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

PUERTO RICO'S 7 DEADLY SINS & 12 STEPS FOR ADDICTION RECOVERY

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

Puerto Rico borrowed freely in 2012. Raters upgraded the Commonwealth in 2010/2011.

In 2013, investors believed they would see good recovery even in default. Puerto Rico's need to borrow was investors' "knockout punch" in this heavyweight battle.

The 2014 Electric Authority crisis put all debt at risk. Analysts assumed the Electric system would default. Oil prices dropped from over $100/ barrel of crude to $35/barrel. resulting in $1.2 billion of annual savings. All savings went to customers, but investors were shunned.

In 2015/16, Governor Padilla defaulted on nearly all Commonwealth debt. Its restructuring proposals are non-starters for investors that believed General Obligation and Sales Tax bonds are guaranteed payment by its Constitution.

Since 2013, Puerto Rico garnered $8.5 billion from bond sales, oil taxes, water rates, its airport sale, and lower fuel costs.

Where the money went must be answered. Officials complain that Puerto Rico hasn't "received an actionable..commitment.. towards a stable and prosperous economy". Moody's Ratings define credit as "Man's Confidence in Man." Confidence in Puerto Rico is non-existent. Puerto Rico must still finance infrastructure and operations. For that to occur, it must show good faith to lenders.

Puerto Rico's 7 Deadly Sins

1. Poor Communications. Spanish-language budgets masked Commonwealth defaults on bond payments. Government has no lines of communication with bond raters. The Electric System shares confidential information with select creditors, unavailable to retail investors.

2. Poor Planning. The Administration is lax to adjust revenue/expenditures facing budgetary shortfalls. The Governor proposed an untested value added tax in his budget. Puerto Rico's tax collections remain suspect.

3. Poor Disclosure. Puerto Rico and its Government Development Bank (GDB) fail to publish audited financial statements since 2014. Any financial disclosures are suspect.

4. PR's Government Development Bank's (GDB) failure to do its job. The GDB precipitated Electric's crisis by not advancing seasonal cash needs. When private loans matured in 2014, the System's crisis exploded. Yet the GDB advanced $2 billion to the Highway Authority.

5. Poor Choice of Bedfellows for Borrowing. Around July 2013, "Vulture" hedge funds accumulated distressed Electric debt. General obligation bonds in March 2014 were structured for only large investors. "Vulture funds" are a subset of hedge funds who invest in distressed credits at "panic" prices, until they reach a commanding position as creditors. This is the second leading reason why defaults are widespread in Puerto Rico. Buyers of Commonwealth bonds from 35 to 50 cents on the dollar will profit from any restructuring by Puerto Rico's leadership.

6. Disregarding Financial Management Practices. Puerto Rico's finances lack policies like "rainy day" funds against stress, avoiding "one shot" budget gimmicks, & multi-year financial planning.

7. Disregard for Puerto Rico's Financial Future. Debt financing is "lifeblood" for state and local governments. Actions to default will cause a "boycott" from the municipal market.

Puerto Rico represents the largest municipal bond defaults in history. Congress passed the "PROMESA" law, prescribing an independent financial control board, but we are months away from any action: there is no professional staff to analyze Puerto Rico's financial position and direction.

Puerto Rico's management is out of control, and its debt addiction is like an alcohol abuser or drug addict. Puerto Rico needs a "Twelve Step Addiction Program". It could look like this:

1. Puerto Rico is Powerless Over Debt Addiction, and Must Work with a Higher Power. The time for finger-pointing is over; many are to blame. Opponents of a control board should discard politics, and change the future.

2. Establish Puerto Rico's True Financial Position. Puerto Rico must provide reliable and timely financial statements.

3. Restore the Efficacy of the Government Development Bank (GDB), or Eliminate It. Material information is essential for investors. Neither the GDB or Office of Budget has anyone's trust.

4. Consolidate Debt into One/Two Umbrella Issuers. Public Authorities all borrow for general government purposes, regardless of legal constructs that govern repayment. All are in default based on actions of the Governor. It will cause more harm than good to have authorities pitted against each other in battles for debt repayment.

5. Develop Multi-Year Financial Plans of 4 Years. The annual budget is the first year of the plan; subsequent years must project the consequences of this year's budget.

6. The Annual Budget (and Four Year Plan) Must be Published in Spanish and English.

7. Cancel a Value Added Tax to replace other taxes until a Reasonable Four Year Financial Plan is Adopted.

8. Abandon Statehood Until the Island Can Manage Its Financial Affairs.

9. Provide Accurate Cash Flow Data to Determine Puerto Rico's Seasonal Cash Flow Needs. July's defaults occurred because expenditures don't match the timing of receipts. Puerto Rico once financed this shortfall from the Government Development Bank, which is now bankrupt. PROMESA will be hard pressed to solve Puerto Rico's liquidity shortfalls.

10. Repay Investors as Much as Possible if the Commonwealth Hopes to Access Inexpensive Debt from the Municipal Market. The only alternative is to pay "loan shark" interest terms.

11. Pensions & Municipal Bond Obligations Should Be Merged. Pensioners should be paid with negotiable debt instruments under the same terms as investors.

12. Puerto Rico needs a "Facelift". It must mount a massive public relations effort to repair its image to tourists and businesses. Since the August 2013 Barrons front page article "Puerto Rico in Trouble", the picture of management ineptitude and irreversible economic decline must change.

<u>PROMESA MEMBERS MEAN BAD NEWS FOR INVESTORS</u>

I believe that the PROMESA Control Board is biased for the Commonwealth, against investors. Three members have bankruptcy backgrounds. Their priority won't be to reform spending, but to cut investor/vendor payments. If PROMESA follows Detroit's bankruptcy precedents, investors are at great risk.

Another Board member is expert at public pensions. It is unclear if he favors pension concessions at the expense of investors that lent Puerto Rico $1.6 billion for pensions in 2008.

This is clearly an evolving situation, which needs to be followed closely. Unfortunately, the PROMESA Control Board looks like the first round of a boxing match where investors took a right hook to the face. In the end, though, investors still hold the "knockout punch".

About the Author

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

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.

"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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