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INVESTOR UPDATE

FEBRUARY, 2020

PUERTO RICO UPDATE - COMPREHENSIVE DEBT PLAN

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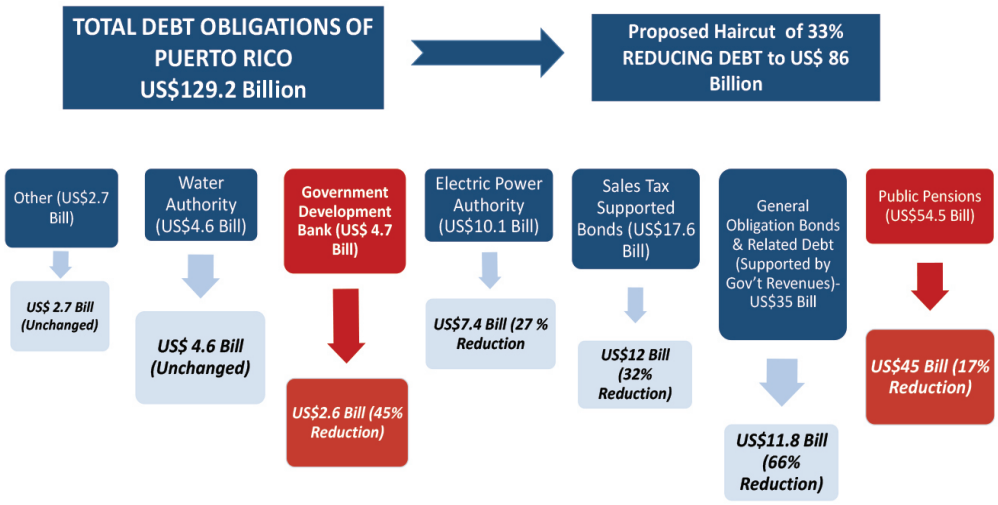
DEBT PLAN PUT FORWARD

Our last look at Puerto Rico in July-2019 focused on the FED appointed Oversight Board's decision to sue bondholders in an attempt to claw back approximately US$1 billion in fees and interest payments tied to $6 billion worth of debt issued between 2012 and 2014. The basis of the lawsuit is that the government breached the constitutional debt limit when it issued the additional bonds. Hence the Oversight's Board's argument is that the US$6 billion worth of debt issued/raised by the Puerto Rico government was illegal and the US$1 billion of interest payments made to bondholders was also illegal.

Since the filing of that lawsuit, the Oversight Board has come up with a comprehensive debt restructuring plan (See Diagram Below). The restructuring plan seeks to reduce overall debt by 33 percent; from US$129 billion to US$86 billion. The proposal is now before a federal judge who will decide any disputes. For the proposal to move forward, the Oversight Board must be able to gather enough support from stakeholders, including bondholders, pensioners, government employees and other citizens for the proposed restructuring to move forward.



Other → includes HFA, PRIDCO, Children's Trust and the University of Puerto Rico
Source: Financial Sector & Management Board For Puerto Rico; The New York Times

Reports suggest that the reception to the terms have been mixed. The teachers have rejected the proposal in a preliminary vote but the majority of the public sector is yet to register their opinion. Some bondholders, for example those owning the Children's Trust, the University of Puerto Rico and the local

Water Authority debt, will see no reduction in their obligations. However, the owners of general obligation bonds and related debt, which is supported by government revenues, will see a 66% reduction based on the terms of the proposal.

The Government Development Bank (GDB) bondholders were the second hardest hit; they faced a 45% reduction. The GDB bondholders were the first to take a hit with the restructuring occurring in a separate proceeding and confirmed by the Federal Court. The Sales tax supported bondholders, who experienced a 32% reduction in value, have also seen their restructuring confirmed in separate proceedings by the Federal Court. Hence the Water Authority, Electric Power Company, the General Obligation Bonds and the Public Pensions represent the outstanding debt to be addressed by the current restructuring proposal.

PREVIOUS OPPORTUNITIES TO EXIT!

Investors who would have felt the majority of the loss of the Puerto Rico default would be those who held on to the debt pre-2011 up to this point. After the 2008 Lehman-driven crisis, Puerto Rico's bonds still had some buoyancy, trading above par/US$100 and giving investors' time to exit. In December-2012, Moody's downgraded the sovereign to "BBB-" or one notch above junk which sent bond prices tumbling. Any exit between Jan-2013 and June-2016 would have seen a price between US$100 and US$60. In fact to be more granular, between Sep-2013 and March-2015, some bonds were trading in the high US$60's to low-US$70's. Investors would also have been warned about taking exposure given the associated risks.

When President Obama signed Promesa (bankruptcy type law to restructure the debt) into law the bond prices got a slight uptick again pushing prices back into the high US$60's to low US$70's region. However, after Hurricane Maria in September-2017, bond prices plummeted as the destruction from the hurricane led to fears that the debt may never be repaid.

Vulture Funds or funds that specialize in distressed debt scenarios would likely be the biggest winners here. Vulture funds would have bought in the immediate aftermath of Hurricane Maria when bond prices fell to the mid US$20's. If distressed debt companies purchased bonds at prices between US$20 to US$40, they would be in the money as all recovery rates suggest prices would come out between US$60 and US$70, an almost tripling of returns in some cases.

MEDIUM TERM FORECAST

The medium term forecast suggests that Puerto Rico will continue to face challenges. While the size of the contraction in the economy is projected to improve from -4.9% to -0.8%; the forecast suggests contraction nonetheless. There is a variation in the forecast for economic growth between economists. Some are suggesting that there will be robust recovery between 2019 and 2020 as the Federal government spends to help the Commonwealth recover from Hurricane Maria. However, we have not seen the type of spending so far that would suggest robust growth.

Puerto Rico also faces the challenge of convincing investors to put back money into a country that has a poor track record of managing its finances. The fact that Puerto Ricans do have a right to seek US citizenship also means that the more educated members of the population, and the not so educated, will seek opportunities on the US mainland. This could lead to a brain drain and deprive the country of quality labour needed to help the economy rebound.

Per capita GDP is projected to increase modestly over the next four to five years. It should be noted that there is a proposed payroll freeze of public sector wages by the Oversight Body as well as a proposed 8.5% reduction in pensions that exceed US$1,200. These factors will make Puerto Rico relatively unattractive to highly skilled job seekers. Given Puerto Rico's use of the USD as its official currency, the outlook for inflation is low and managed by the US FED. The unemployment rate is projected

to decline from about 11.8% in 2016 and settle at about 9.6% from 2021 onwards. Government revenue is projected to decline as the economy slows while government spending is projected to be contained so that the deficit comes in at a sustainable and moderate 1.1% of GDP. This is important in containing the growth rate of the debt and for multilateral support.

Going forward it is highly likely the Puerto Rico will be shut out of the private capital markets for the foreseeable future. Hence IMF and other multilaterals should represent the major source of Balance of Payment (BOP) and non-BOP/budgetary financing. With that in mind, the medium term forecast is for the government to run a primary surplus of about 1% of GDP to help the process of debt/GDP reduction over time. **The above forecast ties in with a stabilization of the debt/GDP number at about 64% over the medium term.**

THE LEGALITY OF BONDS ISSUED IN 2012 AND 2014

The holders of Puerto Rican "general obligation bonds" issued between 2012 and 2014 face a challenge. As noted earlier, the Oversight Board is of the view the Puerto Rican authorities issued these bonds illegally because the Commonwealth was over the constitutionally appointed debt limit. The new plan offers holders of this debt a settlement below the 64 cents on the dollar offered to other bondholders. These bondholders have the option to file a lawsuit. However, if they win they have an upside of getting the 64 cents on the dollar offered to other bondholders. If they lose, the reward is zero and the money set aside to pay them would be used to top-up those who were originally entitled to 64 cents on the dollar.

At the time of writing this report, it has been disclosed that a preliminary deal in principle has been reached between the Oversight Board and the general obligation bondholders of the 2012 and 2014 notes. The details however have not been released as the lawyers are still finalizing some finer points of the deal.

ANALYST'S OPINION

The holders of Puerto Rican debt are slowly seeing light at the end of the tunnel. While this deal is by no means complete, we believe that the federal judge, Laura Taylor Swain, may find it difficult to rule against the US government appointed Oversight Board. There will be legal challenges, however, the need to address the debt issue and get the Commonwealth back to normal operations, or some semblance of such, will be paramount.

The main issue we see here may be a challenge to the "relatively favourable" treatment of the retired government workers/pension scheme that faces only a 17% reduction. Lawyers will argue that the pension scheme has had unfunded liabilities for years and that workers should have been forced into a defined contribution plan long before 2013. On the flip side, having a poor pension plan for elderly citizens will undoubtedly weigh heavily on the local health care system and on an already broke government. After the default, barring a possible citizenship referendum, the Commonwealth government must be able to operate. Consequently the terms of the default must leave the authorities with room to maneuver, earn revenue/taxes and continue to access loans. All this must be placed in a context of the Commonwealth likely being excluded from the international capital markets over the medium to long term.

RECOMMENDATION

Our recommendation on Puerto Rico remains a **SELL.**

APPENDIX

IMPORTANT DISCLOSURES

ABSTRACT— As a part of our new Portfolio Strategy we are recommending strict adherence to the following Portfolio Allocation DEFINITIONS/ RECOMMENDATIONS.

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INVESTOR UPDA

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SELL -
REDUCE EXPOSURE IN YOUR PORTFOLIO TO ZERO.

HOLD/MARKET WEIGHT -
EXPOSURE TO THE ASSET SHOULD BE EQUAL TO 5% OF YOUR TOTAL PORTFOLIO HELD AT JMMB.

OVERWEIGHT/BUY -
EXPOSURE TO THIS ASSET SHOULD BE BETWEEN 5% AND 10% OF YOUR TOTAL PORTFOLIO HELD AT JMMB

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