Puerto Rico enjoys bond rally while it shuffles the deck chairs
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Increased liquidity at the **Government Development Bank** (GDB) has kindled a rally in **Puerto Rico Sales Tax Financing Corporation** (COFINA) bonds, said two bondholders and a trader. But the rally is not yet large enough to issue a new third lien COFINA bond at a 7% targeted interest rate, said the two bondholders and the trader.

“To get it to 7% they’ve got a hell of a long ways to go,” the first bondholder said.

What’s odd is that the GDB has not discovered a new revenue stream or uncovered overlooked assets. Rather it has the option to move about USD 2.8bn in government and municipal deposits into its own coffers and out of the commercial banks where it is currently held, according to a 15 October investor call. The bank can then make loans to government entities using the additional capital.

“I’m not seeing anything fundamentally that’s making it look better,” an analyst said.

Pulling deposits out of the commercial banks doesn’t bode well for those enterprises, said the second bondholder and the analyst. If deposits are transferred, the impact on the commercial banks will not be material, because the transfer will be done in a measured manner and in small numbers as opposed to a lump sum, said a source close to the GDB.

Furthermore, the **Commonwealth of Puerto Rico** doesn’t plan to use any legal instrument to force the transfer of these deposits, but rather it will be in exchange for a rate that both parties find attractive, added the source.

While not a long-term strategy, it does give the commonwealth some breathing room so that the commonwealth doesn’t have to issue this year, or for the remainder of its FY14 ending 30 June 2014, said the analyst and the second bondholder.

The commonwealth has many financing options available and will use the most attractive one, which will not necessarily be the transfer of the deposits, said the source close to the GDB. This is not a strategy to avoid the issuance of COFINA bonds but rather one of the options that the GDB will consider for the selection of the most cost-effective means of raising funds, added the source.

An improving market

Rates on many Puerto Rico issuances have fallen since 11 October, said Chris Mier chief strategist at Loop Capital. The subordinate and senior COFINA bonds have also firmed up, said the first bondholder. COFINA, which obligates USD 6.6bn in senior debt and USD 9.4bn in subordinated debt, is the preferred vehicle for any new issuance, as previously reported.

Despite improving market sentiment, the rally has not tightened spreads enough for a new USD 500m-USD 1.2bn bond that would come under the existing 16bn in COFINA debt.

A USD 74.8m tranche of Series 2011C senior sales tax bonds which mature in 2022 last traded in round lots 30 October at 98.9 yielding 5.15%, according to Electronic Municipal Market Access. The bonds traded in round lots about one week prior, 21 October, between 97.8 and 97.9 yielding 5.3%.

A USD 425.3m tranche of Series 2010A first subordinate sales tax bonds which mature in 2039 last traded in round lots 30 October at 79.8 yielding 7.1%, according to Electronic Municipal Market Access. The bonds traded in round lots 11 October between 65.5 and 66.5 yielding 8.6% to 8.8%.

"While this may indicate the presence of a single large purchaser, it is equally possible that a number of proprietary trading desks have similarly viewed the Puerto Rico debt market as oversold and have bought bonds through their proprietary trading desks to profit from the rebound in prices," Mier said.

A trade not an investment

There will be severe headwinds for a COFINA issue, said the analyst. The structure will be challenged if the commonwealth is forced into a restructuring, as some traders may question the strength and structure of the bonds, the analyst added. General obligation bonds in Puerto Rico have a constitutional first lien on taxes collected on the island. COFINA bonds have a first lien on sales taxes that is subordinate to the GO claim but open to questions, as previously reported.

The other reason it is difficult to increase rates is the glut of supply, the analyst said. When Puerto Rico goes to market it aims to issue USD 500m-USD 1.2bn, as previously reported. Even if the commonwealth does not need to go to market, it will issue as much as the market will bear if the conditions are favorable, the analyst said.

"Puerto Rico is a trade, not an investment," the analyst said. Only high-yield, taxable and people who know they can quickly offload the bonds are interested in playing in the market.

"While banks will frequently lend balance sheet support to clients with whom they have a variety of important customer relationships, the extent to which the buying [of Puerto Rico bonds] has been motivated purely by client considerations cannot be easily separated from the desire to profit from a trading opportunity," said Mier.

If the commonwealth is to keep finances flowing it will need to continue to meet projections, the analyst said. Those projections include tax revenues and fund balances.

The senior bonds were last rated AA- by Fitch Ratings in November 2011, AA- by Standard & Poor's in November 2011 and A2 by Moody's Investor Services on 3 October. The subordinate bonds were last rated A+ by Fitch in November 2011, A+ by S&P in January 2010 and A3 by Moody's on 3 October. There is USD 6.7m senior COFINA debt outstanding and USD 9.4m subordinate COFINA debt outstanding, according to calculations by *Debtwire Municipals* based on the FY12 financials.

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