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

CAN THE U.S. VIRGIN ISLANDS WITHSTAND PUERTO RICO'S FISCAL TSUNAMI?

V.I. Has Similar Vulnerabilities, But an Edge in Several Important Areas

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

Puerto Rico and pending congressional changes bring into question the debt outlook for territories like the U.S. Virgin Islands. The Virgin Islands and their Water & Power Authority (VIWAPA) are not preparing for defaults, and do not necessarily have to follow P.R. into virtual bankruptcy. But there are several areas where comparisons between P.R. & V.I. will receive more attention from analysts in the face of Puerto Rico's meltdown.

Here's the "Tale of the Tape", comparing strengths and weaknesses in a comparison of Virgin Islands' bonds and issuers to those of Puerto Rico.

TALE OF THE TAPE: Selected Financial and Economic Indicators: Virgin Islands VS Puerto Rico

Puerto Rico	INDICATOR	Virgin Islands	Commentary
YES	Population Losses 2010-2015	No	V.I. lost about 90 people on a population of about 106,000
YES	Large Employment Losses 2007-2016	YES	P.R.lost 21.5% of jobs since 2007, while V.I. lost 19.8% of jobs
YES	High Unemployment Rate	YES	Both have current 11.8% unemployed
YES	Low Median Household Income (2014)	YES	V.I.: $30,921 versus P.R.: $23,168
YES	High Dependence on Government Employment (%)	YES	P.R. only 22% dependent after austerity. V.I.: 29%
YES	Dependence on Government Employment + Leisure/Sales (%)	YES	More leisure/retail employment contributes to higher household income
YES	History of General Fund Deficit Borrowing	YES	Both have relied on long term debt to pay general expenses, but P.R. record is larger and more severe.
YES	High Debt Per Capita	YES	Slight edge to V.I., but both are over $20,000 per capita
YES	High Electric Power Costs 2015	YES	P.R. Residential rate of 17 cents/KwH vs. 29 cents/KwH in V.I.
YES	Utility Dependence on Government as Largest Customer	YES	Both vulnerable to high and late payments from government
YES	History of Late Payments by Government to Utility	YES	Both vulnerable to high and late payments from government
YES	Late General Fund Financial Reporting	YES	V.I. late by one year vs. 2 years late for P.R.
YES	Late Utility Financial Reporting	No	P.R. Electric late by two years
YES	Electric Generation Dependency on Oil	YES	V.I. is ahead of diversifying from high dependence on oil
YES	Speculative Tax-Backed Bond Ratings	No	Only junk rating is BB on V.I. implied G.O. rating, while all of Puerto Rico's bond ratings are one notch from 'D' for default
YES	Speculative Electric Revenue Bond Ratings	YES	BBB-/BB- ffrom S&P & Fitch, while Moody's has a negative watch for downgrade below investment grade.
YES	High Sales Tax	No	Big edge for V.I., which has no sales tax cpompared to P.R.'s 11.5%

If this were a boxing match, the judges would score it 4 for Virgin Islands, zero for Puerto Rico, and 13 rounds "even". It is the number of evens that is of concern. In particular, I am concerned about Virgin Islands status on transparent and timely financial statements and V.I.'s high residential power costs, which are almost twice as high as Puerto Rico, and more than four times higher than the U.S. average.

On the other hand, there are three indicators that are decidedly better in V.I. than in Puerto Rico. Median household income is nearly 33% higher in V.I.; there has been minimal population loss; and the economy benefits from having no retail sales tax, as compared to Puerto Rico.

The Virgin Islands' decidedly negative sectors are a higher percent of workers on the government payroll, and much higher electric costs. Puerto Rico reduced its negatively high percentage of government workers from budgetary attrition to cut general spending. And high electricity costs in the Virgin Islands are more than twice as high as Puerto Rico, major contributors to the economic and financial health of their electric utility.

The reason the Virgin Islands Water & Power Authority has come to the forefront is because of recent rating downgrades by Fitch (already in "junk" bond territory), and the recent threat of downgrade to "junk" status by Moody's. While VIWAPA is still paying timely debt service, rating downgrades to junk status have a way of moving to lower rating categories very rapidly if defects are not corrected quickly.

My advice: V.I. issuers should be under scrutiny to make sure they don't start lowering debt coverage and positioning themselves to take advantage of Puerto Rico's "rescue" legislation under review by Congress. If they make that move, "all bets are off".

FOCUS ON VIRGIN ISLANDS ELECTRIC POWER AUTHORI

VIRGIN ISLANDS ELECTRIC AUTHORITY AUDITED FINANCIAL RESULTS					
Fiscal Year ending June 30 ($000)	[redacted]	2014	2013	2012	2011
Total Revenue		**$321,216**	**$339,001**	**$331,414**	**$279,455**
Customer sales and fuel adjustments		$290,799	$318,676	$314,531	$233,965
Electricity sales To Government + In lieu of taxes		$15,753	$16,680	$13,726	$12,436
OPEB surcharge		$3,064	$0	$0	$0
Total Operating Expenses		**$322,546**	**$338,879**	**$334,140**	**$283,602**
Fuel		$231,711	$248,812	$255,248	$213,039
Operations & Maintenance		$26,122	$28,591	$22,610	$19,657
Distribution		$10,547	$10,216	$10,610	$10,729
Administrative & General Expense		$31,395	$27,878	$28,211	$28,225
Depreciation/Amortization		$15,906	$23,320	$22,694	$19,237
OPERATING INCOME (DEFICIT)		**($1,330)**	**$122**	**($2,726)**	**($4,147)**
Non-Operating Income/Expense					
Interest ExpenseGrants & Contributions		($13,521)	($13,889)	($15,524)	($12,302)
		$11,521	$4,944	$1,951	$5,002
DECREASE IN NET POSITION		**($2,887)**	**($8,395)**	**($15,303)**	**($11,448)**
BALANCE SHEET					
Total Current Assets		**$148,895**	**$144,110**	**$127,890**	**$131,154**
Cash		$10,826	$9,112	$9,674	$11,203
Receivable from V.I. Government		$25,953	$19,842	$13,441	$13,693
Other receivables		$21,105	$26,947	$23,571	$24,409
Inventories		$25,920	$25,899	$24,228	$24,228
Restricted Cash & Cash Equivalents		$57,622	$56,894	$52,403	$55,488
Total Current Liabilities		**$198,367**	**$182,627**	**$135,658**	**$174,423**
Accounts payable and accruals		$96,756	$89,179	$58,521	$67,988
Customer deposits		$25,192	$23,548	$23,092	$22,422
Liabilities payable from restricted assets		$31,187	$30,583	$21,219	$20,267
Current long-term debt installment		$10,555	$10,145	$6,925	$6,635
Accrued interest		$6,417	$6,621	$5,594	$4,932
Lines of Credit		$25,128	$16,875	$16,875	$23,000
General Obligation Notes		$3,132	$5,676	$3,432	$29,179
Long-Term Debt		**$238,190**	**$248,745**	**$258,890**	**$213,635**
UNRESTRICTED NET ASSET POSITION		**($174,300.00)**	**($132,573)**	**($92,779)**	**($86,912)**
Current Ratio		0.75 to 1	0.79 to 1	0.94 to 1	0.75 to 1
Quick Ratio		.05 to 1	.05 to 1	.07 to 1	.06 to 1
Actual Debt Service Coverage		1.25x	1.16x	1.02x	0.94x
Electric System Gross Requirements (MWh)		736,782	786,941	833,563	867,470

Comparisons between Virgin Islands' Water & Power Authority (VIWAPA) and Puerto Rico's Electric Power Authority (PREPA) are to be expected. Although VIWAPA's pension funding, is higher than PREPA, its residential rates are twice as high as in Puerto Rico. Add in a weak balance sheet, steadily declining customer usage, and a large dependence on late payments from its largest customer (the Government of the Virgin Islands itself), and you have all of the elements of a stressed utility like PREPA (which is spinning into default).

The cells in orange spell trouble. Despite the obvious declines in unrestricted net assets, extremely low liquidity ratio (current and quick ratios, where current receivables and cash are considerably below current payables), electric usage has dropped dramatically to 620,881 MWh, with revenues down by 16% in 2015. In addition, total receivables from the Government reached $36 million in 2014, after adding $12 million that the power authority believes will not be paid soon. That's more than two years' worth of unpaid electric service, which could increase cash for operations by over 40 days. And debt service coverage in 2013 & 2014 were artificially inflated by a 2012 bond refunding which paid two years' worth of debt payments on 1998 bonds.

Fitch has already downgraded VIWAPA's bond ratings into "BB" junk status; Moody's is threatening to do the same with a negative credit watch listing. Although the 2015 audit is still not available, here are some telling remarks from VIWAPA's interim CEO Julio Rhymer, made before the Legislature last month:

- **Persistently Strained Liquidity**: WAPA's reduced capacity for timely repayment of outstanding debt service obligations as evidenced by a persistent strain on available liquidity. Liquidity pressures have been driven by consistently low unrestricted cash reserves balances, escalation in already high government receivables and high levels of borrowing under the Authority's available lines of credit.
- **Limited Margins of Safety Remains**: Concern that capacity for continued payment is vulnerable to deterioration. *Exacerbating WAPA's operating pressure is a lawsuit recently initiated by the Authority's former fuel supplier alleging failure to pay almost $25 million in fuel delivery charges and continuing build-up of the USVI government receivables.*

As we learned from Puerto Rico, after their ratings dipped below investment grade, downgrades accelerated into free-fall for the next two years. The Virgin Islands may be on the brink of that kind of scenario, unless fiscal reforms and more timely financial reporting take place.

About the Author

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

Richard Larkin is the Director of Credit Analysis specializing in municipal bonds, joining Stoever Glass in April 2016. Earlier in his career Dick spent 8 years at HJ Sims, where his first assignment was to testify before the House of Representatives on the Bond Insurance Crisis. Dick worked at J.B. Hanauer from 2003-2008, performing high-yield municipal bond analysis. Dick was also a Managing Director in Fitch's public finance group as the Co-chairman of its Public Finance Criteria Committee. He covered high-profile tax-supported and revenue bond credits and had supervisory responsibility for credit surveillance and the development of public finance staff. Prior to joining Fitch in 1998, Dick was a Managing Director and Chief Municipal Rating Officer at Standard & Poor's, responsible for municipal rating policies, practices, governance and criteria. Following twenty-one years at S&P, Dick worked as a financial advisor at Fairmount Capital Advisors where he developed credit enhancement programs for public pension funds. Later, he helped found Reliance SRL, a rating agency that performed local credit ratings in Uruguay.

From 1988-1992, Dick was a charter member of the Anthony Commission on Public Finance, created to protect federal tax law on the ability of state and local governments to carry out their responsibilities to their citizens at the lowest possible cost. From 1995-1998, Dick also served on the National Advisory Council on State & Local Budgeting (NACSLB). This industry task force, comprised of representatives from the private sector and officials from all levels of local government, identified and fostered 60 of the best budgeting practices that have been implemented by our best-run state and local governments. Dick earned his BA in economics from Iona College and a Masters in economics from Fordham. In 1999-2000, he was a key participant in the implementation of Fitch's Default Study and revision of its criteria and ratings. During the same period, he authored the definitive study on the impact of municipal government's management practices on credit ratings, defining for issuers a rating agency's relative evaluation of best management practices. Dick has had hands-on rating experience in 42 states, at all levels of state and local government covering virtually every type of debt structure and security pledge. He has been a frequent speaker at state and national Government Finance Officers' Association (GFOA) conferences, and has articles published in national media and public finance textbooks.

Dick has appeared frequently on CNBC, Bloomberg Television and Fox Business News, and has been widely quoted in the Wall Street Journal, BusinessWeek, the Bond Buyer and Bloomberg reports, as well as many other media outlets. Dick serves on the Policy Committee for the Securities Industry and Financial Markets Association (SIFMA), serves on the Governmental Advisory Standards Advisory Council (GASAC), is a member of Municipal Bonds For America (MBFA), a public/private group charged with educating government officials about the benefits of tax-exemption for municipal bonds for government issuers as well as the investment market. He was also awarded the National Federation of Municipal Analysts'

Award for Excellence in 1996, and from 2008 through 2015 was elected as an "All-Star" Special Revenue Bond Analyst by Smith's Research & Gradings.