Stoever Glass&Co
30 Wall Street, New York, NY10005

PUERTO RICO, AND THE DREADED "D" WORD

P.R. Pays Electric, Water/Sewer & Highway Debts
But Not Cornerstone $779 million G.O.'s

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Dick Larkin
Director of Credit Analysis
Stoever Glass & Co., Inc.
P: (862) 432-8818
E: dlarkin@stoeverglass.com

On July 1, Puerto Rico defaulted on $972 million of bonds, while paying $1.03 billion of other debt. For months, officials vowed to repay general obligation debt, which it did not. Rum taxes dedicated to special tax bonds were impounded to pay G.O. debt. They reneged on that promise, days after a federal law passed to stabilize Puerto Rico's finances.

Puerto Rico's debt management has deteriorated to the point where there is no rhyme or reason as to whose debt is getting repaid. General Obligation debt was supposed to be inviolate and protected by Puerto Rico's Constitution, and yet that default accounted for nearly 3/4ths of all defaults on July 1.

STATUS OF JULY 1 PAYMENTS AND DEFAULTS BY PUERTO RICO AND ITS AGENCIES ON JULY 1 2016 (Dollars In Millions)								
	Principal Due	Full Payment & Interest	Full Payment of Principal	Full Payment of Interest	Partial Payment of Interest	Partial Payment of Principal/Interest	Unpaid Payment of Interest	Unpaid Principal in Default
GENERAL OBLIGATION BONDS	$425.6	$779.0	$0.0	$0.0	$0.0	$0.0	$353.4	$425.6
PBA Series L	$86.1	$177.9	$1.0	$91.8	$0.0	$61.0	PAID	$26.1
GDB Series 2013	$0.0	$9.8	$0.0	$9.8	PAID	PAID	PAID	PAID
PRIFA BANS	$10.0	$10.7	$0.0	$0.7	$0.0	$9.3	PAID	$0.7
PRIFA Rum Tax Bonds	$41.1	$77.1	$0.0	$0.0	$0.0	PAID	$35.9	$41.1
ERS	$0.0	$13.9	$0.0	$13.9	PAID	PAID	PAID	PAID
HTA Series '68	$28.2	$50.3	$28.3	$22.0	PAID	PAID	PAID	PAID
HTA Series '98 Sr	$58.7	$148.1	$58.7	$89.4	PAID	PAID	PAID	PAID
HTA Series '98 Subordinate	$3.1	$4.5	$3.1	$0.1	$0.1	$3.1	$1.3	$4.4
HTA Series "2003 Subordinate	$12.5	$18.5	$12.5	$6.0	OK	PAID	PAID	PAID
COFINA	$0.0	$15.4	$0.0	$15.4	OK	PAID	PAID	PAID
PRIDCO	$8.5	$9.9	$8.5	$1.4	OK	PAID	PAID	PAID
PRCCDA	$11.3	$20.8	$11.3	$9.5	OK	PAID	PAID	PAID
PFC	$0.0	$1.4	$0.0	$0.0	$0.0	$0.0	$1.4	$0.0
PREPA	$224.0	$417.7	$224.0	$193.7	PAID	PAID	PAID	PAID
PRASA 2008 Senior	$14.9	$52.2	$14.9	$37.3	PAID	PAID	PAID	PAID
PRASA 2012 Senior	$33.7	$81.4	$33.7	$47.7	PAID	PAID	PAID	PAID
PRASA 2008 Subordinate Rfdg	$0.0	$1.4	$0.0	$1.4	PAID	PAID	PAID	PAID
PRASA Rural Development	$4.8	$12.7	$0.0	$0.0	$0.0	$0.0	$7.9	$4.8
GO Notes held by GDB	$9.5	$11.0	$0.0	$0.0	$0.0	$0.0	$1.5	$9.5
Municipal Finance Authority	$74.9	$90.5	$74.9	$15.7	$0.0	PAID	$0.0	PAID
AFICA University Plaza	$2.3	$4.0	$2.3	$1.7	PAID	PAID	$0.0	PAID
Total	$1,049.2	$2,008.2	$473.2	$557.5	$0.1	$73.4	$401.4	$512.2
					TOTAL PAID INTEREST & PRINCIPAL		$1,104.2	

Defaults are a failure to repay bond investors their principal and interest on the stated maturity date. Defaults are rare. To see how rare, total defaults in the $3.7 trillion-dollar municipal bond market are less than ½ of 1% over the life of municipal bonds after issuance.

It is impossible to divine a strategy from Governor Padilla. For months he shuttled between San Juan and Washington, twisting legislative arms for federal legislation to buffer Puerto Rico until a multi-year plan could be agreed to. During that time, he repeated a mantra emphasizing the need for haste in passing a rescue bill because of the impending July 1 debt payment date. In the end, passage of the law meant nothing except de-facto defaults, as if Puerto Rico operated under the aegis of a bankruptcy court, by using its “Emergency Moratorium” laws to avoid making debt payments until at least February 2017.

Investors holding Puerto Rico bonds face a dilemma. Sell bonds at depressed prices, or hold on for eventual recovery. Since March 2014, P.R. G.O. investors have seen a 35% decline in the price of their bonds. But owners of Puerto Rico Electric, and Puerto Rico Water & Sewer bonds have seen full repayment to date, because of water rate increases and massive reductions in oil fuel costs.

When markets are in flux and confused, as they surely are in Puerto Rico, the best strategy is to hold onto Puerto Rico Bonds until there is more clarity in this man-made financial disaster. For example, looking at the July 1 payment record, an untrained eye might believe that it would be best to sell his/her general obligation bonds, since there was a total default. Yet, current market prices are around 65-70 cents on the dollar for these bonds, have shown improvement since the federal PROMESA relief bill was signed by President Obama, and the last offer that the Government made to a group of general obligation bond holders was for substitute bonds that would be valued at about 80 cents on the dollar.

A federal control board will be placed over Puerto Rico to control its overspending, but will provide no money in a bail-out. In order to survive financially and economically, Puerto Rico must straighten out its financial house. In the end, a structure must be devised that will allow Puerto Rico to regain investor confidence and again be able to borrow using its general obligation credit and its essential utility enterprises like highways, electric, water & sewer systems. The jumble that is Puerto Rico cannot be solved by pitting one class of bondholders against another. Authorities that sell debt for essential services like public safety and schools are likely to get more sympathetic treatment from a federal control board than one that funds recreational projects, although just about everyone agrees that Puerto Rico needs a big shot-in-the-arm for promoting economic development.

Without credit, the infrastructure of roads, schools, water, sewer and electric systems will decay and seal Puerto Rico's fate. Regaining trust and credit requires making good on past debts—there is no other solution. Honoring its Constitutional debt obligations would be a good start.

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About the Author

***RICHARD P. LARKIN, Stoever Glass & Co., Inc*.**

Richard Larkin, a recognized 40 year industry veteran, has joined SG & Co. as Director of Municipal Credit Analysis. Mr. Larkin began his career in credit rating analysis at Standard & Poor's in 1975. After rising through the ranks in various analytical and management positions, Dick left S&P as its Chief Municipal Rating Officer, responsible for municipal rating policy, practices, governance and criteria. In 1998, Mr. Larkin joined Fitch Ratings as Chairman of its Public Finance Criteria Committee. He ultimately left to take leading roles in municipal hi-yield analysis at firms JB Hanauer & HJ Sims.

"Dick will be a unique resource to Stoever Glass' municipal clients. His knowledge in specific issues and areas of the municipal bond industry will aid our representatives and their clients in making educated decisions, in a sector where this type of research is unique," said Roland Stoever of Stoever Glass.

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