Puerto Rico: A Credit Case Study

An in-depth look at PIMCO’s integrated municipal investment process
MUNI PORTFOLIO MANAGEMENT
The municipal PM team reviews both top-down and bottom-up factors to determine portfolio positioning in Puerto Rico.

INVESTMENT COMMITTEE
The muni team regularly briefs PIMCO’s Investment Committee on developments, threats and opportunities in Puerto Rico.

PIMCO Muni Investment Process: Puerto Rico
Access to PIMCO’s broader research capabilities helps the muni team develop its own proprietary forward-looking credit ratings – independent of the rating agencies

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FINANCIAL PROFILE
Puerto Rico’s economy was shrinking and, effectively, remained in recession for over a decade. The public debt was growing faster than the Puerto Rican economy. Budget deficits continued to grow and there was a lack of transparency into Puerto Rico’s true financial position.

STRUCTURE
Puerto Rico’s government faced a series of significant cash flow shortages, which led to the closure of over 1,500 public schools and a partial shutdown of the government.

STAKEHOLDERS
An inefficient local government has to manage 18 different debt issuing entities and various creditors as well as other stakeholders not limited to citizens, government employees, businesses, investors, monoline insurers, lobbyists, etc.

DEMOGRAPHICS
Some 45% of the population in poverty – more than double the rate of any state. Unemployment remained stubbornly high, at times approaching 17% and averaging 12%. The population had been declining since 2005 with outmigration of 150,000 people from 2011–2013.

REAL ESTATE TEAM
The island suffered a house price collapse even steeper than that of mainland U.S., with dim prospects for recovery given the stagnation of the population.

ENERGY TEAM
Puerto Rico is highly dependent on fossil fuels for transportation and electricity generation; thus, our oil price forecast was an important factor in our analysis.

EMERGING MARKETS TEAM
A comparison relative to various emerging economies helped to provide perspective on Puerto Rico’s economy. The commonwealth scored poorly due to its high debt burden, low labor force participation rate weak internal reserves, recurring primary deficits and limited currency flexibility.

FINANCIALS TEAM
Banking
Puerto Rico’s local banking sector has seen a dramatic decline in assets, loans and deposits. The tightening of financial conditions contributed to the economic contraction on the island.

Insurance
Roughly 70% of Puerto Rico’s bonded debt is monoline insured, so a review of the underlying financial strength of each issuer was an important factor in our analysis of recovery expectations.

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CORPORATE CREDIT TEAM
Manufacturing has accounted for 45% of Puerto Rican GDP in recent years and our analysts saw this as a risk. Pharmaceuticals, the most prominent sector, came to the island in the 1980s and 1990s to take advantage of now-expired federal tax incentives. Without these tax incentives and with other challenges including expired patents, cheaper manufacturing costs elsewhere in emerging markets, and higher production costs, pharmaceuticals were expected to move out of Puerto Rico and hurt GDP.

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YEARS OF EASY BORROWING LED TO OUTSIZED DEBT LEVELS

- Puerto Rico: $15,637
- Connecticut: $5,491
- Massachusetts: $4,887
- Hawaii: $4,867
- New Jersey: $4,138
- New York: $3,092
- Washington: $2,892
- Illinois: $2,681
- Delaware: $2,438
- California: $2,407
- Rhode Island: $1,985
- Kentucky: $1,921
- Maryland: $1,889
- Wisconsin: $1,794
- Mississippi: $1,747
- Oregon: $1,636
- Louisiana: $1,566
- Minnesota: $1,538
- Alaska: $1,489
- Average: $1,419

Debt per capita as of 30 June 2015, the year that the governor stated the debt was not payable. Source: Moody's Investors Service. Includes tax-supported debt which excludes pensions and self-supported debt issued by enterprise risk.

PRICE OF PUERTO RICO’S DEBT DROPPED DRAMATICALLY

Governor states “The debt is not payable. There is no other option.”

Hurricane Maria

Price of Puerto Rico 8% coupon bond of 2035 from 11 March 2014 to 31 December 2017
Source: Interactive Data Corporation

PIMCO MUNICIPAL CAPABILITIES

Over 20 years managing municipal assets

Manage $40 billion municipal AUM and $1.75 trillion AUM firm-wide

6 municipal credit analysts supported by 60+ firm-wide credit analysts

Relationships with 70+ Wall Street broker-dealers

Source: PIMCO as of 31 December 2017
For years, Puerto Rico bonds enjoyed exceptional popularity among U.S. taxpayers, because of their triple tax exemption. This made it very easy for Puerto Rico to sell bonds to cover expenses, but contributed to the island’s increasing debt burden.

Puerto Rico had relied on special tax incentives to drive economic development. But in 1996, Congress elected to phase out some of these benefits over the next 10 years. This contributed to the loss of 80,000 jobs.

Our concerns over PR in 2012 resulted in a reduction of Commonwealth risk long before most market participants saw material concern. We memorialized our views externally in an October 2013 Municipal Viewpoint article.

Even as hedge funds and other risk-seeking investors sought to take advantage of Puerto Rico’s high and triple tax-exempt yields, PIMCO’s municipal portfolio managers elected to wind down the firm’s position prior to its extreme drop in valuation and first default. PIMCO’s foresight resulted from our integrated investment process, based on independent, comprehensive credit research incorporating the full resources of the firm.

PIMCO’s municipal team saw Puerto Rico as an isolated incident, away from the muni market as a whole. We remained constructive on the asset class, and looked to take advantage of opportunities that arose from forced selling as a result of the drastic drop in Puerto Rico bond valuations.

At this juncture, we believe risks to some of Puerto Rico’s municipal bonds remain skewed to the downside. Nevertheless, we are continuing to assess opportunities in the commonwealth.

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Head of Municipal Credit Research

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This material contains examples of the firm’s internal investment research capability. The data contained within the reports may not be related to a specific product, may be stale and should not be relied upon as investment advice or a recommendation of any particular security, strategy or investment product. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed. Past performance is not a guarantee or a reliable indicator of future results.

Municipal bonds issued by the Commonwealth of Puerto Rico and its subdivisions are exempt from federal, state, and local taxes (“triple tax exemption”). Unlike other triple tax exempt bonds, Puerto Rican municipal bonds exemption is not limited to Puerto Rican domiciled persons.

All investments contain risk and may lose value. Investing in the bond market is subject to risks, including market, interest rate, issuer, credit, inflation risk, and liquidity risk. The value of most bonds and bond strategies are impacted by changes in interest rates. Bonds and bond strategies with longer durations tend to be more sensitive and volatile than those with shorter durations; bond prices generally fall as interest rates rise, and the current low interest rate environment increases this risk. Current reductions in bond counterparty capacity may contribute to decreased market liquidity and increased price volatility. Bond investments may be worth more or less than the original cost when redeemed. Income from municipal bonds may be subject to state and local taxes and at times the alternative minimum tax; a strategy concentrating in a single or limited number of states is subject to greater risk of adverse economic conditions and regulatory changes.

Management risk is the risk that the investment techniques and risk analyses applied by PIMCO will not produce the desired results, and that certain policies or developments may affect the investment techniques available to PIMCO in connection with managing the strategy. While the Puerto Rico municipal bond call was favorable for PIMCO municipal focused portfolios the market could have turned away from the call which would have resulted in portfolios not participating in a stable or positive market.

Non-municipal focused portfolios managed by PIMCO during the case study period may have held Puerto Rico municipal bonds that have been economically and legally defeased by US Treasuries.

There is no guarantee that any investment strategy will work under all market conditions or are suitable for all investors and each investor should evaluate their ability to invest long-term, especially during periods of downturn in the market. Investors should consult their investment professional prior to making an investment decision.

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