STANDARD & POOR'S
RATINGS SERVICES

RatingsDirect®

Summary:

Puerto Rico Sales Tax Financing Corp; Sales Tax

Primary Credit Analyst:
David G Hitchcock, New York (1) 212-438-2022; david.hitchcock@standardandpoors.com

Secondary Contact:
Horacio G Aldrete-Sanchez, Dallas (1) 214-871-1426; horacio.aldrete@standardandpoors.com

Table Of Contents

Summary:

Puerto Rico Sales Tax Financing Corp; Sales Tax

Credit Profile		
Puerto Rico Sales Tax Fin Corp sales tax		
Unenhanced Rating	A+(SPUR)/Negative	Outlook Revised
Long Term Rating	AA-/Negative	Outlook Revised

Many issues are enhanced by bond insurance.

Rationale

Standard & Poor's Ratings Services has revised its outlook on Puerto Rico Sales Tax Financing Corp.'s (COFINA) first- and second-lien bonds to negative from stable. At the same time, Standard & Poor's has affirmed its 'AA-' rating on COFINA's senior (first-lien) sales tax revenue bonds and its 'A+' rating on the first subordinate (second-lien) sales tax revenue bonds outstanding.

We base the outlook revision on what we view as Puerto Rico's current declining economic and population trends.

Although annual debt service coverage remains strong for both first- and second-lien sales tax-secured debt, particularly after a recent legislated expansion of the sales tax base that has raised annual coverage in the short term, growth in sales tax is still needed to maintain high annual debt service coverage for first-lien bonds, and to cover combined first- and second-lien maximum annual debt service (MADS) occurring in 2041. If we were to lower the rating on the bonds, we believe it would likely be limited to one notch, reflecting gradual economic trends that have seen steady declines in population and economic gross product.

The 'AA-' rating on the first-lien bonds and 'A+' rating on the second-lien bonds reflect our opinion of:

- A large tax base of 3.7 million, which receives substantial federal income transfer payments, and a sales and use tax (SUT) that excludes volatile sectors such as automobile sales and hotel occupancy, and has shown recent trends of increasing tax collections, despite commonwealth economic contraction;
- Very strong current annual debt service coverage on first-lien bonds and adequate historical coverage of first-lien MADS;
- Strong annual coverage on the second-lien bonds, while a small level of growth in SUT will still be needed in the next two decades to enable coverage of second-lien MADS;
- A strong legal structure that separates the revenue stream securing the bonds from the Commonwealth of Puerto Rico ('BBB-/Negative' general obligation [GO] rating);
- COFINA's access, on a priority basis, to the entire 5.5% SUT currently collected to pay debt service for first- and second-lien SUT-secured debt; and
- A recent expansion of the sales tax base to business services, projected by the commonwealth to increase sales tax collections by 28.7% as budgeted in fiscal 2014, 2.4% annual growth in SUT between fiscal years 2010-2013, and a commonwealth projection that only an annual growth rate of 1.1% will be needed to achieve coverage of second-lien MADS in 2041.

Offsetting factors include:

- The inability to completely isolate credit quality from the commonwealth's financial and economic condition -- the ability to levy and collect sales and use taxes depends directly on the underlying activity in Puerto Rico, which can be affected by the government's financial condition; and
- The need to have revenue growth continue in order to meet second-lien MADS occurring in 2041, and to preserve strong annual debt service coverage of first-lien bonds.

Commonwealth officials have publicly announced plans to potentially issue new third-lien secured sales tax bonds. The rating affirmation and outlook revision on the first- and second-lien sales tax debt reflect our view of the current economic climate and is not related to the potential for additional leverage.

We believe economic trends have been weak for a long time, even before the last recession. The commonwealth's population declined to 3.67 million in 2012 from 3.78 million in 2007 and from 3.83 million in 2003. Puerto Rico gross national product fell on a real basis in fiscal years 2007-2011, showed a 0.1% increase in 2012, and the most recent commonwealth disclosure statement estimated GNP fell 1.1% in fiscal 2013. The commonwealth's total employment also fell each year between 2008 and 2012, decreasing 13.9%, according to the U.S. Department of Labor household survey. The separate establishment survey of nonfarm employment showed a similar decline, except for a slight uptick in 2012. However, monthly nonfarm employment figures indicate a decline has continued so far in 2013. At the same time, the unemployment rate improved to a seasonally adjusted 13.5% as of July 2013, compared with a peak average annual unemployment rate of 16.3% in 2010, and tourism visits appear to be increasing.

We believe that weakness in the U.S. mainland economy has had an effect on the Puerto Rico economy, but also believe that particular factors may be contributing to the weak economic results. These include the loss of certain tax benefits for mainland manufacturers on the island in 2006 and high power and water costs, in part due to the need to import high-priced fuel oil for electric generation, as well as competitive pressures with Mexico for U.S. business due to the North American free trade agreement.

Despite what we view as weak economic trends, SUT collections have risen every year except one since the tax began to be collected in fiscal 2007. In fiscal 2009, there was a 5% drop. Since then, SUT has increased 0.6% in fiscal 2010, 1.2% in 2011, 2.8% in 2012, and 3.3% in fiscal 2013, to $1.175 billion. Puerto Rico has enacted an expansion of the SUT base to business services that it expects will substantially increase pledged revenues in fiscal 2014. The commonwealth has budgeted an increase of 28.7% in SUT in fiscal 2014, which includes a 2.5% increase due to underlying economic activity on the existing tax base. At this point, the exact magnitude of the increase due to the expansion of the base is unknown.

Annual debt service coverage of first-lien bonds is very strong, in our view. SUT revenues from the 2.75% dedicated to COFINA provided 3.32x coverage in fiscal 2013. Revenues from the entire 5.5% commonwealth sales tax provided what we believe is a very strong 6.6x senior-lien annual debt service coverage in fiscal 2013. We calculate that the full SUT of $1.51 billion that Puerto Rico has budgeted for fiscal 2014 would provide annual first-lien debt service coverage of 5.80x in 2014, and 1.25x coverage of MADS occurring in 2057.

Annual debt service coverage of combined first- and second-lien bonds in fiscal 2013 from the full 5.5% was 1.94x.

Assuming the full fiscal 2014 budgeted SUT is collected, annual second-lien coverage in fiscal 2014 would be 2.24x, and fiscal 2014 SUT would cover combined MADS occurring in 2041 by 0.83x. However, due to the back-loaded debt service schedule, the level of fiscal 2014 budgeted SUT would still cover second-lien annual debt service through fiscal 2035 with no increase in revenues. We calculate that an annual SUT growth rate of 0.8% from the fiscal 2014 budgeted amount would be sufficient to allow coverage of second-lien MADS, a level of growth we feel is conservative given historical SUT growth trends. Our rating assumes that, while there may be short-term volatility, the SUT will experience long-term growth trends.

The SUT base excludes several volatile sectors typically seen in sales taxes collected by U.S. states, which could lead to greater stability for the Puerto Rico SUT than typical state sales tax collections. The Puerto Rico SUT excludes automobile sales, hotel occupancy, and gasoline sales, among other items. The commonwealth has also taken a number of actions to reduce tax evasion, which is considered a concern. These include hiring more enforcement personnel, and eliminating a tax-exempt seller certificate program, which the commonwealth believes was a source of significant tax evasion. Puerto Rico has budgeted for a capture rate of 88% of business activity on the expanded SUT base for highly regulated businesses, and a 68% capture rate for other businesses, which it believes is consistent with recent experience with SUT collections. We believe that the limited period to date for collection of the expanded tax base creates some uncertainty in the exact magnitude of the tax increase.

In addition, federal transfer payments equal about 26% of island personal consumption, lending potential stability in SUT, to the extent not affected by federal cutbacks. The largest transfer payment sector is social security, which has not been affected by the federal sequester. Nevertheless, Puerto Rico has experienced weak economic results in the past five years, including a long-term population decline and another economic contraction in fiscal 2013 that appears to be continuing into the first part of fiscal 2014.

A key part of our rating is the separation of the sales tax pledge from the credit quality of Puerto Rico's GO bonds. The legislative act creating COFINA, Law 91 of 2006, separates and provides a priority interest in Puerto Rico's sales and use taxes for the bondholders. Law 91 provides that all revenues from SUT go directly to COFINA until a guaranteed base amount of tax collections is met. The statute further grants a statutory lien to bondholders on the commonwealth's sales and use tax revenues once any bonds are issued. In addition, the corporation is not permitted to voluntarily file for bankruptcy protection and cannot be forced into involuntary bankruptcy. Furthermore, Standard & Poor's received multiple legal opinions stating that Law 91 transfers property of the sales and use tax collections to COFINA. This effectively excludes the pledged SUT revenues from Puerto Rico's constitutional provision regarding the commonwealth GO debt's first-lien claim on all available revenues (also known as the claw-back constitutional provision).

COFINA is a corporate and political entity independent and separate from the commonwealth. It was created with the purpose of issuing bonds and using other means to pay or refinance all or part of Puerto Rico's extra-constitutional (appropriation) debt as of June 30, 2006 (totaling $6.8 billion). In early 2009, the legislature approved an amendment to Law 91 that expanded COFINA's corporate purpose to include funding the commonwealth's budget deficit through fiscal 2012; paying accrued obligations to suppliers; establishing a local stimulus plan; and creating an emergency fund to cover expenses related to catastrophic events such as hurricanes and floods. To meet the corporation's expanded purpose, the amendment increased the percent of sales tax receipts pledged directly to the dedicated sales tax fund (Fondo de Interes Apremiante, or FIA) to 2.75% from 1.00%. The FIA will be funded with the first revenues collected by the entire 5.50% SUT, until revenues reach the collections equivalent of the 2.75% dedicated sales and use tax or an annual guaranteed base amount, whichever is greater. The base amount increases by a 4% annual adjustment factor. Regardless of sales tax collections based on the 2.75% dedicated sales tax, Law 91 requires that all of the 5.50% SUT be applied to satisfy and fund the base amount before any money can be transferred to the general fund.

COFINA's ability to issue senior-lien bonds remains limited by statute to the total amount of extra-constitutional debt as of June 30, 2006. In addition, the resolution requires that SUT revenues for the fiscal year before the additional bonds' issuance (increased by the 4% annual adjustment factor) provide at least 3x coverage of annual debt service on all existing and proposed senior-lien bonds. Consequently, COFINA will not issue additional senior-lien bonds unless it is to refund or to expect payment on extra-constitutional debt and related obligations and for refundings that provide annual savings, which in our opinion means that the first lien is effectively closed. The second-lien bonds have a two-pronged additional bonds test (ABT) that requires 102% of the annual combined senior and subordinate bond principal and interest payments due in each year to be less than the amended base amount for the corresponding year. The base amount equaled $550.1 million for fiscal 2010, escalated by 4% thereafter, and is capped at $1.85 billion. In addition, the subordinate-lien ABT requires that total sales taxes collected in the year before the bonds' issuance (increased by an annual factor of 4%) provide at least 2x coverage of combined annual senior and second-lien bonds in every year bonds are outstanding.

Puerto Rico has publicly proposed expanding the guaranteed base to issue third-lien bonds, which could effectively limit the amount of future second-lien debt. However, we do not currently believe that issuance or lack of issuance of third-lien debt would affect first- or second-lien debt ratings, based on the current protection of the second-lien ABT.

(For more information on Puerto Rico's general credit quality, please refer to the commentary "Puerto Rico’s 2014 Budget Makes Progress, But Full Structural Balance Remains Elusive," published Aug. 14, 2013.)

Outlook

The negative outlook on the bonds reflects Standard & Poor's expectation that if current negative economic trends persist there is at least a one-in-three chance that we could lower the ratings during our two-year outlook horizon. We believe such a downgrade would likely be limited to one notch, reflecting gradual economic trends that have seen steady declines in population and economic gross product. Although sales tax has increased during this period, we don't believe sales tax can remain wholly immune to economic trends. While annual debt service coverage remains strong for both first- and second-lien sales tax-secured bonds, growth in sales tax is needed to maintain the current high annual debt service coverage for first-lien bonds in later years, despite the recent legislated expansion of the sales tax base that will raise coverage in the short term. Continued growth in sales tax collections is needed to cover future combined first- and second-lien MADS that occurs in 2041, due to the back-loaded debt service schedule. While the level of historical SUT collections received in fiscal 2013 can cover annual debt service for both liens for more than a decade, and the expanded level of SUT Puerto Rico has budgeted for fiscal 2014 covers second-lien annual debt service for more than two decades, growth is still needed to cover second-lien MADS in 2041, and to raise historical coverage of first-lien MADS (occurring in 2057) to the strong levels of current annual debt service coverage. If economic trends for the island return to significant growth, we could potentially revise the outlook on the bonds to stable.

Related Criteria And Research

USPF Criteria: Special Tax Bonds, June 13, 2007

Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column.