RatingsDirect®

Puerto Rico General Obligation Debt Rating Lowered To 'B' From 'BB' On Potential Inability To Meet Debt Commitments

Primary Credit Analyst:
David G Hitchcock, New York (1) 212-438-2022; david.hitchcock@standardandpoors.com

Secondary Contacts:
Horacio G Aldrete-Sanchez, Dallas (1) 214-871-1426; horacio.aldrete@standardandpoors.com
Gabriel J Petek, CFA, San Francisco (1) 415-371-5042; gabriel.petek@standardandpoors.com

NEW YORK (Standard & Poor's) Feb. 12, 2015--Standard & Poor's Ratings Services has lowered its general obligation (GO) rating on the Commonwealth of Puerto Rico to 'B' from 'BB'. The outlook is negative.

In addition, Standard & Poor's has lowered its ratings on:

- Puerto Rico Sales Tax Financing Corp.'s (COFINA) first-lien sales tax bonds to 'B' from 'BBB';
- COFINA's second-lien sales tax bonds to 'B' from 'BBB-';
- Puerto Rico Municipal Finance Agency's, the Puerto Rico Employees Retirement System's, and the commonwealth's general fund-supported appropriation and moral obligation bonds to 'B' from 'BB-'; and
- Puerto Rico Infrastructure Financing Authority's (rum tax) and the Puerto Rico Convention Center District Authority's (hotel tax) debt to 'B' from 'BB'.

Standard & Poor's rating on the Puerto Rico Highways and Transportation Authority (HTA) is unchanged at 'B'. The outlook on all ratings is negative.

We believe Puerto Rico's current economic and financial trajectory is now more susceptible to adverse financial, economic, and market conditions that could ultimately impair the commonwealth's ability to fund services and its debt commitments. Persistent economic weakness over many years has contributed to declining revenue and fiscal imbalance. Under revolving leadership, the government's response to the situation has vacillated between rounds of spending austerity and tax cuts, or increased taxes and limited layoffs, but in either case it has relied on debt issuance to cover operating deficits. Over time, this has led to high debt levels, which have become harder to sustain because of continued economic weakness has reduced tax resources. In our view, Puerto Rico's focus more recently has turned to new rounds of financing to simply maintain critical levels of operating cash, while paying a steep price for acquiring new financing. All of this poses a threat, in our view, to the commonwealth's ability to continue providing basic governmental services. We have observed in other jurisdictions that such an environment can easily give way to political and policy instability.

The GO and associated downgrades follow what we view as significantly increased near-term liquidity risks for the commonwealth. At this rating level and due to the relatively low proportion of appropriation-supported debt to total GO debt, we believe appropriation and GO debt share similar risk.

We have also lowered the COFINA ratings based on our view that introduction of the new value added tax (VAT) will create increased uncertainty as to the timing of receipts of pledged revenues and whether bond covenants separating the tax revenue from that of the commonwealth may be maintained. The HTA debt is affirmed, whose rating continues to reflect uncertainties relating to the Puerto Rico Public Corporation Debt Enforcement and Recovery Act debt restructuring law. The outlook on all bonds remains negative, reflecting liquidity, budget, and economic uncertainty over the next year that could further erode credit quality.

LIQUIDITY RISK

We believe Puerto Rico has experienced and will continue to face a major reduction in its ability to obtain external liquidity at a reasonable cost, as evidenced by GO bond yields topping 10%, following a lower court decision invalidating its debt restructuring law. As a result, Puerto Rico's access to cash flow financing necessary for the next fiscal year could be severely constrained in our opinion. For the current fiscal year ending June 30, 2015, Puerto Rico has arranged for more than $1 billion in total of cash flow financing, which we expect to provide sufficient liquidity through the end of the current fiscal year based on current cash flow estimates provided by the commonwealth. We note that economic trends continue to weaken, which could widen the current year budget gap and further weaken liquidity. Revenues through December 2014 were already $96.5 million, or 2.5%, below budget forecast. We believe liquidity pressures will mount early in fiscal 2016 because of the Government Development Bank's (GDB) ability to provide liquidity may be constrained, and budget risks may be amplified if a new tax structure in the form of a VAT is implemented while at the same time negative economic trends persist. It is also unclear what effect the imposition of a VAT, if approved, might have on the island's economy.

The court decision on the restructuring law may also pose a threat to the GDB's liquidity by reducing investor appetite for its plan to refinance $2.2 billion of an unrated subordinate HTA loan. In our view, refinancing the HTA loan is needed to recapitalize the GDB and in turn provide for central government liquidity.

IMPLEMENTATION OF VALUE ADDED TAX

We also believe that budget risk is high for the next fiscal year due to the government's announced plan to implement a new VAT, expected to be imposed at 16%.

Puerto Rico's intention in imposing a VAT is to significantly raise overall revenues and create a more equitable tax system that reduces tax evasion, compared with the sales tax it would replace. We believe there is implementation risk in the near term, if the new tax structure is approved, due to the lack of collection history and the uncertainty of collection mechanics. We also believe that it could increase forecasting volatility. While on a long-term basis, higher taxes could improve the budget balance, we have concerns for the potential negative economic implications that could result from the new tax. When the current sales tax went into effect, the commonwealth expected to increase revenues and reduce tax evasion. However, actual sales tax growth fell short of original projections and compliance remains an issue. We are concerned that similar unexpected consequences could arise from implementation of the VAT. If approved, it would be the first time a VAT was implemented within the U.S. governmental system. There appears to be no consensus between the two main political parties on imposition of the tax, suggesting the new tax could be modified if the main opposition party gains office in the future.

Introduction of VAT legislation has negative implications for COFINA's sales tax-secured bonds in our view due to the uncertainty over the amount of pledged revenues that would replace the sales tax, and whether the new structure maintains the separation of pledged revenue from what is pledged to the GO bondholders. COFINA bond covenants allow replacement of sales taxes pledged to bonds by a "substitute like or comparable security," but only if it does not impair an obligation of COFINA. In addition, bond covenants prohibit substitution unless the bond trustee shall have been provided with written confirmation of all bond ratings outstanding from rating agencies maintaining a rating on the bonds, taking such substitution into account. If approved, we will evaluate the new VAT implementation plan and its impact on credit quality.

ECONOMY

The current developments occur against the backdrop of continued economic weakness in the past year. Although employment has stabilized in the past three months, it remains down slightly year-over-year. The GDB leading economic index released December 2014 showed a 1.4% year-over-year decline, and census data for 2014 show the island's population continues to decline. We still believe economic growth is necessary for the commonwealth to pay growing debt service, pension, and health care costs and, in our view, the prospects for this have declined in recent months. (For more information on Puerto Rico's economy, please refer to our commentary published Nov. 7, 2014, on RatingsDirect.)

CAPITAL MARKET ACCESS

As a result of what we believe is constrained capital market access we have used an override factor within our state rating methodology to limit our GO rating on Puerto Rico to the 'B' category. We believe the commonwealth will require access to external debt markets for substantial cash flow financing in early fiscal 2016, or potentially before that if budget forecasts prove weaker than current forecasts. In our opinion, Puerto Rico could potentially find itself without market access at affordable cost if GDB's liquidity falls or the private high-risk investors who currently invest in Puerto Rico and its public corporations abandon this high-yield lending strategy. Recent GO bond yields above 10% are, in our view, an expression of external market risk. The central government's access to loans may also be affected by a recent lower court decision that invalidated Puerto Rico's recent debt restructuring law for public corporations, which investors might perceive as limiting the commonwealth's efforts to isolate or "ring fence" the GO debt from the credit problems affecting its public agencies. Although other overrides apply to our rating on Puerto Rico, such as a high level of expected future long-term liabilities for debt and pension systems, and weak financial management, our downgrade reflects our assessment of the capital market access risk override.

As liquidity becomes more constrained, if the economy continues to weaken, and budget gaps increase, we believe Puerto Rico's access to the capital markets could deteriorate. Proposed changes to the current tax structure could also exacerbate this uncertainty. Although HTA, COFINA, rum, and hotel tax-secured debt appears to have adequate pledged revenues on a strict legal coverage basis, we are concerned that these revenue streams may not be adequately separated from the commonwealth's credit quality in the event of severe general fund credit and/or liquidity stress.

OUTLOOK

Our outlook on Puerto Rico is negative. To the extent the commonwealth's liquidity situation deteriorates in the next year, possibly due to an inability to place cash flow notes, or a widening fiscal 2015 deficit, we could lower our GO and associated ratings on Puerto Rico. Should liquidity also become further constrained during the phase-in period of the proposed VAT, we could also lower the ratings. Should Puerto Rico's liquidity situation improve and the commonwealth regain affordable market access, which we do not expect in the near term, we could revise the outlook to stable.

RELATED CRITERIA AND RESEARCH

Related Criteria

- USPF Criteria: State Ratings Methodology, Jan. 3, 2011
- USPF Criteria: Financial Management Assessment, June 27, 2006

Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at www.spcapitaliq.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column.