MOODY'S INVESTORS SERVICE

CREDIT OPINION
24 January 2017

Update

Rate this Research

Contacts

Kenneth Kurtz 415-274-1737
Senior Vice President
kenneth.kurtz@moodys.com

Nicholas Samuels 212-553-7121
VP-Sr Credit Officer
nicholas.samuels@moodys.com

Timothy Blake 212-553-4524
MD-Public Finance
timothy.blake@moodys.com

U.S. Virgin Islands (Government of)

Rating Update—Moody's Downgrades Virgin Islands Matching Fund Rev. Bonds to Caa1 & Caa2 from B1 & B2; Outlook Negative

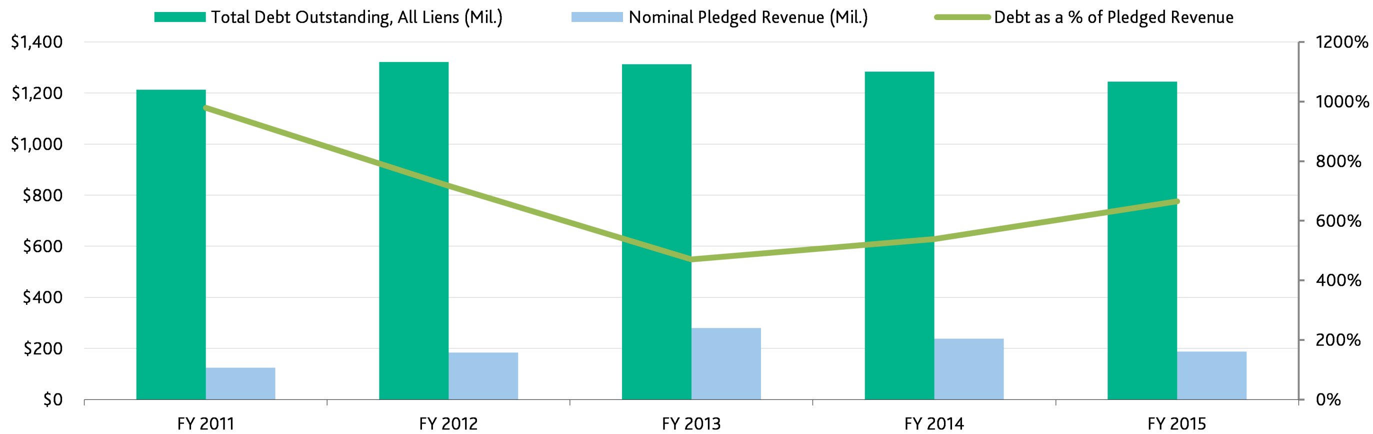
Summary Rating Rationale

Moody's Investors Service has downgraded the ratings on the US Virgin Islands' four liens of Matching Fund Revenue Bonds, issued through the Virgin Islands Public Finance Authority, as follows: Senior Lien Bonds to Caa1 from B1; Subordinate Lien Bonds to Caa1 from B1; Subordinated Indenture (Diageo) Bonds to Caa2 from B2; and Subordinated Indenture (Cruzan) Bonds to Caa2 from B2. The bonds are secured by matching fund revenues which are remittances paid by the federal government to the Virgin Islands' government of a portion of federal excise taxes collected on rum produced in the territory and shipped to the US mainland. The rating action affects approximately $1.16 billion in outstanding debt.

The downgrades are triggered by the territory's extremely weak financial position and liquidity, its apparent failure to access the capital markets for a planned deficit financing which would have balanced the current year budget and bolstered liquidity levels, and an increased possibility that the government may be forced to restructure its debt to address its financial problems. Key characteristics of the government's general credit profile include: persistent general fund deficits addressed primarily with repeated deficit financings; very high debt levels; declining gross domestic product and population; and a high unemployment. The Virgin Islands' government has an extremely large unfunded pension liability and the retirement system is projected to become insolvent by fiscal 2023.

The ratings recognize a number of structural features that provide bondholder protections and stronger credit quality than unsecured general obligation bonds, most notably the direct payment of pledged revenues by the US Treasury to the special escrow agent/trustee. The government recently acted to strengthen the direct payment mechanism by making the instruction to the federal government permanent and irrevocable. The government has pledged and assigned matching fund revenues to the trustee for the benefit of bondholders, establishing a security interest in the revenues. The statutes are written to create a statutory lien on the revenues. We note, however, that these security provisions have not been tested in a stress scenario where the government faces a severe lack of funds to provide basic services and we believe they do not protect bondholders in the event that the government is forced to restructure its debt.

Exhibit 1
Debt Levels Rising Relative to Pledged Matching Fund Revenues



Source: Virgin Islands' Government; Audited Financial Statements

Credit Strengths

» Long history of matching fund payments made by the federal government to the Virgin Islands government.

» Payment of matching fund revenues directly to the special escrow agent/trustee by the federal government.

» Continued strong, although narrowing, coverage of debt service for the four liens.

» Strong brand recognition and market share for Cruzan and Diageo products.

Credit Challenges

» Government's extremely weak general credit quality amid ongoing financial challenges.

» Government's apparent failure to access the capital markets for a planned deficit financing.

» High debt levels and large pension/OPEB liabilities for the general government.

» Federal legislative risk--US Congress has authority over matching fund payments and can reduce or eliminate payments entirely.

» Narrowness of the tax base--shipments from the two distilleries are subject to business risk, competitive pressure, and event risk.

Rating Outlook

The outlook on the ratings is negative, reflecting the severe fiscal challenges facing the government, the possibility that its liquidity and general credit profile could continue to deteriorate, and the increased possibility that the government may be forced to restructure its debt to address its financial problems.

Factors that Could Lead to an Upgrade

» Restoration and maintenance of structural budget balance by the primary government.

Factors that Could Lead to a Downgrade

» Further erosion of the government's financial position and liquidity.

» Decline in matching fund revenues and debt service coverage due to further reduction in rum shipments by the two distilleries.

Key Indicators

Exhibit 2

Pledged Matching Fund Revenues and Coverage Fell in Fiscal 2015

Virgin Islands Public Finance Authority Matching Fund Revenue Bonds	FY 2011	FY 2012	FY 2013	FY 2014	FY 2015
Coverage of Annual Debt Service, Sr & Sub Liens (x)	2.4x	2.3x	3.6x	4.1x	2.3x
Coverage of Annual Debt Service, All Liens (x)	2.2x	2.0x	2.9x	3.1x	1.8x
Total Debt Outstanding, All Liens (Mil.)	$1,213	$1,322	$1,313	$1,283	$1,245
Nominal Pledged Revenue (Mil.)	$124	$184	$279	$238	$187
Pledged Revenue Annual Change	19.5%	48.7%	51.6%	-14.7%	-21.5%
Debt as a % of Pledged Revenue	979.3%	717.5%	470.0%	539.1%	665.6%

Source: Virgin Islands' Government; Audited Financial Statements; Bond Documents.

Recent Developments

The government's fiscal 2017 budget anticipated new deficit financings including a bond sale and draws on a credit facility. The government scheduled a sale of $219 million senior and subordinate matching fund bonds for December, but rescheduled the sale to January. The January sale was unsuccessful and was subsequently canceled.

The governor has proposed a five-year financial plan which would restore structural balance by fiscal year 2019 with revenue increases and expenditure reductions. The plan would also increase government contributions to the retirement system. But the legislature has not enacted the revenue increases and it is uncertain that the revenue and spending initiatives will actually generate the anticipated savings.

Additional recent developments are incorporated in the Detailed Rating Considerations.

Detailed Rating Considerations

Tax Base and Nature of Pledge

Matching fund revenues are remittances paid by the federal government to the Virgin Islands' government, pursuant to US statutes, of a portion of federal excise taxes collected on rum produced in the Virgin Islands and shipped to the US mainland. They have been paid to the government annually for over 50 years. Payments are made based on a "cover over rate" set by Congress. Current statutes provide for a cover over rate of $10.50 per proof gallon. Congress has annually increased the cover over rate to $13.25 since 1999, in some cases retroactively.

In August of each year, the Virgin Islands' Governor requests a matching fund prepayment from the US Department of Interior based on estimated rum shipments for the ensuing fiscal year. Prepayment is received in September and subject to a subsequent adjustment based on actual rum shipments during the year. Pursuant to instructions and covenants of the Virgin Islands government, matching fund revenues are paid directly to the Special Escrow Agent by the US Treasury.

Currently, rum is produced in the Virgin Islands at two distilleries, Cruzan (owned by Beam Suntory, Inc. , Senior Unsecured Rating Baa2 stable) and Diageo (owned by Diageo plc. A3 stable). Cruzan, which produces the Cruzan and Ronrico brands, has produced rum in the Virgin Islands since 1946. Diageo, which produces the Captain Morgan brand, completed its Virgin Islands distillery in 2010 and began shipments in February 2012. Prior to constructing its new facility, Diageo purchased bulk rum produced outside of the Virgin Islands on a contract basis. Rum's share of the US distilled spirits market increased steadily through 2011, but declined from 2012 through 2015. Together, Cruzan and Diageo branded rum products accounted for 28.8% of the US rum market in 2015. Cruzan is also the largest supplier of bulk rum to the US. Cruzan and Diageo have both entered into 30-year agreements to produce rum exclusively in the Virgin Islands in return for capital grants, operating subsidies and tax exemptions.

Actual matching fund revenues generally showed steady growth through 2014, although year-to-year numbers can vary based on the timing of payments and the receipt of retroactive adjustments to reflect actual shipments and changes in the cover over rate. Matching fund revenues declined by 21.5% to $187.0 million in 2015, primarily due to a decline in bulk rum shipments by Cruzan as a result of competition from Puerto Rican producers. This loss in bulk rum shipments is not expected to be recovered. For 2016, the government and its consultants currently estimate shipments for Diageo of 9.4 million proof gallons and for Cruzan of 6.7 million proof gallons. At a cover over rate of $13.25, these shipments would generate matching fund revenues of $213.8 million with $125.2 million attributable to Diageo shipments and $88.6 million attributable to Cruzan shipments.

Future matching fund revenues will depend upon shipments from the two distilleries which in turn depend upon the level of rum consumption in the US, Cruzan's and Diageo's ability to maintain their respective shares of the rum market, and the continued financial viability of the distilleries. Production is also vulnerable to event risk, including natural disasters such as hurricanes. Finally revenues are also vulnerable to Congress's ability to change the matching fund program. Congress has changed the cover over rate in the past and retains the ability to reduce or eliminate matching fund payments.

Debt Service Coverage and Revenue Metrics

The senior and subordinate lien bonds are secured by a first and second lien, respectively, on all matching fund revenues received by the Virgin Islands government. Projected fiscal 2016 matching fund revenues of $213.8 million would provide 3.07 times coverage of peak debt service on the senior lien bonds ($69.8 million in 2017) and 2.50 times coverage of peak debt service on the senior and subordinate bonds combined ($84.5 million in 2017).

The subordinated indenture Diageo bonds are secured by Diageo matching fund revenues remaining after the payment of debt service on the senior and subordinate bonds. Projected 2016 Diageo revenues of $125.2 million provide an estimated 1.90 times coverage of peak debt service on the Diageo bonds and Diageo's share of the senior/subordinate bonds. The subordinated indenture Cruzan bonds are secured by Cruzan matching fund revenues remaining after the payment of debt service on the senior and subordinate bonds. Projected 2016 Cruzan revenues of $88.6 million provide an estimated 2.32 times coverage of peak debt service on the Cruzan bonds and Cruzan's share of the senior/subordinate bonds.

LIQUIDITY

The flow of matching fund revenues and coverage levels provide ample liquidity for the payment of principal and interest as long as the direct payment of pledged revenues to the special escrow agent/trustee remains in place. The general government's own liquidity is very weak and, given the apparent failure of the deficit financing, available cash will be completely depleted in the near term unless the government takes immediate emergency action.

Dent and Legal Covenants

The bonds at all four liens have a fully funded debt service reserve. The issuance of additional bonds at each lien is governed by multiple, interrelated tests. For example, the issuance of additional senior lien bonds is governed by a three-prong test: (1) average total matching fund revenues received in the 3 immediately preceding fiscal years must be greater than 1.5 times maximum annual debt service on the senior lien bonds; (2) average total matching fund revenues projected to be received in the 2 succeeding fiscal years less certain amounts required to be transferred under the Cruzan and Diageo project agreements (the "incremental cover over revenues") must be greater than 1.5 times maximum annual debt service on the senior lien bonds; and (3) Average total matching fund revenues projected to be received in the 2 succeeding fiscal years less the incremental cover over revenues must be greater than 1.2 times maximum annual debt service on the senior and subordinate lien bonds combined.

DEBT STRUCTURE

Debt levels are high and have risen rapidly. As of November 1, 2016, the Virgin Islands had $1.16 billion matching fund revenue bonds outstanding, including $741 million senior, $147 million subordinate lien bonds, $232 million Diageo bonds, and $35 million Cruzan bonds. The territory's net tax supported debt also included $714 million gross receipts tax bonds (not rated) which are general obligations of the government additionally secured by a pledge of gross receipts (sales) tax revenues. Net tax supported debt totaled $1.97 billion an increase of over $700 million from 2009, largely the result of deficit financings. Net tax-supported per capita for 2016, at $19,024, was 18 times Moody's 50-state median of $1,025. Net tax-supported debt as a percent of GDP for 2014 was 53.6%, more than 24 times Moody's 50-state median of 2.2% and higher than the amount for all of the US territories and commonwealths except for Puerto Rico.

DEBT-RELATED DERIVATIVES

The Virgin Islands has no variable rate debt and no debt-related derivatives.

PENSIONS AND OPEB

Pension and OPEB liabilities are high and a major credit challenge for the government. The employee retirement systems Unfunded Actuarial Accrued Liability (UAAL) increased from $1.397 billion in 2009 to $2.583 billion in 2015. Moody's average Adjusted Net Pension Liability (ANPL) for 2015 equaled $3.76 billion or 418% of revenues, almost 5 times Moody's 50-state median of 85%. Annual contributions have been consistently far below bot the Actuarially Determined Contribution and actual benefits paid. The 2015 valuation report projected the retirement system will become insolvent in fiscal year 2023. The government reported a OPEB UAAL of $1.02 billion in 2013, the most recent valuation available.

Management and Governance

Under the terms of the Revised Organic Act, an act of the US Congress, the Virgin Islands is an unincorporated territory of the United States, with separate executive, legislative and judicial branches. The governor and lieutenant governor are elected to four year terms. The legislature is unicameral, consisting of 15 members serving two year terms. The US Congress retains full power to legislate directly for the territory and to make rules and regulations with respect to the territory. The Department of Interior has certain oversight and audit responsibilities for the territory.

From fiscal 2005 through 2011 the governments audited financial statements were not released on a timely basis; in some cases audits were release more than 25 months after the close of the fiscal year. The timeliness of the governments audited statements has improved significantly in recent years, but the audit letters remain highly qualified.

Legal Security

Bond security is established by the trust indenture, the loan agreement, the special escrow agreement, and Virgin Islands statutes. The government has pledged and assigned matching fund revenues to the trustee for the benefit of bondholders, establishing a security interest in the revenues. The statutes are written to create a statutory lien on the revenues. In the loan agreement the government covenants to direct the US Treasury to pay the pledged matching fund revenues directly to the trustee. This structure provides apparent bondholder protections and stronger credit quality than unsecured general obligation bonds, but it has not been tested in a severe stress scenario.

Use of Proceeds

Not applicable.

Obligor Profile

With the closure of the Hovensa oil refinery in 2012, the territory's economy is primarily concentrated in tourism. While there have been some positive trends in visitor counts since the recession, GDP continues to decline, dropping at a compounded annual rate of 2.7% from 2009 to 2014. Population fell from 115,852 in 2008 to 103,450 in 2015, while employment fell from 49,677 to 43,024 over the same period. Unemployment at 11.9% in 2015 was more than twice the US levels. Per capita personal income in 2014 was 47.6% of the US level.

Government finances have been severely strained. Revenues fell abruptly in fiscal 2008 and 2009 as a result of the recession and operating losses at the Hovensa refinery. The government addressed the resulting deficits primarily with deficit financings. Revenues have recovered somewhat in recent years. The Hovensa refinery was recently sold generating a $220 million one-time payment which benefited government finances and liquidity in fiscal 2016. Nevertheless, the general fund still has a structural deficit.

Exhibit 3

Virgin Islands Challenged Financially by Rising Debt Levels, High Pension Liability, and Struggling Economy

U.S. Virgin Islands	FY 2011	FY 2012	FY 2013	FY 2014	FY 2015
General Fund Revenues ($000s)	736,122	768,970	784,534	812,617	800,258
Total Fund Balance as % of General Fund Revenues	-10.0%	2.7%	-1.3%	-10.8%	-7.3%
Net Tax-Supported Debt (000s)	1,710,449	1,853,095	2,041,515	2,030,050	1,990,485
Net Tax-Supported Debt/GDP	40.4%	45.3%	53.9%	55.3%	N/A
Net Tax-Supported Debt/GDP 50 State Median	2.4%	2.5%	2.4%	2.2%	2.2%
Debt/All Governmental Funds Revenue	233.9%	220.7%	223.2%	221.4%	220.8%
Debt/All Governmental Funds Revenue 50 State Median	22.7%	24.3%	23.8%	23.0%	20.4%
3-Yr Av Adj Net Pension Liability/All Govt Funds Revenue	N/A	N/A	N/A	263.9%	N/A
3-Yr Av ANPL/All Govt Funds Revenue 50 State Median	N/A	52.0%	53.0%	53.0%	N/A
Total Non-Farm Employment Change (CY)	-0.9%	-7.4%	-4.4%	-1.4%	N/A
Per Capita Income as a % of US (CY)	53.5%	53.7%	47.9%	47.6%	N/A

Source: Audited Financial Statements; USVI Bureau of Economic Research; Moody's State Debt and Pension Medians Reports.

Methodology

The principal methodology used in this rating was US Public Finance Special Tax Methodology published in January 2014. An additional methodology used in this rating was US States Rating Methodology published in April 2013. Please see the Rating Methodologies page on www.moodys.com for a copy of these methodologies.

REPORT NUMBER 1056631

Contacts

Kenneth Kurtz 415-274-1737
Senior Vice President
kenneth.kurtz@moodys.com

Nicholas Samuels 212-553-7121
VP-Sr Credit Officer
nicholas.samuels@moodys.com

CLIENT SERVICES

Americas	1-212-553-1653
Asia Pacific	852-3551-3077
Japan	81-3-5408-4100
EMEA	44-20-7772-5454

MOODY'S INVESTORS SERVICE