

# The Virgin Islands Consortium

## In Troubling Sign, Fitch Downgrades USVI Bonds Further Into Junk Status

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When Fitch, one of three respected ratings agencies in the U.S., announced in July that it was maintaining its negative watch guidance on the territory's bonds, Governor Kenneth Mapp deemed the guidance as a good sign, noting that Fitch did not downgrade the bonds, and that the firm noted actions the government had taken to address the territory's financial crisis.

But on Tuesday Fitch replaced its recent negative watch with a negative outlook, and downgraded the territory's bonds further into junk status, dealing another crushing blow to a government already under immense financial pressure. According to Fitch, the negative outlook reflects its assessment that the USVI will remain challenged in

stabilizing its financial operations and its debt and pension positions.

The government's "USVI" and "Public Finance Authority" bonds were downgraded to the following:

--Issuer Default Rating (IDR) of the USVI, to 'CCC' from 'B'; --\$697.8 million gross receipts tax (GRT) revenue bonds, to 'B' from 'BB-'; --\$741.4 million senior lien matching fund revenue bonds, to 'B' from 'BB-'; --\$147 million subordinate lien matching fund revenue bonds, to 'B' from 'BB-'; --\$232.2 million subordinate lien matching fund revenue bonds (Diageo project) series 2009A, to 'B' from 'BB-'; --\$34.9 million subordinate lien matching fund revenue bonds (Cruzan project) series 2009A, to 'B' from 'BB-'.

Fitch says the downgrade of the USVI's IDR to 'CCC' from 'B' incorporates the significant financial pressures confronting the USVI that are compounded by an extremely high liability burden. The inability to access capital markets for debt issuance has added further stress, with a strained liquidity position giving rise to a sizable escalation in accounts payable.

According to the ratings firm, while the government has attempted to address this situation through proactive cash management, revenue enhancements and some expenditure reductions, Fitch believes that prospects for stabilization in the USVI's financial position are limited. Budget imbalance will continue until such time as expenditures, including those related to retiree benefit obligations, are aligned with realistic expectations of future revenue performance, or economic growth well beyond current expectations bolsters revenue sources, according to Fitch.

The outstanding payables are expected to weigh on the USVI, as will a debt burden that has risen considerably following multiple years of borrowing to fund ongoing operations and the exponential growth in the net pension liability (NPL) of the pension system due to significantly inadequate annual contributions.

Fitch says downgrade of the USVI's gross receipts tax and matching fund bond ratings to 'B' from 'BB-' incorporates the downgrade in the USVI's IDR and continues to reflect Fitch's analysis of the territory's dedicated tax bonds following the passage of the Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA). While PROMESA does not currently apply to the USVI, Fitch believes that its passage created an avenue for the federal government to adopt future legislation allowing for a restructuring of USVI-backed debt even though the USVI is not eligible to file for bankruptcy under current federal law. As a result, Fitch treats the USVI as analogous to a local government in applying dedicated tax bond criteria.

### **Operating Performance, according to Fitch**

The USVI's financial resilience is very limited. It is hampered by an unrestricted fund balance deficit of \$89.9 million that equated to 10% of revenues in fiscal 2016, prior leveraging of significant revenue streams that reduces resources available for operations, and the high fixed costs for debt service and retiree benefits noted earlier that reduce its ability to respond to cyclical weakness. The fiscal 2016 audit reported a \$3.7 billion total governmental funds deficit position that captures the long-term pension liability and sizable bonded debt outstanding. At present, the USVI does not carry a budget reserve.

Of note, the auditor declined to offer an opinion on the financial statements for several major funds in fiscal 2016. The disclaimers highlighted substantial faulty, missing, or inaccurate records that were unable to provide support to the USVI's financial information.

The USVI has been unable to materially strengthen its fiscal position during the current economic expansion given its considerably imbalanced financial operations and slow economic growth that was significantly impeded by the sudden closure of HOVENSA in 2012. While the purchase of HOVENSA and current capital project at the facility should add to economic and revenue prospects for the USVI, the improvement is only modest in the context of necessary and sustained economic growth that would move the USVI forward. While Fitch believes the current administration is committed to improving fiscal sustainability, implementing significant, ongoing budget austerity and applying more conservative revenue forecasts remains a challenge for the USVI, leading to Fitch's conclusion that true budgetary balance remains many years away.

### **Current Developments, according to Fitch**

Fiscal 2017 financial operations have been considerably stressed due to the inability to fully address a budget imbalance estimated at about \$100 million (15% of fiscal 2017 expenditures). The USVI's liquidity position has tightened from this lack of adequate funds and accounts payable have increased by an almost commensurate amount as the USVI has been unable to make payments to its retirement system, for employee health care expense and for PIT and CIT refunds. The USVI currently expects to record an increase in accounts payable liability of about \$62 million at the close of fiscal 2017. Management has also held back on agency allotments, left vacancies unfilled, and implemented revenue enhancements that will largely benefit fiscal 2018. The USVI has continued to seek a short- or long-term debt issuance to address some of the accounts payable backlog but does not expect to complete a transaction prior to the end of fiscal 2017 on September 30. The USVI currently estimates a fiscal 2017 operating deficit of approximately \$8.4 million.

The USVI governor has proposed a budget for the fiscal year that begins on October 1 that relies on the assumption of strong 7.6% growth in revenues after netting gross receipt taxes that are set aside for debt service, based on actual cash receipts in fiscal 2017 through June. Preliminary highlights of the budget, which corresponds with the USVI's five-year plan, include increased collection efforts as well as the fuller implementation of the revenue initiatives enacted by the legislature earlier this year. Expenditures are also envisioned to grow considerably as they incorporate additional hires for collection efforts and on-time payments for charges that were delayed in fiscal 2017 as well as an escalation in debt service expense related to repayment of a \$20 million short-term note secured by the GRT. The governor has also proposed a considerable holdback on the payout of tax refunds, a continuation of the strategy applied in fiscal 2017 to bolster cash position but one that causes the liability to carry over into future years.