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Puerto Rico Sales Tax Financing Corp.; Sales Tax

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Credit Profile		
US$3,022.437 mil taxable sales tax rev bnds ser 2007B due 08/01/2057		
Long Term Rating	A+/Stable	New
US$2,599. mil sales tax rev bnds ser 2007A due 08/01/2057		
Long Term Rating	A+/Stable	New
US$941.805 mil taxable sales tax rev bnds ser 2007C due 08/01/2043		
Long Term Rating	A+/Stable	New

Rationale

Standard & Poor's Ratings Services assigned its 'A+' rating to Puerto Rico Sales Tax Financing Corp.'s (COFINA) $6.3 billion sales tax revenue bonds series 2007A, B, and C.

The rating reflects a strong legal structure that separates the revenue stream supporting the bonds from the Commonwealth of Puerto Rico, along with strong cash flows that, under severe stress assumptions, are still sufficient to make timely payments of interest and principal. The rating is constrained by the Commonwealth's 'BBB-' GO rating, however, because the structure cannot completely isolate COFINA's bondholders from the Commonwealth's financial condition. The ability to levy and collect sales and use taxes depends directly on the underlying economic activity in Puerto Rico, which can be affected by the government's financial condition, and that dependence cannot be entirely eliminated by the structure supporting the bonds. The limited history of the sales and use tax, which has been collected since Nov. 15, 2006, is another limiting factor.

The legislative act creating COFINA, Law 91 of 2006, successfully separates and provides a priority interest in the Commonwealth's sales and use taxes for the bondholders. Law 91 provides that all revenues from the Commonwealth's 5.5% sales and use tax go directly to COFINA until a guaranteed base amount of tax collections is met. The statute further grants a statutory lien to bondholders on the Commonwealth's sales and use tax revenues once any bonds are issued. In addition, COFINA is not permitted to voluntarily file for bankruptcy protection and cannot be forced into involuntary bankruptcy. Furthermore, Standard & Poor's received an opinion from bond counsel stating that Act 91 successfully transfers property of the sales and use tax collections to COFINA. This transfer of property effectively excludes the pledged sales and use tax revenues from Puerto Rico's constitutional provision regarding the Commonwealth GO debt's first-lien claim on all available revenues (also known as the "claw-back" constitutional provision).

COFINA is a corporate and political entity independent and separate from the Commonwealth of Puerto Rico. COFINA was created with the purpose of issuing bonds and utilizing other financing mechanisms to pay or refinance all or part of the "extra-constitutional" (appropriation) debt of the Commonwealth of Puerto Rico as of June 30, 2006 (totaling $6.8 billion). To meet COFINA's corporate purpose, Act 91 created the Dedicated Sales Tax Fund (Fondo de Interés Apremiante, or FIA). The FIA will be funded with the first revenues collected by the entire 5.5% Commonwealth sales and use tax, until revenues in the FIA reach the collections equivalent to the 1%

dedicated sales and use tax or an annual guaranteed base amount--whichever is greater. Regardless of the sales tax collections based on the 1% dedicated sales tax, Act 91 requires that all of the 5.5% Commonwealth sales tax be applied to satisfy and fund the base amount before any money can be transferred to the Commonwealth's general fund. COFINA's ability to issue bonds is limited by statute to the total amount of extra-constitutional debt as of June 30, 2006. Consequently, COFINA will not issue additional senior-lien bonds unless it is to refund or to anticipate payment on existing parity debt. Subordinate debt is permitted as long as the bonds are issued to repay extra-constitutional debt.

Outlook

The stable outlook reflects the prospects for strong coverage of debt service from revenues generated by the access to the entire 5.5% Commonwealth sales tax to guarantee the base amount.

Coverage Sensitivity

Fiscal 2006 sales tax collections through April 2007 reached $95.2 million for the dedicated 1% sales tax and $428.3 million for the 4.5% general fund sales tax. Assuming that all these revenues would have been deposited in the FIA account, the base amount for fiscal 2008 ($185 million) would have been fully funded during the first two and a half months of collections. Based on actual collections through April, annualized collections from the 1% dedicated sales tax would generate approximately $207.7 million, or about 1.12x coverage of projected fiscal 2008 annual debt service. Revenues from the entire 5.5% Commonwealth sales tax, annualized based on actual collections through April 2007, provide 5.6x debt service coverage in fiscal 2008. Furthermore, a very conservative zero-growth assumption of annualized actual year-to-date 1% sales tax collections provides sufficient coverage of debt service payments through 2034. This same assumption for the entire 5.5% sales tax provides at least 1x coverage of debt service payments through 2052.

Another revenue stress scenario includes a 4% decline in annual sales tax revenue collections through 2010 and a conservative 0.35% annual growth rate thereafter. Under this scenario, debt service coverage provided by the entire 5.5% is maintained through the 50-year maturity of the bonds.

Transaction Overview

Statutory revenues

The bonds are payable from COFINA's revenues. Act 91 creates a statutory pledge over COFINA's revenues for the benefit of the bondholders. Because this pledge is created by statute, no further action is necessary to perfect the bondholders' interest in COFINA's revenues. COFINA derives its revenues from sales and use taxes collected throughout the island. The sales and use tax is broad based and includes most goods and services. Major items that are exempt from the sales and use tax include health care services and prescription medications, motor vehicles, nonprepared food, financial services, services provided by designated professionals, and services provided by the Commonwealth such as water and electricity. The current sales and use tax of 7% includes a 1.5% municipal sales tax, a 4.5% general fund sales tax, and a 1% dedicated sales tax. The structure securing the series 2007 bonds provides bondholders first access to the entire 5.5% sales and use tax to cover the guaranteed base amount allocated to the FIA. The FIA is funded with the 1% dedicated sales and use tax or a base amount--whichever is greater.

Pursuant to Act 91, the base amount for fiscal 2008 is $185 million. This base amount increases each fiscal year thereafter at a statutory rate of 4%. On or prior to Oct. 1 of each fiscal year, the Secretary of the Treasury is required to determine whether the amount of Commonwealth sales tax required to be transferred to the FIA, based on the dedicated 1% sales tax, exceeded the applicable base amount; if so, Act 91 requires that all Commonwealth sales tax collections of the prior fiscal year representing such excess be transferred to the FIA (to the extent that they were not previously transferred).

Collection and payment procedures

Sales tax revenues are collected on a monthly basis by First Data Corp., a provider of electronic commerce and payment solutions for businesses and consumers; Banco Popular de Puerto Rico; or any other authorized collector designated by the Secretary of the Treasury. Merchants have until the 20th of every month to remit sales tax collections for the prior month. Collectors transfer sales tax revenues on a daily basis to a bridge account at Banco Popular in the name of the Treasury Department, as paying/receiving agent. Once the funds are deposited in the Banco Popular bridge account, Banco Popular then transfers on a daily basis (with a two-day delay) to the trustee collections from the entire 5.5% sales and use tax until the base amount has been deposited in the FIA, and thereafter to the Treasury Department all subsequent sales tax collections until the department has received its share (4.5%/5.5%) of the collections received to date in the fiscal year. Thereafter, Banco Popular divides additional sales tax receipts between the FIA and the Commonwealth's Treasury on the basis of the 1.0%/4.5% split.

The structure for the series 2007 bonds does not include a debt service reserve account. However, the allocation of first revenues from the full 5.5% sales tax to the FIA and the timing of scheduled debt service payments alleviate concerns over the lack of a funded debt service reserve account. The series 2007 bonds will pay interest starting on Feb. 1, 2008, and interest and principal starting in October 2008. Based on historical sales tax collections for the first five and a half months since the approval of the sales tax, the base amount is expected to be fully funded by September of each fiscal year, providing a four-month period to generate sufficient cash flow protection in the event of an unforeseen decline of collections in the early part of the fiscal year.

Flow Of Funds

Dedicated sales tax revenues are deposited in the FIA account on a daily basis. The bonds benefit from the availability of the first collections of the entire 5.5% Commonwealth sales tax.

Pledged sales taxes are first used to pay scheduled fees of the trustee and operating expenditures not to exceed a $200,000 cap.

Sales taxes next pay bond interest and principal costs on a semiannual basis. After debt service is paid, sales taxes next fund a senior debt service reserve account (if one is established, which is not anticipated at this point). Next, sales taxes pay debt service on subordinate bonds and subordinate obligations. Thereafter, sales taxes fund a subordinate debt service reserve account, if one is established. Finally, excess sales tax funds can be retained in the revenue account; be transferred to the early redemption account; pay credit facilities, liquidity facilities, and qualified hedges; and be used to pay of operating costs in excess of the operating cap.

Legal Risks

COFINA was established by statute as an instrumentality of the Commonwealth. COFINA is not authorized to file a petition for bankruptcy under Chapter 9 of the Bankruptcy Code. Its assets and liabilities are separate from those of the Commonwealth. In addition, as a public agency or instrumentality of the Commonwealth, COFINA cannot be the subject of an involuntary bankruptcy filing. COFINA's sole legal purpose is to issue bonds and use other financing mechanisms to pay or refinance (directly or indirectly) all or part of the extra-constitutional debt of the Commonwealth of Puerto Rico as of June 30, 2006, and the accrued interest thereon, using as a source of repayment the portion of the tax deposited in the Dedicated Sales Tax Fund.

Credit Risks

Underlying economic viability of the Commonwealth is key

The ability of COFINA to make payments on the bonds according to the elongated maturity schedule is dependent on the timely generation of sufficient sales and use tax receipts over a 50-year time horizon. This in turn is dependent on the Commonwealth of Puerto Rico's ability to attract and retain corporations that pay wages in the island and residents and visitors who buy goods and services in the island. Standard & Poor's took into account that, to generate sales tax revenue, the Commonwealth must provide and pay for essential services such as police, fire, sewer, and water. It is because of this reliance on the island's economic viability that the rating on COFINA's bonds cannot be completely de-linked from the Commonwealth's GO rating. However, Standard & Poor's believes that the Commonwealth will be able to generate sufficient sales and use tax revenues to cover debt service on the bonds even under stressful conditions. During some of these stressful scenarios, the Commonwealth may be impaired to operate normally because COFINA's bonds have first call on a substantial portion of the Commonwealth's revenues.

Over the past decade, Puerto Rico's economy has been characterized by an increasing reliance on the public sector as the employer and economic engine of last resort. Consequently, it is not surprising that a reduction in government spending coupled with the implementation of a sales and use tax and significant increases in public services triggered the island's current economic recession. Economic activity declined each of the last seven months in 2006, reaching a year-over-year decline of 2.02% in December 2006. The Puerto Rico Planning Board projects a 1.4% decline in GNP for fiscal 2007 (July 2006 to June 2007) and only a minimal recovery in fiscal 2008. The employment base has also suffered. Total employment has dropped by nearly 12,000 jobs, or approximately 1.1% over fiscal 2006 levels, resulting in a high unemployment rate of 10.1%, which is consistent with historical unemployment rates for the island. Preliminary figures for calendar year 2006 reflect a GNP of $56.7 billion, or 0.66% growth in real terms over 2005. Puerto Rico's wealth and income levels remain well below the U.S. median. At $17,184, the island's median household income is approximately 37% of the U.S. median. Disposable personal income levels have exhibited steady growth, increasing 28.6% since 2000.

Over the past decade, labor-intensive manufacturing firms have been under intense competitive pressures, reflected in the ongoing plant closings in traditional leather, apparel, textile, and canning plants. Since 2000, manufacturing employment has declined 27.4% to a total of 103,000 jobs. The loss of jobs, however, has not affected the importance of the sector. Over the same period, manufacturing as a percent of GDP increased to 42% in 2006 from 40% in 1997. The difference has been the growth in capital-intensive pharmaceutical, chemical, and high-tech firms and continued investment in high value added manufacturing.

The loss of labor-intensive manufacturing has reduced the sector's employment to just 8% of the total employment base. The importance of the government and its investment in the island economy cannot be overstated. Public employment, including public sector at the federal, Commonwealth, and municipal levels, accounts for 28.7% of the island's employment, slightly down from 29.4% in 2004. Likewise, public investment continues to be an economic stimulus, particularly during hard economic times.

Tourism and hospitality, while comprising just 7% of the employment base, has a multiplier effect on the local economy and remains one of its rapidly expanding sectors. The opening of the Puerto Rico Convention Center in 2006 has spurred approximately $1 billion in related investment projects, including a 500-room convention center hotel, which is expected to begin operations in mid-2009.

The major risk for Puerto Rico's economic growth remains a continued pattern of laggard private sector job creation, which will limit the Commonwealth's ability to reduce its dominant presence in the local employment base. High energy costs, which have historically constrained the island's competitiveness, also remain a concern for the island's prospects for future growth.

Puerto Rico has a very short history of consumption-based taxation. Consequently, the information on the performance of sales tax collections is limited to the seven months that the sales and use tax has been in place, and just five and a half months of complete collections data.

Personal income and personal consumption data are perhaps the best evidence of what the historical trend of the sales and use tax would have been, and are the closest indicators to evaluate the vulnerability of sales tax collections to economic cycles.

Total personal consumption expenditures have steadily increased over the past 10 years to $49.6 billion in 2006 from $29.9 billion in 1997, for average annual growth of 5.8%. The bulk of the growth has been in services, which includes tourism. This sector has nearly doubled over the past 10 years and now accounts for $24.5 billion of personal consumption expenditures, or roughly half of total in 2006. Monthly retail sales have seen steady growth, averaging 8.4% annually over the past 10 years (through fiscal 2006). These figures do not include retail sales data during the current recession; year-to-date sales tax collections, however, indicate that retail sales and personal consumption are performing well overall. Puerto Rico has a fairly deep and diverse retail base that includes essentially all retailers with operations in the mainland (including Walmart, K-mart, Macy's, Pep Boy's, Sam's Club, Costco, Home Depot, Borders). The 20 leading sales and use tax generators account for approximately 25% of sales tax revenue collections.