Gurtin Municipal Bond Management

Credit Research Flash

Puerto Rico's Uncertainty Appears Lost in Translation to Some Investors

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Last week, Puerto Rico's governor, Alejandro Garcia Padilla, and senior members of his staff stated that they would likely seek concessions from all of the island's creditors remarking that "the debt is not payable."[1] As the Commonwealth nears a full-blown debt crisis (for more detail see Puerto Rico "House of Cards" July 2014 research report[2]), we continue to believe that Puerto Rico's situation is clouded with tremendous uncertainty. Though their financial trajectory and depletion of available cash has followed a predictable trajectory down a well-trodden path travelled by other distressed municipal obligors, the end game for investors in Puerto Rico is far murkier than any of its infamous precursors, such as Detroit, on the U.S. mainland. This is in large part due to the Commonwealth's esoteric status as a U.S. territory that lacks the mechanism to pursue protection from creditors under the Chapter 9 bankruptcy code. Simply put, there is no clear analog for Puerto Rico that can be used to predict how investors will be treated, what securities may be held harmless, or what recovery rates will be. Further, we believe that even if Puerto Rico could seek something analogous to Chapter 9 protection,

[1] "In Puerto Rico, Debt Is Called 'Not Payable'" New York Times, June 29, 2015.

[2] For more information, see our report titled "Puerto Rico's House of Cards: The Little Known Risks of the Government Development Bank and Its Role in a Likely Liquidity and Full-Blown Debt Crisis" - http://www.gurtin.com/UserPages/1015989.pdf

treatment of various security classes and recovery rates would be highly suspect given the dizzying array of securities that exist, the tangled and complex interconnected web of the Commonwealth's debt, and Puerto Rico's dubious ability to repay its creditors.

Non-traditional municipal investors believe their time-tested restructuring tools honed in corporate and sovereign finance will work in Puerto Rico.

The lack of comparable case studies has not stopped non-traditional municipal investors from investing in Puerto Rico. An array of hedge fund and other investors specializing in distressed corporate bonds have piled into Puerto Rico in search of yield.[3] Many of these investors have vast experience navigating through the process of restructuring distressed corporate debt and believe their expertise of successfully restructuring failing companies or correctly identifying junk bonds that can still yield attractive returns will work in the case of Puerto Rico. However, we believe these investors have underestimated the uncertainty inherent in Puerto Rico's status, and are attempting to ply their trade in an unfamiliar field with rules and political motives they may not understand or fully appreciate. These corporate specialists' belief that they understand the lowest rungs of municipal credit quality is directly analogous to Meredith Whitney's belief that her expertise in the banking field would translate to analyzing high-grade municipal bonds. As you no doubt recall, Whitney infamously predicted billions in imminent looming defaults in high grade municipal bonds on *60 Minutes* in December 2010. Likewise, hedge funds and other non-traditional investors appear certain that they understand how to protect themselves and gain impressive returns for clients when investing in distressed municipal obligors. However, these tactics and their analysis may not translate to a municipal market that is unfamiliar to them and largely unacquainted with the sort of exotic demands being made by the non-traditional investors.

Uncertainty rules the day. Nobody knows how Puerto Rico's debt crisis will end, and what securities will be impacted.

The reality is that it is too early and remains pure guess work to attempt to accurately handicap the ultimate value of each of the obligors that make up Puerto Rico's massive debt load. What is clear, however, is that there is no way that Puerto Rico's languishing economy can support its roughly $72 billion in municipal debt. Whether it is nontraditional investors suggesting that their experience in navigating through the tumultuous waters of distressed corporate debt will carry the day, or more traditional municipal managers positing that they can use lessons learned from mainland bankruptcies to navigate the waters and ultimate fair value of each of the various Puerto Rican obligors, we believe all are professing a degree of certainty that simply does not exist. This is uncharted territory given Puerto Rico's status as a U.S. territory and its astonishingly large fiscal, economic, and demographic problems. We believe Puerto Rico's position is sufficiently dire that it is likely considering all available options in attempting to put its house back in order, and this

[3] "Munis Meet Milken as Hedge Funds Dictate Puerto Rico Debt Terms," Bloomberg News, June 29, 2015.

may ultimately include defaulting on obligations that many in the market believe historically have offered protection from default. In the case of Puerto Rico, all bets are off, because the standard tools of analysis simply remain untested in the murky waters of a Commonwealth unable to satisfy their enormous and untenable debt load.

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