

Bond Case Briefs

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Muni Bond Contrarian Stands Firm.

Cites fiscal progress in Puerto Rico, favorable terms as positive signs; sees volatility easing

As we wrote in InvestmentNews last September (Puerto Rico muni bonds: A contrarian view), we continue to think that the government of Puerto Rico has the ability and willingness to honor its debt service obligations to bondholders, and at current prices, general-obligation and various agency debt offer extremely attractive long-term investment opportunities.

To be sure, the commonwealth continues to face fiscal challenges and needs strong sustained policy discipline and commitment from government leaders.

We recognize that further actions will be required to improve credit quality but note that much was accomplished on this front last year.

POSITIVE SIGNS

- Sweeping pension reform to the two largest public-pension systems was enacted. The Teacher's Retirement System, approved in December, was modeled after the changes imposed and upheld by the Puerto Rico Supreme Court on the main Public Retirement System in the spring and summer. Conversion to a defined-contribution model should eliminate the growth of future liabilities, alleviating some of the risk associated with poor funding levels and make "pay as you go" funding more manageable.
- Continued reduction of a chronic budget deficit, which had reached \$3.3 billion in the fiscal year ended June 30, 2009, but is now targeted to be reduced to \$820 million by June. Year-over-year general-fund revenue growth (driven by higher taxes and fees) and expenditure control are keeping deficit reduction on track. General-fund revenue for the first half of the fiscal year ending in June was \$80 million above projections and 15% higher year over year. Expenses have declined and are under budget. Reaching its goal of a balanced budget by fiscal 2016 will require Puerto Rico to remain committed to its plan and execute it effectively.
- Significant rate increases for two of the island's public corporations. Effective July 1, Puerto Rico Aqueduct and Sewer Authority, a widely held bond issuer, raised water rates by 60%, and the Highway Transportation Authority increased revenue by 57% through increased taxes and fees. As with any loan, legal structure and borrower covenants are key elements in our credit analysis. And here, the various Puerto Rico issues demonstrate strength.
- The constitution of the Commonwealth of Puerto Rico, which was ratified in 1952, gives first priority to debt service on public debt, which is defined as general-obligation and commonwealth-guaranteed debt.
- Revenue bonds issued by the various agencies have pledged first claims on specific cash flows, such as sales tax bonds issued by the Puerto Rico Sales Tax Financing Corp. With a debt service coverage ratio of 1.9 and AA- ratings on senior debt from both Standard & Poor's and Fitch Ratings, I ask: On what basis does one predict a required and imminent restructuring? Is this a false assumption based on hyperbole and/or fear? I pose that same question about excise-tax-backed rum bonds issued by the Infrastructure Finance Authority, with coverage ratios of 3.2 and Baa3/BBB+ ratings. Many other commonwealth revenue bond issuers have similarly favorable

terms.

KEEPING PROMISES

Puerto Rico isn't a Latin American sovereign and, in my view, not likely to walk away from debts. It is a United States territory inhabited by U.S. citizens, and it has a long history of keeping the promises it has made to the capital markets.

We aren't alone in recognizing the value of investing in Puerto Rico. Municipal bonds issued by the commonwealth are found in many muni bond funds.

More than 70% of all muni bond funds hold bonds issued on the island, according to Morningstar Inc.

Additionally, Citigroup Inc. estimates that \$25 billion to \$30 billion in bonds are owned directly by individual investors.

Near-term risks include ratings agency downgrades, for which Moody's Investors Service Inc. is reviewing, and further price volatility.

The volatility of Puerto Rico bond pricing last year was no doubt unsettling but, in my view, temporary. When it comes to muni debt issued on the island, we take the long-term view, swayed by the facts and the attractive yields that carefully researched Puerto Rico muni bonds can offer.

And of course, the ability to earn double or triple tax-exempt income has for many years helped satisfy many long-term fixed-income investors.

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By Dan Loughran

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