PUERTO RICO DEBT: A COMEDY OF ERRORS, BUT NO ONE IS LAUGHING

Puerto Rico government and its citizens will pay higher debt costs for decades
Puerto Rico's Government Development Bank (GDB): A Help or hindrance?

Stoever Glass & Co
MUNICIPAL BONDS FOR INDIVIDUALS AND FAMILIES SINCE 1964

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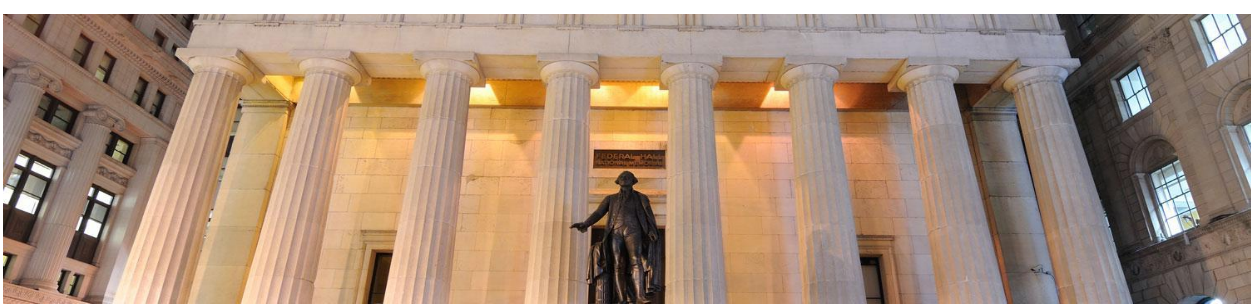
Dick Larkin
Director of Credit Analysis
Stoever Glass & Co. Inc
P: (800) 223-3881
E: dlarkin@stoeverglass.com



In 2012, Puerto Rico still had reasonably priced access to the municipal bond market, with ratings of "A3/BBB/BBB+" by all of the bond raters. In fact, both Moody's and S&P had upgraded the Commonwealth's ratings in 2010 & 2011.

In the last six months, however, the elected and appointed leadership has damaged Puerto Rico's creditworthiness. As witness to this, Puerto Rico has voted to unilaterally reduce payments to its bondholders, at the same time it is waging a battle in U.S. Congress that would provide legal authority for missing debt payments. What started as a 2014 debt crisis for the Puerto Rico Electric Power Authority (PREPA) has now spread to all debt, including constitutionally protected Generally Obligation and COFINA sales tax bonds.

Many believed that Puerto Rico would do anything to prevent default and avoid a loss of market access. Their premise was that Puerto Rico would not take actions that would close off bond market access for its operating and capital needs.

In 2013, at the start of the current Puerto Rico debt crisis, even the most vocal critics and analysts believed that if defaults were to occur, investors could count on fairly good recovery of their investment after default. Many advised that clients should not sell their Puerto Rico bond investments at "fire sale" prices which were driven by panic. That was good advice at the time, because bond prices improved temporarily through August 2015.

Earlier this month, the Governor and Legislature formally approved bond defaults across almost every type of bond security the Commonwealth issues. This proposal has no legal standing in bankruptcy court. Some might say that this could be the best time to sell your Puerto Rico investments. On the other hand, Puerto Rico has already "sweetened" its original offer of voluntary defaults and recoveries. Puerto Rico's new plan proposes an increase toward annual aggregate debt service from $1.7 billion to $1.85 billion (equal to 15% of 2021 revenues), allowing the Commonwealth to increase its original aggregate amount of replacement bonds by approximately 11 to 30 percent. Still, the proposed recoveries are disappointing, especially for investors that believed the Commonwealth's constitutional backing for General Obligation and COFINA Sales Tax bonds assured 100% full and timely payment. The latest proposals for bondholders can be summarized crudely as:

- GO and Commonwealth-Guaranteed – 74% (Note: the proposal treats GO bonds (80% recovery and Commonwealth Guaranteed bonds (with equivalent GO guarantees) at 71%, so the blended recovery rate is 74%)
- COFINA – 57%
- GDB – 36%
- HTA – 56%
- Other – 51%

In the corporate bond sector, these restructured debt proposals of 36% to 74% might be viewed as positive—surely, Puerto Rico's bondholders will not see a complete loss. In the traditional municipal bond market, which tends to be more conservative and risk-averse, Puerto Rico's debt proposal is, at best, disappointing.

On a positive note, the Puerto Rico Aqueduct and Sewer Authority (PRASA) is not included in bond payment cuts, likely because it raised its rates by about 60% a few years ago, putting it on a self-supporting basis. PRASA expects no borrowing needs until 2017.

I believe that Puerto Rico's unilateral proposal to recover investor defaults is still too low, but it has definitely weakened bond prices, adopting a stance that defaults across the board are inevitable. Puerto Rico debt remains speculative and price recovery is unpredictable for retail bond investors. Puerto Rico will still need borrowed money to maintain its infrastructure and daily operations. For that to occur, Puerto Rico has to show good faith in making bondholders whole. That alone should help investors that stand to lose substantial money based on the latest weak proposals by Puerto Rico's leadership.

"Show Me The Money!"

Much has been made of Puerto Rico's economic malaise and finances. And yet, since 2013 Puerto Rico has gathered over $8.5 billion of cash infusions from:

- Borrowing ($5.1 billion spread amongst the Treasury, Government Development (GDB) and Puerto Rico Electric & Power Authority (PREPA),
- $916 million from sales tax increases,
- $281 million from oil shipments taxes,
- $317 million from higher water rates,
- $615 million from the lease of its largest airport, and
- Substantial fuel cost savings for PREPA.

It is the last of these “budget balancers” that troubles me the most. PREPA suffered from high oil and purchased power costs in recent years. In fact, most analysts assumed that PREPA would be the first Authority to default on its debt when the Governor proposed his local version of bankruptcy laws in June 2014. However, the precipitous fall in crude oil prices from over $100 per barrel of crude to $35 per barrel has resulted in $1.2 billion of savings for PREPA compared to budgeted costs since 2013. Why all of these savings went to customer rate cuts, and left virtually nothing for investors that lent it over $8 billion of debt has yet to be rationally explained by PREPA’s management, and the Commonwealth’s elected and appointed leadership. Where did all of this money go?

It’s a valid question that needs to be answered, especially at this time of crisis. Unfortunately, untimely financial disclosure by Puerto Rico and its Authorities (including the Government Development Bank) muddies the water. The President of the GDB just last week complained that Puerto Rico has not “received an actionable, binding financing commitment from anyone, and (we) have received no offers that would lead Puerto Rico towards a stable and prosperous economy for years to come”. Given all the machinations and lack of disclosure (no audited financial results since 2013) to investors, what did the GDB expect? Moody’s Ratings used to have a sign over its door, defining “Credit is Man’s confidence in Man.” I think that as a result of poor financial and debt management, Puerto Rico has irreparably impaired the confidence the municipal bond market.

Anatomy of Puerto Rico’s Defaults

Here are the 7 top reasons as to why Puerto Rico defaulted, rather than the 100% full payment I envisioned in 2012:

1. **Poor Communications.** A detailed budget proposed by the Governor for 2016 was in Spanish, making it extremely difficult to realize that the government did not appropriate this year’s payments for so-called “appropriation bonds”. These bonds issued by the Public Finance Authority and similar debt issuers, where debt payment depended on the promise to pay by annual appropriations. It appears that all appropriation bonds are now suffering 100% default, including the Public Finance Authority, The Public Building Authority, and even PRIFA bonds that have a first lien pledge on rum excise taxes. The rum tax bonds are at risk because government can sequester those funds to pay general obligation bonds; that appears to be their intent. The only positive development here is that the Governor is proposing to partially repay these bonds that are in default.

In addition, the government did not keep lines of communication open between themselves and the bond raters; the government did not meet with rating agencies until a downgrade decision was made, at which point discussions were futile. Finally, PREPA was told to form a "confidential relationship" with certain PREPA creditors, by which they disclosed confidential information unavailable to analysts like myself and retail investors.

2. **Poor Planning.** Examples here are the refusal by government budget administrators to make intra-year adjustments to revenue and expenditures in the face of budget shortfalls. To compound the problem, in February 2015, the Governor proposed a radical 2016 budget based on a value added tax, which was untested. Puerto Rico already had a poor record of collecting taxes and charges currently in existence. This was a gamble that failed, and when his budget was defeated by the legislature in April 2015, there was not enough time to develop a credible "plan B", which would have been smart budgeting. In addition, government officials knew even before the June 2014 "bankruptcy plan" for Authorities that financial crises lay ahead; they did not act until June 29 2015, when the Governor announced that Puerto Rico's debt was "unpayable".

3. **Poor Disclosure.** Audited financial statements for 2013 came out late, and Puerto Rico as well as the GDB has failed to publish audited financial statements for 2014 or 2015. In my opinion, I believe the 2014 audited results are late because of the "closed door" transactions agreed to between the Commonwealth, the Government Development Bank, and the Puerto Rico Electric Authority (PREPA), whose institutional investors obtained a confidential disclosure agreement regarding the Electric Authority's operations and finances. Without reliable financial statements, how can an investor make informed decisions about a debt restructuring?

4. **The Failure of the Government Development Bank (GDB) to do its job**. In 2013, the GDB precipitated PREPA's cash crisis by not advancing them funds for seasonal cash flow needs. Instead, the bank insisted that PREPA deal with private banks for these loans. The inability of PREPA to come up with the cash to pay these loans in July 2014 is the major reason why PREPA needed a "debt moratorium", or a forbearance agreement to avoid insolvency. And yet, the GDB advanced over $2 billion of loans to the cash poor Highway Authority. Those loans to Highway are now unpayable, putting the GDB in a cash crisis because the loans are not being repaid. In addition, the GDB was instrumental in making "vulture" hedge funds the predominant creditor with which debt negotiations would be worked out. Frankly, instead of assisting Puerto Rico in financial management and debt issuance, the GDB now just adds more

liabilities spread amongst a multitude of other debt issues that are complex and difficult to track by even the most experienced analysts.

5. Poor Choice of Bedfellows for Debt Issuance. Probably around the time of the July 2013 PREPA electric revenue bond sale, "vulture" hedge funds began accumulating distressed debt of Puerto Rico; this continued with 8% general obligation bonds in March 2014, where large institutional investors were the only ones allowed to purchase the new deal, and retail clients were excluded as investors. There is nothing intrinsically wrong with hedge funds; they are unregulated entities that permit investors to take advantage of unusual high yield opportunities. "Vulture funds" are a subset of hedge funds. They basically invest in distressed credits at "panic" low prices, until they can achieve a majority or commanding position as creditors. That allows these funds to dictate terms to the debtor, which is where we are right now in Puerto Rico, September 2015. This is the second leading reason why defaults will be widespread in Puerto Rico. Aggressive investors, who bought Puerto Rico bonds and PREPA bonds at prices anywhere from 35 cents to 50 cents on the dollar will profit from any default agreements by Puerto Rico's leadership. It has been estimated that hedge funds now own about 37% of Puerto Rico debt. But retail investors who bought bonds at par in good faith with an expectation of steady income are excluded as a negotiating party in Puerto Rico's restructuring plan. It is unfortunate that many investors have already taken a hit. Remaining retail investors are now being forced to take a hit as well.

6. A Complete Disregard for Common, Widely Adopted Financial Management Policies and Standards.
Things like maintaining budgetary "rainy day" funds as a cushion against economic stress, avoiding the use of "one shot" budget gimmicks to balance the current budget, adoption of multi-year financial forecasts, even the common practice of issuing financial reports and budgets that meet minimum standards of the Government Financial Officers Association, are practices observed by most state and local governments in the U.S. Puerto Rico's track record on "best practice" financial management practices is underwhelming, at best.

7. **Finally, the Lack of "Political Will" to Repay Debt and the Total Disregard for the Financial Future of Puerto Rico.** For a government unit as large as Puerto Rico, the need and ability to borrow money for capital and seasonal operating needs is the financial lifeblood of a state or local government unit. With last week's decision by Governor Padilla and the Legislature, the leadership of Puerto Rico has will face a wary bond market. Using the debt markets to refinance

current debt or issue new bonds for much-needed capital projects to improve electric service, highway repairs and expansion, or any other large capital project will be at risk.

Where does the U.S. Congress Fit Into This Controversy?

Before the House of Representatives (and ultimately the Senate) can consider new laws for Puerto Rico, it must first “pass muster” before the House Committee on Natural Resources.

This Committee last met on the Puerto Rico debt issue on Thursday, April 13. It’s not yet scheduled for further discussion at this point, but the Bill seems to have a measure of bi-partisan support.

The bill includes a fiscal oversight body with at least 7 members, 6 of which are appointed by the President, with the advice and consent of six members of Congress. At least one member must be a resident of Puerto Rico.

I believe that everyone in the financial community supports an oversight body to keep Puerto Rico’s financial management sound. However, an item at issue will be the amount of debt reductions and repayments that will be advocated by this board.

A “Port of Riches”, or “Credito Bandidos”?

It is ironic that Puerto Rico is translated as “rich port”. Puerto Rico is basically following the lead of defaulted third-world countries to shed debt repayments. Puerto Rico may also be looking to be accepted as the 51st state in the United States. With a record like this, I wouldn’t worry anytime soon that Puerto Rico can convince Congress to accept a State in bankruptcy like Puerto Rico, based on the lack of political leadership demonstrated by elected officials. Retail investors, who invested in Puerto Rico for income and safety of principal, find themselves being “robbed”. Bandidos de Credito, indeed.

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