



Moody's Investors Service

New Issue: MOODY'S ASSIGNS Baa3 TO APPROXIMATELY \$150 M PUERTO RICO PUBLIC BUILDINGS AUTHORITY GOVERNMENT FACILITIES REVENUE REFUNDING BONDS, SERIES Q

Global Credit Research - 15 Oct 2009

RATINGS AFFIRMED ON ALL COMMONWEALTH GENERAL OBLIGATION AND GUARANTEED DEBT AS WELL AS COMMONWEALTH APPROPRIATION BONDS; OUTLOOK IS STABLE

Puerto Rico (Commonwealth of)
State
PR

Moody's Rating

ISSUE	RATING
Government Facilities Revenue Refunding Bonds, Series Q (Guaranteed by the Commonwealth of Puerto Rico)	Baa3
Sale Amount	\$150,000,000
Expected Sale Date	10/14/09
Rating Description	General Obligation

Opinion

NEW YORK, Oct 15, 2009 -- Moody's Investors Service has assigned a long-term rating of Baa3 to approximately \$150 million Puerto Rico Public Buildings Authority Government Facilities Revenue Refunding Bonds, Series Q (Guaranteed by the Commonwealth of Puerto Rico). The bonds are expected to price on October 14, 2009. At the same time, Moody's has affirmed the Baa3 rating on the commonwealth's bonds backed by the state's general obligation pledge, including general obligation bonds and bonds guaranteed by the commonwealth, and the Ba1 rating on outstanding bonds backed by commonwealth appropriations. The outlook is stable.

This refunding will allow the commonwealth to push almost \$60 million of debt service costs out of 2010 for some budget relief, and some of the proceeds will also be used to capitalize interest costs in 2011 and 2012; approximately \$8.2 million of the principal in the transaction will mature in 2022 while the remaining approximately \$140 million of the principal will mature in 2037-2039.

Puerto Rico's Baa3 debt rating reflects the commonwealth's recessionary environment, challenging budgetary and financial situation, and the plans put in place by the administration to deal with the budgetary gaps and economic challenges.

STRENGTHS

- * Politically and economically linked to the U.S., with benefit of the nation's strong financial, legal, and regulatory systems.
- * Large economy, with gross product exceeding those of 10 states and population exceeding those of 24 states.
- * Broad legal powers to raise revenues, adjust spending programs, and employ borrowing in order to maintain fiscal solvency.
- * Strong management dedication to tax and fiscal reform, including strengthening the commonwealth's general obligation and other credits.

CHALLENGES

- * High unemployment, low workforce participation, and high poverty levels compared to the U.S. Average income levels remain below 50% relative to the U.S. mainland median.

- * Large size of commonwealth government relative to the economy (although recent government actions should reduce the size of government in the future).
- * Multi-year trend of large General Fund operating deficits, financed by deficit borrowing.
- * Very high government debt level relative to the economy, due in part to financing budget deficits.
- * Low pension funding ratios relative to U.S. states.
- * Local economy that has been in recession since 2006.

SECURITY FOR THE BONDS

The security for the bonds is the rentals of government facilities financed or refinanced by parity bonds and leased by the authority to departments, agencies, and municipalities of the commonwealth. The bonds are further secured by the guarantee of the commonwealth, under which the commonwealth pledges to draw from any funds available in the Treasury such sums as may be necessary to cover any deficiency in the amount required for principal and interest payments on the bonds. The full faith and credit of the commonwealth, like with general obligation bonds, are pledged for such payments. As a result, the bonds are rated the same as the commonwealth's general obligation bonds.

NEW LAWS AIMED AT REESTABLISHING FISCAL BALANCE

Governor Luis Fortuño, who ran on a platform of expenditure reduction, won the election in 2008 with 52.8% of the popular vote. This support translated into the passage of seven pieces of legislation in the first three months of the newly elected governor's term, evidencing a change in Puerto Rico's willingness to make structural changes in its operations meant to lead to an improvement in financial position. The newly adopted laws established a state of fiscal emergency in Puerto Rico due, in large part, to the decline in revenues, projected rise in expenditures, and expected gap of \$3.2 billion in fiscal 2009 and each subsequent year during the forecast period.

Most significantly, one of the new laws permits the reduction of workforce to save the island a total of \$2 billion annually. The new laws also provide for some permanent and other temporary revenue enhancements that together with improved tax collections and compliance measures are estimated to be worth approximately \$1.2 billion per year to the commonwealth as soon as they are fully implemented. Through two different measures, the government has agreed to dedicate an additional 1 3/4 cents of the existing sales and use tax to support bond issues that will repay some debt, help to ease the deficit, and fund local fiscal stimulus (one cent of the existing sales and use tax was already leveraged in this manner).

EMPLOYMENT REDUCTIONS UNDERWAY

Expenditure reductions were initiated by the governor in his first executive order whereby he ordered a 10% reduction in government expenses, a hiring freeze and the reduction of 30% of trust (non civil service) personnel. The government then offered voluntary retirement to government workers.

On September 25, 2009, the Fiscal Board announced the dismissal of 16,970 government employees in the second and final round of layoffs by the commonwealth under Phase II of Act No. 7. Approximately 1,000 of the laid-off employees are expected to be recruited and retrained by the Treasury to help them with collections and by private collection firms to assist the Treasury. The commonwealth expects that approximately 2,200 of the laid-off employees will be hired by workers' cooperatives or private companies to be school janitors for the Education Department. The Fiscal Board expects the net amount of employees affected by these layoffs to be 13,774, and projects the annual savings resulting from these actions to be approximately \$386 million. The Fiscal Board estimates that the annual savings from all cost reduction measures implemented or identified by the commonwealth as of September 30, 2009 will amount to approximately \$1.2 billion, which is approximately 60% of the \$2 billion target. The additional savings are expected to come from both cost reduction and revenue generating initiatives, which include, among others, improvements in government procurement processes, reorganization and increased fiscal oversight of government agencies and improvements in tax collection and enforcement measures.

NEW TAXES TO RAISE REVENUES

The legislature has passed bills containing new and increased taxes to raise revenues. The bills contain a

multitude of revenue raising measures, some permanent and some temporary. Tax revenue collections are down, and these measures attempt to increase revenues to the commonwealth. The permanent revenue increases include the imposition of the alternative minimum tax on certain items of exempt income, the repeal of the credit against sales and use tax for purchases of products manufactured in Puerto Rico for export, an increase of the cigarette excise tax by \$1.00 per pack, and an increase in excise taxes on alcoholic beverages. The temporary measures include a special state tax on real property, a modification to the alternative minimum tax on corporations, a 5% income tax surcharge on individuals, corporations and other taxpayers, and a moratorium on certain tax credits.

ADDITIONAL DEFICIT FINANCING

Puerto Rico is already highly leveraged and has begun to issue considerably more debt to strengthen the Government Development Bank's balance sheet, fund a local stimulus package, and pay for operations. The commonwealth intends to use these funds to bridge operations while it restructures the size and cost of its government and increases its recurring revenues. We will monitor the implementation of corrective actions to ensure that our rating appropriately reflects improvement in the commonwealth's financial position over the next few years. Recently, the commonwealth has issued bonds backed by a dedicated portion of the existing sales and use tax. A portion of the proceeds will be used to fund operational deficits.

FEDERAL AND LOCAL STIMULUS BILLS WILL PROVIDE SOME RELIEF

Puerto Rico estimates it will receive approximately \$6 billion in federal stimulus aid. Of this, approximately \$187 million in additional Medicaid funding is available to be used to close the budget deficit, and a small portion (approximately \$100 million) of education aid may also be used for gap-closing purposes. In addition, the commonwealth created the Puerto Rico Economic Stimulus Plan Act in an attempt to promote economic growth on the island. The local stimulus program is worth approximately \$500 million, as estimated by the commonwealth, and is expected to be funded with proceeds from sales tax revenue bonds. It contains mortgage relief, a stimulus for home purchases, loans for small and medium businesses, and workforce retraining.

GAAP DEFICITS HIGH

The consolidated annual financial report for fiscal year 2008 reports a GAAP-basis General Fund balance of negative \$1.1 billion, compared to negative \$511 million for fiscal 2007. The General Fund showed an operating deficit (revenues minus expenditures) of \$3.6 billion, compared to an operating deficit of \$872 million in the previous year. These GAAP deficits may increase next year, but are expected to decline over a four-year period as the commonwealth's deficit-reduction plan is implemented.

ECONOMY REMAINS A WEAKNESS

The commonwealth is currently in a recession, and has been since March 2006. The risks associated with the economy are heightened by the national slowdown. The housing market has been sluggish in the commonwealth for the past three years, with housing permits, number of new dwelling units, and the value of new dwelling units all showing declines in recent years. It appears, however, that the poor performance of the housing market in the commonwealth is a result of the general economic weakness of the commonwealth, and is not connected to the housing downturn caused by the sub-prime mortgage crisis in the U.S. Downside risks to the economy exist once the commonwealth reduces government employment. The Commonwealth is attempting to mitigate this risk by funding a local stimulus program (funded with \$500 million of sales tax revenue bond proceeds).

DEBT CONTINUES TO BE HIGH

Debt ratios for the commonwealth are very high, with net tax-supported debt at over \$8,000 per capita and more than 66% of personal income. Debt measures are expected to increase as the commonwealth has begun to issue debt backed by sales tax revenues to fund operating deficits. Pension funding ratios are low relative to U.S. states, even considering the commonwealth's issuance of pension funding bonds in 2008. The unfunded actuarial accrued liability for other post-employment benefits (OPEB) was deemed to be \$1.6 billion for the ERS (employees retirement system) as of July 1, 2007.

MOST RECENT RATING ACTION AND PRINCIPAL METHODOLOGY

The last rating action with respect to the Commonwealth of Puerto Rico was on September 9, 2009, when

the rating of Baa3 with a stable outlook was assigned to the Puerto Rico Public Improvement Refunding Bonds, Series 2009A.

The principal methodology used in rating the Commonwealth of Puerto Rico was Moody's "State Rating Methodology," available on www.moodys.com in the Rating Methodologies sub-directory under the Research & Ratings tab. Other methodologies and factors that may have been considered in the process of rating this issuer can also be found in the Rating Methodologies sub-directory on Moody's website.

Outlook

The rating outlook for the Commonwealth of Puerto Rico is stable at this time, reflecting the implementation of numerous measures to steadily bring the commonwealth to fiscal stability.

What could move the rating--UP

- Strong rebound in economic growth leading to improved and sustained revenue results.
- Spending controls that lead to long-term improved budgetary results and outlook.
- Significant improvement in the condition of the commonwealth's pension system, including greater recurring budgetary contributions.
- Reversal of General Fund's deficit position.

What could move the rating--DOWN

- Growth in structural budget gap and an increase in GAAP deficits beyond that which is expected in the near term.
- Prolonged recession, resulting in declining revenues and deficit financing in excess of currently projected amounts.
- Increase in structural imbalance.
- Lack of market access.
- Lack of a plan to address the potential fall-off in revenues related to the federal fiscal stimulus money.

Analysts

Emily Raimés
Analyst
Public Finance Group
Moody's Investors Service

Edith Behr
Backup Analyst
Public Finance Group
Moody's Investors Service

Contacts

Journalists: (212) 553-0376
Research Clients: (212) 553-1653



CREDIT RATINGS ARE MIS'S CURRENT OPINIONS OF THE RELATIVE FUTURE CREDIT RISK OF ENTITIES, CREDIT COMMITMENTS, OR DEBT OR DEBT-LIKE SECURITIES. MIS DEFINES CREDIT RISK AS THE RISK THAT AN ENTITY MAY NOT MEET ITS CONTRACTUAL, FINANCIAL OBLIGATIONS AS THEY COME DUE AND ANY ESTIMATED FINANCIAL LOSS IN THE EVENT OF DEFAULT. CREDIT RATINGS DO NOT ADDRESS ANY OTHER RISK, INCLUDING BUT NOT LIMITED TO: LIQUIDITY RISK, MARKET VALUE RISK, OR PRICE VOLATILITY. CREDIT RATINGS ARE NOT STATEMENTS OF CURRENT OR HISTORICAL FACT. CREDIT RATINGS DO NOT CONSTITUTE INVESTMENT OR

FINANCIAL ADVICE, AND CREDIT RATINGS ARE NOT RECOMMENDATIONS TO PURCHASE, SELL, OR HOLD PARTICULAR SECURITIES. CREDIT RATINGS DO NOT COMMENT ON THE SUITABILITY OF AN INVESTMENT FOR ANY PARTICULAR INVESTOR. MIS ISSUES ITS CREDIT RATINGS WITH THE EXPECTATION AND UNDERSTANDING THAT EACH INVESTOR WILL MAKE ITS OWN STUDY AND EVALUATION OF EACH SECURITY THAT IS UNDER CONSIDERATION FOR PURCHASE, HOLDING, OR SALE.

© Copyright 2009, Moody's Investors Service, Inc. and/or its licensors including Moody's Assurance Company, Inc. (together, "MOODY'S"). All rights reserved.

ALL INFORMATION CONTAINED HEREIN IS PROTECTED BY COPYRIGHT LAW AND NONE OF SUCH INFORMATION MAY BE COPIED OR OTHERWISE REPRODUCED, REPACKAGED, FURTHER TRANSMITTED, TRANSFERRED, DISSEMINATED, REDISTRIBUTED OR RESOLD, OR STORED FOR SUBSEQUENT USE FOR ANY SUCH PURPOSE, IN WHOLE OR IN PART, IN ANY FORM OR MANNER OR BY ANY MEANS WHATSOEVER, BY ANY PERSON WITHOUT MOODY'S PRIOR WRITTEN CONSENT. All information contained herein is obtained by MOODY'S from sources believed by it to be accurate and reliable. Because of the possibility of human or mechanical error as well as other factors, however, such information is provided "as is" without warranty of any kind and MOODY'S, in particular, makes no representation or warranty, express or implied, as to the accuracy, timeliness, completeness, merchantability or fitness for any particular purpose of any such information. Under no circumstances shall MOODY'S have any liability to any person or entity for (a) any loss or damage in whole or in part caused by, resulting from, or relating to, any error (negligent or otherwise) or other circumstance or contingency within or outside the control of MOODY'S or any of its directors, officers, employees or agents in connection with the procurement, collection, compilation, analysis, interpretation, communication, publication or delivery of any such information, or (b) any direct, indirect, special, consequential, compensatory or incidental damages whatsoever (including without limitation, lost profits), even if MOODY'S is advised in advance of the possibility of such damages, resulting from the use of or inability to use, any such information. The credit ratings and financial reporting analysis observations, if any, constituting part of the information contained herein are, and must be construed solely as, statements of opinion and not statements of fact or recommendations to purchase, sell or hold any securities. NO WARRANTY, EXPRESS OR IMPLIED, AS TO THE ACCURACY, TIMELINESS, COMPLETENESS, MERCHANTABILITY OR FITNESS FOR ANY PARTICULAR PURPOSE OF ANY SUCH RATING OR OTHER OPINION OR INFORMATION IS GIVEN OR MADE BY MOODY'S IN ANY FORM OR MANNER WHATSOEVER. Each rating or other opinion must be weighed solely as one factor in any investment decision made by or on behalf of any user of the information contained herein, and each such user must accordingly make its own study and evaluation of each security and of each issuer and guarantor of, and each provider of credit support for, each security that it may consider purchasing, holding or selling.

MOODY'S hereby discloses that most issuers of debt securities (including corporate and municipal bonds, debentures, notes and commercial paper) and preferred stock rated by MOODY'S have, prior to assignment of any rating, agreed to pay to MOODY'S for appraisal and rating services rendered by it fees ranging from \$1,500 to approximately \$2,400,000. Moody's Corporation (MCO) and its wholly-owned credit rating agency subsidiary, Moody's Investors Service (MIS), also maintain policies and procedures to address the independence of MIS's ratings and rating processes. Information regarding certain affiliations that may exist between directors of MCO and rated entities, and between entities who hold ratings from MIS and have also publicly reported to the SEC an ownership interest in MCO of more than 5%, is posted annually on Moody's website at www.moody's.com under the heading "Shareholder Relations - Corporate Governance - Director and Shareholder Affiliation Policy."