are potentially "subject to substantial discretion and delay." Furthermore, despite efforts of bondholders for venue protection, "there is no assurance that any judgment from a New York court would be given effect by a Puerto Rico court."

Given these risks, the GDB states that this issuance is suitable only for purchasers in $100K denominations and emphasizes buyers are those "who can bear the risks of price declines, limited liquidity and the possible failure to pay debt service." Also, the large lot sizing should aid expected liquidity in the new borrowing, allowing for fewer "odd lot" trades and the gaping price dispersion now plaguing the general PR market.

MMA expects sufficient demand will emerge to take down this issuance; post-sale reports likely will reflect broad-based demand. Potential preliminary structuring entails a $3B, 8% coupon term maturity in 2035 sold to an 8.625-8.875% yield. With sinking funds schedule from 2022 to 2035, callable at par.

How long the bond proceeds will enable PR to bridge itself to a sustainable path is the central question. Hopefully, there will be notable progress before the Commonwealth returns to the market by the end of CY2014. Remember that, even with the new bond proceeds—and under best-case scenarios—PR and its agencies face $2.5B in short term debt obligations through FY2015 and GDB faces large debt maturities in FY2016 as well.

Impact on Ratings: PR's new disclosure of risks does not break new ground for investors already awake to the fragility of Commonwealth finances and the dependence of same on inter-agency liquidity transfers and volatile market access. As noted above, the POS is a positive step toward greater transparency and, more importantly, avoiding action from a recently more restive SEC municipal enforcement division. However, the credit profile depicted in the risks section is also clearly not an investment grade security—nor has it been for some time—despite its being rated as such only one month ago. The new disclosures are thus a reproach to those ratings and the agencies themselves, which all investors should welcome. Although the Commonwealth has hopes of regaining IG (and so

traditional municipal investor demand) in the medium-term, this goal is better depicted as an aspiration for the very long term.

February 24, 2014

PUERTO RICO UPDATE: With their extended investor call last week, the Commonwealth has moved closer to executing the planned new loan, now estimated at just shy of $3.0B, to finance immediate and near-term cash flow needs. A bill to authorize up to $3.5B in new borrowings (ostensibly to provide some cushion for an additional loan if needed) is moving through the PR legislature, but media reports this morning (www.noticel.com) that a contemplated waiver of the Commonwealth's sovereign immunity may not have gotten through the Senate. Still, we expect this financing to be completed in the next few weeks, allowing some optimism to return in PR bond pricing (indeed, multiple sources are noting firmness at the end of last week and sub-50 cent odd-lot trading in current interest bonds subsided to ~2% of total PR CIB trades (**Figure 5**). Keep in mind that, should liquidity and prices in PR names continue to improve, we expect more bondholders will choose to exit PR positions, limiting the potential for near-term outperformance in PR.

February 10, 2014

PUERTO RICO DOWNGRADED: Last week's long anticipated double downgrade of Puerto Rico GOs and other credits—S&P's by one notch, Moody's by two—has dominated news flow into this week's open. The island's exhaustive campaign to maintain investment grade ratings was valiant, but inevitably futile. Puerto Rico's persistent economic downturn and unsustainable debt load had simply become too weighty for the agencies to ignore. The agencies simply ran out of methodological exceptions and one-offs for Puerto Rico. The simple truth is that the evident lack of cash (and market access to get more) by definition had made the island's long-term credit rating "speculative" quality months before.

Also, revenue numbers just out this morning were mixed. To the positive, January sales tax collections were their highest ever since inception, completing the transfer of new funds to COFINA bondholders. Negatively, year-to-date general fund net revenue surplus shrunk from $80M to $36M. The December economic index (still not released) will likely be negative as preliminary reports show payroll employment (-2.7%), gasoline consumption (-8.9%), power generation (-3.1%) and cement sales (-18%) are all again down.

The Ratings Contrast. Agency reports were similar in tone, both citing marginal progress despite the outcome. Generally, S&P's report focused on liquidity, while Moody's looked more to the economy and macro-factors. Most importantly, Moody's downgraded both senior-lien (Baa1 from A2) and subordinate (Baa2 from A3) COFINA's bonds. S&P left COFINA untouched, reflecting their view that the dedicated sales tax is "not subject to the prior diversion of revenue for GO debt service payments" (aka "claw back"). Still, Moody's **COFINA action obviously dampens the prospects for a Third Lien bond deal (see below)**. Noteworthy as well, while S&P spared PREPA, Moody's cut the power agency's rating to Ba2. This is an issuer that some believe is politically ripe for restructuring—many blame the power authority for the island's economic woes arising from its high cost structure and intransigent management. Related reform efforts are languishing.

*Lack of Transparency Hurt the Island***.** Experienced municipal investors recognize that constrained liquidity, and consequent reliance on short-term lending rollover, is the tipping point in most municipal crisis. By last week, few took any solace in GDB Chairman David Chafey's verbal insistences that GDB liquidity is "adequate" as a pillar for prudent investment thesis. It was vexing that, Mr. Chafey, an experienced banker and investor, would fail to provide basic quantitative evidence of his assertion of GDB's liquidity. Investors gradually interpreted GDB's extraordinary actions (pulling government deposits at private banks and using the Workers Comp and State Insurance Fund) as an indication that liquidity was probably much lower than represented. Mr. Chafey, appointed by the Governor's, failed to realize that without disclosure, his credibility, and investor patience, would suffer.

In the aftermath of the downgrades, PR leadership has shown resolve in hopes of forestalling more downgrades and maintaining demand for a bond deal. The press release said, "We strongly disagree…and we will not relent in our plans to strengthen our fiscal situation" again maintaining that liquidity is adequate. The Governor offered various budget balancing proposals to cut spending and stimulate economic growth and reportedly will make an speech today at 4:50 PM to talk with "more detail and precision," about proposals that have already been made public. It is stated he will address recent proposal by Senator José Luis Dalmauto remove the sales and use tax (SUT) and restore the general excise tax. The bill states that that the SUT is woefully inefficient, as evasion is 44%, which causes annual losses to the treasury about $900M.

What Next? The oft-cited Chinese character for "crisis" representing both danger and opportunity is one that PR investors are considering:

· Bulls contend downgrades were priced in, evidenced by light trading in the aftermath, and that forced fund selling had been exaggerated. The liquidity impact of the downgrades may have been overstated (with extensions of existing liquidity facilities and forbearance of swap terminations a possibility), while fresh liquidity awaits from hedge-funds, assuming prices are showing satisfactory resilience. The downgrades also present an opportunity for Puerto Rico to adapt to the realities and form new political alliances and enhance fiscal practices.

· Skeptics are less willing to accept rosy narratives. The juxtaposition of the news of downgrades with the announcement of borrowing sends a message that PR is returning to "business as usual" by presenting a last-gasp bonding attempt that puts undue pressure on the market. With deep problems (highlighted in yesterday's sobering, most-emailed *NY Times* article), the attempt to borrow at rates approaching double-digits would, if successful, provides temporary salve but longer term worsens the island's economic and fiscal condition. The issuance would also tap out the Commonwealth's remaining $1.3B of available borrowing capacity, leaving future leaders with no borrowing capacity.

The terms of this proposed debt issuance (currently subject to negotiations between prospective buyers, bankers and GDB's depleted management team) regarding legal protections, requirements, timetables and acceleration provisions will likely be revealed this week. Note a new article showing PR's securing a $2-2.5B "backup" commitment from RBC while negotiating with a Latin American syndicate for another. Reportedly, these would be used should traditional market sources be inadequate. We assume some form of stronger security and high yields, deep discounts would be involved. In the event new borrowing initiatives are unsuccessful, **MMA** notes an increase in legal briefs contemplating the legal consequences of Puerto Rico not paying bondholders, whether Puerto Rico be sued, who can sue as well as complex

questions regarding court jurisdiction over a sovereign entity and "forum-scouting."

Stay Tuned. The downgrades have ignited an already fluid situation for investors as well as the people of Puerto Rico's people. Driving Puerto Rico's efforts to maintain the investment grade was a pride and patriotism, now bruised. The loss of investment grade now will chafe among citizens who are paying higher taxes, workers, retirees and local investors who borne financial losses, and leaders who risked political careers to assuage the investor community, which (in their view) prematurely and coldly turned their backs. There have been encouraging signs that PR will rise to the occasion and adapt to the new reality, balancing the demands of bondholders and its economy toward rational outcomes. We expect developments in the next several weeks to carry enormous weight as to how the island's leaders will respond.

BOND INSURANCE AND PUERTO RICO: Despite widespread market commentary and assurances that the bond insurers will ably survive Puerto Rico's current situation, we believe that risks warrant a somewhat more cautious perspective. There are likely severe loss scenarios for PR in which the insurers would be at risk of downgrade or, worse, regulatory intervention. **MMA** thus recommends investors calibrate the size and quality of their insured positions according to their own projections for default and loss severity in PR.

Last week's downgrades do not on their own threaten Assured, National, or Ambac in any material way. The lower ratings do increase the required capital buffer for the companies; however, both Assured and National currently maintain excess capitalization versus their ratings (ratings being lower than existing capital would imply, based on thin market opportunities, agency mistrust of the business model in general, etc.). A more difficult scenario—running to a temporary default on principal and interest—should also be manageable by the insurers, Assured and National/MBIA likely retaining the ability to raise incremental new capital if needed to demonstrate excess solvency to the rating agencies.

However, if some or all of the Commonwealth's issuers ultimately need to reduce their debt loads, things become less predictable. Again, modest or even material haircuts by only one or two of the weaker credits should be reasonably affordable. By statutory guideline, the monolines are only charged with covering the timely payment of principal and interest as originally scheduled. This stops capital from going out the door to cover a single insured bond's acceleration, preserving the monoline's resources to ensure fair treatment of its other contingent liabilities (policies).

Which is exactly the problem for the insurers from a business perspective. If PR's worst case scenario indeed produces the sweeping haircuts current market discounts imply, **MMA** believes there emerges a risk of regulatory intervention (as occurred with Ambac and FGIC) for the companies with large exposures to PR names. In other words, the regulators may choose to intervene in the companies' operation to conserve cash and protect the holders of non-PR insured bonds. This was the case with FGIC, where massive structured finance losses precipitated the monoline's rehabilitation and subsequent capping of policy payments at a fraction of par.

Because regulatory intervention is a major negative for new business generation prospects and ratings, the insurers in a worst case scenario could choose to pro-actively solicit PR policy commutations (the exchange of a policy cancelation for a partial cash payment by the insurer to bondholders). This occurred with many troubled structured finance transactions during the financial crisis, as well as the Las Vegas Monorail bonds. Commutations, if completed smoothly, would reduce the risk of a forced

rehabilitation but would likely pose severe damage to ratings and new business generation.

Finally, although BAM has no direct PR exposure, we expect that events similar to the above could do further damage to the bond insurance model generally, undermining the industry's reputational improvements following full payment to holders in JeffCo, Harrisburg, Stockton, and Detroit.

January 27, 2014

PUERTO RICO FAST AND FURIOUS BUT MAYBE NOT ENOUGH OF EITHER: Facing ongoing rating agency pressure**,** PR Governor Alejandro García Padilla signed a flurry of legislation ahead of his team's visits to the rating agencies in NYC this week. The NYC trip was postponed from last week, presumably as the Legislature took action to roll out a new sales tax backed credit, enhance the COFINA structure, and demonstrate progress in protecting GDB's solvency and liquidity.

The actions failed to sufficiently impress S&P, however, which late Friday placed the Government Development Bank on CreditWatch with negative implications, then followed with a CreditWatch placement of the GO and appropriation debt as well as various other agencies, including the Highway and Transportation Authority. COFINA's ratings were not affected. S&P follows similar Fitch and Moody's actions, all of which certainly will not help PR's ability to place either a sizable COFINA bond issue or a large $2-$3 billion private deal (as has been rumored in recent weeks). S&P states that, "GDB's ability to provide liquidity to the commonwealth has become constrained could have limited liquidity by fiscal year-end June 30, 2014 without access to the debt market by either GDB or the commonwealth.' The agency also acted on four private banks stating, the Commonwealth's funding challenges "could hurt the local banking sector through increased loan exposures and reduced deposits from public agencies and local municipalities."

MMA believes that GDB's leadership has done a poor job satisfying investors and rating agencies questions regarding the bank's liquidity position, offering only vague pronouncements of adequacy. The imminent release of GDB's FY2013 financial statements (released in mid-February last year) will provide real numbers and context. S&P states that PR's routine funding needs could be as high as $1 billion over the next six months; other estimates are twice that level. A downgrade would exacerbate the monetary impact given the cost of interest rate swap agreement collateral postings, termination costs, variable-rate demand obligations liquidity terminations, mandatory tenders, unwinds, etc., not to mention the debilitating impact on the island's economy.

The speculation regarding negotiations for a hedge fund pool loan and PR to raise additional capital is no surprise and is consistent with the island's efforts to provide capital to meet its near term operating and capital needs. **For current investors in PR bonds, the potential for a large cash infusion from hedge funds represents a short-term balm by as it could help patch any unanticipated liquidity shortfalls. However, to the extent the new loan is structured to be senior or effectively senior to outstanding bonds, current holders will see their own security diminished. This is particularly a concern if the Commonwealth does in fact need to move to a restructuring phase over the next several years**.

MMA has reviewed the new PR bills noted above and offers some preliminary analysis:

· Maintain the Sales and Use Tax (SUT) at 7% versus the proposed reduction to 6.5 % The actions will

strengthen Corporation Tax Fund (COFINA) coverage by adding 0.5% beyond the 5.5% currently pledged. Of course, there may well be negative economic implications of a higher tax on consumption.

· Create the Municipal Financing Corporation (COFIM) fund into which shall be deposited directly on 1% of the municipal portion of the SUT. COFIM shall have the power to issue bonds to pay or refinance $600 million debt owed to GDB by municipalities. The bill also enhances collections as it makes mandatory that all 78 municipalities municipal charge SUT 1 % to sales of unprocessed foods (17 municipalities had chosen not to implement the tax).

· Strengthen GDB liquidity and impose fiscal discipline measures limiting loans that GDB can issue to government entities. Specifically, Bill 857 requires:

* Government entities generally (with some exemptions) are required to transfer their private bank deposits to GDB, which must offer "competitive market interest rates and minimize the costs of penalties." The House amended the bill stating it will apply to the extent that it doesn't have an adverse effect on its operational income or its capacity to generate revenues necessary to provide financing.

* Government entities formalize, restructure and document their debts with GDB and negotiate repayment plans by July 1, 2016. This bill also prohibits GDB from loaning over $100 million to the General Fund without legislative authorization or extending loans to entities without corresponding increases in tariffs and other fees. GDB, nevertheless, may provide loans not subject to this cap, when needed to honor debt service payments by any government entity or loan to cover required debt service payments or to make emergency loans to avoid the interruption of essential services. Violation will constitute a felony with a maximum three year jail term.

* SB 857 also addresses of $2B in GDB financings that were extended to HTA on or before Dec. 1, 2013. While the original language allowed that, if HTA revenues were insufficient to cover debt service, the Treasury Secretary would be required to transfer available resources from the General Fund to cover such deficiencies, the bill now states that when GDB determines an insufficiency, "the necessary appropriations to cover such deficiencies shall be included in the recommended budget".