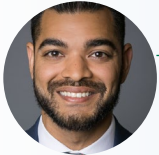


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Notes from the Global Value Equity Desk



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“After nearly 20 years of economic struggles, Puerto Rico appears to be turning the corner.”

Hurricane Fiona made landfall in Puerto Rico in September 2022, leaving many residents without power for days. The widespread outages underscore the need for the island to upgrade its infrastructure. We expect to see accelerated government spending to modernize the electrical grid.

Key Takeaways

- After nearly two decades of recession, Puerto Rico has exited bankruptcy and is experiencing robust economic recovery. Disproportionate stimulus benefits, \$70 billion in largely unspent hurricane rebuilding funds, rising tourism and an influx of new businesses are spurring the island's rebound.
- Puerto Rico's banks have benefited from a credit outlook that has improved along with the island's economic prospects. Local banks have historically carried higher loan reserves than their mainland counterparts and have been returning capital to shareholders through dividends and stock buybacks.
- Dividend payments by Puerto Rico's three largest publicly traded banks have grown rapidly over the last two years and we think there's potential for continued growth.

Puerto Rico's Economy Has Shifted to Recovery Mode

After nearly 20 years of economic struggles, Puerto Rico appears to be turning the corner. Despite the devastating impact of Hurricane Maria in 2017, the commonwealth's long-awaited turnaround was evident in 2021 when it posted its first year of positive Gross National Product (GNP) growth in 15 years.

The rising tide has been so long in coming that it's not fully appreciated by investors who may have written off the island. As a result, we've identified opportunities to invest in well-capitalized banks that have the potential to sustain and increase their dividend payouts, execute share buybacks, and grow their profits.

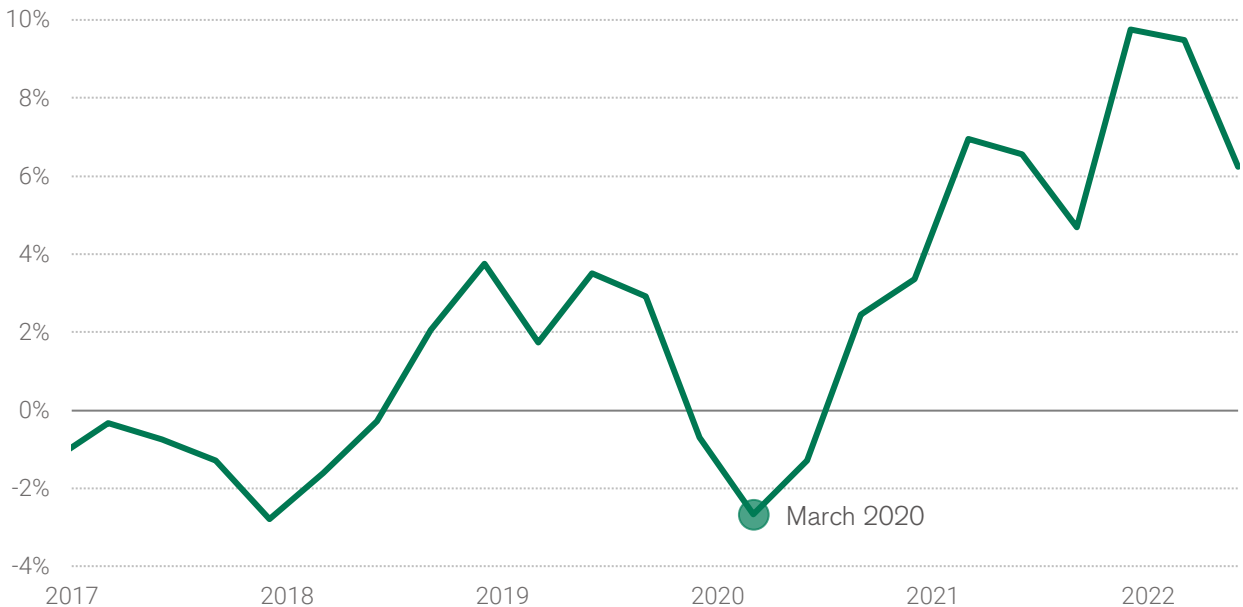
Here are some of the factors that contributed to Puerto Rico's rebound and may help sustain it in the future.

Economic Indicators Pointing Up

Employment has recovered fully from the pandemic. As shown below in **Figure 1**, employment has ramped up since bottoming in March 2020. Other positive indicators for the economy include improving auto and cement sales, as well as rising credit and debit transaction volume that's climbed above pre-pandemic levels.

Figure 1 | Employment Has Climbed Steadily from Pandemic Lows

Employment Growth, Year-Over-Year



Data from 6/30/2017 – 6/30/2022. Source: FactSet.

Bankruptcy Is in the Rearview Mirror

Puerto Rico hit another major milestone in March 2022 when it formally exited bankruptcy after completing the largest public debt restructuring in history. This development does not directly impact banks, but we believe it should greatly improve the perception of investing and doing business on the island.

Stimulus Provided a Big Lift

The \$931 billion in pandemic-related stimulus has had an outsized positive impact on Puerto Rican families compared to mainland families. For example, when a family of four in Puerto Rico received \$5,600 in stimulus (\$1,400 per person), it represented a nearly 30% average boost to per capita income. An equal \$5,600 payment for a family of four on the U.S. mainland amounted to an average 8% lift in per capita income.

Our analysis shows Puerto Rican banks have nearly three times more exposure to consumer loans than mainland banks. As a result, the boost to individual financial health from government stimulus produced a significant improvement in credit quality for local banks.

Infrastructure Spending Is on the Rise

In the years following 2017's devastating Hurricane Maria, the U.S. Congress appropriated approximately \$70 billion to rebuild Puerto Rico's infrastructure. The rebuild is now fully underway with a long runway of funds yet to be spent.

The government has distributed approximately \$20 billion so far, leaving nearly \$50 billion in assigned funding that has yet to make it to the island as shown in Figure 2. For context, \$50 billion represents half of the commonwealth's annual GNP.

Projects include a multi-year upgrade of the island's electrical grid. LUMA Energy now operates Puerto Rico's Electric Power Authority (PREPA) through a public-private partnership to rebuild the system. The effort will likely spur significant hiring. We believe these and other major infrastructure projects will fuel significant economic growth over at least the next five years.

Tax Code and Tourism Are Big Draws

Puerto Rico's favorable tax code is attracting businesses and wealthy individuals to the island. They are relocating to take advantage of a 2012 tax law change that allows businesses to avoid taxes on capital gains and performance fees. The law is particularly attractive to mainland hedge funds and wealth managers seeking to avoid a tax bite that approaches 50% in New York.

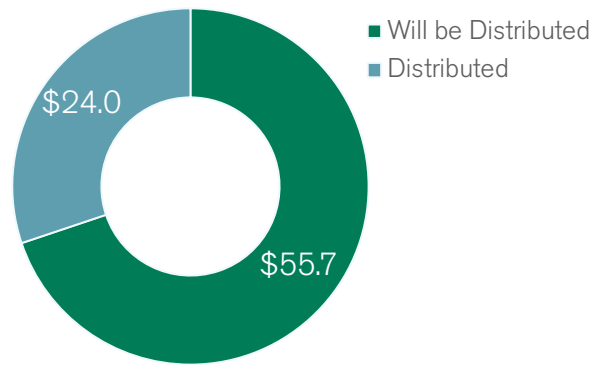
According to local records, Millennium Management and ExodusPoint are among those that have recently established subsidiaries on the island. Individuals also benefit because they can avoid real estate taxes and pay much lower state income tax rates.

Tourism is a draw as well, accounting for nearly 7% of Puerto Rico's GNP, according to data technology company Knoema. After a pandemic setback, leisure travelers have returned with consulting firm Tourism Analytics reporting that hotel occupancy and arrivals at the main airport have exceeded pre-pandemic levels as of July 31, 2022.

Opportunities in Puerto Rican Banks

The Puerto Rican banking industry has consolidated over the last decade. Today it's essentially an oligopoly with three major players controlling nearly 90% deposit market share: Popular (BPOP), OFG Bancorp (OFG) and First Bancorp (FBP).

Figure 2 | Nearly \$56 Billion in Hurricane Relief Funds Remain for Infrastructure Reconstruction
Puerto Rico Recovery Funds (\$B)



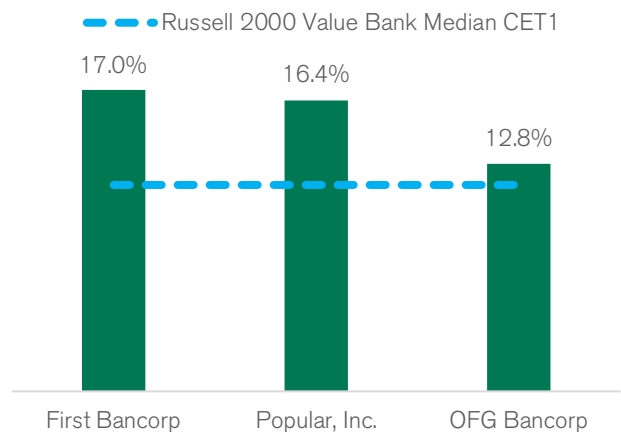
Data as of 8/16/2022. Source: Government of Puerto Rico.

Financially Strong Compared to Mainland Banks

Though banking is one of the most highly regulated industries in the U.S., we observe that the levels of capital and balance sheet strength of Puerto Rican banks are far above regulatory requirements.

The Common Equity Tier 1 (CET1) ratio is a key indicator of an institution's financial condition. It measures a bank's capital against its risk-weighted assets in order to determine ability to withstand periods of financial distress. As you can see in Figure 3, Puerto Rican banks carry significantly higher CET1 than mainland banks.

Figure 3 | A Key Measure Demonstrates the Financial Strength of Puerto Rican Banks



Data as of 6/30/2022. Source: SNL Financial Data & Company 10Qs.

Banks Have the Capital and Experience to Manage Credit Risk

Banks on the island are inherently riskier than mainland banks because consumer mortgages and auto loans account for a larger share of their loan books. However, local banks have managed these risks for decades. They have adequate capital in case of default, and they have generated nearly twice the profit on their loans than mainland banks. In addition, recent charge-off trends have been favorable and are in line with the charge-off rates of mainland banks.

Credit Outlook Is Improving

With the Puerto Rican economy improving, local banks appear to be sitting on more excess capital than is necessary. We think this creates opportunities for dividend-focused small cap investors because the banks have the option of returning cash to shareholders via dividends and stock buybacks. We note that since the fourth quarter of 2019, BPOP has repurchased approximately 20% of its outstanding shares while FBP has repurchased approximately 12% and OFG has repurchased approximately 7%.

Positive Outlook for Dividend Growth

Since 1930, dividends have represented approximately [40% of the total return](#) of the U.S. stock market, according to FactSet data. Furthermore, within the small cap universe the stocks of dividend-paying companies have historically provided higher returns with lower volatility than non-dividend payers.¹

When analyzing Puerto Rican banks, we analyze several factors to assess the institution's ability to sustain and grow their dividends.

Excess Capital

Based on the large and growing surplus of excess capital on the balance sheets of BPOP, FBP and OFG, we believe that even in crisis scenarios these banks would have enough cash on hand to continue their dividend payments.

Payout Ratios

Payout ratio measures the amount of earnings a company pays out to shareholders in the form of dividends. The current payout ratios for Puerto Rico's largest banks average 20%-30%. During a period of stress, we estimate that the payout ratio could increase to 50%-60%, which we believe would provide enough cushion for the banks to continue their dividends. Given the amount of the banks' excess capital available, we also believe there is opportunity for them to continue increasing their dividends as they grow earnings.

Earnings Growth

Puerto Rican banks derive their earnings power from loan activity. Considering our expectations for continued economic growth on the island, we believe local banks will grow their loan books. Therefore, we think it follows that dividends could potentially grow in concert with earnings, assuming flat payout ratios.

Recent Performance Supports Our Thesis

Puerto Rican banks have been increasing dividends over the last several quarters. For example, relative to pre-pandemic levels (we use Q4 of 2019 as a proxy for pre-pandemic), BPOP has increased its quarterly dividend by 83% while FBP has grown its dividend by 140% and OFG has increased its dividend by 114%.

¹ *Financial Analysts Journal*, "What Difference Do Dividends Make?" Conover, Jensen and Simpson, 2016.

Past performance is no guarantee of future results.

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