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## Puerto Rico Downgraded To 'CCC+' From 'B' On Weakened Market Access; Placed On CreditWatch Negative

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NEW YORK (Standard & Poor's) April 24, 2015--Standard & Poor's Ratings Services has lowered its general obligation (GO) rating on the Commonwealth of Puerto Rico to 'CCC+' from 'B'. At the same time, Standard & Poor's has placed the GO rating on CreditWatch with negative implications.

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

- Puerto Rico Sales Tax Financing Corp.'s (COFINA) first-lien sales tax bonds to 'CCC+' from 'B' and COFINA's second-lien sales tax bonds to 'CCC+' from 'B';
- 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 'CCC+' from 'B';
- Puerto Rico Infrastructure Financing Authority's (rum tax) and the Puerto Rico Convention Center District Authority's (hotel tax) debt to 'CCC+' from 'B'; and
- Puerto Rico Highway and Transportation Authority's rated debt (HTA) to 'CCC+' from 'B'.

These bonds have also been placed on CreditWatch with negative implications.

We base the downgrade of Puerto Rico's tax-supported debt on our view that the commonwealth's market access prospects have further weakened and Puerto Rico's ability to meet its financial commitments is increasingly tied to the

business, financial, and economic conditions on the island. Absent improvement in those conditions, we believe debt and other financial commitments will be unsustainable.

Our placement of the ratings on CreditWatch negative reflects our view that the commonwealth's current lack of consensus on key elements of the fiscal 2016 budget could exacerbate liquidity and fiscal pressure. We expect to resolve the CreditWatch within three months when enactment of a budget will provide additional information allowing us to evaluate overall liquidity. We believe enactment of a credible balanced budget by the start of the new fiscal year (July 1) could be an important element in Puerto Rico regaining external market access. Should passage of a fiscal 2016 budget become significantly delayed, or the budget is enacted with significant structural flaws, we could lower the rating to 'CCC' or lower. Alternatively, if timely budget adoption translates into stabilized liquidity, we could remove the ratings from CreditWatch and affirm the 'CCC+' ratings.

Recent developments highlight what we see as liquidity risk for the commonwealth from diminished external market access. The board of the Puerto Rico Government Development Bank (GDB) recently sent a letter to the Governor and state legislators indicating increasingly remote prospects for selling a proposed refinancing of a \$2.2 billion Highway and Transportation Authority loan from GDB with a larger \$2.95 billion external bond issue backed by petroleum taxes. The purpose of the refinancing would be to improve GDB liquidity.

The GDB board cited liquidity problems that could occur as early as the start of fiscal 2016 unless legislators enact a budget and address tax reform. We believe the existence of such a letter indicates liquidity stress.

In our view, it is unclear how the GDB's efforts to attract a nontraditional base of debt investors for the \$2.95 billion external bond issue are affecting the commonwealth's budget and fiscal policy negotiations.

It is our opinion that even if the proposed value-added tax (VAT) were enacted by the legislature without delay, without external financing, liquidity may still fall below thresholds necessary to maintain operations and fund financial commitments. Further underscoring liquidity pressure is legislation introduced April 8 (P. de la C. 2406), which includes new restrictions on depositors in order to preserve GDB liquidity.

Introduction of the executive budget proposal for fiscal 2016 has been delayed as the legislature debates the administration's proposal to implement a new 16% VAT, whose level may be reduced after legislative deliberations. We believe that imposition of a new VAT is subject to implementation risks, whose uncertainties might affect future budget performance and the willingness of investors to extend future credit, and which is incorporated into our CreditWatch designation.

We also believe budget pressures are exacerbated by current weak economic

trends and high debt levels, factors likely to persist in the long term. Imposition of a large VAT may increase overall tax revenue, but have negative short-term economic implications.

As a result of what we believe is increasingly constrained capital market access, we have used an override factor within our state rating methodology to limit our GO rating on Puerto Rico to 'CCC+'. We are now using our 'CCC' criteria, which provides clarity for assigning ratings within the 'CCC' and 'CC' categories. Under our 'CCC' criteria, the degree of financial stress and the time frame for anticipated default are primary factors in our assessment of issuers rated within the 'CCC' and 'CC' categories. Although we believe that passage of a structurally balanced budget by July 1 may improve the odds of accessing the private debt markets to improve liquidity, we believe that substantial doubt exists as to whether an external debt sale of sufficient size may be accomplished by the end of fiscal 2015, or later in fiscal 2016, when we believe substantial seasonal cash flow financing will be needed. At present, we believe Puerto Rico has very limited or no external debt market access in either the public or private external debt markets, including investment from private high-risk investors who have provided cash flow financing during the current fiscal year. Our downgrade reflects our criteria override assessment of increased capital market access risk, combined with near-term liquidity pressures. We believe this could lead to a government shutdown without access to external debt markets.

Although HTA, COFINA, rum, and hotel tax-secured debt appear 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 or liquidity stress caused by the lack of debt market access. For more information on our view of the potential impact of the proposed VAT on COFINA's sales tax secured bonds, please refer to our article published Feb. 12, 2015, on RatingsDirect.

#### RELATED CRITERIA AND RESEARCH

##### Related Criteria

USPF Criteria: State Ratings Methodology, Jan. 3, 2011

USPF Criteria: Financial Management Assessment, June 27, 2006

USPF Criteria: Special Tax Bonds, June 13, 2007

USPF Criteria: Moral Obligation Bonds, June 27, 2006

Criteria For Assigning 'CCC+', 'CCC', 'CCC-', And 'CC' Ratings, Oct. 1, 2012

Complete ratings information is available to subscribers of RatingsDirect at

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