BARRON'S COVER: TROUBLING WINDS

Puerto Rico's huge debt could overwhelm attempts to revive its economy. Bond investors, beware.

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The municipal-bond market has been rattled by Detroit's bankruptcy, but an even bigger problem may be developing in the Caribbean, where Puerto Rico is grappling with a stubbornly weak economy, persistent budget deficits, and onerous debt.

Amid rising investor worries about the U.S. territory's financial health, a $673 million municipal-bond issue earlier this month from the Puerto Rico Electric Power Authority offered a top yield of more than 7%. That compares with 5% yields on well-regarded California general-obligation bonds. Most Puerto Rico debt carries barely investment-grade bond ratings, and with more of it expected to come to market in coming months, investor confidence will soon face a key test.

Puerto Rico has $53 billion of tax-supported debt outstanding from more than a dozen issuers, according to Moody's Investors Service, and nearly $70 billion of total debt, according to the commonwealth. Even using the lower figure, Puerto Rico's debt load would rank third among the states, behind only California and New York. And its debt burden relative to key financial measures—gross domestic product, personal income, and population—is off the charts (see table, No Recovery). Puerto Rico's debt per capita, for instance, of $14,000 is 10 times the average of the 50 states.

In addition to its debt, Puerto Rico has more than $30 billion of unfunded pension liabilities.

The backdrop in the U.S. territory isn't promising: The economy has been in recession since 2006, the unemployment rate is 13.2%, and the budget has been structurally imbalanced for nearly a decade. The poverty rate is high, government employment accounts for a quarter of all jobs, and transfer payments make up 40% of income. More than a quarter of Puerto Rico's nearly four million residents receive food stamps.

"There's a debt spiral in Puerto Rico that will not turn out well unless there is a dramatic turnaround in the economy," says Dan Heckman, senior fixed-income strategist at U.S. Bank Wealth Management in Minneapolis. "We've been advising clients to stay away from Puerto Rico. The government is doing all it can, but it has to climb out of a very deep debt hole."

THERE ARE SOME BIG differences, however, between Puerto Rico and Detroit. Puerto Rico has taken painful and politically unpopular steps to cut bloated government payrolls, raise taxes, and shore up its badly underfunded pension system. A new government elected in 2012, led by the populist Governor Alejandro García Padilla, is committed to putting Puerto Rico and its various bond-issuing authorities on a stronger financial footing. Default and restructuring aren't in the government's vocabulary.

Who Owns Puerto Rico's Debt?

Oppenheimer municipal-bond funds have by far the highest exposure to Puerto Rico debt in the industry. Franklin also has a sizable holding, while Vanguard, Fidelity, and T. Rowe Price have less than 1%.

Family	Number of Municipal Funds	% Holding Puerto Rico Bonds	Mkt Val of Puerto Rico issues (mil)	Weight %	Total Investments As of Most Recent Portfolio Date (mil)
OppenheimerFunds	20	100%	$4,969.38	14.8%	$33,678
Franklin Templeton	32	97	4,819.39	6.5	74,612
Legg Mason	13	100	622.32	4.3	14,574
AllianceBernstein	19	95	521.67	3.5	14,769
Lord Abbett	8	100	390.71	3.4	11,421
Eaton Vance	32	84	295.47	2.9	10,218
USAA	6	100	191.90	1.9	10,018
DWS Investments	7	86	214.17	1.9	11,575
Nuveen	34	91	467.01	1.8	26,323
Invesco	7	86	144.68	1.3	10,956
Wells Fargo Advantage	14	86	257.73	1.3	20,506
Columbia	18	83	140.35	1.0	14,596
Fidelity Investments	22	86	226.05	0.8	28,677
T. Rowe Price	12	92	104.96	0.7	15,158
Vanguard	12	100	644.21	0.6	105,328

Source: Morningstar

"In less than five months, we have tackled several key challenges faced by Puerto Rico for decades to protect our investment-grade ratings." So read the opening slide at a presentation by Puerto Rico in New York in the spring.

In a statement to *Barron's* on Friday, Puerto Rico's Government Development Bank said, "The fiscal measures implemented by this administration, along with the strategic plans developed by the public corporations and the commitment to transform them into self-sustaining enterprises, will be a positive factor that will ensure the full repayment of the debt incurred...We are confident that no major debt issuer will default on its debt."
The coming year is likely to be critical, as the Puerto Rico government aims to reduce the fiscal deficit to an anticipated $800 million from $2.2 billion in the fiscal year that ended in June, on spending of $10 billion. Last year's deficit initially was projected at about $300 million.

Puerto Rico has a history of borrowing money to fund its operating deficit as well as required principal and interest payments on its debt. But skeptics wonder if an array of new taxes will raise enough revenue to solve the territory's debt problems. They also worry that Puerto Rico's fragile economy might not be able to handle a heavier tax burden.

If the government's moves don't work, and its borrowing costs stay stubbornly high, Puerto Rico might well have to restructure its debt somewhere down the road, demurrals notwithstanding.

A closely watched index of economic activity compiled by the Puerto Rico Government Development Bank, shows a year-over-year decline of 4.5% in June. This indicator, which reflects gasoline consumption, payroll employment, electricity generation, and cement sales, has a high correlation with GDP. It suggests that the current estimate of 0.2% real growth in GDP in the current fiscal year may prove optimistic.

Alan Schankel, the municipal analyst at Janney Capital Markets, says he is regularly asked by investors whether Puerto Rico ultimately will default. "I think Puerto Rico is good for the next few years," he says. "Beyond that, I won't speculate. I'm encouraged by what the government has done, but Puerto Rico has a history of overpromising. I'm taking a wait-and-see approach."

AMERICAN INVESTORS HAVE a big stake in the financial outcome because Puerto Rico debt is widely held by mutual funds and individuals. That contrasts with Detroit, whose $18 billion of liabilities cited in its bankruptcy filing include about $9 billion of pension and health-care liabilities and a sizable amount of secured debt.

Since interest payments on most Puerto Rico bonds are exempt from state and local taxes in all 50 states, the debt has long appealed to muni investors in high-tax states such as New York and California. Puerto Rico's "triple" tax exemption—federal, state, and local—is rare in the municipal market. Interest on state and local debt typically is exempt from taxes in the home state but not in others, meaning interest on New York debt is taxable to bondholders living in New Jersey.

Among mutual funds, Oppenheimer Rochester funds have been the most aggressive buyers, with Puerto Rico debt accounting for almost 15% of the firm's $33.7 billion in open-end muni funds, based on data compiled by Morningstar. Other fund groups with sizable exposure to Puerto Rico include Franklin Templeton, Dreyfus, and Goldman Sachs. In contrast, Fidelity, T. Rowe Price, Vanguard, American, and JPMorgan have low exposure to Puerto Rico, with less than 1% of their muni-fund assets in Puerto Rico debt, Morningstar data show.

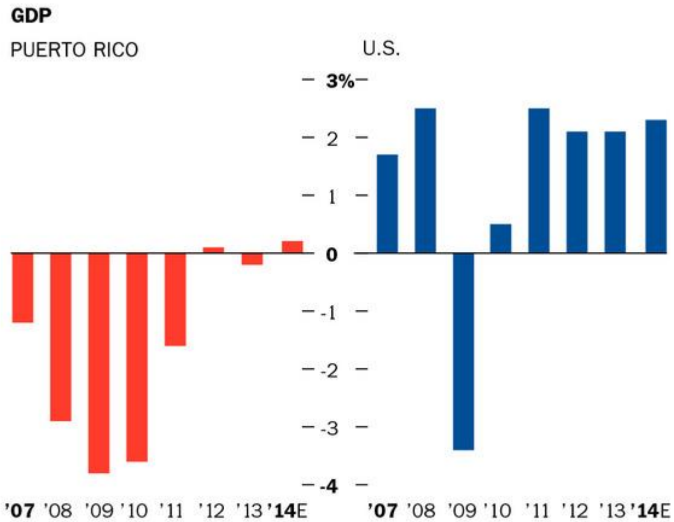
Many investors aren't aware of the risk in their muni portfolios. Puerto Rico debt isn't just held by more adventurous "high-yield" muni funds but most single-state funds, due to the triple tax exemption. Oppenheimer Rochester's $90 million Maryland fund, for example, had 37% of its assets in Puerto Rico debt in March. While the Oppenheimer prospectuses permit such a large investment, it's debatable whether any single-state fund should have such a large out-of-state exposure, especially to lower-rated debt. Among muni mutual funds, Oppenheimer is the most aggressive investor when it comes to lower-grade credits.

Troy Willis, a vice president and senior portfolio manager at OppenheimerFunds, attributes the recent weakness in Puerto Rico debt to a "drumbeat of negativity" from the rating agencies and others. "Puerto Rico is moving in the right direction," he says. "It's cutting the budget deficit and could have a structurally balanced budget in a year. That's a lot more than you can say for the federal government."

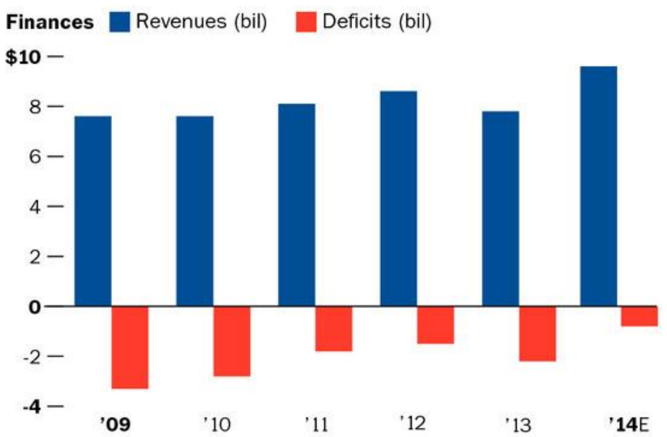
Willis says investors underestimate the ability of governments to raise needed revenue, and he argues the risk/reward in Puerto Rico debt is "pretty compelling" at current levels. Some of the weakness in Puerto Rico debt reflects the selloff in the muni market, prompted in part by continuing outflows from mutual funds.

No Recovery

Puerto Rico's economy has been mired in recession since 2006, hurt by the end of tax breaks, a business-unfriendly environment, and high electricity costs. The jobless rate tops 13%.



Puerto Rico ran a budget deficit of $2.2 billion in the fiscal year ended June 30, excluding one-time revenue boosts. Investors are hoping the government can narrow the gap to a projected $800 million in fiscal '14.



Puerto Rico has $53 billion of tax-supported debt, behind only California and New York. Its debt per capita is far above that of any state.

State	Debt (bil)	Population (mil)	Debt Per Capita
California	$97.6	37.2	$2,624
New York	62.1	19.4	3,201
Puerto Rico	53.0	3.7	14,324
New Jersey	35.7	8.8	4,057
Massachusetts	33.0	6.5	5,077
Illinois	32.5	12.8	2,539

Sources: Commonwealth of Puerto Rico; Moody's Investor Service; U.S. Census Bureau, 2010 Census

Barron's wrote critically on Puerto Rico a year ago as part of a broader article on the financial health of the 50 states, when the interest rate on the territory's long-term debt was about 5% ("Puerto Rico Munis Are No Vacation," Aug. 27, 2012). We wrote that Puerto Rico debt carried the most risk among major tax-exempt issuers and that "its economic and financial woes don't appear to be reflected in its bond yields."

ASIDE FROM PUERTO RICO, there are few major problem areas in the municipal market, where credit quality generally has been improving with the economy. Detroit's financial woes were decades in the making. About the only worrisome state situation involves Illinois, mostly due to its huge unfunded pension liability. Based on Moody's data, Illinois' combined debt and pension liability is $165 billion, far more than Puerto Rico's total of $89 billion. But Puerto Rico has less than a third of Illinois' population, and its per capita GDP and personal income are a fraction of the average U.S. state.

It doesn't help investor confidence that timely financial reporting isn't available from Puerto Rico. The government doesn't plan to release audited financials for the fiscal year ended in June 2012 until next month. "Until we get better transparency that the economy is improving or that the revenue streams they expect to receive are becoming a reality, an investment in Puerto Rico is not the most prudent thing to do," says John Loffredo, co-manager of the MainStay High Yield Municipal Bond fund. MainStay muni funds don't own any Puerto Rico debt.

Adds Vanguard Group: "Although we see some encouraging signs from the new administration, we will remain cautious on Puerto Rico until we see substantive and sustained improvement in economic growth and government revenues."

Key questions include whether the federal government would step in to aid Puerto Rico if it sought financial help. It's unclear how any potential default would play out because Puerto Rico, like the 50 state governments, can't avail itself of Chapter 9 of the bankruptcy code that applies to cities like Detroit. As a self-governed U.S. territory with its own constitution, Puerto Rico is different than the 50 states. Puerto Ricans don't vote in national elections and are represented in Congress by a nonvoting resident commissioner. They don't pay most federal taxes, with the exception of Social Security.

THE CREDIT RATINGS ON Puerto Rico's general-obligation bonds—Baa3 from Moody's Investors Service and triple-B-minus from Standard & Poor's—are the lowest investment-grade ratings the agencies assign. Both have negative outlooks on Puerto Rico's credit rating, meaning there is a possibility that its debt could get downgraded to junk in the coming year. That could make it more difficult for Puerto Rico to sell debt, because muni-bond investors tend to be risk averse. It needs access to the debt market given continuing financing needs. So far it has that access, but at a price.
"The rating agencies probably will give Puerto Rico until the end of this year or early next year to see if revenue projections used for the 2014 budget are looking accurate," says Janney's Schankel. "If they don't come in as expected, a downgrade is possible."

Schankel says the risk/reward tradeoff in Puerto Rico bonds has improved since last year, when he urged investors to stay away. Still, he recommends that investors limit their exposure to Puerto Rico in their muni portfolios.

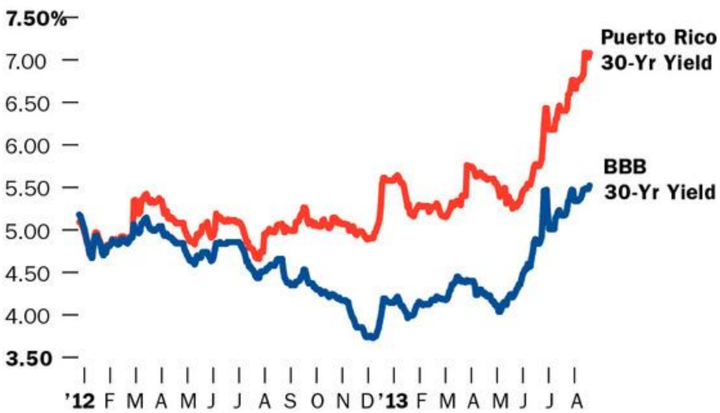
"Puerto Rico passed a number of very significant tax initiatives to stabilize the fiscal situation. We're looking to see if they are achievable in light of a challenging economic situation," says Moody's analyst Lisa Heller.

In a report last year on the Puerto Rico economy, the Federal Reserve Bank of New York cited several barriers to growth, including a business-unfriendly environment, regulatory restraints, structurally high unemployment, and high electricity costs.

The electricity cost per kilowatt hour is nearly 30 cents, about triple the U.S. average. A federal tax break that prompted many drug companies to set up manufacturing facilities in Puerto Rico expired in 2006, and that has hurt the economy. The electricity company is seeking to address its high costs by shifting to liquefied natural gas from oil, but the switch is expensive and will take time. One big plus is that many Puerto Ricans are bilingual in Spanish and English, and 66% of young Puerto Ricans are in college, comparable with the national average.

Rising Risk, Rising Yields

Many Puerto Rico long-term bonds are yielding 7% or more, compared with yields of 5% on high-quality municipals. The high yields reflect increasing concerns about the territory's economy.



Secured Cofina debt is viewed as the strongest among Puerto Rico bonds. Much other debt is rated just above non-investment grade.

Key Puerto Rico Issuers	Total Debt (bil)	Rating Moody's/S&P	Recent Yield*
General-Obligation Bonds	$10.8	Baa3/BBB-	7.25%
Sales Tax (Cofina)	15.2	AA3/AA-	6.00
Aqueduct & Sewer	4.6	Ba1/BB+	7.60
Highways & Transportation	4.7	Baa3/BBB	N.A.
Electric Power Authority	9.3	Baa3/BBB	7.15

*Long-term debt. N.A.= Not Available. Sources: Bloomberg; Commonwealth of Puerto Rico

There are several major bond issuers in Puerto Rico, including the government, the aqueduct and sewer authority, the electric-power authority, the highway and transportation authority, and the sales-tax authority, known by its Spanish acronym Cofina (see table). Cofina is viewed as the strongest issuer and has the highest bond rating, due to a lien on sales-tax revenues. The electricity authority is probably viewed as the next-strongest credit. About $9 billion of Puerto Rico debt carries bond insurance, according to BTIG analyst Mark Palmer. The insurance adds a layer of investor protection.

MOODY'S LUMPS TOGETHER many of the semiautonomous authorities within the Puerto Rico government in arriving at its total of tax-supported debt of $53 billion, since several of them have received financial support from the government or rely on taxes that are unrelated to their revenue bases. The highway and transportation authority, for instance, has operated in the red in recent years after debt-service costs, while the electricity authority didn't cover its principal and interest payments in the latest fiscal year.

The aqueduct and sewer authority, which has junk-grade ratings, was authorized to boost its water rates by 60% this year. The government increased the tax on petroleum products to $9.25 a barrel from $3 a barrel, equal to about 15 cents a gallon on gasoline, to shore up the highway and transportation authority, as its toll revenues are insufficient to carry its $4.7 billion of public debt. In a sign that political pressure may undermine tax policy, the higher petroleum tax was delayed by 45 days, according to an article on the Website Caribbean Business.

The higher tax and water rates are designed in part to take pressure off the Government Development Bank, whose primary function is as a provider of liquidity and financing for the interlocking web of Puerto Rico issuers and government agencies. The GDB has a $2.2 billion loan to the highway and transportation authority, or about 25% of its loan book. It lent the government $600 million in the latest fiscal year to finance the deficit.

It's expected that both the highway and transportation authority and the government will sell debt in the coming months to pay off the GDB. The president of the Government Development Bank said in April the bank's position was "fragile." He resigned three months later.

U.S. Bank's Heckman is skeptical about the success of the government moves. "Puerto Rico is trying to come to market and issue additional debt, and it's being severely penalized by the market," he says. "It is walking a financial tightrope."

Puerto Rico might be able to extricate itself from its financial troubles, but that probably would require an extended period of growth in what has been a stubbornly moribund economy. While there doesn't appear to be an imminent danger of default for bondholders, investors ought to question whether the government will continue to have the political will to impose painful measures on relatively poor Puerto Rican residents to service debt held mostly by affluent Americans. The tempting yields on Puerto Rico debt aren't enough to compensate for the risk.