

Tax Supported
New Issue

Puerto Rico Sales Tax Financing Corporation

Ratings

New Issue
Sales Tax Revenue Bonds, First Subordinate, Series 2009A A

Outstanding Debt
Sales Tax Revenue Bonds, Senior Lien A+

Rating Outlook

Stable

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New Issue Details

Sale Information: \$3,500,000,000 Sales Tax Revenue Bonds, First Subordinate, Series 2009A, expected via negotiation the week of June 8.

Security: Limited obligation of the corporation, payable from pledged revenues (sales and use tax); subordinate lien to outstanding senior lien bonds.

Purpose: Fund commonwealth operating budget deficit, repay outstanding extra-constitutional (i.e. appropriation) debt of the commonwealth, and support economic stimulus efforts.

Final Maturity: Aug. 1, 2014–2044; early redemption provisions to be determined upon final sale.

Related Research

- [Puerto Rico Sales Tax Financing Corporation, July 5, 2007](#)
- [Fitch Places Puerto Rico's Sales Tax Bonds on Rating Watch Negative, Feb. 7, 2008](#)

Rating Rationale

- The bonds have a first claim on all Commonwealth of Puerto Rico sales tax revenues (5.5%), providing wide current debt service coverage.
- Strong legal opinions find that neither the commonwealth general fund nor commonwealth GO bondholders have a claim on pledged sales tax revenues, which consist of the higher of revenue generated from the 2.75% sales tax or a stated base amount.
- The sales tax base is broad, and the retail environment in Puerto Rico has shown strength even in challenging economic times.
- Recent legislation strengthened the non-impairment clause of the commonwealth, eliminating prior concern about diversion or elimination of the revenue stream.
- Offsetting the bonds' strengths is the very long final maturity in conjunction with the limited operating history of the sales tax (first levied November 2006) and the bonding program's rising debt service profile.

Key Rating Drivers

- Evidence of growth in the pledged sales tax so that coverage of increasing debt service requirements remains strong.
- Successful implementation of fiscal and economic reform that results in a balanced budget going forward and emergence from the prolonged recession.

Credit Summary

This is the first offering of subordinate lien sales tax revenue bonds by the Puerto Rico Sales Tax Financing Corporation (the corporation, or COFINA), an independent governmental instrumentality of the commonwealth and affiliate of the Government Development Bank of Puerto Rico (GDB). The corporation's board of directors is the same as the GDB board (appointed by the governor with approval of the council of secretaries).

The 'A+' and 'A' ratings on the senior and subordinate lien bonds, respectively, reflect a structure and revenue pledge that result in a much stronger credit than the commonwealth's strained GO credit. Bonds have a first claim on all commonwealth sales tax revenues, providing strong current coverage. The legal opinions are strong, finding that neither the commonwealth general fund nor commonwealth GO bondholders have a claim on pledged sales tax revenues. Recent enhancements to the bond resolution, in particular a strengthening of non-impairment language, provide some additional protection to bondholders. The sales tax base is broad, and the retail environment in Puerto Rico has shown strength even in challenging economic times. Offsetting these credit strengths is the very long final maturity of both the senior and subordinate lien bonds and the program's rising debt service profile, which requires some growth in revenues to achieve coverage of later maturities. Additional risks include the commonwealth's strained fiscal and economic environment. The analysis for the ratings assumed that the commonwealth will fully leverage the pledged revenue

**Rating History —
Subordinate Lien**

Rating	Action	Outlook/ Watch	Date
A	Assigned	Stable	5/20/09

**Rating History —
Senior Lien**

Rating	Action	Outlook/ Watch	Date
A+	Affirmed	Stable	5/20/09
A+	Affirmed	Negative ^a	2/7/08
A+	Assigned	—	6/27/07

^aRating Watch.

stream and covers the full program issuance, including series 2009B bonds to be issued in Puerto Rico.

The bonds are secured by a portion of the commonwealth's islandwide sales and use tax, which became effective on Nov. 15, 2006. This broad-based tax was instituted as part of Puerto Rico's 2006 tax and fiscal reform, and its use is being restructured as part of a comprehensive fiscal and economic package designed to stimulate Puerto Rico's economy and address recurring budget deficits. The tax is currently levied at the rate of 5.5%, with a 1.5% additional municipal option. As originally structured, assuming revenue performance consistent with estimates, the commonwealth's general fund was expected to receive 4.5% of the 5.5% sales tax, with the remaining 1% paying debt service on the senior lien bonds, which were used to retire extra-constitutional (i.e. appropriation) debt of the commonwealth. As noted in Fitch Research on "Puerto Rico Sales Tax Financing Corporation," dated July 5, 2007, available on Fitch's web site at www.fitchratings.com, when the senior bonds were issued and the structure was initially analyzed, a key credit feature supporting the 'A+' rating on the senior lien bonds is that the pledge for the senior lien sales tax revenue bonds is the greater of collections from the 1% or a base (minimum) amount payable from all commonwealth sales tax revenues each year. Since debt service in any year is capped at the applicable base amount, debt service on senior lien bonds will be covered by pledged revenues as long as collections from the entire 5.5% commonwealth sales tax, rather than just the 1%, are sufficient to fund the base amount.

Legislation was passed in early 2009 amending the governing resolution and authorizing COFINA to issue subordinate lien bonds secured by an additional 1.75% of the 5.5% sales tax. The base amount, which was originally \$185 million in fiscal 2008, rising 4% per year thereafter, has been increased to \$550 million, also rising 4% per year thereafter, up to a maximum of \$1.85 billion. The 'A' rating on the subordinate lien bonds reflects coverage by the full 5.5% due to the strong flow of funds. At the start of each fiscal year, revenues from the entire commonwealth sales tax flow directly from Banco Popular de Puerto Rico to the trustee until revenues deposited with the trustee in that year equal the base amount. Only thereafter does the general fund receive its share.

Coverage of annual debt service from current revenues is ample; however, debt service escalates fairly rapidly. Sales tax revenues would have to grow just 0.38% annually to assure 1.0x coverage of senior lien debt service throughout the life of the bonds and approximately 1.6% annually to assure 1.0x coverage of senior and subordinate lien debt service throughout the life of the bonds by the entire 5.5% tax. Even with escalating debt service and the long final maturity of the bonds, achieving this relatively low level of growth in tax revenues appears reasonable.

The 2009 legislation also strengthened non-impairment language, making it more difficult for the commonwealth to eliminate or divert the sales tax in the future. This is positive for bondholders given that the former governor of Puerto Rico proposed suspending collection of 4.5% of the 5.5% sales tax in February 2008, shortly after the senior lien bonds were issued. Fitch Ratings placed the rating on the senior lien bonds on Negative Rating Watch at that time. The former governor's proposal was not implemented. The revised resolution includes language specifying that only the nonpledged portion of the sales tax may be lowered or abolished and only if it is replaced with a "like or comparable security." To do so, the trustee must be provided written ratings confirmation and written opinions from the secretary of justice, bond counsel, and other experts indicating that the Puerto Rico Supreme Court would conclude that the substituted assets/revenues have been validly imposed by law, have been validly transferred to COFINA, and do not constitute available resources of the commonwealth subject to the clawback provisions for GO debt in the constitution.

Bond proceeds provide deficit financing for fiscal years 2009 and 2010 until the commonwealth's fiscal restructuring plan is fully implemented and new revenues and expenditure reductions are expected to bring the budget into balance. Bond proceeds will also be used to repay outstanding extra-constitutional debt of the commonwealth, lessening the burden going forward on the general fund, and will support the commonwealth's efforts to stimulate the local economy.

Security Features

Security: The bonds are a limited obligation of the corporation, payable from pledged revenues (sales and use tax), subordinate to outstanding senior lien bonds. Pledged revenues equal the greater of the 2.75% sales tax or the guaranteed base amount (originally \$185 million, now increased to \$550 million in fiscal 2010, rising 4% each year up to a maximum of \$1.85 billion); the percentage of the sales tax pledged has been increased to 2.75% from 1% to support the additional debt service on the subordinate bonds. No appropriation is required. There is no debt service reserve.

Flow of Funds: From the start of each fiscal year, all sales tax revenues, attributable to that fiscal year — that is, collections after July 20 — flow to the trustee until revenues deposited equal the \$550 million guaranteed base amount. All revenues received by the trustee are deposited into the revenue account and withdrawn and deposited as of the last business day of each calendar month for the following purposes, in the following order:

- Trustee fees.
- Operating expenses (capped at \$200,000 in fiscal 2007, rising 2% per year).
- Debt service account until the amount equals the aggregate of principal and interest due in the next 12 months.
- Senior debt service reserve replenishment.
- Subordinate lien debt service.
- Subordinate lien debt service reserve account.
- Payments under credit and liquidity facilities and qualified hedges.
- The balance is used at the direction of the corporation for limited corporate purposes, including accelerating debt retirement or repaying outstanding extra-constitutional debt.

Additional Bonds Test: Debt service in any year is capped at the level of the guaranteed base amount in that year. In addition, the corporation must show that the total amount of commonwealth sales tax assumed to be received in each fiscal year, inflated by 4% growth, provides at least 3.0x debt service in that year to issue additional senior lien bonds and 2.0x debt service in that year to issue additional subordinate lien bonds.

Enhanced Non-Impairment Clause: The revised resolution includes language specifying that only the nonpledged portion of the sales tax may be lowered or abolished and only if it is replaced with a like or comparable security. To do so, the trustee must be provided written ratings confirmation and written opinions from the secretary of justice, bond counsel, and other experts concluding that the Puerto Rico Supreme Court would conclude that the substituted assets/revenues have been validly imposed by law, have been validly transferred to COFINA, and do not constitute available resources of the commonwealth subject to the clawback provisions of the constitution.

Commonwealth Sales Tax

The Puerto Rico sales tax was established with the goal of broadening the general fund tax base and reducing tax evasion. The commonwealth passed extensive tax and fiscal reform in 2006 following extended fiscal deterioration that resulted in a fiscal crisis, culminating in a government shutdown. The most significant tax change repealed the commonwealth's 5% general excise tax that had been imposed since 1975 on imported goods and goods manufactured in Puerto Rico. This tax was replaced by a new general sales and use tax of 5.5% to be imposed by the central government, with an additional 1.5% for municipalities. The expectation is that the general fund will receive 4.5% of the 5.5% commonwealth tax, with the remaining 1% the property of the corporation, although flow to the general fund would be lower if revenues from the 1% were not sufficient in any year to meet the base (minimum) amount.

The sales tax base is broad, covering tangible personal property, taxable services, admission fees, and bundled transactions. Phone service, cable television, and internet access are subject to the tax, as are alcoholic beverages and tobacco. Nonprepared food, oil, and motor vehicles are some of the items not included in base.

Sales Tax Performance and Coverage

The sales tax has performed relatively well, given the ongoing weakness in the Puerto Rico economy. Each 1% of the tax collected produced approximately \$208 million in fiscal 2008, declining somewhat to approximately \$200 million year to date in 2009. At passage, each 1% was expected to generate \$191 million annually. Base sales tax revenues declined 1.6% year over year through March 2009; total receipts declined 3.3% over that period, largely due to a sales tax holiday implemented earlier in the year. The commonwealth is focusing attention on enforcement efforts to increase sales collections, as it is only estimated to be capturing approximately 52% of the taxes levied. Actions being implemented include increased voluntary compliance, better systems to detect noncompliance, increased tax collections agents, and incentives to purchasers to prove tax payments.

Total fiscal 2008 collections of \$1.143 billion provided 6.16x coverage of the original base amount and 2.08x coverage of the original plus additional base amounts. To maintain sum-sufficient (1.0x) coverage of senior and subordinate lien debt throughout the life of the bonds, the sales tax would have to grow approximately 1.6% annually.

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