S&P Global Ratings

RatingsDirect®

Summary:

Guam; Miscellaneous Tax

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Guam MISCTAX		
Long Term Rating	A-/Stable	Affirmed

Rationale

S&P Global Ratings affirmed its long-term rating of 'A-' on the Government of Guam's series 2011A hotel occupancy tax (HOT) revenue bonds. The outlook is stable.

The rating reflects our view of:

- A senior pledge of gross HOT revenue from approximately 40 hotels on the island and collected by the Guam Department of Revenue and Taxation (DRT);
- Strong bond provisions, including a 1.25x rate covenant, a debt service reserve (DSR) funded at MADS, and a 1.8x historical revenue additional bonds test (ABT), although high debt service coverage (DSC) and limited additional debt capacity under the government's debt ceiling lead us to anticipate that Guam won't issue additional bonds to the fullest extent permitted by the ABT; and
- New hotel construction and ongoing or planned renovation projects at several hotels that will result in additional room inventory to help meet rising demand.

Partly offsetting the above strengths, in our view, are:

- Exposure to global economic, terrorism-related, epidemic, and weather-related events (e.g., the Japanese earthquake and tsunami and local typhoons), which have significantly impaired HOT revenue in previous years--including five of the past 17 years, when revenue declined by at least 12% (2009) or by as much as 26% (2002);
- Significant concentration of hotel vendors, with the leading 10 hotels responsible for 58% of total room inventory; and
- Concentration in visitor markets, with Japanese visitors representing 49% and South Korea 36% of total visitors in calendar year 2016.

The bonds are limited obligations of Guam, and are payable and secured by all or any part of the HOT revenue. Bond provisions include a DSR funded at MADS, a 1.25x rate covenant, and what we consider a strong parity ABT requiring 1.8x historical revenue coverage of MADS on issued and proposed bonds. Debt service payments have a first lien on revenue. Bond proceeds were used to refund certain debt and to construct a new museum.

HOT revenue appears in Guam's financial statements in a special revenue fund, outside of the general fund. The DRT collects the HOT revenue, which is immediately pledged to bondholders (sent directly on a monthly basis to the revenue fund held by the trustee). In case HOT revenue exceeds what is needed to satisfy debt service requirements or replenish the reserve fund, the surplus goes toward the budget of the Guam Visitors Bureau, and then to the Tourist

Attraction Fund. Pursuant to the authorization and indenture, the HOT revenue may not be (and historically has not been) commingled with general fund money. Bondholders have a first-priority perfected security interest in such revenue, to the extent that it is required for debt service payments or used to replenish the reserve fund.

In addition, the government, cannot file for or be filed for bankruptcy under the U.S. Bankruptcy Code. However, we also believe that, in light of the speculative-grade general obligation (GO) rating of 'BB-' on Guam, characterized by a large negative unassigned general fund balance position, the government has no incentive to interfere with such HOT revenue, because doing so would likely restrict its future market access not only to bonds secured by HOT revenue, but also to other securities such as GO bonds. The Puerto Rico Oversight, Management, and Economic Stability Act (PROMESA) was signed into law on July 1, 2016. While the law provides Puerto Rico and possibly other U.S. territories access to a potentially more orderly process for debt restructuring, our credit ratings on Guam's HOT bonds and other Guam debt reflect the relative likelihood of default and our view of its capacity and willingness to pay debt on an ongoing basis--not the process for restructuring debt if or when it defaults. While PROMESA currently establishes an oversight board only for Puerto Rico, we believe the bill's passage introduces the possibility that similar oversight boards could be established in other territories, such as Guam, especially if or when Guam experiences heightened fiscal distress. In our view, given the direct link between worsening fiscal distress and the likelihood of Guam's seeking to establish its own oversight boards, our ratings continue to focus on predefault credit fundamentals, including the ongoing ability to pay obligations in full and on time.

Guam has collected and enforced the collection of HOT revenue for more than 40 years, and about 35 hotels are in operation on the island, with a total room inventory of 8,904 in 2016.

According to management, to support Guam's Tourism 2020 strategic plan to add 1,600 new hotel rooms in support of its goal of bringing in 2 million tourists annually, the government has been aggressively marketing the island to hotel developers. Ken Corp., a Japan-based developer, broke ground in March 2016 on a new 340-room luxury hotel, Tsubaki Tower. In addition, the owners of the Ladera Towers and the Pago Bay resort have announced $134 million and $87.5 million investments, respectively, for the renovation and construction of two new hotels. Another developer from Korea has announced plans for a new $133.2 million hotel to be called "Citta di Mare" featuring four towers ranging from 13 to 18 stories with a total of 500 hotel rooms. Construction is likely to begin in two-to-three years. Another project is the Emerald Oceanview Park, a $100 million four-tower development to house 260 luxury condominium units in Tamuning next to the Guam Memorial Hospital.

The 10 leading hotels accounted for 58% of total Guam hotel room inventory in 2016, a consistent level of concentration the past three years. Occupancy rates have generally been rising, to 87% in fiscal 2016 from 79% in 2015 and 58% in 2004, but during peak months they approach 100%. The weighted average room rate was $198 for fiscal 2016, up from $157 in 2015 and $114 in 2011. In our view, the island's isolation and lack of competing hotels in nearby jurisdictions somewhat mitigate the concentration in revenue among the top 10 hotels.

The number of visitors grew a healthy 10.1% for fiscal 2016, increasing the past three years. Over the past four years, visitor composition has changed as the number of visitors from South Korea has been rising while those from Japan have decreased. The island has also seen a noticeable boost in visitors from the People's Republic of China. Management attributes the decline in visitors from Japan to several factors, including a recent increase in the sales tax in Japan that led to lower spending, devaluation of the yen to the dollar, a trend toward domestic travel, an aging and decreasing population, and increased competition for tourism with Southeast Asia. Guam welcomed 132,952 visitors in July 2017, an 8.1% increase when compared to the previous year. July 2017 surpassed the top record held in 1997 to become the best July in Guam's tourism history. Total fiscal 2017 year-to-date arrivals rose by 5.3%, while total calendar year-to-date arrivals grew by 4.8%.

Visitor arrivals remain highly concentrated, with Japan representing 50.4% of total visitors in fiscal 2016, but this has diversified from 71% in fiscal 2012. Although tourism diversification has its merits, with the Korean market now at 36% of total visitors from 14% in 2012 and just 8% in 2009, the decline in visitors from Japan is a credit weakness given the importance of that market to Guam.

The Japan visitor market experienced a decline of 5.2% in visitor arrivals for July. While still remaining Guam's top market, Japan has been facing a lack of seating capacity because airline carriers pulled out of gateways such as Osaka and Nagoya. Almost 1.4 million seats between Japan and Guam were available in 2012, but this number has since decreased to less than 900,000 in 2017. The government anticipates the announcement of HK Express opening a new connection between Nagoya and Guam at the end of October will help open up more seats to the island. July 2017 arrivals show Korea arrivals increased by 25%, while other visitor markets achieved some growth. Arrivals from Hawaii rose by 30.6%, while the Russia Federation grew by 57%. Markets that also demonstrated growth include the U.S. mainland by 14.9%, Australia by 57%, Europe by 13%, Hong Kong by 12%, and the Northern Mariana Islands by 7.1%.

On Aug. 8, 2017, Guam made headline news around the world when it was announced by state-run news agency KCNA that North Korea's military was "examining the operational plan" to strike areas around Guam with medium- to long-range strategic ballistic missiles. The threat specifically called out Guam's Andersen Air Force Base, and subsequently the waters about 19-25 miles off Guam's coast, as potential targets, where it would fire missiles "to send a serious warning signal to the US." The indication from North Korea was that it would finalize its plans by mid-August. Later, on Aug. 15, according to state media, North Korean leader Kim Jong Un reviewed his military's plans but opted to not move forward with the plan at that time, but at the same time warned that "the U.S. should not test North Korea's self-restraint." In our view, these threats have the potential to disrupt tourism, one of Guam's main economic pillars, as future visitors could opt to vacation elsewhere. We believe it could also lead to a meaningful population decline. If either of these outcomes occurred, it would likely put downward pressure on many of the ratings we maintain on Guam and related entities, including the GO (and certificates of participation), business privilege tax and hotel occupancy tax ratings, and potentially other ratings. We believe it is too early to determine if, or to what extent, tourism or population will be affected by these threats, and we also note that this is not the first time Guam has been threatened in this manner. We also believe additional future threats are likely given the ongoing tension because Guam represents the closest American soil to North Korea, and it hosts substantial U.S. military operations.

The HOT rate has been 11% since April 1995. It has historically varied, but has been no less than 10% since 1972. The government has complete authority to make changes, as it believes necessary, to the tax rate. The hotel visitor pays HOT to the operator owner of the hotel, and the DRT collects the taxes on or before the 20th of the month following the month in which the sale occurred. The tax is imposed and enforced under Chapter 30, Sections 30101 to 30106 of

Title 11 of the Guam Annotated Code. The DRT is committed to aggressive enforcement of the collection of HOT, with late payments subject to penalties. Hotels also have an incentive to pay the HOT because hotels are subject to gross receipt taxes that are net of HOT. In addition, for a hotel to be able to renew its business license each year, it must have no HOT due. We note that two super typhoons hit Guam in 2002 (Pongsona and Chataan). In both instances, the DRT continued to receive monthly HOT revenue from Guam's hotels.

Given audited fiscal 2016 HOT revenue of $40.8 million, up 11.7% from 2015, MADS coverage grew to 4.8x from 5.2x. Estimated HOT revenue for fiscal 2017 indicated an additional strong year of growth, up 7.7% to $44 million, providing 6.3x MADS coverage. The governor's proposed 2018 budget projects only a 1.2% increase in HOT revenue to about $42 million; in our opinion, this is a conservative estimate given HOT has increased nearly 12% on average from fiscal years 2014 to 2016. Given high DSC and limited room under the government's debt ceiling, we don't anticipate that Guam will issue additional bonds to the fullest extent permitted by the 1.8x ABT.

For more information regarding the general creditworthiness of Guam and other economic demographics, see our GO analysis published Aug. 30, 2017, on RatingsDirect.

Outlook

The stable outlook reflects our anticipation of continued good demand for hotels in Guam, as well as relative stability in HOT revenue during the life of the bonds, notwithstanding our anticipation of occasional declines in HOT revenue given various risks facing the island (macroeconomic events, especially in Japan, and weather-related ones). In our view, the strong DSC, the good ABT, and the absence of plans to issue additional bonds partly mitigate such occasional declines. In addition, the outlook reflects our view of Guam's ability to withstand a significant decrease in tourism, as evident in its rapid recovery from a 12% decline in HOT revenue in fiscal 2009. We also anticipate that the rate of collections will remain high, based on the strong enforcement provisions built into the tax act. We don't anticipate raising the rating during the next two years given moderate uncertainty with regard to tourism from Japan. At the same time, given very strong MADS coverage, we don't anticipate lowering the rating during the next two years.

Related Research

Special Tax Bonds: U.S. Recovery Underpins The Sector's Stability, Sept. 14, 2015

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