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NEWS & VIEWS--------Trading Commentary, From Our Desk to Yours

Commonwealth of Puerto Rico
General Obligation & Dedicated Tax Bonds
Highway & Transportation Authority
Electric Power Authority
Port Authority

Recommendation: Hold for all levels of risk tolerance; Buy for investors with long term risk tolerance.

Executive Summary:

Puerto Rico's current budget and cash crises are very severe, and could result in rating agency downgrades on G.O and dedicated tax bonds to below investment grade in the very near term. With the closing of schools and furloughs of tens of thousands of non-emergency personnel, things may get worse before consensus can be reached between the battling political parties. If history holds true, however, bondholders should see their current holdings of Puerto Rico general obligation bonds paid with full interest and principal, even in the worst case scenario of a temporary default caused by the burgeoning cash crisis. The Commonwealth's ongoing need for credit, both for capital construction as well as to finance ongoing essential services, are such that the Commonwealth cannot risk the potential for being locked out of the credit markets, as New York City was in the mid-1970's. For investors willing to withstand the continuing barrage of bad news coming out of Puerto Rico, weakness in Puerto Rico prices may represent buying opportunities.

As for the self-supporting enterprise systems (Highway & Transportation Authority, Electric Power Authority and the Port Authority), the Commonwealth's current financial problems should not have a direct impact on cash flow and debt service payments, as all of these Authorities' revenues and expenses are segregated for direct use by the enterprises; there is no commingling of Commonwealth general cash with enterprise system cash. While Highway & Transportation Authority bonds are paid from revenues which can be used to first pay General Obligation debt, there is no reason yet to believe that the Commonwealth will begin to raid those revenues to pay other indebtedness. The Electric and Power Authority may see some temporary reductions in cash flow because of the possibility of late or deferred payment by the Commonwealth for its own power purchases, as well as pressure on receivables from customers that have recently been furloughed because of the fiscal crisis. For Port Authority debt, the current rash of bad publicity generated by Government failures to maintain stable operations could have a muted effect on tourism, which generates the bulk of the Port's revenues from air travel and cruise dockings. The biggest threat to the Electric and Port Authority debt could come from weakened cash flow support from the Government Development Bank (GDB), whose liquidity and ratings are being threatened by the fiscal crisis. A majority of current GDB assets are loan receivables from the Commonwealth, the Bank's largest borrower. Because Electric and the Port rely on GDB lines of credit to maintain working seasonal cash, disruptions to the Bank's ability to borrow and lend could ripple through to these two enterprises. Hanauer doesn't expect, however, that a lowering of the Commonwealth's and GDB's ratings to below investment grade will automatically result in below investment grade ratings for Electric and the Port.

General Obligation Bonds:

Puerto Rico's current fiscal environment has all of the makings of a classic credit crisis, in the same vein as New York City in the 1970's, California and Massachusetts in the late 1980's, and the 2003-04 deficit borrowing of California:

- Ongoing budget gaps between recurring revenue and spending of about $1 billion per year (roughly 10% of the annual budget;
- High debt and a traditionally weak economy;
- High short-term debt, with impending maturities that will further stress cash flow, and a continuing need for seasonal borrowing to support daily expenditures; and
- A severe political impasse preventing agreement on actions to raise revenue and lower spending to eliminate deficits.

The budget impasse between the Governor and the House in Puerto Rico dates back to 2005, when a temporary budget based on the prior year was implemented until agreement could be reached on balancing the budget. As a result, the deficit of $1 billion for FY 2005 is virtually repeated for the current fiscal year. Because the Commonwealth has a built-in deficit, eventually cash flow runs out as the end of the fiscal year approaches on June 30.

The Governor currently estimates the deficit and the cash need at $738 million to meet all service demands through the end of the fiscal year. In the face of failure to raise any meaning revenue, the only way to avoid "bouncing checks" is to suspend spending, and/or borrow additional money as a temporary stop-gap measure. The Commonwealth has already borrowed heavily ($5 billion) from its state-owned Government Development Bank, and liquidity at the bank is dramatically reduced from normal levels, forcing the bank to be concerned about its own creditworthiness and ability to borrow in the capital markets.

The current stand-off revolves around revenue measures needed to fund current levels of spending. Governor Acevado Vila favors a 7 cent sales tax; the House favors a smaller sales tax of 4% (Puerto Rico currently levies no sales tax), coupled with higher taxes on corporations already bearing one of the highest corporate tax burdens in the U.S. and its territories. The stalemate has resulted in a shut-down of schools on May 1, coupled with furloughs in all other areas not deemed to be essential emergency services such as police and public safety. It is reported that today's actions put about 90,000 of Puerto Rico's 200,000 employees on temporary leave. As time progresses, these furloughs will exacerbate an already weak economy, because of the importance of government sector jobs to the overall economy. The Commonwealth assures bondholders that funds will be sufficient to meet maturing debt requirements, but the shut-down of standard essential services puts that assurance under scrutiny, at a minimum.

Because the budget battle has waged for more than a year, and with short-term debt coming due in the next few weeks, there is a clear possibility that Puerto Rico could see its credit ratings go to "junk" status (non-investment grade) in the next month. More than likely, the raters may use one more downgrade to the step just above investment grade (Baa3/BBB-) in the next week or so, as a final "warning shot across the bow" before junk ratings are considered. The bond raters are very wary of lowering a government to below investment grade (Ba/BB or lower) , particularly one with many of the sovereign powers associated with a state-level government such as Puerto Rico. If events lead to such action, the raters are also loathe to restore investment grade ratings quickly after finances have gotten so far out of hand. In any case, the continuing need for credit by Puerto Rico will ultimately be the driver of budget consensus, so that temporary borrowing can be arranged, and actions can be taken to end the current cycle of large deficits.

Highway & Transportation Fund Bonds:

These bonds are paid from dedicated gas taxes, tolls, and other motor vehicle related fees. The raters, however, rate them very close to the G.O.'s because the constitution requires that the tax and fee revenues must be available to first pay G.O. debt in the case of insufficient funds. Toll revenue remains dedicated first to Highway fund bondholders. Despite the current crisis, it is not likely that highway funds would be diverted to pay General Obligation debt, and the toll pledge could be enough to prevent these bonds from being downgraded to non-investment grade.

Electric Power System Bonds:

This enterprise is run separately from general Commonwealth operations, so the system is somewhat insulated from the Commonwealth's cash crisis. The system also maintains the typical debt service reserves that are available to prop up debt service in a cash crisis. Therefore, a downgrade of the Commonwealth to non-investment grade should not result in a similar downgrade to Electric. There is some room for rating slippage within investment grade, however, and the utility could see some cash flow weakening because of late or deferred payments by the Commonwealth for its own power purchases. Receivables may also grow because of cash flow problems of Commonwealth employees that have been furloughed, which are a significant percentage of the island's workforce. Finally, the utility maintains low cash balances, and is reliant on commercial paper borrowing from the Government Development Bank, whose credit is under the same pressures facing the Commonwealth. The utility is trying to mute this exposure by negotiating credit lines with other banks.

Port Authority Revenue Bonds:

This enterprise is run separately from general Commonwealth operations, so the system is somewhat insulated from the Commonwealth's cash crisis. In addition, the Authority does not rely on the Commonwealth as a major customer or user of its facilties. These bonds are heavily dependent on tourism, and an increasingly competitive market for Carribean tourist dollars. The negative publicity generated from the fiscal crisis could have a muted effect on tourism, which could be exarcerbated by widespread demonstrations of furloughed employees and disgruntled citizens over the loss of Commonwealth services. The Port Authority's rating should operate independently of any downgrades that the raters may be contemplating. The weak fundamentals of this issuer continue to warrant only barely investment grade ratings on its own. The Authority also relies on the GDB for seasonal working cash needs; liquidity needs of the Port, however, are far less than required by Electric.