



Height Research Report

11 SEPTEMBER 2018

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Puerto Rico & Monolines

Momentum Is Positive for Puerto Rico Debt Restructuring

THE TAKEAWAY

Progress is being made to restructure Puerto Rico's (PR) debts. A deal with COFINA creditors has been reached, progress is being made on Government Development Bank (GDB) and PR Aqueduct and Sewer Authority (PRASA) debts, and some general obligation (GO) and PR Electric Power Authority (PREPA) creditors have been negotiating with the Financial Oversight and Management Board (FOMB) and PR officials. This progress is positive; however, no deals are complete or court approved and there are risks that could disrupt the process. While the progress is positive, a conclusion to PR's debt restructuring is still not likely before 2020 and likely 2021. These are some of the takeaways from our recent conference call with John Mudd, a PR lawyer. We consider the progress positive for Ambac Financial (AMBC), Assured Guaranty (AGO), and MBIA, Inc. (MBI) as it reduces uncertainty regarding insured exposures and expected loss payments.

Conclusion: It is unclear what factors have moved FOMB members to begin working with PR creditors. It may be losing several court cases, concerns about the fiscal plan relative to actual economic results, or a realization that there are funds for some level of debt service and many debts cannot be eliminated. Whatever the reason, momentum for restructuring the Commonwealth's debts is building and finalizing the COFINA settlement would be the first major step to resolving PR's fiscal crisis.

COFINA agreement may face hurdles. We maintain our 75% odds that the COFINA agreement will be finalized. Mudd agreed that the deal will get approved by the court. A completed deal is significant as FOMB can begin to move forward on developing a plan of adjustment (POA) to submit to the court; however, groups could object to the plan, including GO creditors, COFINA junior bondholders, and the unsecured creditor committee (UCC).

FOMB is expected to file a COFINA disclosure statement on October 15. The disclosure statement will contain all of the deal details along with COFINA's financial statements. At the same time, the Board will also file a motion to settle claims with COFINA and GO bondholders. Objections are likely to be filed when the settlement is filed with the court. Mudd expects GO creditors to maximize their leverage to restructure the GO debt by at least threatening to object to the COFINA deal, if not actually objecting.

Plan of adjustment approval is needed. FOMB will submit a POA next year and the court must approve it. Mudd noted that Judge Swain is good at assessing financial information. If Judge Swain determines that the POA is unacceptable, it is likely that an extension will be needed to permit FOMB to submit a viable POA. He



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stated that in the San Bernardino case four extensions were needed. Given that actual economic activity in the Commonwealth is performing well above FOMB's projections and that the Commonwealth "found" and additional \$6 billion, it is possible that the court will reject the POA, which will force FOMB to request an extension, revise its certified fiscal plan, and resubmit the POA.

GO creditors are unsecured. In most municipalities' bankruptcy filings, GO have been unsecured creditors. They usually have a preference, but there is a difference between having a lien and having a preference. GO bondholders claim they have a lien on all the funds of PR due to Article 6 Section 8 of the PR Constitution. It is questionable how FOMB or the court will treat the GO's claims. The court may rule that GOs do not have a lien on revenues. In this case, it is expected that GOs will appeal the ruling. Mudd thinks GO creditors have a good chance of receiving a favorable ruling, but time will tell.

PREPA outlook unknown. While there is a draft PREPA restructuring support agreement (RSA), it does not have the support of secured creditors or monoline insurers. Advancing an RSA will need this support as well as clarity regarding the future of PREPA. Several ideas are under consideration, including privatizing all or part of the utility, creating micro-grids, and creating energy cooperatives. The PREPA restructuring process will take a significant amount of time and the negotiations are in process. We expect creditors to secure a lien of revenues regardless of the final structure of PREPA.

Act 154 tax revenue outlook stable so far. Governor Rossello extended Act 154 until 2027; however, the benefits of the law could be eliminated if the Internal Revenue Service determines that companies can no longer receive a federal tax credit for the payment of Act 154 taxes to PR. This is an issue that the IRS has been reviewing for several years. The Obama administration permitted the 154 taxes to be credited against federal taxes, but now there is some concern that the Trump administration would like to end the tax credit. Others understand that eliminating the tax credit would have negative ramifications for PR's fiscal situation and do not support ending the tax credit at the federal level. At present, our best assessment is the IRS will continue to permit corporations to deduct Act 154 taxes from their federal tax returns. This is an issue that will remain open until the IRS issues a final determination.

ERS bonds are in limbo. The court has ruled that Employee Retirement Services (ERS) bonds do not have a properly perfected lien. In addition, there are no assets to repay the debts. If creditors win at the appellate court, which is a possibility given that Judge Swain's opinions have been overturned three times on appeal, then they are still unsecured creditors because there are no assets. However, if the ERS bondholders win a takings case, then PR will have to pay the bonds, which would reduce cash flows available to service other debts, notably GOs.

GDB and PRASA adebt restructuring process. GDB and PRASA debt is currently being restructured under Title VI versus Title III for GO and COFINA debts. The GDB debt restructuring was objected to by the UCC and the court is scheduled to hear the objection this week. PRASA is working with creditors and initial expectations are bondholders will receive 95-98% of par. PRASA bondholders want to receive a gross lien on PRASA revenues, which will enable them to get paid before the expense of the utilities.

Other debt series. Other creditors (HTA, PRIFA, PRIDCo) believe they have liens, but the court needs to make that determination. To date, the court has ruled against the bondholder claims regarding liens. FOMB has taken the view that all creditors are unsecured. In one case, the court agreed and ruled that HTA does not have a statutory lien. An appeals court decided that the creditors have a consensual lien. No further action has been initiated with regards to the consensual lien. We view most of these series of debts as unsecured and likely to receive very little in the amount of recoveries, if they receive any funds at all.



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