GRANT'S

INTEREST RATE OBSERVER®

Vol. 31, No. 20a — Two Wall Street, New York, New York 10005 • www.grantspub.com — OCTOBER 18, 2013

Speculative debt at a speculative price

Troubled borrowers are a dime a dozen in the leveraged world we live in. Vanishingly rare are bonds priced to compensate an investor for the risks associated with that fact. Enter here the Commonwealth of Puerto Rico, the Isle of Enchantment.

To come right out with it, this publication is now bullish on the debt on which, in the issue of *Grant's* dated April 5, it was bearish. And to be entirely clear, we are bullish on a speculation, not an investment. Puerto Rico is a speculative-grade general obligation credit still clothed in triple-B ratings, as all but Moody's, Standard & Poor's and Fitch seem to comprehend. Black headlines will herald the commonwealth's credit demotion when it belatedly, almost certainly, arrives. On that truth-telling day, cheap Puerto Rican debt may become cheaper. It may well become cheaper anyway.

In any turnaround situation, the bullish argument is hypothetical, the bearish case self-evident. If it were otherwise, the dinged and dented securities—Puerto Rico public improvement 5s of July 1, 2041, priced at 60.93 to yield a triple tax-exempt 8.78%, for instance—would be priced for recovery, not salvage. Things may turn out for Puerto Rico; we expect they will. But just by extrapolating recent trends and problems, one would not necessarily jump to that conclusion.

What are these difficulties? Over-leverage and overborrowing—related but separate issues—are near the top of the list. Also, poverty, economic contraction, joblessness, governmental mismanagement, population loss, brain drain, public safety and undercapitalized banks holding lots of underwater real estate loans. Zero-percent interest rates, too, have contributed to the general unhappiness. They have facilitated both excessive borrowing and the leveraging up of that debt by yield-scavenging investors.

It can't be said that the bad news is anybody's top secret. On Oct. 2, each of the 15 most popular bonds searched on Bloomberg terminals was a Puerto Rican name. The commonwealth's publicly traded debt is ubiquitous. Some $70 billion is on the hoof, and it has a place in the portfolios of 77% of tax-exempt mutual funds, according to Morningstar. Puerto Rican debt was incongruously ubiquitous in the $125 million Oppenheimer Rochester Virginia Municipal Bond Fund (ORVAX), a single-state muni fund ostensibly focused on the Old Dominion but actually, as of Aug. 31, one-third invested in high-yielding Puerto Rican obligations. The Oppenheimer fund is down by 19% this year, which, as an observer quoted by the Web site *InvestmentNews* pointed out, would be a hard thing to explain to the stockholders "short of a North Korean invasion of Virginia." Oppenheimer Rochester single-state funds devoted to North Carolina, Arizona, Massachusetts and Maryland have also paid the performance price for outsize exposures to the leveraged Caribbean paradise.

Puerto Rico's debt is variously packaged, priced and rated. There are general obligation bonds, corporate bonds guaranteed by the commonwealth and pension obligation bonds. There are sales tax bonds and non-guaranteed public corporation bonds. These securities vary in their risks. For instance, certain revenue bonds of the Highway and Transportation Authority are backed by toll receipts, an obvious exposure to the health of the

A Puerto Rican debt sampler

Issuer	coupon	par outs., $ millions	price	yield	maturity date	rating
Commonwealth of Puerto Rico [General Obligation]	5.00%	$633.0	$60.93	8.78%	7/1/41	BBB-/Baa3/BBB-
Government Development Bank for Puerto Rico *	5.00	540.8	59.65	12.20	8/1/23	BBB-/Baa3
Puerto Rico Aqueduct and Sewer Authority	5.25	551.2	63.81	8.70	7/1/42	BB+/Ba1/BBB-
Puerto Rico Electric Power Authority**	5.25	588.4	68.05	8.22	7/1/40	BBB-/Baa3/BBB-
Puerto Rico Highway and Transportation Authority	5.25	263.8	61.64	9.15	7/1/39	BBB/Baa3
Puerto Rico Public Buildings Authority	5.25	538.7	61.22	9.06	7/1/42	BBB-/Baa3/BBB-
Puerto Rico Sales Taxes Financing Corp. [COFINA]	0.00	701.5	5.97	7.04	8/1/54	AA-/A2/AA-
University of Puerto Rico	5.00	87.0	56.69	9.79	6/1/36	BBB-/Ba1

*taxable for non-Puerto Rico residents
**guaranteed by commonwealth
source: The Bloomberg

economy. In contrast, sales tax bonds have a dedicated revenue base (the COFINA) that does not impact the general fund and are perceived to be safer (see table) by the ratings agencies. However, the COFINA was created by the legislature, which could always change the law. Bonds also vary in their tax advantages. For example, the Employees Retirement System 6.15% pension obligation bonds of 2038, which, despite being priced at 51.24 to yield 12.6%, are somehow still rated investment grade and are taxable at the federal level for mainland residents, but not for Puerto Rican locals.

Some of this debt is insured. According to *The Bond Buyer*, bond insurers backed $15.7 billion of Puerto Rican obligations as of June 30 (expressed as total net par outstanding exposure to all Puerto Rican names). Assured Guaranty was the busiest writer of insurance on commonwealth bonds, with $5.7 billion of exposure, of which $2.17 billion was assigned to general obligation debt. MBIA's National Public Finance Guarantee, in second place, had wrapped up $5.19 billion worth, followed by Ambac Assurance ($2.53 billion) and Syncora Guarantee and FGIC (a combined $2.29 billion). "A lot of these exposures were built up over the years, and it's always been a big part of the business model to have very high operational leverage," James Eck, senior credit analyst at Moody's Investors Service, told *The Bond Buyer*. "The view has always been that the probability of default is low, and when the credits do default, the recovery is fairly high. Some of the more recent high-profile defaults may punch a hole in that view."

To date, Puerto Rico ranks as a highly publicized non-default. A Sept. 10 Reuters dispatch reported on the commonwealth's chronic demographic problems. "Statistics suggest young professionals are leaving the island in droves," the story said. "The number of doctors and teachers getting on planes quadrupled in 2011, according to a study entitled, 'Profile of the Migrant' by Puerto Rico's Institute of Statistics. At the same time, the median age of returnees is steadily rising."

"The graying of society occurs at an alarming rate in Puerto Rico," Reuters quoted Vincente Feliciano, an economist at Advantage Business Consulting, as saying. "The migration is up and down the socioeconomic scales, from neurosurgeons to housemaids. The constant is that the migrants tend to be younger."

Would that more felons could scratch up the plane fare. According to a Michigan State University professor of criminal justice, David Carter, Puerto Rico has a murder rate nearly six times the continental average. As to which state and which commonwealth have managed the dubious feat of showing net population losses since 2010, you can already guess the name of the sun-drenched, tropical commonwealth. The state was Rhode Island.

To begin to understand the lapses in public oversight that have served up the Puerto Rican recovery opportunity, look no further than the commonwealth's Aqueduct and Sewer Authority, one of a clutch of what we on the mainland used to call government-sponsored enterprises. In August, Alberto Lazaro, the authority's executive president, made a startling admission. More than 60% of the authority's water goes missing, 40% or so to leakages and the rest to theft, he said.

"If you go to the back of engineering reports," Jonathan Carmel, portfolio manager of Carmel Asset Management in New York and a bull on Puerto Rico, tells colleague Charley Grant, "every municipal water system has leakage. Fire hydrants open, etc. The top quartile of water systems lose about 5% of their water to leakage. The bottom quartile has 15% leakage. These guys lose 64% of their water. People must be stealing left and right. Over the last few years, it's gone from 59% to 64%, so they're actually going backwards, which is remarkable."

As for economic vital signs, year-over-year readings in August provide no obvious support to the bullish narrative. The Government Development Bank's economic activity index fell by 5.4%, following declines of 5% in July and 4.6% in June. Electric-power generation was off by 2.2%, non-farm employment by 4.4% and cement sales by 14.9%. As for the commonwealth's structural deficit (i.e., recurring revenues minus recurring expenses), it totaled $1.6 billion in the fiscal year ended June 30, representing 18.3% of the general fund.

"A drive through San Juan confirms much of what the statistics suggest," visiting analyst Grant relates. "The city, set smack on the Atlantic, is beautiful but signs abound of the recession that officially began in 2006 and that ended officially—i.e., politically if not visibly—in February 2012. Throughout the neighborhood of Hato Rey, the city's financial district, 'for rent' signs—that's '*Se Alquila*' in Spanish—festoon buildings, some of which appear to be abandoned. Maintenance cap-ex seems not to be the city's strong suit, either with respect to buildings or the narrow, winding roads on which some—but by no means all—drivers agree to stay to the right. One local banking insider (and *Grant's* reader) who asks to go nameless tells me that he and his professional cohorts have agreed not to discuss the island's financial difficulties. 'Nobody wants to talk about the decedent at his funeral,' he says."

That is one opinion. For us, we are struck by how much fight the ostensible corpse is putting up. And let it be said on behalf of the commonwealth's debt that the Puerto Rican constitution affords its general-obligation bondholders a not inconsequential legal protection. From Article VI, Section 8: "In case the available revenues including surplus for any fiscal year are insufficient to meet the appropriations made for that year, interest on the public debt and amortization thereof shall first be paid, and other disbursements shall thereafter be made in accordance with the order of priorities established by law."

In April, our main complaint was the shocking underfunding of the commonwealth's principal public pension system. A reform act, signed in April and upheld in the Puerto Rico Supreme Court by a 5-4 margin on June 24, freezes defined benefit plans of public employees in the largest pension system and converts those accounts into 401(k)-style defined contribution plans. And not a fiscal quarter too soon. As of June 30, the funded ratio of the Employees Retirement System was all of 4.5%, one of the few such figures that can make the wastrel state of Illinois, with its combined 40.4% funded ratio, appear prudent.

Between 2000 and 2012, public debt as a share of the island's GNP leapt to 100.7% from 58.4%, or 2.1 times faster than growth in the island's GNP. Unmanageable public debt got Puerto Rico into this mess. And while the government's newfound fiscal religion may or may not get the commonwealth out of it, the powers-that-be seem to be trying. Two Thursdays ago, the government issued a statement of fiscal intent that would have been unimaginable in years past. "Other than through COFINA," said the authorities, referring to the agency that borrows against sales-tax receipts, "the commonwealth has no current plans to issue bonds under any other credit during the rest of the calendar year."

The island's jobless rate stands at 13.9%, an estimated 22.2% of the labor force works for the commonwealth and 45% of Puerto Ricans live below the $22,050 poverty line. All the more striking, then, that the number of employees on the payroll of the central government and the taxpayer-financed GSEs had fallen to 171,420 at the end of June 2013 from 202,525 in 2010.

As a territory of the United States, Puerto Rico must make do with neither its own central bank nor an escape hatch through the federal bankruptcy code. That is, it must contrive to live within its currently dwindling means. Would the U.S. Treasury consider an emergency infusion above and beyond the $6.6 billion or so in transfer payments already expected this fiscal year? "That all depends," observes Grant, "on which anonymous source you listen to. Let's say no federal bailout, just to be on the safe side."

"Puerto Rico pays its debts because it has a responsible government," the governor of the commonwealth, Alejandro Garcia Padilla, was quoted as saying in the Sept. 12 issue of *Caribbean Business*. "Even if it didn't, the island Constitution requires it."

To the noble end of paying its bills, the government in February reached a deal to lease the Luis Muñoz Marin International Airport. Quoting Puerto Rican officials, Reuters said the transaction featured a $615 million up-front payment and annual revenue-sharing payments projected to foot to $552 million. A law passed on June 30 and effective immediately levies a tax on 1% of business revenues greater than $1 million—that is, on gross income not net income. In July, the leaky Aqueduct and Sewer Authority raised water rates by a full 60%, and in 2012, the commonwealth passed a law that might as well have been captioned the "money-management and hedge-fund welcome act." It exempts a resident who has lived on the island for six months and one day from federal or local capital-gains taxes. If analysts at the San Juan-based Center for a New Economy are on the beam, the current fiscal year, ending next June, will produce a structural deficit of $775 million, the lowest since 2005.

"From a bondholder's perspective, the overall financial situation has improved mildly over the past 12 months," says the afore-quoted Jonathan Carmel. Besides the improving fiscal backdrop, there is another bullish feature, he notes: Just 15% of the commonwealth's debt must be rolled over in the next five years. This compares with over 40% in Greece and over 70% in Hungary. On the question of what to buy, Carmel observes that the market "is making only the most basic differentiations between issuers and none between various series of bonds. So there is a great opportunity here to pick and choose. The Public Buildings Authority bonds we bought have three levels of protection. First, they are backed by the revenue from needed facilities—schools, administration buildings, etc. Second and more powerful, they are explicitly guaranteed by the commonwealth and have a constitutionally protected claim on the first available revenues (even before government salaries) brought in by the general fund. Third, and more powerful still, is that almost 80% of the coupon is paid by the U.S. federal government into a lockbox for the benefit of only these bonds—no other. This last feature alone amounts to a PV of 81% of our purchase price. So there are great opportunities here and now. If there is a downgrade, other bonds will present even better opportunities."

The scandalous underfunding of the commonwealth's pension plan was, as noted, the lead point of attack in the bearish *Grant's* analysis of six months ago. The market's willful ignorance of Puerto Rico's troubles was argument No. 2. Early in April, the general obligation Puerto Rico 5¼s of July 2023 (callable at par in July 2022) changed hands at 101.72, to yield 5.03%. But, as the commonwealth has addressed the pension crisis, so has Mr. Market. At press time, the Puerto Rico 5¼s trade at 81.28 to yield 8.07%. For reference, a 10-year G.O. issue wrapped by Assured Guaranty, the triple-tax-exempt 4⅛s of 2023, changes hands at 85.72 to yield 6.095%.

"That uninsured 8.07% yield," Grant observes, "is the taxable equivalent of 13.4% for an American investor in the top income tax bracket. Consider some of the alternatives. One is Spain's 4.4% bond of October 2023. Like Puerto Rico, Spain is rated in the vicinity of triple-B-minus. And like Puerto Rico, Spain has a persistently high unemployment rate (26.6% vs. 13.9% for Puerto Rico). Unlike Puerto Rican debt, however, Spain's is priced just above par to yield a taxable 4.30%. Hungary, which is rated junk by S&P and Moody's, has a forint-denominated, 6% coupon, 10-year note that changes hands above par to yield 5.61%.

"And when one considers tax-exemption," Grant proceeds, "the yields on offer in Puerto Rico top those even for a certified banana republic, B/B2/B-plus-rated Venezuela, whose dollar-denominated 9% notes of 2023 trade at 80 cents on the dollar to yield 12.61%. Puerto Rico has its problems, but how much worse are they than those of the land over which the successor to the late Hugo Chavez, Nicolas Maduro, presides? As the *Financial Times* recently quoted him, Maduro is seeking 'special powers' to 'fight against corruption and the economic war declared by the bourgeoisie against the people.' A little closer to home, the state of Illinois, generously rated single-A, has a 10-year, general-obligation bond outstanding, the 5s of 2023 (taxable at state and local levels) that trades at 106¾ to yield 4.15%."

Adherents of the efficient-markets hypothesis will be tempted to infer from the plunging prices and soaring yields of the commonwealth's debt that something is irreparably wrong in Puerto Rico. Something to temper that inference, observes Ramon Dominguez, a local resident and longtime *Grant's* subscriber, is that not a few Puerto Rican holders of the local debt were leveraged 5:1. Especially were these pushers of the edge of the financial envelope exposed to the kind of bonds that are tax-exempt only for Puerto Rican holders, so-called non-103 paper. "In other words," Dominguez advises in an e-mail, "the PR community was invested in the same asset and at the same price. This started expanding as rates went to zero after 2008. And the government supplied all this paper to the dealer community—good times!"

"Look," says Carmel, who takes the words right out of our mouth, "it is not pretty in any way, shape or form, but the prices are starting to get interesting."

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