Rating Update: Moody's downgrades Puerto Rico general obligation and related bonds to Baa3 from Baa1 and certain notched bonds to Ba1

Global Credit Research - 13 Dec 2012

Approximately $38 billion of debt affected; outlook is negative

PUERTO RICO (COMMONWEALTH OF)
State Governments (including Puerto Rico and US Territories)
PR

Opinion

NEW YORK, December 13, 2012 -- Moody's Investors Service has downgraded the general obligation rating of the Commonwealth of Puerto Rico to Baa3 from Baa1. The downgrade also applies to those ratings that are based on or capped at the G.O. rating of the commonwealth (see list later in the report). The outlook is negative.

SUMMARY RATING RATIONALE

The downgrade to Baa3 and the assignment of a negative outlook reflect four primary rating drivers:

- Economic growth prospects remain weak after six years of recession and could be further dampened by the commonwealth's efforts to control spending and reform its retirement system, both of which are needed to stabilize the commonwealth's financial results. The lack of significant economic growth drivers and the commonwealth's declining population have also reduced prospects for a strong economic recovery.

- Debt levels are very high and continue to grow.

- Financial performance has been weak, including lackluster revenue growth and large structural budget gaps that have led to a persistent reliance on deficit financings and serial debt restructurings to support operations in recent years.

- Lack of meaningful pension reform and no clear timetable to do so. Reform of the commonwealth's severely underfunded retirement systems is needed to avoid asset depletion and future budget pressure.

CREDIT STRENGTHS

- Politically and economically linked to the US, with benefit of the nation's strong financial, legal, and regulatory systems

- Large economy, with gross product exceeding that of 15 states and population exceeding that of 22 states

- Broad legal powers to raise revenues, adjust spending programs, and employ borrowing in order to maintain fiscal solvency

- Constitutional first priority lien on revenues of the commonwealth for general obligation and commonwealth-guaranteed debt

CREDIT CHALLENGES

- Very large unfunded pension liability relative to revenues that we expect will claim an increasing share of the budget over the medium term

- Very high and growing government debt relative to the size of the economy, due in part to financing budget deficits

- High unemployment, low workforce participation, and high poverty levels compared to the US; average income levels remain well below 50% relative to the US mainland median

- Declining population
- Large size of commonwealth government relative to the economy (although recent government actions are reducing the size of the government employment sector)
- Multi-year trend of large General Fund operating deficits, financed by deficit borrowing
- Local economy that has been in recession since 2006

DETAILED CREDIT DISCUSSION

ECONOMY STILL VERY WEAK WITH NO CLEAR GROWTH DRIVERS

Until the mid-2000s, Puerto Rico's economic growth direction tended to mirror that of the US. In 2006, however, Puerto Rico entered recession when the rest of the US was still in full expansion mode. Since then, the commonwealth has remained in recession. Some economic indicators, such as retail, auto and cement sales and the Government Development Bank for Puerto Rico's Economic Activity Index, have stabilized or are now trending up for the first time since 2006, but they are improving off a very low base, and reflect what is still essentially a weak economy that is not likely to be able to absorb much additional stress. Moreover, the commonwealth's economy lacks clear growth drivers as its manufacturing sector continues to see employment reductions.

Population declined by 3% from 2005 to 2011 and slight declines are expected in the near term. Unemployment has ticked up slightly to 13.8% after reaching a low of 13.5% versus the US average of 7.8% at the end of the first quarter of fiscal 2013. Tourism has been a relatively good performer, but it remains relatively small and is susceptible to weakness in the larger US economy.

Puerto Rico's weak retirement system funding could also challenge the commonwealth's finances and economy, as any new money put into the system would likely come from the government (weakening finances) or employees (weakening the economy). As the economy and financial situation are both fragile, this additional challenge will likely be difficult for the commonwealth to manage. There are approximately 330,000 active and retired members of the commonwealth's two main pension plans, or 9% of the population.

DEBT LEVELS ARE HIGH AND CONTINUE TO RISE

As reported in our 2012 State Debt Medians Report (published in May 2012), debt ratios for the commonwealth are very high, with net tax-supported debt at over $14,000 per capita and approximately 89% of personal income, significantly higher than any US state and also reflective of the relatively low per capita incomes in the commonwealth. Net tax-supported debt as of December 31, 2011 was $51.9 billion reflecting significant new issuance by the commonwealth and Government Development Bank over the past year. Debt measures are also relatively high for similarly rated sovereigns and regional governments outside the US.

REVENUE GROWTH IN FISCAL 2012 DUE TO TEMPORARY EXCISE TAX

The commonwealth's general fund net revenues increased 6.1%, or $502 million, in fiscal 2012, in line with the commonwealth's revenue estimates for the year. The increase was mainly due to a temporary, multi-year excise tax imposed on certain foreign persons which yielded approximately $1.2 billion in revenue for the year. Collections from the excise tax, however, were offset by declines in other sources of revenue, including income taxes on individuals and corporations, withholding taxes on non-residents, and property taxes in part due to tax relief provided to individuals and corporations as part of the commonwealth's tax reform program.

General fund net revenues through October of fiscal year 2013, however, are down 3.3% or $76 million as compared with the same period last year and about 3.7% below estimates largely due to declines in corporate excise taxes, off-shore shipments of rum and corporate income taxes.

CONTINUED WIDE BUDGET GAPS, RELIANCE ON DEBT RESTRUCTURING AND DEFICIT FINANCING

The commonwealth's deficit for fiscal year 2012 was approximately $1.6 billion, or 17% of general fund revenue, including principal and interest payments on commonwealth general obligation and other debt that was paid with bond proceeds. This is a considerable improvement from 2010 when the commonwealth faced a deficit of $3.1 billion including debt restructurings, or 40% of fiscal 2010 general fund revenues. The commonwealth was able to do this through spending control (reducing spending largely through large government layoffs) and conservative revenue forecasting. Total payroll expenses have been reduced by $907 million, or 16%, since 2009.

The budget for fiscal year 2013 is $9.08 billion, down 2% from the fiscal year 2012 budget and down 11% as compared with the fiscal year 2010 budget, mostly due to continuing declines in payroll spending. General fund revenues are projected to be $8.75 billion, or 0.9% over fiscal 2012, with the shortfall being made up with bond...
proceeds issued by the Puerto Rico Sales Tax Financing Corporation (COFINA) and other sources. Net revenues for fiscal 2012 were $8.66 billion, just slightly above projections of $8.65 billion. The budget gap however, does not include expenditures for approximately $745 million of debt service payments which are expected to be refinanced during fiscal 2013. In addition, the commonwealth recently cut its forecast for economic growth for fiscal 2013 from 1.1% to 0.6% indicating that the projected deficit for the fiscal year ending June 30th will grow.

LACK OF PROGRESS ON PENSION REFORM TO AVOID ASSET DEPLETION

In 2011, the commonwealth completed a modest first phase of pension reform (adopting an ascending schedule of future employer contributions and limiting the size of personal loans available to members), but did not undertake further meaningful additional reforms. The timetable for additional reforms remains unclear.

The commonwealth's pension plans that comprise its retirement systems are far weaker financially when compared to the pension plans of the 50 US states. As of June 30, 2011, the date of the latest actuarial valuations of the retirement systems, the unfunded actuarial accrued liability (including basic and system administered benefits) for the Employees Retirement System (ERS), the Teachers Retirement System (TRS) and the Judiciary Retirement System was $23.7 billion, $9.1 billion and $319 million, respectively. The pension systems' combined unfunded liability of $33 billion is almost four times the annual budget ($9 billion), a burden that will exert significant budgetary pressure for many years to come.

Estimated benefit payments from both ERS and TRS exceed incoming employee and employer contributions by wide margins - approximately $938 million between the two plans in fiscal 2012- resulting in a projected rapid depletion of system assets. A $3 billion issue of pension bonds in 2008 has helped extend the asset life, though these funds are included in the current depletion forecast.

In addition to low asset levels, ERS commingles the assets of both its defined benefit and defined contribution members, meaning future DC payouts must eventually be paid by ERS. No corresponding liabilities for these eventual payouts have been disclosed.

Without meaningful additional reforms, the commonwealth will be forced to add direct retirement benefit payments to the budget within several years. Moody's estimates that in fiscal 2012, benefit payments for the major systems plus incremental benefits granted by special laws (currently paid directly from the general fund) plus debt service on the existing pension bonds, less employee contributions, together equal nearly 22% of the $8.7 billion in fiscal 2012 general fund revenues. This is substantially more than the approximately 9% of general fund revenues currently paid in employee contributions and indicative of the size of the budgetary burden of a future "pay-as-you-go" pension structure.

Since the ERS defined benefit plan was closed in 2000, the benefit amounts will grow relatively slowly over the next few years, reach a peak benefit level around 2038 and then start to decline. Future costs for TRS and the System 2000 defined contribution payouts, however, are unknown.

ACTION AFFECTS MULTIPLE CREDITS

The downgrade and negative outlook affects general obligation bonds of the commonwealth, and also affects bonds whose ratings are determined by or linked to that of the commonwealth. Affected credits are listed below.

DOWNGRADED TO Baa3 FROM Baa1

--General obligation bonds
--Pension funding bonds
--Puerto Rico Infrastructure Finance Authority (PRIFA) Special Tax Revenue Bonds
--Convention Center District Authority Hotel Occupancy Tax Revenue Bonds
--Government Development Bank (GDB) Senior Notes
--Municipal Finance Authority (MFA) Bonds
--Puerto Rico Highway and Transportation Authority (PRHTA) Transportation Revenue Bonds
--Puerto Rico Aqueduct and Sewer Authority (PRASA) Commonwealth Guaranteed Bonds
DOWNGRADED TO Baa2 FROM A3
--Puerto Rico Highway and Transportation Authority (PRHTA) Highway Revenue Bonds

DOWNGRADED TO Ba1 FROM Baa2
--Puerto Rico Public Finance Corporation (PRPFC) Commonwealth Appropriation Bonds
--Puerto Rico Aqueduct and Sewer Authority (PRASA) Revenue Bonds
--Puerto Rico Highway and Transportation Authority (PRHTA) Subordinate Transportation Revenue Bonds

Outlook
The rating outlook is negative, reflecting the stress the commonwealth will face in the next few years as it continues to attempt to address the underfunding of the retirement system from an already weak financial and economic position. While the economy has shown some preliminary signs of stabilizing, the lack of apparent growth drivers, the commonwealth's rising debt levels and continued reliance on deficit financing to fund budget gaps continue to pressure the rating.

WHAT COULD MAKE THE RATING GO UP
--Significant improvement in the condition of the commonwealth's pension system.
--Strong rebound in economic growth leading to improved and sustained revenue results.
--Spending controls and/or revenue increases that lead to long-term improved budgetary results and outlook.
--Reversal of General Fund's deficit position.

WHAT COULD MAKE THE RATING GO DOWN
--Lack of liquidity
--Lack of market access
--Indication that total fixed costs, including pension contributions and debt service on bonded debt, have become unsustainable or unaffordable.
--Steep growth in structural budget gap and an increase in GAAP deficits, solved with non-recurring solutions.
--Further recession, resulting in declining revenues, deficit financing and continued out-migration
--Inability to curtail increase in debt experienced in recent years.

PRINCIPAL METHODOLOGY
The principal methodology used in rating the Commonwealth of Puerto Rico was the State Rating Methodology published in November 2004.

The principal methodologies used in rating the Government Development Bank for Puerto Rico were the Credit Substitution Methodology published in August 2009 and the State Rating Methodology published in November 2004.

The principal methodology used in rating the Puerto Rico Public Finance Corporation appropriation debt was the Fundamentals of Credit Analysis for Lease Backed Municipal Obligations published in 2011.

The principal methodologies used in rating the Puerto Rico Highway and Transportation Authority were the Special Tax Methodology published in March 2012 and the State Rating Methodology published in November 2004.

The principal methodologies used in rating the Puerto Rico Infrastructure Finance Authority Special Tax Revenue bonds were the Special Tax Methodology published in March 2012 and the State Rating Methodology published in November 2004.

The principal methodologies used in rating the Puerto Rico Municipal Finance Authority were the State Rating Methodology published in November 2004 and a methodology based on evaluating factors we believe are relevant...
to the credit profile of the issuer, such as i) the business risk and competitive position of the issuer versus others within its industry or sector, ii) the capital structure and financial risk of the issuer, iii) the projected performance of the issuer over the near to intermediate term, iv) the issuer's history of achieving consistent operating performance and meeting budget or financial plan goals, v) the debt service coverage provided by such revenue stream, vi) the legal structure that documents the revenue stream and the source of payment, and vii) the issuer's management and governance structure related to the payment. These attributes were compared against other issuers both within and outside of the issuer's core peer group. The ratings are believed to be comparable to ratings assigned to other issuers of similar credit risk.

The principal methodology used in rating the Puerto Rico Employees Retirement System bonds was the State Rating Methodology published in November 2004.

The principal methodologies used in rating the Puerto Rico Convention Center AuthorityHotel Occupancy Tax Revenue Bonds were the Special Tax Methodology published in March 2012 and the State Rating Methodology published in November 2004.

The principal methodologies used in rating the Puerto Rico Aqueduct and Sewer Authority were the Analytical Framework for Water and Sewer System Ratings published in August, 1999 and the State Rating Methodology published November 2004.

Please see the Credit Policy page on www.moodys.com for a copy of these methodologies.

REGULATORY DISCLOSURES

For ratings issued on a program, series or category/class of debt, this announcement provides certain regulatory disclosures in relation to each rating of a subsequently issued bond or note of the same series or category/class of debt or pursuant to a program for which the ratings are derived exclusively from existing ratings in accordance with Moody's rating practices. For ratings issued on a support provider, this announcement provides certain regulatory disclosures in relation to the rating action on the support provider and in relation to each particular rating action for securities that derive their credit ratings from the support provider's credit rating. For provisional ratings, this announcement provides certain regulatory disclosures in relation to the provisional rating assigned, and in relation to a definitive rating that may be assigned subsequent to the final issuance of the debt, in each case where the transaction structure and terms have not changed prior to the assignment of the definitive rating in a manner that would have affected the rating. For further information please see the ratings tab on the issuer/entity page for the respective issuer on www.moodys.com.

Please see the credit ratings tab on the issuer/entity page on www.moodys.com for additional regulatory disclosures for each credit rating.

Please see the ratings disclosure page on www.moodys.com for general disclosure on potential conflicts of interests.

Please see the ratings disclosure page on www.moodys.com for information on (A) MCO's major shareholders (above 5%) and for (B) further information regarding certain affiliations that may exist between directors of MCO and rated entities as well as (C) the names of entities that hold ratings from MIS that have also publicly reported to the SEC an ownership interest in MCO of more than 5%. A member of the board of directors of this rated entity may also be a member of the board of directors of a shareholder of Moody's Corporation; however, Moody's has not independently verified this matter.

Please see Moody's Rating Symbols and Definitions on the Rating Process page on www.moodys.com for further information on the meaning of each rating category and the definition of default and recovery.

Please see ratings tab on the issuer/entity page on www.moodys.com for the last rating action and the rating history.

The date on which some ratings were first released goes back to a time before Moody's ratings were fully digitized and accurate data may not be available. Consequently, Moody's provides a date that it believes is the most reliable and accurate based on the information that is available to it. Please see the ratings disclosure page on our website www.moodys.com for further information.

Please see www.moodys.com for any updates on changes to the lead rating analyst and to the Moody's legal entity that has issued the rating.
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, all information contained herein is provided “AS IS” without warranty of any kind. MOODY’S adopts all necessary measures so that the information it uses in assigning a credit rating is of sufficient quality and from sources Moody’s considers to be reliable, including, when appropriate, independent third-party sources. However, MOODY’S is not an auditor and cannot in every instance independently verify or validate information received in the rating process. 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 ratings, financial reporting analysis, projections, and other 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. Each user of the information contained herein must make its own study and evaluation of each security it may consider purchasing, holding or selling. 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.

MIS, a wholly-owned credit rating agency subsidiary of Moody's Corporation ("MCO"), hereby discloses that most issuers of debt securities (including corporate and municipal bonds, debentures, notes and commercial paper) and preferred stock rated by MIS have, prior to assignment of any rating, agreed to pay to MIS for appraisal and rating services rendered by it fees ranging from $1,500 to approximately $2,500,000. MCO and 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 at www.moodys.com under the heading "Shareholder Relations — Corporate Governance — Director and Shareholder Affiliation Policy."

Any publication into Australia of this document is by MOODY’S affiliate, Moody's Investors Service Pty Limited ABN 61 003 399 657, which holds Australian Financial Services License no. 336969. This document is intended to be provided only to "wholesale clients" within the meaning of section 761G of the Corporations Act 2001. By continuing to access this document from within Australia, you represent to MOODY’S that you are, or are accessing the document as a representative of, a "wholesale client" and that neither you nor the entity you represent will directly or indirectly disseminate this document or its contents to "retail clients" within the meaning of section 761G of the Corporations Act 2001.

Notwithstanding the foregoing, credit ratings assigned on and after October 1, 2010 by Moody's Japan K.K. ("MJKK") are MJKK's current opinions of the relative future credit risk of entities, credit commitments, or debt or debt-like securities. In such a case, “MIS” in the foregoing statements shall be deemed to be replaced with “MJKK”. MJKK is a wholly-owned credit rating agency subsidiary of Moody’s Group Japan G.K., which is wholly owned by Moody's Overseas Holdings Inc., a wholly-owned subsidiary of MCO.

This credit rating is an opinion as to the creditworthiness of a debt obligation of the issuer, not on the equity securities of the issuer or any form of security that is available to retail investors. It would be dangerous for retail investors to make any investment decision based on this credit rating. If in doubt you should contact your financial or other professional adviser.