FitchRatings

Fitch Downgrades U.S. Virgin Islands' IDR, GRT & Matching Fund Bonds; Removes Rating Watch

Fitch Ratings-New York-15 August 2017: Fitch Ratings has downgraded the following ratings of the United States Virgin Islands (USVI) and the USVI Public Finance Authority (VIPFA):

--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 has removed the ratings from Rating Watch Negative. The Outlook on all of the ratings is Negative.

SECURITY
The GRT revenue bonds issued by 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.

All current and future GRT and matching fund bondholders have been provided with a statutory lien on the respective, dedicated revenue streams, following passage of legislation granting this lien in 2016. The rating on the bonds is two notches above the USVI's IDR, reflecting Fitch's assessment that even though the bonds are exposed to operating risks of the territory, bondholders benefit from enhanced recovery prospects due to the statutory lien on the respective revenue streams for bondholders.

ANALYTICAL CONCLUSION

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. 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. 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.

The 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.

The Negative Outlook reflects Fitch's assessment that the USVI will remain challenged in stabilizing its financial operations and its debt and pension positions.

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 consists 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 relatively flat economic performance going forward. The USVI has benefited from the conversion of a large, vacant former refinery on St. Croix to an oil storage facility and a current expansion project at the refinery is expected to modestly benefit the labor market and the USVI's revenue sources.

KEY RATING DRIVERS

Revenue Framework: 'a'
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 legal 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'
Natural spending growth is expected to be well above revenue growth and Fitch views the USVI's expenditure flexibility as constrained. The Fitch-calculated carrying cost for debt and retiree benefits approximates a very high 33% of expenditures, reflecting the USVI's sizable burden of debt and pension liabilities that have pushed the actuarially determined contribution (ADC) to a very high level.

Long-Term Liability Burden: '< bb'
The USVI's combined long-term debt and pension liability is very large relative to resources, at an estimated 223% of personal income, reflecting outstanding debt obligations issued for both capital and operating purposes and the government's unfunded pension liability.

Operating Performance: '< bb'
Fitch believes the government has a long path to right-size its budget given the extent of the structural challenges. 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 recently enacted tax and fee increases. Given the challenges the USVI is currently confronting even with economic growth, operations are poorly positioned to absorb even a modest economic downturn.

RATING SENSITIVITIES
IDR: The USVI's IDR is sensitive to developments related to its financial position. Successful budget re-alignment, action to improve the sustainability of its pension system, and/or economic development efforts that materially boost prospects for the USVI's ongoing financial sustainability could bolster the rating, while deterioration in the government's ability or willingness to continue efforts in support of credit improvement could result in a downgrade.

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, although the current ratings are well below the level that the revenue streams alone would support.

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. Consecutive years of employment declines through 2014 incorporated the closure in 2012 of the HOVENSA refinery, the USVI's largest employer at the time. More recently, the USVI reports a modestly improving employment trend in 2015 and 2016 although the unemployment rate remains high at a USVI-estimated 11% as compared to a 4.9% rate for the U.S. Indicating low wealth levels, personal income per capita on the USVI is estimated at 47% of the national level and approximately 32% of individuals live in poverty in the USVI compared to 16% for the U.S. as a whole. Recent population trends have been negative.

Revenue Framework

The U.S. federal personal income tax (PIT), collected as the USVI PIT, provides the largest support of operations, at 59% of operating tax revenues, followed by GRT revenue after payment of related debt service obligations, at 15% 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 government recently enacted several new revenue measures to stabilize operations, including increases to existing excise taxes on tobacco products, alcoholic beverages, and sugar carbonated beverages, in addition to the establishment of a new fee on timeshare units. Many of the USVI's five-year plan initiatives have effective dates of either October 1, 2017 or January 1, 2018 and so will provide greater benefit in fiscal 2018, although modest collections of some new fees and taxes have commenced.

The USVI's revenue trends over the past several fiscal years have been variable, with fairly consistent growth in personal income tax (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 could be positive inputs for USVI revenue over the next one to two fiscal years; however, several primary revenue sources such as the PIT and corporate income tax (CIT) are trending below expectations in fiscal 2017 and Fitch believes these revenue sources will remain fairly flat over the medium term absent more robust economic growth. The USVI's preliminary forecast for revenue growth in fiscal 2018 is contrary to this expectation, with robust 7.6% preliminary growth forecast that includes the expected positive impact of revenue measures that have not been successful in prior fiscal years, such as increased attention to delinquency collections, in addition to a strong forecast for new revenue initiatives.

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. The higher $13.25 rate expired on Dec. 31, 2016 and Congress has yet to enact an extension. The federal matching fund advance received in September 2016 was based on the higher matching fund rate but prior delays in reauthorization or shifting federal practices for calculated advances have periodically affected the USVI's financial operations.

Expenditure Framework
The USVI has a broad scope of spending given that most public services are delivered directly by the territory itself, rather than by 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 periodic expense initiatives, a large structural budget gap remains as the government has been unable to align its expenditures with revenues. The inability to access capital markets for working capital to support operations as planned in early 2017 has led to a ballooning accounts payable balance, as the USVI has sought to bolster its liquidity position. Prior to April PIT collections, the USVI's liquidity position only provided one to two days of cash on hand for expenditures. The USVI reports that liquidity has increased to about three to five days cash on hand with a weak position in August reflecting three payroll cycles that will require funding. The cash position is expected to improve in September with additional income tax collections, but seems likely to remain strained in the absence of a successful borrowing.

Initial plans for the fiscal 2018 budget indicate a disinclination to impose greater austerity on operations, in Fitch's view, and will likely result in limited progress on initiatives to provide structural balance to the budget. Implementing meaningful expenditure cuts is complicated by territory government employment that accounts for 29% of all employment on the USVI (39% when including federal employment) and almost 32% of total employee compensation. These figures compare to 15% total government employment for the U.S. as a whole. Prospective revenue growth absent policy changes is expected to be insufficient to fund ongoing spending needs, requiring continual reliance on one-time sources, including external borrowing, when possible, or allowing accounts payable to escalate.

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-determined contributions ($68 million vs. $186 million in fiscal 2016), 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 2016, carrying costs for debt, actual other post-employment benefit spending, and the pension ARC totaled $503 million, equivalent to a high 33% 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 223% of 2014 personal income. Net tax-supported debt as of Nov. 1, 2016, at about $2 billion, equated to 88% of 2014 personal income, while unfunded pension liabilities of almost $3.1 billion equaled about 135% of personal income. Under the GASB 67 standard for pension systems, the government employees retirement system (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 in the absence of significant reform. 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 GERS' 2015 valuation, Fitch estimates this additional burden (net of current contributions) at $118 million, for a total estimated pay-go retiree payment of $185 million (27% of fiscal 2017 General Fund expenditures), with escalation expected over time.

Operating Performance

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

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.

Contact:

Primary Analyst
Marcy Block
Senior Director
+1-212-908-0239

Fitch Ratings, Inc.
33 Whitehall Street
New York, NY 10004

Secondary Analyst
Douglas Offerman
Senior Director
+1-212-908-0889

Committee Chairperson
Laura Porter
Managing Director
+1-212-908-0575

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.

Media Relations: Elizabeth Fogerty, New York, Tel: +1 (212) 908 0526, Email: elizabeth.fogerty@fitchratings.com; Benjamin Rippey, New York, Tel: +1 646 582 4588, Email: benjamin.rippey@fitchratings.com.

Additional information is available on www.fitchratings.com

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