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Guam; Sales Tax

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Rationale

S&P Global Ratings affirmed its 'A' long-term rating on the Government of Guam's series 2011A, 2012B, 2013C, and 2015D business privilege tax (BPT) bonds. The outlook is stable.

The rating reflects our view of Guam's:

- Strong coverage of projected maximum annual debt service (MADS) at 3.2x using audited fiscal 2016 pledged revenue of \$179 million;
- Improved BPT revenue stability, with the most recent double-digit decline in 2005 (13%);
- Strong bond provisions that include a 3x historical revenue additional bonds test (ABT), and bondholders' first-priority perfected security interest in BPT revenue, with pledged BPT revenue deposited directly into the bond fund;
- Senior revenue pledge of three percentage points of the existing BPT--a 4% tax on business receipts--which makes up about one-third of Guam's general fund revenue; and
- Full ability to increase the BPT levy as needed, with such pledge not subject to termination or modification by the government, and legislation that prohibits a reduction of the BPT levy rate to less than the 3% pledged to bondholders, elimination of current categories to which the BPT applies, or expansion of current exemptions from the BPT.

Partly offsetting the above strengths, in our view, are Guam's:

- Potential additional debt being issued against pledged BPT revenue, although we understand this would most likely occur only if the BPT rate is raised to 4.75% from 4.00%;
- Significant additional BPT bonds issued in 2015 (\$411 million) that reduced MADS coverage to 3.2x from 6.2x;
- Relatively small revenue stream and population base, and shallow economy when compared with U.S. states, which we believe results in a more volatile and vulnerable collection pattern during economic cycles or other one-time events;
- BPT revenue decline of 5% in fiscal 2015, although BPT revenue bounced back 5% in 2016 and is projected by the government to grow almost 4% for fiscal 2017;
- Exposure to financial, macroeconomic, and weather-related events, which have historically led to declines in BPT revenue, some quite large (three double-digits declines since and including 1999); and
- Concentration of BPT revenue by sector, with retail representing 42% of BPT revenue, followed by service (24%) and construction (13%).

The bonds are limited obligations of Guam payable solely from and secured by revenue from three percentage points'

worth of the total 4% (75% of total revenue) BPT levy on goods, services, and the sale of tangible property (among other inclusions) on Guam. Approximately \$756 million in BPT bonds is outstanding, all maturing on or before Jan. 1, 2042.

BPT bond provisions include a parity ABT that we consider extremely strong, in that it requires 3x historical MADS coverage on issued and proposed bonds. Nonetheless, Guam has little debt capacity, with \$287 million under its cap as of March 1, 2017. Debt service payments have a first lien on revenue.

BPT revenue appears in Guam's financial statements within the general fund. BPT payments are made through the postal service, directly at the Department of Revenue and Taxation's offices, with the Treasurer of Guam, or online. Pledged BPT revenue is held in a special revenue fund of the treasury once collected, and is not deposited into the general fund unless the minimum monthly deposit amounts into the bond fund are satisfied. On or before the 25th of each month, one-sixth of the next interest payment and one-12th of the next principal payment is deposited into the bond fund. The deposits are accelerated by three months so that 100% of debt service payments is on deposit three months prior to debt service payment dates. Despite the government's general fund challenges, including a large negative unassigned general fund balance and high debt burden, the government has a disincentive, in our opinion, to interfere with such revenue: doing so would likely restrict the government's future market access not only to bonds secured by BPT revenue, but also to other securities such as GO or hotel occupancy tax (HOT) bonds, and any attempt, according to bond counsel, would be subject to the same impairment of contract doctrines that apply to the 50 states.

The BPT rate has historically been 4% except for the period from 2003 through 2004, when it was increased to 6%. The government has complete authority to increase the tax rate as it deems necessary, but may neither reduce the 3% pledged portion nor eliminate the transaction categories to which the pledged portion applies. Governor Calvo recently introduced two bills that would provide much needed funding for Guam Memorial Hospital and other infrastructure. One bill authorizes a \$125 million bond issuance, and the other proposes to increase the BPT rate to 4.75% from 4.00%. The higher BPT rate would cover the debt service of the proposed \$125 million bond issuance and provide an ongoing subsidy for the hospital (relieving the general fund of making such subsidy). We understand that medical and dental clinics would be exempt from the proposed tax hike.

Each taxpayer that is subject to the BPT levy must file a return and make its required payment by the 20th of the following month, or else pay a 5% late fee plus interest on the unpaid portion. Taxpayers have an incentive to keep current on BPT payments in that annual business license renewal requires one to be current on all taxes due. Delinquencies in fiscal 2016 are approximately 5% to 6%, as reported by the government.

Tourism is Guam's primary economic driver, accounting for about 11% of the island's GDP, and contributes to BPT performance. Overall BPT revenue (the full 4.0% levy portion) totaled \$238 million in audited fiscal 2016, up 5.2% from fiscal 2015 but flat versus 2014. The compound annual growth rate in BPT revenue is 3.0% since 1990, or 5.1% since the low of \$119.3 million in 2002. Using fiscal 2016 audited pledged BPT revenue (three percentage points of the levy) of \$179 million, coverage of proposed MADS is 3.2x--strong, in our view, although down significantly from what it would have been (over 6x) had Guam not recently issued the 2015D bonds. Projected total BPT revenue for fiscal 2017 is \$247 million, an increase of 3.2%, and this would provide 3.3x MADS coverage.

According to data on BPT revenue since 1990, the maximum decline in any given year was 13% (1999, 2002, and 2005), with the maximum increase 31% (1991). The years with the most severe downturns in BPT revenue collections include the 13.4% decline in 1999 resulting from the Asian financial crisis, the 13.1% decline in 2002 stemming from two typhoons and the events of Sept. 11, 2001, and the 12.6% decline in 2005 related to the lowering of the BPT tax rate to 4% after it held at 6% from April 2003 through April 2004. BPT revenue is moderately concentrated by sector, according to fiscal 2016 data, with retail representing 42%, followed by service (23%) and construction (13%). However, the leading 10 BPT accounts represented a diverse 17% of BPT revenue in 2016. In our view, the island's isolation and lack of competing BPT producers in nearby jurisdictions somewhat mitigate the sector and taxpayer concentration. As opposed to a U.S. state, Guam cannot undergo sales tax leakage as a result of people crossing its borders to another state. As with BPT revenue, visitor trends have been positive, helping to spur on-island spending.

Despite potential occasional fluctuations in BPT revenue, we anticipate that MADS coverage will remain strong, although likely not significantly above the 3x ABT given plans for additional debt. Using the low point in BPT revenue from 1991 through 2016 of \$119 million (2002), MADS coverage would have been 1.5x. We believe that the island's exposure to weather- and economy-related events poses some risk to BPT revenue. For example, BPT revenue fell 35% during the 1997-2002 period because of various events. However, had Guam issued BPT revenue bonds to the maximum level permitted under the 3.00x ABT in 1997, we calculate that debt service coverage would have declined to a still good 1.95x in 2002. Guam's BPT revenue is also, in our view, somewhat exposed to the global economic climate--specifically in Japan and Korea, which together accounted for 84% of total visitors to the island--and exchange rate risk. Despite this exposure, the 3x ABT provides substantial credit cushion.

Outlook

The stable outlook reflects our anticipation of good BPT revenue performance during the next two years, notwithstanding our anticipation of occasional declines in BPT revenue given the island's areas of exposure. Partly mitigating such declines, in our view, are very strong debt service coverage of 3.2x (based on fiscal 2016 revenue) and a strong 3.0x ABT. We also anticipate that the rate of collections will remain high based on the strong enforcement provisions built into the tax act.

Upside scenario

Rating upside during the next two years is unlikely given the government's plans to issue additional bonds against the pledged revenue stream, and even if the government's bill to raise the BPT rate to 4.75% is approved. Further constraining the rating is Guam's relatively shallow economic base.

Downside scenario

We could lower the rating if BPT taxpayer concentration significantly increases, if revenue performance materially weakens, or if a disruption of the flow of funds to bondholders becomes more likely, such as if a bill similar to PROMESA were to be introduced that specifically applies to Guam.

Economic Performance Is Mixed

Guam (population: 162,742 estimated as of July 2016) is the westernmost territory of the U.S., and the island encompasses 212 square miles. Guam's economic activity is largely based on tourism and military spending. Because of this, many of the government's economic development initiatives focus on these pillars, especially tourism. Hotel property owners have invested substantially in hotel renovations and expansions in recent years, with more than 600 new rooms available now compared with five years ago. The opening in 2015 of the 419-room Dusit Thani Guam hotel, which includes a ballroom and banquet rooms with a total seating capacity of 2,000, has helped to relieve hotel capacity issues. Construction of another 340-room luxury hotel, the Tsubaki Tower, is also underway with completion estimated by the end of 2018. Various airlines have increased capacity, and new airlines are serving additional markets, including China and South Korea, from which management anticipates strong visitor growth. This has helped offset the continued weakening tourism trends from Japan, where airlines have reduced service. The hotel occupancy rate was 83% as of 2016; during peak months occupancy rates approach 100%, indicating the need to continue to increase room capacity. The average room rate was \$198, up significantly from \$144 in 2011. Room inventory was 8,904, up from 8,285 in 2012.

Visitor arrivals to Guam totaled a record 1.51 million in fiscal 2016, eclipsing the 1.41 million in 1997 and increasing by a robust 10% over fiscal 2015. Guam also recorded 132,952 visitors in July 2017, an 8.1% increase versus July 2016 and the highest July volume ever. The number of visitors grew a healthy 5.3% for fiscal 2013, but growth slowed to 0.3% in 2014 to 1.34 million as a result of what we view as a significant 9.5% decline in visitors from Japan. The number of visitors grew 2.3% in fiscal 2015. The number of visitors from Japan declined an additional 5.6% in fiscal 2015 and 3.4% in fiscal 2016. South Korea and China together accounted for 36.6% of visitors in fiscal 2016, up from 18% in 2013, and this has mitigated the decline in visitors from Japan. Management has attributed the decline in visitors from Japan to several factors, including an increase in the sales tax in Japan that led to lower spending, devaluation of the yen, a trend toward domestic travel, an aging and decreasing population, reduced seat capacity, and increased competition for tourism with Southeast Asia. Guam Visitors Bureau projects 4% visitor growth in fiscal 2017 (year-to-date visitors through July are up 5.3%). Guam recently launched its Tourism 2020 Plan, with a goal to add 1,600 rooms to support a projected 2 million annual visitors by 2020.

Visitor arrivals remain highly concentrated, with Japan representing 50% of total visitors in fiscal 2016, but this has diversified from 79% in fiscal 2006. Although tourism diversification has its merits, with the Korean market at 34.8% of total visitors in 2016 from just 8% in 2009, the decline in visitors from Japan in fiscal years 2014 through 2016 is a credit risk given the importance of that market to Guam. The U.S. has a visa waiver in effect for several countries, including Japan, South Korea, and Taiwan, the three largest markets for tourism, which represent about 90% of annual visitors combined. The Government of Guam and Guam Visitors Bureau continue to work to expand the visa waiver program to visitors from mainland China, but little progress has been made as a result of security and intelligence concerns. Although Guam's request for a visa waiver for Chinese tourists continues, an agreement between the U.S. and China to extend short-term Chinese visas to 10 years from one year (and shorten processing time to three to five days) has, in our view, boosted the number of visitors.

The ongoing U.S. military buildup, while still a large undertaking, has been scaled back. Originally as many as 9,000 troops were to relocate to the island, mainly from Japan, between 2014 to 2017. A couple years ago, however, the Department of Defense (DOD) reported that the number would be closer to 4,700 active duty personnel, along with family members, support and civilian staff, vendors, and suppliers. What was once estimated at a \$15 billion economic impact is now estimated at \$8.7 billion. A record of decision, which identifies the final locations for additional bases and facilities to accommodate the marines, was released in August 2015. A 13-year period (revised from seven years) of moderate construction followed by a gradual phase-out is planned. All facets of Guam's government, from the general government to utilities, the port, and airport, have reached a general understanding with DOD that any impact from the relocation would be cost neutral to Guam, even if many of the details are undetermined. Two large military construction contracts totaling over \$200 million (improvements to Marine Corps Base Guam and a Naval Base Guam sanitary sewer project) were awarded in August 2017.

Recent economic trends show improvement, but Guam's economic base is concentrated and vulnerable and the island's lack of economic diversity is an area of exposure. In addition, we believe that the island's small geography (it is one-seventh the size of the smallest of the 50 states, Rhode Island) and limited population base make it especially susceptible to financial and economic volatility. We also note that the level of system support from the U.S. government and Guam's ability to influence national reforms are significantly less than that for U.S. states.

Tourism trends (visitors), room rates, occupancy rates, HOT revenue, and BPT revenue have demonstrated good growth during the past four fiscal years. More generally, however, Guam's economic performance has been just adequate during the past few years, with total jobs--63,250 as of March 2017--actually below the level realized in September 2009 (63,800). Also, real GDP growth trailed that of the U.S. in all but one year of the 2010-2015 period after outperforming it in 2008 and 2009. Guam's employment base is also relatively more concentrated than that of the U.S. as a whole, especially within governmental employment and construction, and the manufacturing job sector is very limited and weakening. We do note, however, that as of September 2016 Guam's unemployment rate declined to 5.4%, its lowest in several years but higher than the U.S. rate of 4.9% at that time. Other economic initiatives and events bode well for the island, including jobs created at Guam Regional Medical City, increased marketing efforts at Asian trade missions, large infrastructure projects, major projects related to the military buildup, and additional hotel and condo developments.

Guam's annual population growth has ranged from 0.1% to 0.6% since 2003, lagging the U.S. pace of 0.7% to 1.0% during the same period. We consider Guam's other key economic metrics weak. Guam's per capita GDP was just \$34,234, or 70% of the U.S.' \$50,577, in 2016. In addition, GDP growth has generally lagged that of the U.S. since 2009, and per capita effective buying income is just 26% of the U.S. level. Although we believe the military buildup and generally good tourism trends present Guam with favorable growth prospects, we also recognize that they could lead to an even more concentrated economic base.

PROMESA

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 GO bonds, COPs, and other 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. The passage of PROMESA, as signed into law on July 1, 2016, establishes a financial oversight and management board to assist the Government of Puerto Rico, including its instrumentalities, in managing its public finances and providing an avenue whereby Puerto Rico can achieve fiscal responsibility and tap capital markets. PROMESA provides certain protections for eligible debtors that parallel those established under the federal bankruptcy code, including the ability to impose an automatic stay on creditor actions, provide an orderly forum for negotiations, and certify as to the sustainability of any proposed plan of adjustment for debts. While PROMESA 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.

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