

From: "Morris, Paul V" <[REDACTED]>
To: "jeffrey E." <jeevacation@gmail.com>
Subject: FW: (BUS) Fitch Downgrades United States Virgin Islands' IDR, GRT &
Date: Mon, 22 Aug 2016 22:12:42 +0000

FYI

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From: Ellis, Robert T <[REDACTED]>
Date: Monday, Aug 22, 2016, 5:44 PM
To: Morris, Paul V <[REDACTED]>
Subject: FW: (BUS) Fitch Downgrades United States Virgin Islands' IDR, GRT &

Hi Paul,

Just got this notification on Bloomberg, wanted to make sure you saw.

Rob

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-----Original Message-----

From: Ellis, Robert T. (Bloomberg Mail)
Sent: Monday, August 22, 2016 5:42 PM
Subject: (BUS) Fitch Downgrades United States Virgin Islands' IDR, GRT &

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Matching Fund Bonds; Removes Rating Watch

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Fitch Downgrades United States Virgin Islands' IDR, GRT & Matching Fund Bonds; Removes Rating Watch
2016-08-22 20:28:00.207 GMT

Fitch Downgrades United States Virgin Islands' IDR, GRT & Matching Fund Bonds; Removes Rating Watch

Business Wire

NEW YORK -- August 22, 2016

Fitch Ratings has assigned 'BB' ratings to the following issues of the United States Virgin Islands (USVI) Public Finance Authority (VIPFA):

--\$217.135 million VIPFA revenue bonds (Virgin Islands gross receipts taxes loan note) series 2016A (senior lien - capital projects and working capital);

--\$126.09 million VIPFA revenue bonds (Virgin Islands matching fund loan note) series 2016A (senior lien - capital projects and working capital);

--\$69.28 million VIPFA revenue bonds (Virgin Islands matching fund loan note) series 2016B (subordinate lien - capital projects and working capital).

The bonds are expected to price via negotiation on or about Sept. 30, 2016.

In addition, Fitch has downgraded the Issuer Default Rating (IDR) of the Government of the Virgin Islands to 'B+' from 'BB-' and downgraded the ratings of USVI dedicated tax bonds issued by the VIPFA as follows:

--\$722.3 million gross receipts tax (GRT) revenue bonds, downgraded to 'BB' from 'BBB';

--\$773.4 million senior lien matching fund revenue bonds, downgraded to 'BB' from 'BBB';

--\$155.1 million subordinate lien matching fund revenue bonds, downgraded to 'BB' from 'BBB-';

--\$237.1 million subordinate lien matching fund revenue bonds (Diageo project) series 2009A, downgraded to 'BB' from 'BBB-';

--\$35.6 million subordinate lien matching fund revenue bonds (Cruzan project) series 2009A, downgraded to 'BB' from 'BBB-'.

Fitch has removed the ratings on the GRT bonds and the matching fund revenue bonds from Rating Watch Negative. The bond ratings are now two notches above the USVI's IDR, reflecting Fitch's assessment that the bonds are exposed to operating risks of the territory but benefit from enhanced recovery prospects assuming passage of legislation by the USVI legislature to provide a statutory lien on the respective revenue streams for bondholders. Fitch believes a statutory lien would enhance the recovery prospects for bondholders should the federal government adopt legislation in the future allowing for a restructuring of USVI-backed debt. Failure of the USVI to pass the proposed legislation to create a statutory lien would result in downgrade of the bond ratings to the level of the 'B+' IDR.

The GRT and matching fund bonds had previously been rated based on the assumption that the territory had no avenue to restructure its debts. This allowed for a rating significantly above the USVI IDR based on the criteria used to rate dedicated tax bonds of U.S. states, which cannot declare bankruptcy. The passage of the Puerto Rico Oversight, Management, and Economic

Stability Act (PROMESA) does not currently apply to the Virgin Islands. However, it led Fitch to conclude that this assumption can no longer be the basis for a rating above the USVI's general credit and triggered the placement of the USVI's dedicated tax bond ratings on negative watch.

The adoption of PROMESA demonstrated the capacity of the federal government to adopt legislation controlling territorial bankruptcy in much the same manner that a state might do to control the ability of municipalities to seek bankruptcy protection. As a result, going forward Fitch will treat the USVI as analogous to a local government in applying dedicated tax bond criteria and believes that GRT and matching fund bondholders are exposed to the operating risk of the USVI, capping the ratings at the level of the IDR plus whatever notching up for enhanced recovery prospects is warranted under Fitch's criteria.

The Rating Outlook on all of the ratings is Negative.

SECURITY

The GRT revenue bonds issued by the VIPFA are secured by a pledge of GRT collections deposited to the trustee in a separate escrow account for bondholders prior to their use for general purposes. The bonds also carry a general obligation pledge of the USVI.

The matching fund revenue bonds are special, limited obligations of VIPFA payable from and secured by a pledge of and lien on the trust estate of each respective indenture, primarily matching fund revenues associated with rum production at the Cruzan and Diageo facilities located on the USVI.

Legislation under consideration by the USVI Senate in conjunction with the current bond sale is expected to provide all current and future GRT and matching fund bondholders with a statutory lien on the respective, dedicated revenue streams. The USVI is not eligible to file for bankruptcy under current federal law.

KEY RATING DRIVERS

The downgrade of the USVI's IDR to 'B+' from 'BB-' reflects the significant financial and economic pressures confronting the USVI that are compounded by an extremely high liability burden. A severely unbalanced operating budget has led to multiple years of borrowing to fund ongoing operations, including portions of proceeds from the current bond issues. Budget imbalance is expected to continue over the medium term despite the government's plans to seek revenue enhancements and implement austerity measures. The debt burden of the USVI has escalated as a result of extensive borrowing for operations, as well as the exponential growth in the unfunded liability (UAAL) of the USVI pension system due to inadequate annual contributions. The funded ratio for the Government Employees Retirement System (GERS) was 19.6% as of the pension system's October 2015 valuation report.

The downgrade of the USVI's gross receipts tax and matching fund bond ratings to 'BB' incorporates both the downgrade in the USVI's IDR and the transition of Fitch's analysis of the territory's dedicated tax bonds to criteria applicable to local rather than state governments following the passage of PROMESA. As discussed above, PROMESA fundamentally altered the premises under which Fitch rated the bonds, which had previously been rated distinct from and above the territory's IDR under the criteria applicable to U.S. states. There is no longer a rating distinction between the senior and subordinate lien matching fund bonds because the rating on all of the debt is capped at the USVI's IDR plus the recovery enhancement provided by the statutory lien to be granted to bondholders. The proposed statutory lien legislation meets the

conditions laid out in Fitch's criteria to provide rating enhancement, with the two-notch uplift, the most allowable under the criteria, reflecting the low level of the USVI IDR and the adequacy of pledged revenue coverage.

The Negative Outlook on the bonds reflects Fitch's assessment that the USVI will be challenged in stabilizing its financial operations and its debt and pension positions in the near term.

Economic Resource Base

The USVI is a small and remote unincorporated territory of the U.S. located in the Caribbean, about 1,075 miles from Miami. The USVI is comprised of three separate main islands; St. Croix, St. Thomas, and St. John and is about twice the size of the District of Columbia. The economy of the USVI is limited, with a reliance on economically-sensitive tourism, particularly from the U.S., and some industrial development that includes rum production. Fitch anticipates flat economic performance going forward. The USVI recently benefited from the purchase of a large, vacant former refinery on St. Croix, that has been converted to an oil storage facility and is expected to modestly benefit the labor market.

Revenue Framework: 'a' factor assessment

Revenue growth is expected to be modest assuming steady tourism and slow growth in rum production, which is an important contributor to operating revenues. The USVI has extensive control over its operating revenues and the provision of grants and other operating aid from the U.S. government provides additional sources of revenue.

Expenditure Framework: 'bb' factor assessment

Natural spending growth is expected to be well above revenue growth and Fitch views the USVI's expenditure flexibility as constrained. The carrying cost for debt and pensions approximates a very high 41%, reflecting the USVI's sizable burden of debt and pension liabilities that have pushed the actuarially required contribution (ARC) to a very high level.

Long-Term Liability Burden: '< bb' factor assessment

The USVI's combined long-term debt and pension liability is very large relative to resources, at about 204% of personal income, reflecting both outstanding debt obligations issued for capital and operating purposes and the pension UAAL.

Operating Performance: '< bb' factor assessment

Financial operations have been strained and structurally imbalanced for many years, maintained largely by cash flow borrowing and by long-term debt issuance in support of operations. Budget imbalance is expected to persist over the next several years, despite plans to increase revenues and exercise expenditure restraint. While the USVI retains some ability to respond to fiscal stress, its operations are poorly positioned to absorb routine economic cyclicity or other shocks without further impairing its long-term liability position.

RATING SENSITIVITIES

IDR: The USVI's IDR is sensitive to further erosion in its financial position, the success of economic development efforts, continued growth in outstanding debt obligations, and action to improve the sustainability of its pension system.

GRT and Matching Fund Bonds: The ratings on the GRT and matching fund bonds are sensitive to movement in the USVI's IDR, to which they are linked. The ratings are also sensitive to trends in pledged revenue and future leveraging if such events result in material weakening in coverage. The 'BB' ratings assume that the USVI legislature passes the proposed legislation to create a statutory lien in the near term; failure to do so would result in downgrade of the dedicated tax bond ratings to the 'B+' IDR.

CREDIT PROFILE

The economy of the USVI is limited, with a reliance on cyclical and highly competitive tourism via cruise ship visits and resort stays, with some diversification provided by industrial development and rum production on St. Croix. Economic data reflects the economy's limitations with five years of consecutive employment declines through 2015 and an unemployment rate estimated at 11.9% by the USVI as compared to a 5.3% rate for the U.S. Until its closure in 2012, the USVI's largest employer was the HOVENSA refinery on St. Croix. Indicating low wealth levels, personal income per capita on the USVI is estimated at 46.4% of the national level and approximately 32% of individuals live in poverty in the USVI compared to 15.6% for the U.S. as a whole. Recent population trends have been negative.

Revenue Framework

U.S. personal income tax (PIT), collected as the USVI PIT, provides the largest support of operations, at 58% of operating tax revenues, followed by GRT revenue after payment of related debt service obligations, at 17.6% of operating tax revenue. Financial operations are also supported by corporate income taxes, real property taxes, and a variety of fees and smaller tax revenue sources. Matching fund revenue beyond what is needed for annual debt service obligations also flows to the general fund but this has been a declining resource in recent fiscal years.

The USVI's revenue trends over the past several fiscal years have been variable, with fairly consistent growth in PIT revenue, aside from the years following the closure of HOVENSA, and slow growth in GRT revenue. These trends were offset by declines in real property tax revenue as the USVI sought to bring its tax rolls up to date, as well as declines in matching fund revenue due to increasing debt service requirements, fluctuations in federal advances, and reduced rum production. Currently stable tourism trends and recently improved rum shipments are expected to provide stable sources of revenue for the USVI over the next one to two fiscal years.

The USVI has few legal limitations in federal law on its ability to raise revenues through base broadenings, rate increases, or new taxes or fees. Currently, the PIT in the USVI matches the federal structure; the USVI is authorized to levy additional income taxes but currently does not. Federal actions can affect revenues, including the U.S. Congress' periodic reauthorizations for an increased 'cover over' rate on matching fund revenue, from the \$10.50 base to the \$13.25 rate. Delays in reauthorization or shifting federal practices for calculated advances have periodically affected USVI receipts after payment of matching fund bonds.

Expenditure Framework

USVI has a broad scope of spending given that most public services are delivered directly by the territory itself, rather than lower levels of government. Similar to U.S. states, a large share of direct spending is for education and health and human services. While the USVI has sought to rein in expenditures, through head-count reductions and other expense initiatives, it

has been unable to eliminate a large structural budget gap.

Prospective revenue growth absent policy changes is expected to be insufficient to fund ongoing spending needs, requiring continual reliance on lines of credit or bond proceeds.

Fitch believes the USVI's ability to adjust budgeted expenditures to meet changing fiscal circumstances is constrained. Although expenditure control initiatives have frequently been pursued in the context of annual budgets or in response to underperformance, USVI actions have often shifted spending needs into future periods. Actual pension contributions are consistently budgeted far below actuarially-required levels (\$72 million vs. \$200 million in fiscal 2015), raising the pension system's liability and elevating future required contributions. With continued reliance on debt to cover operations, debt service consumes a greater share of key revenue sources than would be the case if debt were solely pursued for capital purposes. For fiscal 2015, carrying costs for debt, actual other post-employment benefit spending, and the pension ARC totaled \$636 million, equivalent to 41% of USVI governmental fund appropriations in that fiscal year.

Long-Term Liability Burden

The USVI's burden of debt and pensions is extremely high relative to resources. Fitch estimates net tax-supported debt and unadjusted, unfunded pension obligations attributable to the USVI at 204% of 2014 personal income. Net tax-supported debt as of Aug. 1, 2016, at about \$2 billion, equated to 90% of 2014 personal income, while unfunded pension liabilities of \$2.58 billion equaled about 114% of personal income. Under the GASB 67 standard for pension systems, GERS maintains assets sufficient to cover only 19.6% of projected liabilities as of Sept. 30, 2015 and reports a depletion date in fiscal 2023.

Fitch views the depletion of GERS' pension assets as becoming an increasingly likely scenario over the intermediate term. All else being equal, asset depletion would expose the USVI's budget to the additional burden of covering current retiree benefits from operating resources. Based on fiscal 2015 GERS figures, Fitch estimates this additional burden (net of current contributions) at \$145 million, a figure likely to rise over time.

Operating Performance

The USVI's financial resilience is very limited. It carries an unrestricted fund balance deficit of \$74 million that equated to 10.8% of revenues in fiscal 2015, leveraging of significant revenue streams reduces resources available for operations, and the high fixed costs for debt service and pensions noted earlier reduce its ability to respond to cyclical weakness. At present, the USVI does not carry a budget reserve.

The USVI has been unable to materially strengthen its fiscal position during the current economic expansion given ongoing fiscal uncertainty, economic and revenue setbacks such as the sudden closure of HOVENSA, and the limitations posed by its stressed fiscal operations. While Fitch believes the current administration is committed to improving fiscal sustainability, challenges abound and budgetary balance remains many years away despite plans to enhance revenues and implement austerity.

Current Developments

Fiscal 2016 benefitted from a \$220 million windfall from the sale of the dormant HOVENSA refinery. Positively, the USVI applied a portion to paying delayed tax refunds, lines of credit, revenue anticipation notes, and balances owed to the Water and Power Authority (WAPA; senior lien bonds rated 'BB-' on

Rating Watch Negative). However, a portion of the payment was applied to restoring agency cuts.

For fiscal 2017, which begins on Oct. 1, the proposed budget factors in a structural deficit estimated at \$168 million that is expected to be addressed through use of proceeds from the current GRT bond issue and funds from lines of credit.

DEDICATED TAX BONDS

Gross Receipts Tax Bonds

Senior lien debt service coverage from fiscal 2015 collections that are certified by an independent auditor was 3.9x; when including unrated, junior lien obligations, combined debt service coverage was 3.5x that year. Coverage of MADS, which includes debt service on the current bond issue, on all GRT-secured debt is 2x by fiscal 2015 revenues, down from 2.5x by fiscal 2014 revenues as the additional debt service on this issue is incorporated. The average annual growth rate in GRT collections since fiscal 2012, when the USVI increased the rate to 5%, has been an essentially flat 0.4%, reflecting marginal growth in the USVI's economy. Through the first three quarters of fiscal 2016, GRT revenue is down 1.4% year-over-year compared to the same time period in fiscal 2015.

GRT revenue collections are deposited daily to a special escrow account. With the exception of a small required payment for housing, all revenues are allocated to the trustee for the benefit of bondholders, only after which are remaining receipts available for general purposes. Security features include an additional bonds test requiring 1.5x MADS coverage by historical and prospective revenues, a debt service reserve funded at MADS, and covenants precluding tax rate reductions or the granting of excessive tax incentives. Additionally, should a 1.5x MADS coverage level be reached in any 12-month period, the USVI has covenanted to seek out additional revenue to pledge to the bonds. With the GRT rate increase to 5% in March 2012, the USVI amended the bond resolution to permit the GRT rate to fall back to 4.5% should corporate income tax receipts reach \$185 million in any fiscal year; CIT receipts were \$76.6 million in fiscal 2015.

The Fitch Analytical Sensitivity Tool (FAST) output indicates a possible 7% drop in revenue in a moderate U.S. recession scenario (1% U.S. GDP decline). The largest consecutive decline in GRT revenues since 2006 was a two-year 18.4% drop during the recession.

Matching Fund Bonds

Matching funds are an established revenue stream based on federal law derived from substantially all excise taxes imposed and collected on certain products produced and exported to the U.S., primarily rum. Pledged revenues are based on proof (alcohol content) gallons, with a higher proof per gallon subject to a higher tax. The federal excise tax rate has provided revenue to the USVI since 1954 at a \$10.50 base 'cover-over' rate that has been periodically increased to a higher \$13.25 rate. The higher \$13.25 rate was last approved by Congress in December 2015 and extends through calendar 2016. Payment on the VIPFA bonds, particularly the subordinate indentures linked to specific facilities, is ultimately dependent on ongoing rum production at the facilities and sales in the U.S. Production of rum in the territory itself is tied to continuation of the federal matching fund program and the availability of incentives and subsidies to producers from the USVI.

Matching fund bonds have been issued under a senior indenture (1998 indenture) and two subordinate, parallel project indentures associated with the USVI's

two distilleries (Cruzan indenture and Diageo indenture). The project indentures, each established in 2009, funded facility improvements at the longstanding Cruzan distillery and financed the construction of the new Diageo distillery. The two project indentures are part of broader 30-year incentive agreements reached between the USVI and local affiliates of Suntory Holdings Ltd. (not rated by Fitch), owner of the Cruzan facility, and Diageo plc (rated 'A-', Stable Outlook), owner of the Diageo facility. A debt service reserve funded at MADS provides additional protection.

An annual, advanced payment is made to the USVI, calculated from projected sales of USVI-produced rum in the U.S. in the following fiscal year (Oct. 1 fiscal year start), adjusted by an amount reflecting the difference between estimated and actual sales two fiscal years prior. The U.S. Treasury transfers all matching fund revenue directly to a special escrow agent, who deposits the funds for payment of annual debt service requirements. The bonds include a covenant that if matching fund revenues are replaced with another federal funding stream, the USVI will use its best efforts to use the substitute revenues for bond repayment. Actual and forecast sales of USVI-produced rum are determined by market forces as well as the production capabilities of the two facilities. The advance payment made to the USVI for fiscal 2016 totaled \$213.3 million and was based on the higher \$13.25 rate. The USVI has requested a payment of \$202.7 million for fiscal 2017.

Actual matching fund revenue received in fiscal 2015 totaled \$187 million, above the \$177.9 million federal advance for that year that was initially based on the lower \$10.50 rate. Revenue received in fiscal 2015 covered 1998 indenture senior and subordinate debt service by 2.3x, down sharply from 4x coverage in fiscal 2014 due to a decline in rum shipments from competitive pressures and the full-year effect of Cruzan's loss of two large bulk rum customers. Coverage of all debt service including both Cruzan and Diageo-related debt service was 1.76x. Including debt service for the current bond issue, fiscal 2015 pledged revenue provides MADS coverage of 1.9x on 1998 indenture debt and 1.6x coverage on all new outstanding debt.

Shipments and matching fund revenue through the first three-quarters of fiscal 2016 have improved year-over-year from fiscal 2015. Shipments are up 9.7% and actual matching fund revenue is up 2.5%. Based on current trends, Fitch expects the USVI to achieve its matching fund revenue target for this fiscal year. However, MADS coverage on the bonds could become stressed under a moderate recession scenario or a drop in revenue equivalent to the largest prior decrease. The FAST output indicates a possible 6% drop in revenue in the moderate U.S. recession scenario. The largest consecutive decline in matching fund revenues since 1999 was a two-year 33% drop that occurred in fiscal years 2014 and 2015 when the USVI received a partial year of payments at the lower \$10.50 matching rate concurrent with the loss of two large bulk rum customers to Puerto Rico.

Issuing Entity Exposure

Fitch believes that GRT and matching fund bondholders are exposed to operating risks of the USVI as expressed in its IDR. As such, the bond ratings are limited to the IDR enhanced by the benefit of a statutory lien.

Additional information is available at www.fitchratings.com.

In addition to the sources of information identified in Fitch's applicable criteria specified below, this action was informed by information from Lumesis and InvestorTools.

Applicable Criteria

U.S. Tax-Supported Rating Criteria (pub. 18 Apr 2016)

<https://www.fitchratings.com/site/re/879478>

Additional Disclosures

Dodd-Frank Rating Information Disclosure Form

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