PUERTO RICO

ACCOMPLISHMENTS AND CHALLENGES

JANNEY FIXED INCOME STRATEGY

SEPTEMBER 13, 2013

Janney CAPITAL MARKETS

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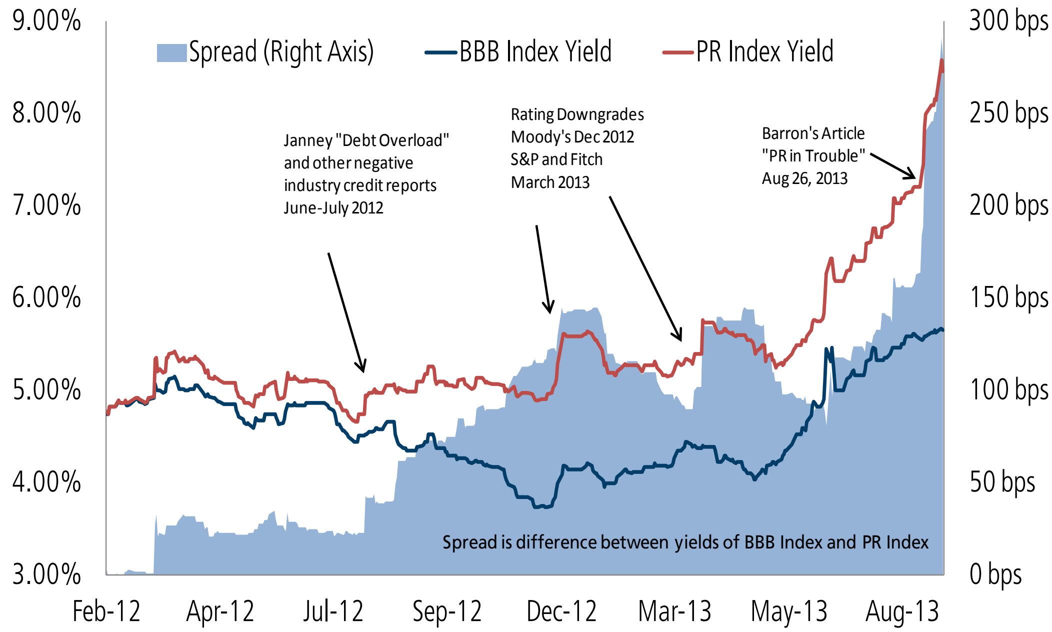
Investing in Puerto Rico bonds is not for the faint of heart. We believe Puerto Rico will avoid default, but this outcome is not assured.

- Puerto Rico's new administration and legislature have taken significant actions to narrow the FY14 budget gap through increased revenues, reform of the primary pension plan, and movement of the three major public corporations towards self sufficiency, but;
- The island's struggling economy remains a strong headwind to financial stability.
- The Commonwealth Treasury Secretary recently announced that revenues in July, the first month of the current fiscal year, came in about 9% ahead of initial estimates, an encouraging indicator.
- We believe rating agencies, which downgraded Puerto Rico to the lowest rung of investment grade in December 2012 (Moody's) and March 2013 (S&P and Fitch), will give the Commonwealth time to determine if projections based on the June budget are realized.
- On a fiscal basis, Puerto Rico is in better shape than it was a year ago, but the market has evidenced a dim view of island bonds, with prices falling and credit spreads widening, particularly after a Barron's article titled "Puerto Rico in Trouble."
- The risk vs reward proposition for Puerto Rico debt has improved in the past year, with a stronger fiscal position and significant price declines.
- Investing in Puerto Rico bonds is not for the faint of heart. We believe Puerto Rico will avoid default, but this outcome is not assured.

PR Yields and Credit Spreads Rose Sharply After an August 26 Barron's Article



Source: Janney Fixed Income Strategy, Thomson Reuters MMD

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The Supreme Court of Puerto Rico confirmed the constitutionality of pension legislation enacted in April, the strongest reform plan of any US state or major municipality in recent years.

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Fiscal Accomplishments in Puerto Rico

While Detroit was moving quickly down the path to bankruptcy in June, the month was active and quite credit positive in Puerto Rico. With six months under its belt, the new administration of Governor Alejandro Garcia Padilla enacted legislation to finalize the FY14 budget, which included $1 billion of new taxes (about 10% of FY14 budget). The governor also signed into law a measure to triple the excise tax on petroleum products to $9.25 per barrel, providing an estimated $189 million in additional annual revenue to the Puerto Rico Highway and Transportation Authority (PRHTA – Baa3/BBB/NR), which due to annual operating deficits (estimated $138 million before depreciation FY 2012) has become heavily dependent on loans from the PR Government Development Bank (GDB), running up multiyear debt totaling over $2 billion. This tax increase, along with another $92 million of taxes and fees to be redirected from the government to PRHTA, will benefit not only PRHTA, but also GDB, since the additional cash flow should eliminate need for further GDB loans. Eventually, balanced operations may allow PRHTA to refinance GDB loans through issuance of long term debt.

Also in June, the Supreme Court of Puerto Rico confirmed the constitutionality of pension legislation enacted in April, the strongest reform plan of any US state or major municipality in recent years. The new plan, which freezes the defined benefit plan for current employees and replaces it with a 401(k)-like defined contribution plan going forward, along with other reforms, is expected to reduce annual payments from the Commonwealth general fund by about $700 million per year over the next 25 years. Pension changes targeted the largest of the three government retirement plans. In a May credit conference presentation and in a communication this week, finance officials indicated that poor funding levels of the second largest plan, the teacher's retirement plan, would be addressed soon through future legislation.

Public Corporations' Finances Strengthened

Large strides have been made to strengthen finances of the three major public corporations. The lowest rated, Puerto Rico Aqueduct and Sewer Authority (PRASA), approved a 60% rate increase for the island's monopoly provider of water and sewer services, which Moody's characterized in a July 2013 report as a credit positive for both PRASA and the Commonwealth. The rate hike is projected to increase PRASA operating income by 42% in 2014, to more than $1 billion, eliminating the need for a projected pre-hike $340 million subsidy from the Commonwealth. As noted earlier, the petroleum tax increase for PRHTA should bring that public corporation's operations into balance.

The third member of the island's triad of major public corporations, Puerto Rico Electric Power Authority (PREPA - Baa3/BBB/BBB-), has generally been regarded as the stronger of the three. PREPA came to market in August with $673 million, which will finance the utility's capital improvement program through FY 2015 according to the Official Statement. Debt service coverage has averaged about 1.62 times in the past 5 years including a projected 1.38 coverage rate in FY13. These coverage levels do not take into account contributions in lieu of taxes (CILT) which are paid to municipalities. When CILT is factored in, average 5 year coverage drops to 1 time, including projected FY13 coverage of 0.82 times. The CILT obligation is subordinate to debt service. A key determinant of future financial improvement is conversion from an oil dominated fuel mix to cheaper natural gas. In 2000, oil accounted for 99% of fuel. This fell to 61% in 2012, with projections of only 2% reliance by 2017.

Challenges Persist

As we've pointed out in various reports and commentary since our initial report in June 2012, the Commonwealth faces significant challenges, not the least of which is the struggling island economy, which has contracted in each of the eight months through July 2013. The headline numbers for the Economic Activity Index (EAI), as reported by the Government Development Bank (GDB), indicated 4.6% and 5% declines in June and July compared with the same months in 2012, the steepest monthly drops in three years. The unemployment rate remains high at 13.5% in July but is below the 16.9% peak of May 2010. Continued economic contraction will likely lead to reductions in tax revenue, electric power revenue, toll collections and other revenues upon which the various issuers are dependent. The governor has announced various job creation and economic stimulation initiatives but it is too early to see potential impact.

The Commonwealth Treasury Secretary, Melba Acosta Febo, recently announced that revenues in July, the first month of the current fiscal year, came in about 9% ahead of initial estimates, an encouraging indicator, but history has shown that Commonwealth projections often fall short, a significant contributor to a long history of annual general fund deficits. We believe rating agencies, which downgraded Puerto Rico to lowest investment grade in December 2012 (Moody's) and March 2013 (S&P and Fitch), will give the Commonwealth some time to determine if projections based on the June budget are realized. Of course the conundrum arises when trying to determine the negative economic impact of tax increases. If revenues come in well under projections, downgrades to below investment grade are increasing likely.

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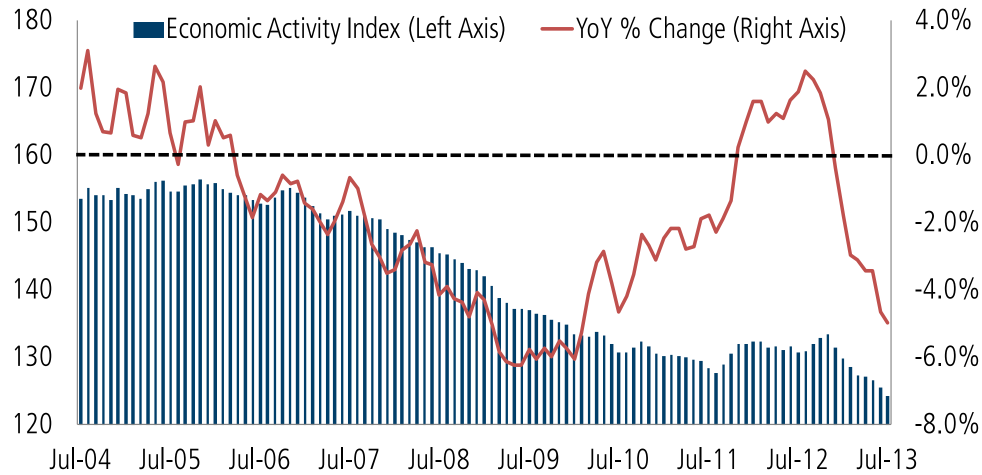
Following Several Months of Growth Last Year, The PR Economy is Again Contracting



Souce: Janney Fixed Income Strategy, PR Government Development Bank

Market Reaction

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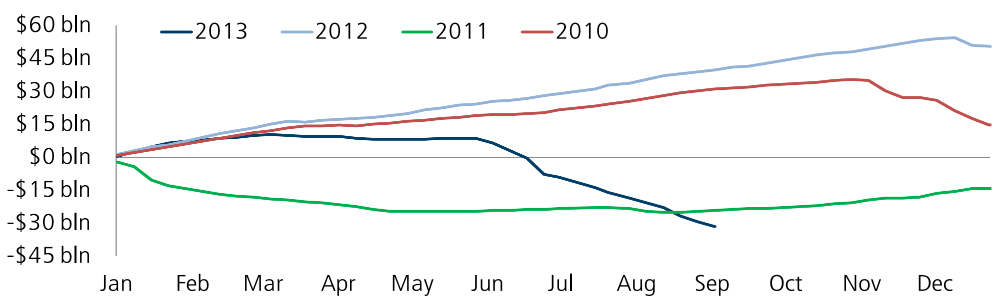
June was a month of accomplishment for Puerto Rico, but overall municipal market turmoil was increasing. In early June, Jefferson County, AL approved agreements for emergence from bankruptcy (including 40% haircuts for some bondholders); Rhode Island flirted with potential default on moral obligation bonds issued for defunct video game company 38 Studios; and on June 14 Detroit Emergency Manager Kevyn Orr released a "Proposal for Creditors", which included haircuts of as much as 90% for general obligation bondholders. Municipal mutual fund flows, which began the year on a strongly positive note before evolving to mild outflows in the Spring, turned sharply negative in June, totaling $16 billion, the fastest monthly outflow pace since at least 2007 according the Investment Company Institute statistics. The supply pressure created by the sharp uptick in mutual fund redemptions weighed heavily on the market, culminating with record backup in tax free yields through three late June days, with AAA benchmarks rising 52 and 55 basis points in 10-year and 30-year maturities respectively. The negative vibes continued with the July 18th bankruptcy filing by Detroit.

Fund Outflows Have Accelerated, Surpassing Those of Any Recent Year



Souce: Janney Fixed Income Strategy, Investment Company Institute

On a fiscal basis, Puerto Rico is in better shape today than it was a year ago. The largest pension system has been restructured to lower general fund support in future years. Significant revenue measures to narrow the budget gap have been enacted. The public corporations have more solid revenue streams, and will require less Commonwealth and GDB support. Legislative and executive leadership has demonstrated a spirited willingness to take difficult steps to shore up finances. The market however has evidenced a dim view of island bonds. Certainly the cloud of Detroit and other distressed municipal issuers has had a negative impact, but the reaction in Puerto Rico pricing has been well disproportionate to underlying fundamentals.

Legislative and executive leadership has demonstrated a spirited willingness to take difficult steps to shore up finances.

An August cover page article in Barron's titled "Puerto Rico in Trouble" catapulted investor concerns, which led to liquidations. Within a few days of the article, credit spreads widened by more than 100 basis points. Block trades of longer maturity bonds rose from 7% handle yields to 9% and in a few instances 10%. The market seems to have gained some stability in the past few days (as of 9-12-13). In very general terms blocks of longer maturity PRGOs, PREPAs, PRASA, PRHTA and PR Infrastructure (Rum Tax) are trading with 8% handles (8.25% to 8.75%), while senior lien sales tax bonds (COFINA – Aa3/AA-/AA-) have 6% handles and subordinate COFINAs (A3/A+/A+) are trading with 7% range yields. Odd lot trades are more volatile and less liquid and have significant yield variability beyond the block trading ranges noted.

Debt and Liquidity

A fact often unmentioned is the low amount of borrowing levels by Puerto Rico in recent years. In this report, unless noted otherwise, debt references are to debt of the various issuers, not only GOs. Although there are important distinctions among the creditworthiness of different PR issuers, which we have discussed in prior reports, our consideration of trading levels is more general. In any case, the underlying economy, and the web-like role of the Government Development Bank with all issuers, limits significant differentiation (other than COFINA). After years of large annual issuances, including $15 billion COFINA Sales Tax bonds in FY2008-2010, used to refinance debt and plug several years of budget gaps, borrowing has slowed, in part because progress was made at reducing annual budget gaps. The 2012 jump in borrowing was partially the result of refundings which, by taking advantage of very low interest rates, refinanced prior issues of bonds and so did not add to debt. FY2013 borrowing was almost nonexistent. So far in FY14, only one major issue has come to market, $673 million Puerto Rico Electric Power Auth in August. Top finance officials recently announced curtailed borrowing plans for the remainder of FY14, in the range of $500 million to $1.2 billion.

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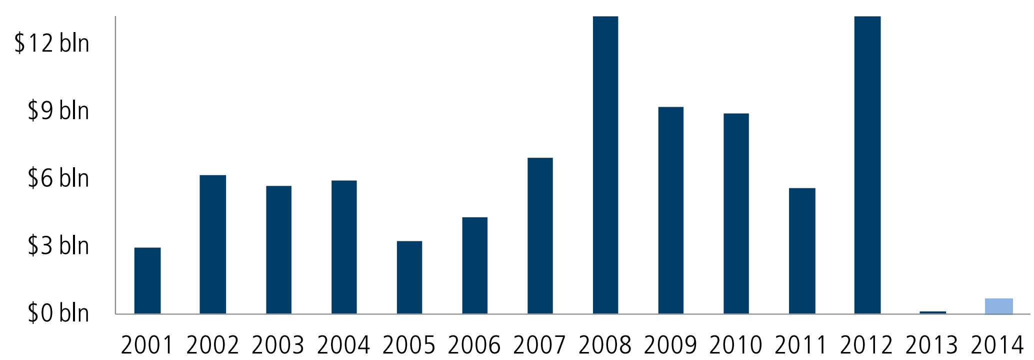
Puerto Rico Did Not Increase its Debt Load in FY2013



Souce: Janney Fixed Income Strategy, Bloomberg

In recent months liquidity has been improved with several short term loans totaling $1.4 billion. $600 million was in the form of tax and revenue anticipations notes (TRANS), while $800 million was bond anticipation notes (BANS). This can be viewed in a positive light, in that cash in the coffers makes it easier to delay long term borrowing if market access is questionable or too expensive. Of concern however is rollover risk. The TRANs will presumably be paid from those revenue streams as they come into the Treasury. The BANs are dependent on future bond issuance for repayment. One part of the BANs, $400 million by PRHTA, matures in 2 years, with sinking fund payments required beginning December 1, 2014. Interest rates float with LIBOR, but start out at around 2.60%. After the first year however, the rates become almost punitive, rising by 2.25% in month 13, and hitting Libor plus 11.40% in the final seven months.

High Yield, Distressed Security Investors Emerge

Propelled by the aforementioned mutual fund outflows, selling continues, but an increasing number of nontraditional investors are active on the buy side in recent days and weeks, including hedge funds. Discussions increasingly focus on potential recovery outcomes and probability of default. Assured Guaranty (A2/AA-) and National (Baa1/A) each have exposures to amounts of Puerto Rico debt in the $5 billion range. One strategy involves buying an insured Puerto Rico bond and purchasing a credit default swap (CDS) on the credit of the insurer. CDS levels for the two insurers have widened by more than 200 bps in the past 2 weeks, reflecting increased demand for the CDS in support of the strategy as well as concerns about the insurers' exposure to Puerto Rico.

Investment Considerations

We believe that Puerto Rico will avoid default, although this outcome is not assured. If the tax revenues come in at or near projections after the first and second quarter, and overall budget estimates are met, market confidence will improve. If the numbers are less than expected, it will be important for the administration to pursue additional measures to achieve balance. Thus far the willingness to make difficult decisions on the part of this administration has been evident, so we are optimistic that it will continue. If numbers are poor and unaddressed, further deterioration of credit and valuations is likely, as are downgrades to below investment grade. We must also not lose sight of the weak economic indicators. Economic stabilization and eventually improvement are necessary for market improvement.

Investing in Puerto Rico bonds is not for the faint of heart. A block of 20 year PREPA 7%, which came to market as a new issue at par in early August, traded at a price of 85.22 this week. PR GO 5% of 41, which were priced at 95.27 as a new issue in March 2012, and traded at 99.43 as recently as May 20, 2013 saw block trades at 64 (8.35% ytm) today (9-12-13). Despite the investment grade ratings (barely), most PR issues trade as high yield bonds, with the associated price volatility. Investors who consider bonds at current levels should have a high tolerance for and well understand the risk. We've seen other commentators refer to Puerto Rico bonds as buy and hold securities as in "don't worry about the price fluctuation, as long as interest and principal is paid on time." This is a poor investment strategy. Not only are value declines distressing, and a diminishment of financial net worth, they are often indicative of future problems encompassed by an age old saying in the securities business, "you can't fight the tape."

Current holders of Puerto Rico debt should consider concentration (how much of muni portfolio is Puerto Rico), ability to withstand future losses, and the sleep factor as in "will I sleep at night if I hold these bonds." The same considerations apply to prospective investors, whether buying PR for the first time, or adding to existing bonds. An 8.35% tax free yield is equivalent to 14.36% taxable for a top bracket investor (assuming the aforementioned 5% of 41 at 64), but if the bond defaults, the actual yield will likely be negative. Our emphasis on limiting exposure to 5% of a portfolio (Debt Overload June 27, 2012) continues.

Conclusion

In the 14 months since our Debt Overload report, Puerto Rico bond values have deteriorated significantly by both absolute and relative measures. We believe the fiscal situation has actually improved in that time frame, although the economy has deteriorated. Based on our opinion that Puerto Rico bonds will continue to pay principal and interest, the risk reward proposition for Puerto Rico debt has improved in 14 months. Based on recent activity, the market seems to believe otherwise. Only the most risk tolerant of investors should buy or even continue to hold Puerto Rico bonds. The increasing potential for default brings dollar price considerations into play, so we favor the deeper discounted 5% handle coupons. (We make no predictions but as example if post default recovery is 70 cents on the dollar, a 65 dollar price investment will likely fare better than one with an 80 dollar price). The one assurance we make is that volatility is likely to continue in the near term and perhaps beyond.

Analyst Certification

I, Alan Schankel, the Primarily Responsible Analyst for this report, hereby certify that all of the views expressed in this report accurately reflect my personal views about any and all of the subject sectors, industries, securities, and issuers. No part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in this research report.

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