LONG ROAD AHEAD FOR PUERTO RICO

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In late June, the long-simmering fiscal troubles of Puerto Rico escalated into a full-scale crisis when Governor Padilla announced the Commonwealth would be unable to pay its debts. The statement was a reversal of an earlier assertion that the government would honor its debt obligations, yet the Governor's admission should not have been a surprise to observant analysts. Puerto Rico has been unable to balance its budget for the past decade and instead, has financed its operating deficits by selling long-term debt. (See Table 1.)

Recall, the administration signaled the impending fiscal fallout with the introduction of The Puerto Rico Public Corporations Debt Enforcement and Recovery Act in June 2014. As a territory of the U.S., Puerto Rico and its entities do not have access to Chapter 9 under the Bankruptcy Code. The Recovery Act (later ruled unconstitutional) established a framework for public agencies to restructure their debt and served as a formal acknowledgment of trouble ahead. Shortly thereafter, the Puerto Rico Electric Authority (PREPA) entered negotiations with its creditors. In more recent weeks, the Commonwealth and its fiscal agent, the Government Development Bank (GDB) have made repeated efforts to secure short-term financing with a pledge of various tax revenues, yet have been unable to strike a palatable deal with lenders. Absent some form of bridge loan, the GDB estimates the central government could run out of cash by late summer.

The Commonwealth's financial situation is dire. The island has amassed over $72 billion of debt, most of it linked to the central government and its public corporations. (See Table 2.)

Puerto Rico's debt burden overwhelms the island economy, representing 104% of GNP or $20,000 per capita compared to the medians of 2.2% and $1,012 respectively, for the 50 states. Additionally, the territory continues to suffer from a struggling economy. GNP growth has been negative each year but one since 2006. Employment has declined 12% since 2006 and 225,000 (or 6%) citizens have left the island in search of better opportunities.

The stark realities detailed above point to a widespread, complex and prolonged restructuring process for Puerto Rico. The island's recovery does not hinge solely on writing down debt, but also requires the immense task of revitalizing the local economy and instituting much-needed financial policies and controls to ensure economic and fiscal sustainability in the future. Debt restructuring alone promises to be a contentious process spanning several years, given the breadth of government issuers, the variety of debt outstanding, the number of stakeholders and the absence of a legal framework.

Market reaction to the events in Puerto Rico has been subdued. Certainly, prices of Puerto Rico bonds dropped sharply following the Governor's comments, but the broader market has been largely unaffected, trading in sympathy with Treasuries. Extensive media coverage of the territory's troubles in recent years has provided retail the impetus to exit the name. Although many mutual funds continue to hold positions, exposure to the island has been pared to modest levels and in many cases, is mitigated by bond insurance. Currently, the majority of Commonwealth paper is held by hedge funds and other non-traditional buyers, thereby tempering the impact of Puerto Rico trade activity on municipal valuations.

Having sold our Puerto Rico holdings years ago, we are following developments on the island to gauge the potential impact on the market. Our expectation is municipal investors will continue to view Puerto Rico as an outlier, rather than a symptom of widespread distress. Most states continue to exhibit positive credit trends including employment gains, higher tax receipts, replenished reserves and for many, lower debt levels. Although not expected, to the extent we witness spread widening due to Puerto Rico contagion, we will view it as a buying opportunity.

TABLE1: PUERTO RICO GENERAL FUND BUDGET DEFICITS (FISCAL YEAR END 6/30, $MIL)

Fiscal Year	Total Revenues	Total Expenditures	Deficit
2009	7,825	10,689	(2,864)
2010	8,032	10,756	(2,724)
2011	8,343	10,144	(1,801)
2012	8,783	11,158	(2,375)
2013	8,664	9,974	(1,310)
2014	9,142	10,011	(869)

Source: Government Development Bank Quarterly Report dated 5/7/15

TABLE 2: COMMONWEALTH DEBT (AS OF 3/31/15)

Type	Par ($mil)
GO Bonds and Notes	13,055
Commonwealth Guaranteed	5,511
GO & Guaranteed Subtotal	**18,566**
Supported by PR Appropriations or Taxes	4,038
TRANS (Short-term notes)	1,200
Payable from General Fund	**23,804**
COFINA	15,224
Commonwealth & its public agencies	24,102
Municipalities	4,114
ERS Pension Bonds	2,948
Other Debt	2,013
Other Public Sector Debt	**48,401**
Total Public Sector Debt	**72,205**

Source: Government Development Bank Quarterly Report dated 5/7/15